Like Kind Property

BY DANIEL J. PAGE, CCIM

Like-kind exchanges offer complicated, but important option to clients interested in disposing of property.

Even if commercial property prices are rising, sellers can't make a profit if taxes absorb all the appreciation. That's why tax-deferred exchanges continue to be an attractive alternative for a growing number of private investors, companies, and even governmental bodies interested in delaying payment of capital gains taxes.

Often called 1031 exchanges for the section of the IRS code that governs them, these transactions allow the deferral of all federal capital gains taxes when qualified real estate is exchanged for qualified real estate of an equal or greater value. Note that owner-occupied, single-family homes don't qualify, although homes owned as investment properties do.

Here's how 1031 exchanges work:

· **The property owner, sometimes with the help of a broker, identifies a "like-kind" property that qualifies for the exchange.** A like-kind property is one of more or less comparable value as the first property being exchanged. Like-kind doesn't mean that the properties must have the same use, so an apartment building could be exchanged for a warehouse of similar value, for example.

· **You must exchange real estate for real estate (as opposed to other types of property) to qualify for the tax deferral.** The real estate may be used for a trade or business or held for an investment. Vacant land may also be used as an exchange provided the land is held as an investment. Small variations in the value of the two properties may be reconciled by the use of a "boot," which represents either cash or other assets that are transferred along with the real estate.

· **All tax-deferred exchanges have time limits on their completion.** Once owners identify a property they want to exchange, they have 45 days to identify a substitute property and 180 days to negotiate an exchange with that property's owners and close the transaction. Some exchanges take place simultaneously, but most are time-delayed since both exchanging parties may apply the 180-day rule to each property.

· **When there's a delay between the portions of the exchange, a qualified intermediary such as an attorney or a title company often assumes temporary ownership of the property until the entire transfer**

can be made.

Exchanges are complex, so working with a competent tax attorney is imperative.

Today, little, if any, hard data exists on the number of properties exchanged or the dollar volume of transactions. However, several factors point to a surge in 1031 exchanges as a viable investment strategy:

· **The mounting number of industry specialists entering the field.** The Sacramento, Calif.-based Federation of Exchange Administrators reports that its membership has climbed to 220 member companies in 2000 from just 24 members in the early 1990s.

· **The growing number of retirees eager to shield gains from commercial property investments for estate planning purposes.** For example, a retiring investor could shift equity from an apartment complex or small strip mall into a “passive” property, such as undeveloped land. Passive investments provide another way to avoid taxation, as they don’t generate income until they are developed or sold.

By using 1031 exchange, a real estate investor’s equity remains intact, and any capital gains liability can be deferred until the property is sold. In addition, acquisition by exchange has historically raised the overall rate of return by 3 to 8 percentage points over the traditional sales method.

More information on 1031 exchanges can be found in a book entitled **The Tax-Free Exchange Loophole** by Jack Cummings (John Wiley & Sons Inc., 2005)
This book attempts to make the intricacies of the 1031 tax-free exchange easy to understand and use in your own real estate deals.

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