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# How Can Like Kind Exchanges Benefit a Real Estate Investor?

Just like any prudent investor, real estate investors review their holdings periodically to reevaluate their investment strategy. In real estate, this may be focusing on different types of properties, looking at geographically new markets, changing how long to hold each investment, or simply locking in appreciation on an investment property. Typically, all of these strategy adjustments require selling a property and purchasing another property.

Unfortunately, selling real estate which has been rented for many years can often result in a large tax gain and a significant balance due at tax time. Other than appreciation, the primary reason that a sale generates tax gain is due to the tax accounting deductions for depreciation which are deducted from rental income each year. The following is a simple illustration.

For example, a residential rental property which cost $100K might have depreciated approximately $80K after 22 years leaving only $20K of remaining tax basis in the property. If this property were sold at only the original purchase price of $100K (i.e. no appreciation), this sale would still result in a taxable gain of $80K due to prior tax depreciation deductions. Assuming a 25% federal tax rate (a rate specific to depreciated real estate) and a 5% state tax rate, tax on this transaction would be $24K.

The investor in the above example could have avoided paying this significant tax bill by simply entering into a like kind exchange.

## The Like Kind Exchange

A like kind exchange, which is defined in IRC Section 1031, allows a taxpayer to exchange real or personal property which was held for investment or used in a business (the “relinquished” property) for some other real or personal property which will be held for investment or used in a business (the “replacement” property). Fortunately for real estate investors, all real property is considered like kind with any other real property.

This open ended definition means that raw land held for investment can be exchanged for a single family home, a triplex with significant deferred maintenance can be exchanged for a newly built duplex, a low rise garden apartment can be exchanged with commercial property, and so on. However, personal property is not considered like kind with real property. Thus, a piece of machinery could not be exchanged for real property since they are not like kind.

Further, both the relinquished property and the replacement property must be held for investment or used in a business (the “held for” requirement). Invariably the question comes up: how long does the relinquished or replacement property need to be held to ensure it will qualify in a IRC Section 1031 exchange? The statute does not provide any set rules regarding how long property should be held in order to qualify. Generally, it is recommended that property be held for at least two years but each situation is unique and the facts and circumstances must be considered.

An exchange will generally be a tax free transaction provided that the investor did not receive any cash or have any liabilities assumed by the other party. However, the equity and fair market value of the replacement property must be equal or exceed the equity and fair market value of the relinquished property to ensure tax free treatment. This is commonly referred to as "up or equal in equity and value."

## "Forward" Deferred Exchange

The discussion of a like kind exchange, up until this point, has referred to a situation where two parties each have property which they would like to exchange. In practice, this rarely happens. A significant number of exchanges are completed as deferred exchanges where the relinquished property is sold and the replacement property is acquired at a later time.

A "forward" deferred exchange generally involves a 45-day identification period where the investor must specifically identify the replacement property to be acquired. The 45-day period starts the day the relinquished property is transferred and this period is fixed regardless of weekends or holidays and there are no exceptions. Once identified, the investor must acquire the replacement property by the earlier of 180 days from the transfer of the relinquished property or the due date (including extensions) of the investor's income tax return for the in which the relinquished property was transferred.

There are several rules related to the identification of replacement property which are described below. Planning and timing of transactions are very important given the inflexibility of the 45-day and 180-day timeframes.

- Up to 3 properties can be identified without regard to the fair market values of such properties
- An unlimited number of properties can be identified to the extent the fair market value of these replacement properties do not exceed 200% of the fair market value of all relinquished property.
- In the event the investor identifies more than 3 properties and the fair market values of such properties exceeds 200% (i.e. fails both of the above rules), the replacement property identification will only be respected if the investor actually acquires at least 95% of the fair market value of all identified replacement property.

Finally, in order for a deferred exchange to be respected as a like kind exchange, the investor must not "constructively" receive the proceeds and must not have control over the funds from the sale of the relinquished property. Many investors accomplish their deferred exchanges by using a qualified intermediary ("QI") who acts not as an agent of the taxpayer, but rather it places a layer between the relinquished property sale transaction and the subsequent acquisition of the replacement property. Ultimately, the taxpayer's rights to receive, pledge, borrow, or otherwise obtain any benefits from money or other property before the end of the exchange period must be limited.

A QI is a person who is not the taxpayer or a disqualified person. The QI is a person who agrees to acquire the relinquished property from the taxpayer, transfer that property to the other party, acquire the replacement property, and then transfer the replacement property to the taxpayer. As such, the use of a QI provides assurance that the investor would not be considered to "constructively" receive the proceeds and the QI would place appropriate limits on access over the funds.

While outside the scope of this article, an investor is also able to acquire the replacement property prior to transferring the relinquished property in a "reverse" like kind exchange. The rules, requirements, and processes differ from the "forward" exchange and must be followed with precision to preserve the like kind exchange treatment.

## Benefits of Like Kind Exchanges

There are many benefits of a like kind exchange as compared to a traditional sale and repurchase. The following describes the benefits of an exchange where no gain is recognized.


- **The income taxes are deferred into the future.** This means no taxes will be paid resulting from the exchange and this may lead to more consistent taxes each year for a real estate investor.
- **Additional equity to reinvest.** Since no taxes are being paid, taxpayer has more equity to invest into the replacement property.
- **Increased return on investment.** Similar to putting money away in a retirement account, multiple exchanges over time can enable a real estate investor to compound earnings tax free until property is ultimately sold.
- **Real estate leverage.** The increased equity generated by an exchange (since no taxes were paid) can be used to scale into a larger property. Taking the example from above, the taxable sale of property for $100K might only net $76K after taxes which might translate into property worth $380K with an 80% loan-to-value. However, an exchange of property for $100K could enable an investor to leverage into property worth $500K at 80% loan-to-value.
- **Real estate over generations.** If a real estate investor continues to exclusively exchange properties until death, then the investor will have never paid income tax. If the real estate investor's estate is valued at less than $5.45M individually or $10.9M with a spouse filing taxes jointly (these are 2016 figures) and none of the assets are held outside the investor's estate, then the investor's heirs would inherit the real estate with a basis equal to the fair market value. If the heirs were to sell all property immediately at the same fair market value, no gain or loss would be recognized by the heirs.

While there are many significant benefits to a like kind exchange, there are several situations where a real estate investor may not wish to use an exchange.

- **Expected loss on transaction.** Given the beneficial rules surrounding the sale of business property, it may make sense to structure the transaction as a sale to ensure deductibility of the loss.
- **Real estate investor has net operating losses ("NOLs") carrying forward.** If the real estate investor has NOLs, especially if there is any risk of the NOLs expiring unused, it may make sense to create a taxable sale to utilize the NOLs and increase the investor's basis in the replacement property.
- **No intention of reinvesting.** If the investor does not intend to reinvest the proceeds in like kind property, then it may not make sense to do a like kind exchange.
- **No intention of holding property.** If the real estate investor does not intend to hold the property for an extended period of time, then it may not be beneficial due to the transaction costs incurred to do an exchange.

Between these two alternatives of doing a full like kind exchange or entering into a fully taxable sale transaction, there are a few alternatives which offer a blend of both alternatives.

- **Installment method sale.** If a property is sold with any payments occurring after the end of the tax period, then the sale will generally be treated as an installment sale. Under this method, gain is only recognized to the extent principal is collected on the installment note.
- **Cash out refinance.** This option does not generate taxable income and enables this cash to be used towards further investments (lenders typically offer as much as 70% - 80% loan to value). Care must be taken to trace the flow of cash since this can impact the deductibility of the interest.
- **Contribution to partnership.** The property could be contributed to a partnership where the fair market value could be used to credit capital in the partnership giving the investor economic rights to the fair market value of the property without having to sell it. There are complicated rules regarding these transactions and require careful planning.

## Conclusion

The use of like kind exchanges by real estate investors can provide tremendous tax planning opportunities which can help real estate investors decrease their income tax bill, increase their net worth, scale their investments, and pass more of their wealth on to their heirs.

Please contact us if you think you or your business could benefit from the use of a like kind exchange.

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