



## **Like Kind Exchanges: An Old Strategy Still a Good Way to Defer Gain**

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Even with the current downturn in the real estate market, like-kind exchanges continue to be a popular way to dispose of property while deferring the taxable gain. An example of a like-kind exchange is the exchange of an apartment building for an office building. An exchange of like-kind property will receive nontaxable treatment if the exchanging party satisfies the following conditions:

- The transaction is, in fact, an "exchange" (not a sale);
- The property transferred and the property received are held for productive use in a trade or business or for investment; and
- The properties are qualifying and of like-kind.

If a like-kind exchange is used to defer tax, it is important to meet the technical requirements of IRC Section 1031. Otherwise, the exchanging parties would have a tax liability, but no sales proceeds with which to pay the tax.

### **Qualifying Property**

Only certain types of property qualify for tax-free exchange treatment. Some assets such as stocks, bonds, notes and partnership interests do not qualify, regardless whether the underlying properties are of like-kind. Since the property must be held for use in a trade or business or held for investment, inventory and property held for sale to customers do not qualify.

The words "like-kind" refer to the nature or character of the property, not to its grade or quality. It doesn't matter if the real property is improved or unimproved since that designation relates only to the grade or quality of the property and not to its character. In fact, the regulations specifically state that improved real estate may be exchanged for unimproved real estate.

Although the categories of real property that may be exchanged are broad, dealer property will not qualify under any circumstances.

## Treatment of Boot

If additional property (not of like-kind) is given or received in a like-kind exchange, then gain may be recognized. Non-qualifying property is termed "boot." In general, gain realized on the exchange is recognized to the extent of the fair market value (FMV) of boot received. This rule is illustrated by the following example:

### Example 1:

Tom exchanges a piece of vacant land with a FMV of \$100,000 and a tax basis of \$25,000. He receives a duplex worth \$90,000 and cash of \$10,000. Tom's realized gain is \$75,000 (\$100,000 less \$25,000) but his recognized gain is only \$10,000 - the amount of the boot received.

Any liability from which either party to the exchange is relieved is also treated as boot received. Thus, if either party to the exchange is relieved of liability as a result of the exchange, gain is recognized to the extent the liability relief exceeds the liability assumed in the exchange.

### Example 2:

Susan exchanges a retail strip center for an office building. The retail strip center is worth \$1.2 million with a mortgage of \$800,000 and a tax basis of \$800,000. The office building is worth \$1.0 million and has a mortgage of \$600,000. The gain recognized on the exchange would be computed as follows:

FMV of property received	\$1,000,000
Liability relief	800,000
Liability assumed	<u>(600,000)</u>
Amount Realized	1,200,000
Adjusted basis	<u>(800,000)</u>
Gain realized	<u>\$ 400,000</u>
Liability relief	\$ 800,000
Liability assumed	<u>(600,000)</u>
Recognized gain	<u>\$ 200,000</u>

In this example, even though Susan didn't receive any cash, she must recognize \$200,000 of taxable gain on the transaction. The remaining \$200,000 of gain is deferred.

## Basis of Property Received

If an exchange qualifies for like-kind treatment, the basis of the property received is not increased by any deferred gain. In general, the tax basis of like-kind property received is the same as that of the property exchanged, decreased by the amount of any money received, and increased by any gain (or decreased by any loss) recognized on the exchange. The basis of the office building acquired in the previous example would be determined as follows:

Basis of shopping center given up	\$ 800,000
Gain recognized	<u>200,000</u>
New tax basis in office building Acquired	<u>\$1,000,000</u>

## Other Considerations

Although a like-kind exchange provides the benefit of deferring tax now, keep these factors in mind:

- Tax basis of property;
- The property's FMV
- Current status of any unused passive losses, and
- Your need for liquidity

Each of these factors plays a part in your overall decision to make an exchange. If you look at only the property's tax basis, a low basis generally warrants an exchange due to the potential for a large taxable gain. On the other hand, a high tax basis generally results in a smaller gain and the benefit of the exchange is reduced.

Typically, gains from the sale of improved rental real estate offset passive losses. If you have excessive current and suspended passive losses, you may be better off selling your property and recognizing taxable gains to offset your unused passive losses. Not only will this allow you to get a current benefit out of your suspended losses, but you will receive a higher tax basis in any new property you acquire with the sale proceeds.

If you are planning an exchange with a related party, the exchange may become taxable. Gain is triggered if the related party disposes of the exchanged property within two years.

An exchange is appropriate if you are only trying to upgrade your real estate holdings without the need for cash. However, if you are trying to liquidate properties in order to generate cash, then an exchange would obviously not accomplish your goal.

## Conclusion

Like-kind exchanges are becoming increasingly popular for deferring recognized gain on appreciated assets such as investment real estate. This is especially true in areas of the country high inflation in real property values.

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