

## **Like-Kind Exchanges Under IRC §1031**

Dennis J. McMenimen  
Shuttleworth & Ingersoll, PLC  
115 3<sup>rd</sup> Street SE; Suite 500  
PO Box 2107  
Cedar Rapids, Iowa 52406-2107  
319-365-9461

### **Introduction:**

Like-kind exchanges made under Section 1031 of the Internal Revenue Code (“IRC” or “Code”) provide property owners the ability to defer any potential gain from the sale of such property to the extent that “like-kind” property is obtained to replace the property. More specifically, §1031(a)(1) provides that:

- “No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.”

### **Key Concepts in a §1031 Exchange:**

- **Exchange:** There must be an exchange, i.e., the relinquishment and receipt of property. (IRC 1031(a)(1)).
- **Like-kind:** The property exchanged must be of “like-kind.” Property is generally of like-kind if it is similar in nature or character. This definition includes personal property that the taxpayer holds for productive use in a trade or business or for investment.
- **Use Requirement:** The taxpayer must have held the property relinquished, and must hold the property received, either for productive use in a trade or business or for investment. (IRC 1031(a)(1)). In determining whether these “held for” tests are met, the taxpayer's intent and actions immediately before and after the exchange are usually determinative.
- **Statutory Exclusions:** The property exchanged must not be of a type that is statutorily ineligible for IRC 1031 treatment. Ineligible properties include:
  - stock in trade or other property held primarily for sale;
  - stocks, bonds, or notes; other securities or evidences of indebtedness;
  - partnership interests;
  - certificates of trust or beneficial interests; and
  - choses in action.

These properties do not qualify for nonrecognition even if they are exchanged for property that is similar in character or grade. (IRC 1031(a)(2)).

## Types of §1031 Like-Kind Exchanges:

- **Direct Exchange:**

Exchangor transfers Property S to Buyer in exchange for Property B. No cash is paid.

To the extent cash is paid in addition to the transfer of property, gain or loss is recognized to the extent of the cash (or other “boot” received).

- **Deferred Exchange:**

Basic Deferred Exchange: Exchangor transfers Property S to Qualified Intermediary (the “QI”) (or other “Exchange Accommodator”) who then transfers Property S to the Buyer for cash. The QI then acquires “replacement property” and transfers to the Exchangor in exchange for Property S.

Documentation:

1. Exchange Agreement: Between the Exchangor and the QI for the exchange of the “relinquished property”.
2. Assignment to QI: Exchangor “assigns” interest in the Purchase and Sale Agreement to the QI.
3. Notice of Assignment: The Exchangor must give notice of the assignment to the QI prior to the closing. The Buyer must acknowledge the assignment.
4. Conveyance Instruction: The QI must direct the Exchangor as to the conveyance of Property S “on behalf of the QI”.
5. Proceeds: The proceeds of the sale of the “relinquished property” held by the QI under the Exchange Agreement.
6. Identification of Replacement Property: The Exchangor must identify potential “replacement property” within the specified time period and subject to the limitations on the number and value of properties “identified”. In order for an identification to be valid, the potential replacement property must be unambiguously identified in a written document (i.e. sufficient specific detail regarding the replacement property --description and value).
7. Replacement Property: The QI must acquire the replacement property and transfer or cause to be transferred to the Exchangor within the “exchange period”.

Time Requirements: The transfer of the relinquished property and receipt of the replacement property must occur within a statutorily mandated time period. Property that is otherwise of “like-kind” will not be treated as such unless it is:

1. Identified as exchange property within 45 days after the Exchangor transfers the relinquished property; and
2. Received by the Exchangor within 180 days after the Exchangor transfers the relinquished property or the due date (including extensions) of the taxpayer's tax return for the year in which the taxpayer relinquished the property, whichever is earlier. (IRC 1031(a)(3)).

Types of Deferred Exchanges:

1. Property To Be Constructed.
2. Buyer-Accommodator. No QI but Buyer enters into Exchange Agreement and agrees to acquire replacement property.

- **Reverse Exchange:**

Seller/Exchangor enters into Exchange Agreement with QI (or other Exchange Accommodator). QI acquires “replacement property”. Seller S finds buyer for Property S (the “relinquished property”) and assigns sale agreement to QI. Upon closing of sale of Property S, QI transfers replacement property to Seller/Exchangor.

Income Tax Consequences:

- **Non-Recognition of Gain/Loss**
- **Carry Over Basis**

Potential Issues:

- **Exchanges Between “Related Parties”**

Although exchanges between “Related Parties” are not prohibited, the special rules under IRC §1031(f) and §1031(g) state that if Related Parties enter into a §1031 a taxpayer will lose the benefits of nonrecognition if either the taxpayer or the related party disposes of the exchange properties within two years of the date of the last transfer which was part of the exchange. However, the Code does provide exceptions for dispositions occurring by reason of death, involuntary conversion, and where the taxpayer can prove neither the exchange nor the subsequent disposition had as a principal purpose the avoidance of federal income tax. (See IRC §1031(f)(2)).

Related Parties are specifically set forth in IRC §267(b) and include within that listing (i) family members, (ii) corporations that are members of the same control group, (iii) a

grantor and fiduciary of any trust, and (iv) an individual and any corporation owned directly or indirectly by such individual.

- **Calculation of “Replacement Property” Value**

Property S FMV = \$500,000.00  
Property S Mortgage Balance = \$300,000.00  
Cash at Closing = \$150,000.00  
Closing Deductions/Credits to Buyer = \$50,000.00

Replacement Property Value:

\$500,000	
<u>(\$50,000)</u>	Allowed Closing Costs
\$450,000	Exchange Value

- **“Held for Investment” Requirement**

Applies to the relinquished property and the replacement property.

Implications for Residential Property.

- **No Partnership Interests**

**Sample Language for Asset Purchase and Sale Agreements:**

- **Example 1:**

TAX FREE EXCHANGE

\_\_\_.1 Section 1031 Exchange. Purchaser’s acquisition of the Ownership Interests may be the acquisition of replacement property in a qualifying exchange of like-kind property under Section 1031 of the Internal Revenue Code, as amended (the “Exchange”), pursuant to Purchaser’s separate Exchange Agreement with a qualified intermediary (the “Intermediary”). Seller agrees to cooperate with Purchaser (without liability or cost to Seller) in the completion of the Exchange. Such cooperation shall include (i) the assignment of this Contract by Purchaser to the Intermediary, and the acknowledgment of such assignment by Seller, (ii) the acceptance of the Purchase Price from the Intermediary, (iii) the conveyance of the Ownership Interests to Purchaser pursuant to a written direction of the Intermediary, and (iv) the reassignment of this Contract to Purchaser from the Intermediary immediately following the completion of the Exchange, and the acknowledgment by Seller of such reassignment. In consideration for the cooperation of Seller, Seller shall not be liable for any acts or omissions arising from its relationship with the Intermediary. Upon receipt of title to the Ownership Interests by Purchaser and payment of the consideration payable to Seller or for its benefit, under this Contract, Seller shall not have any further obligations or responsibilities under this paragraph and Purchaser

agrees to fully indemnify Seller from any resulting liability to third parties (including, but not limited to, the Intermediary) which indemnity shall be effective from and after the date of this Contract, shall not merge with the assignment of Ownership Interests and shall survive the Closing of this transaction or the termination of this Contract.

Purchaser shall in all events be responsible for all costs and expenses related to the Exchange and shall fully indemnify, defend and hold Seller and the LLCs harmless for, from and against any and all liability, claims, damages, expenses (including, without limitation, reasonable attorneys' and paralegal fees), taxes, fees, proceedings and causes of action of any kind or nature whatsoever arising out of, connected with or in any manner related to the transaction contemplated by this Contract or such Exchange that would not have been incurred by Seller or the LLCs if the transaction did not involve an Exchange. The provisions of the immediately preceding sentence shall survive Closing or the termination of this Contract. Any Exchange shall be consummated on behalf of Purchaser through the use of a facilitator or intermediary, and neither Seller nor the LLCs shall be required to acquire title to any real property in connection therewith.

13.2 Disclaimer. **PURCHASER HEREBY ACKNOWLEDGES THAT PURCHASER IS AND SHALL BE SOLELY RESPONSIBLE FOR COMPLIANCE WITH ALL LAWS, RULES AND REGULATIONS RELATED TO THE EXCHANGE. FURTHER, PURCHASER ACKNOWLEDGES THAT NEITHER SELLER NOR ANY OF ITS AGENTS, REPRESENTATIVES OR AFFILIATES HAS ADVISED PURCHASER, AND NO SUCH PERSON OR ENTITY HAS ANY OBLIGATION OR DUTY TO ADVISE PURCHASER, WITH RESPECT TO WHETHER THE TRANSACTION CONTEMPLATED BY THIS CONTRACT COMPLIES WITH THE LAWS, RULES AND REGULATIONS APPLICABLE TO THE EXCHANGE. FURTHER, PURCHASER REPRESENTS, WARRANTS AND ACKNOWLEDGES TO SELLER THAT IT HAS RELIED UPON ITS OWN TAX AND LEGAL COUNSEL IN DETERMINING COMPLIANCE WITH ALL LAWS, RULES AND REGULATIONS APPLICABLE TO THE EXCHANGE. THE PROVISIONS OF THIS SECTION 13.2 SHALL SURVIVE THE CLOSING OR TERMINATION OF THIS CONTRACT.**

• **Example 2:**

Like-Kind Exchange. Either Buyer or Seller may elect to treat the transaction as a deferred like kind exchange under Internal Revenue Code Section 1031. The parties agree to cooperate in the event the one or both elects such deferred exchange treatment, provided:

(i) The non-exchanging party shall not be required to take title to any exchanged or replacement property;

(ii) The non-exchanging party shall incur no additional costs or liabilities beyond the scope of this Agreement, and the exchanging party agrees to indemnify the other from such costs or liabilities;

(iii) The exchanging party shall provide to the other party three (3) days in advance of the Closing Date, copies of all exchange documents, if any, for said party's counsel's review and approval; and

(iv) Said exchange shall not delay the closing on the Property.

- **Example 3:**

Like-Kind Exchange. The rights of either party under this Agreement shall be assignable by such party without further consent of such other party to a qualified intermediary or exchange accommodator for the assigning party for purposes of affecting a like-kind exchange. The non-assigning party agrees to sign an acknowledgment of any such assignment and otherwise to cooperate with the assigning party provided such cooperation does not subject the non-assigning party to any greater liability or expense.

### **Other Types of Tax-Free Exchanges:**

- **IRC Section 1033 Exchanges: Involuntary Conversion**

(a) General rule. If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) Conversion into similar property. Into property similar or related in service or use to the property so converted, no gain shall be recognized.

(2) Conversion into money. Into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) Nonrecognition of gain. If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made

at such time and in such manner as the Secretary may by regulations prescribe. For purposes of this paragraph—

(i) no property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and

(ii) the taxpayer shall be considered to have purchased property or stock only if, but for the provisions of subsection (b) of this section, the unadjusted basis of such property or stock would be its cost within the meaning of section 1012 [26 USCS § 1012].

(B) Period within which property must be replaced. The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—

(i) 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized, or

(ii) subject to such terms and conditions as may be specified by the Secretary, at the close of such later date as the Secretary may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary may by regulations prescribe.

**Questions:**