Taxation Tidbit

Delayed Like-Kind Exchanges

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Tax rates on long-term capital are at a historically low-rate. Still, tax on capital gains can present a stumbling block for individuals desiring to realign their business, trade, or investment assets. Code Section 1031, an asset exchange provision, is a tool that can provide for the tax-free realignment of these types of assets.

For example, you have 300 acres of farmland acquired for $100,000 many years ago is now worth $600,000. Section 1031 provides a method of selling this property and deferring the recognition of the $500,000 gain – if the $600,000 from the relinquished property is reinvested in like-kind replacement property within 180 days. This procedure is known as a delayed like-kind exchange.

For real estate, the definition of like-kind property is very liberal. Like-kind real estate means any improved or unimproved real estate held for income, investment, or business use. Improved real estate can be replaced with unimproved real estate, and vice versa. Additionally, one property can be replaced by two or more properties, and vice versa.

Section 1031 is a “big gun” in the hands of a tax planner. While I would not classify the deferred exchange of like-kind property as an aggressive tax strategy, it is a strategy that must be carried out with timeliness and exactness. Thus, if this is a strategy you would like to utilize, get your tax professional involved in the planning process as early as possible.

1. An “intermediary agent” must be utilized to hold the sale proceeds during the replacement period.
2. Replacement property must be “identified” to the intermediary agent within 45 days of closing on the exchanged property.
3. The replacement property must be acquired, i.e. closed, within 180 days of closing on the exchanged property.
4. “Boot received” will always result in recognition of gain, the lesser of the boot received or the total gain. Avoid recognition of any gain by acquiring replacement property at a price equal to or greater than the sale amount of the exchanged property.

Other types of Section 1031 exchanges you may want to investigate:

- **Simultaneous Exchange** – direct asset exchange
- **Reverse Exchange** – replacement property acquired prior to sale of relinquished property
- **Improvement Exchange** – improvements made to replacement property as part of the exchange