A Primer On Like Kind Exchanges

By Michael P. Dunworth

How do you feel about helping a client with taxes? Many of us get into that on a regular basis. But what about "like kind exchanges"?

That transaction is a tax-planning technique that many business lawyers may face from time to time. A like kind exchange allows a taxpayer to dispose of real or personal property, but defer the recognition of gain or loss on the disposition by exchanging such property for other property that is of "like kind" to the property disposed of.

The purpose of this article is to provide business lawyers with the basics on like kind exchanges so that they have an understanding of when they can be used, and the issues that may arise in evaluating a potential like kind exchange.

The operative statute for a like kind exchange is Section 1031 of the Internal Revenue Code of 1986, as amended (the Code), which states that:

No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or 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.

Thus, the basic requirements for a nontaxable like kind exchange are:

- there must be an exchange of property;
- the property relinquished in the exchange must qualify for exchange treatment under Section 1031;
- the property received in the exchange must be of "like kind" to the property relinquished in the exchange; and
- the property received in the exchange must be held for productive use in a trade or business or for investment.

The exchange requirement. The first requirement, that there be an exchange of property, appears quite straightforward. Complications can arise, however, in the common situation where more than two parties are involved in the transaction.

For example, assume that A has property that he would like to sell to B, and invest the proceeds in other similar property. C owns such property, but she is only willing to sell her property for cash. If A were to sell his property to B and use the proceeds to buy C's property, the tax law would treat the transaction as a sale and purchase, rather than an exchange of property, and A would have to pay tax on the gain from the sale.

A simple solution under these facts would be for B to purchase C's property for cash, and then transfer that property to A in exchange for A's property. Under these facts the exchange requirement will have been met.

However, commercial considerations may make the above approach impractical. For example, B may refuse to purchase C's property to facilitate the exchange (for example, B may be concerned with potential environmental liabilities or the possibility of A's default). To address this concern, a so-called four- corner exchange can be used, in which an accommodation party (D) acquires C's property and exchanges it for A's property, and then sells A's property to B. The accommodation party is frequently a professional intermediary (that is, an organization that provides like kind exchange intermediary services for a fee).

While it is important that these transactions clearly take the form of an exchange of property by A, the Internal Revenue Service has issued a number of rulings to facilitate such exchanges. For example, the IRS has ruled that it is not necessary that the accommodation party (that is, D) actually receive title to the property relinquished by A; thus, A can deliver title to B at D's direction, and C can deliver title directly to A at the direction of D. Further, A can actively participate in locating and designating the property to be received in the exchange.

The issue that must be carefully guarded against in a multiple party exchange is that A should in no circumstances be treated as having actually or constructively received any of the sales proceeds from the relinquished property. Thus, A should not exchange property with a party that could be considered to be A's agent, such as A's lawyer or accountant.

The rule that a taxpayer not be in constructive receipt of the sales proceeds of his or her property is particularly relevant in the context of a deferred exchange. A deferred exchange occurs in situations where one of the parties must complete the transaction before all of the pieces are in place. For example, B may be unwilling to wait for A to find a suitable replacement property in order to complete an exchange.

In order to qualify as an exchange under Section 1031, a deferred exchange must satisfy two rules set forth in the statute: (a) the property to be received in the exchange must be identified by the taxpayer within 45 days of the date on which the relinquished property is disposed of (the "identification period"); and (b) the replacement property must be received on or before the earlier of (1) the date that is 180 days after the date that the relinquished property is disposed of, and (2) the due date of the taxpayer's tax return for the year in which the relinquished property is disposed of (the "exchange period").

In order to be treated as properly identified, the replacement property must be designated as replacement property in a written document signed by the taxpayer and delivered before the end of the identification period to the person obligated to transfer the replacement property, or to any other person involved in the exchange as long as such person is not the taxpayer, or a "disqualified person."

In general, a disqualified person is any person who is an agent of the taxpayer at the time of the transaction, family members, entities in which the taxpayer holds at least a 10 percent ownership interest, 10 percent shareholders and partners, and trusts, their beneficiaries and fiduciaries.

A person who acts as the taxpayer's employee, lawyer, accountant, investment banker, broker or real estate agent within the two-year period ending on the date of the transfer of the relinquished property will generally be treated as an agent of the taxpayer.

The replacement property must be unambiguously described in the written document. If the replacement property has not been designated in a written document, but is actually received by the taxpayer before the end of the 45- day identification period, the property will be treated as having been identified before the end of the identification period.

Treasury regulations permit the identification of multiple replacement properties, provided that the aggregate fair market value of such properties does not exceed 200 percent of the fair market value of the relinquished property. Alternatively, a taxpayer can select up to three replacement properties without any regard to the fair market value of the properties.

A failure to adhere to these limits can have severe consequences: If as of the end of the 45-day identification period the taxpayer has identified more than the permitted number of properties, he or she will be treated as having identified no property to be received in a like kind exchange, with the result that the transfer of the relinquished property will be a taxable sale.

If a taxpayer is in a situation where the identification period is expiring and has identified more than the permitted number of properties, the solution is to revoke identification with respect to the required number of properties by delivery of a signed, written revocation to the persons to whom the written identification was delivered.

As noted above, the identified replacement property must be received before the end of the exchange period. The property actually received by the taxpayer must be "substantially the same" as the property that was identified during the identification period. Relatively minor variations in the property, such as erecting a fence on real property, should not result in a failure to meet this requirement.

Again, it is important that the taxpayer in a deferred exchange not be treated as having received any sales proceeds prior to the completion of the exchange. Under the tax law, funds received by an agent are usually treated as having been received by the agent's principal. In addition, one of the indicia of ownership of funds held in escrow is the entitlement to income generated by the escrowed funds.

This rule can raise some fairly obvious questions for the business lawyer. For example, how do you secure performance by the other party to a deferred exchange? How do you secure the services of a professional intermediary that is not the agent of the taxpayer? And what about the lost income to the taxpayer from the date that the relinquished property is transferred until the replacement property is received?

Fortunately, Treasury regulations provide for a number of "safe harbor" arrangements that should provide satisfactory resolutions to these issues without the taxpayer being treated as having constructive receipt of the proceeds from the transferred property. Specifically, the regulations provide that the determination of whether the taxpayer has actually or constructively received any of the sales proceeds will be made without giving consideration to the existence of the safe harbor arrangement.

The first of these safe harbors is the use of a qualified security or guarantee agreement. According to this safe harbor, the obligation of the taxpayer's transferee (that is, the party to whom the relinquished property is transferred) to transfer the replacement property to the taxpayer can be secured by mortgage, deed of trust or other security interest in property (other than cash or cash equivalents), certain standby letters of credit (which can not be drawn on in the absence of a default), and guarantees of third parties.

The second safe harbor is the use of a qualified escrow account or qualified trust. These arrangements have an escrow holder or trustee who is not the taxpayer or a disqualified person, and an escrow or trust agreement that limits the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of the funds held in the escrow or trust until the end of the exchange period, except in certain circumstances such as the failure to identify replacement property by the end of the identification period, the receipt of all replacement property, or the occurrence of certain material and substantial contingencies. The contingencies must be in writing, relate to the deferred exchange, and must be beyond the control of the taxpayer and any disqualified person.

The third safe harbor is that a taxpayer may be entitled to receive interest or a "growth factor" with respect to the deferred exchange. As in the case of a qualified escrow account or qualified trust, the agreement providing for the interest or growth factor must limit the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of the interest or growth factor until the end of the exchange period (subject to the same exceptions described above).

Finally, the fourth safe harbor provides that a "qualified intermediary" will not be treated as the agent of taxpayer, with the result that funds held by the qualified intermediary will not be treated as constructively received by the taxpayer. A qualified intermediary is a person other than the taxpayer or a disqualified person that enters into an "exchange agreement" with the taxpayer.

The exchange agreement provides that the qualified intermediary will acquire the relinquished property from the taxpayer and transfer it to the ultimate transferee, and acquire the replacement property and transfer such property to the taxpayer. Further, the exchange agreement must limit the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of any funds held by the qualified intermediary until the end of the exchange period (also subject to the same exceptions described above).

These safe harbor arrangements were established for the purpose of facilitating deferred exchanges in which the taxpayer transferred the relinquished property first, and then subsequently identified and received replacement property. In September 2000, the IRS issued Revenue Procedure 2000-37, 2000-2 C.B. 308, which provided a safe harbor for completing a so- called reverse exchange. The procedure states that property will not fail to be treated as relinquished property or replacement property for purposes of Section 1031 if the property is initially transferred to an "exchange accommodation titleholder" pursuant to a "qualified exchange accommodation arrangement."

In order to be a qualified exchange accommodation arrangement the following requirements must be met:

First, the exchange accommodation titleholder must be a person other than the taxpayer or a disqualified person, and must be subject to federal income tax. Generally, a person who qualifies as a qualified intermediary can be an exchange accommodation titleholder.

Second, the exchange accommodation titleholder must hold either title to the property, or beneficial ownership of the property, at all times from the date of acquisition by exchange accommodation titleholder until the property is transferred to the ultimate transferee.

Third, the taxpayer must clearly intend that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in a like kind exchange. The taxpayer and exchange accommodation titleholder must enter into a written agreement within five business days of the exchange accommodation titleholder's acquisition of the property, which agreement must provide that the property is being held for the benefit of the taxpayer to facilitate a like kind exchange, and that the exchange accommodation titleholder will be treated as the owner of the property for all federal income tax purposes.

Fourth, the taxpayer must identify the relinquished property (in accordance with the Treasury Regulations for deferred exchanges described above) no later than 45 days after the exchange accommodation titleholder acquires the replacement property.

Fifth, within 180 days of the exchange accommodation titleholder acquiring the property, the exchange accommodation titleholder must transfer the property through a qualified intermediary either (1) to the taxpayer as replacement property or (2) to a person other than the taxpayer or a disqualified person as relinquished property.

Finally, the relinquished property and the replacement property together can not be held in a qualified exchange accommodation arrangement for more than 180 days in the aggregate.

See New tool in the real estate biz: A tale of parked properties and reverse exchanges, by Mary B. Foster in the January-February 2002 issue of Business Law Today for a more detailed analysis of reverse exchanges and qualified exchange accommodation titleholder arrangements.

The qualified property requirement. In order to qualify as property that is eligible for like kind exchange treatment, the property relinquished in the exchange must be either used in the taxpayer's trade or business or held for investment. Thus, a second home maintained for the personal use of the taxpayer, or a property used in the pursuit of a taxpayer's hobby, would not qualify for exchange treatment.

In addition, Section 1031 expressly excludes the following property from nonrecognition treatment under Section 1031:

- stock in trade or property held primarily for sale (that is, inventory);
- stocks, bonds or notes;
- other securities or evidence of indebtedness or interest;
- partnership interests;
- certificates of trusts or beneficial interests; and
- choses in action.

With the exception of stock in trade, all of the foregoing have a common feature: They all represent intangible property rights. Thus, the business lawyer should seek the advice of a tax lawyer if the transaction under consideration purports to exchange intangible property interests that are not listed above.

The like kind requirement. In order to qualify as a like kind exchange, the property received in the exchange must be of "like kind" to the property disposed of. The Treasury regulations state that the words "like kind" refer to the "nature or character of the property and not to its grade or quality." By way of example, the regulations state that improved real estate can be of like kind to unimproved real estate, as the improvements only relate to the grade or quality of the real estate. However, domestic real estate is not of like kind to foreign real estate.

IRS rulings have held that an exchange of gold bullion for Canadian Maple Leaf gold coins was an exchange of like kind property, while an exchange of U.S. numismatic-type $20 gold coins for South African Krugerrand bullion type gold coins was not an exchange of like kind property. An exchange of gold bullion for silver bullion was held to not be an exchange of like kind property, while an exchange of a radio broadcast license for an a television broadcast license was held to be a like kind exchange.

Obviously, the determination of whether items of personal property are of like kind is a subjective exercise, which can cause a degree of uncertainty. Fortunately, the Treasury regulations also provide an objective rule that provides that an exchange of depreciable tangible property will qualify for like kind exchange treatment if the exchanged properties are of "like class." Properties will be treated as of a like class if the properties are either within the same "General Asset Class" or the same "Product Class."

Properties are in the same product class if they are both listed in the same four-digit product class contained in Division D of the Standard Industrial Classification Codes set forth in the Standard Industrial Classification Manual.

Properties are in the same General Asset Class if they are described in certain categories of assets set forth in Revenue Procedure 87-56, 1987-2 C.B. 647, which was promulgated by the IRS for the purpose of classifying assets for depreciation purposes. These categories of assets generally describe types of depreciable tangible personal property that are frequently used in many businesses. Examples of general asset classes include computers and peripheral equipment, automobiles, light general purpose trucks, heavy general purpose trucks, tractor units for over the road use, and office furniture, fixtures and equipment.

A question that may fairly be asked at this point is how one accounts for differences in value between the exchanged properties. Even if properties are clearly of like kind, it is unlikely that they will be of equal value; thus, the parties to the exchange will likely require that some other consideration be included in the transaction. Fortunately, Section 1031 allows this, providing that if an exchange otherwise would be eligible for tax-free treatment under Section 1031 but for the receipt of cash or nonqualifying property (commonly referred to by tax professionals as "boot), then gain will be recognized on the exchange, but only to the extent of the boot received.

The following example illustrates how this rule works: Assume that A originally acquired his property for $1 million, and it now has a value of $2.5 million. If A sells his property for cash, he recognizes a gain of $1.5 million. Now assume that B's property is worth $2 million, and she is willing to exchange her property and pay an additional $500,000 to A to make up the difference in value. In this case A will only recognize gain of $500,000, which is equal to the "boot" received in the exchange.

The last point that should be mentioned in this regard is that business lawyers should remember that the tax law treats a reduction in a taxpayer's liabilities as the equivalent of receiving cash. Thus, if B assumed A's $500,000 liability in lieu of paying $500,000 in cash (or if B took A's property subject to an existing $500,000 liability), the result would be the same: A is treated as having received $500,000 of boot.

Property used in a trade or business. The last requirement of Section 1031 is that the property received in the exchange must be held for productive use in a trade or business, or for investment. Thus, an exchange of investment real estate for other real estate to be used as a personal residence would not qualify.

Perhaps the more relevant question for the business lawyer is how long the property received in the exchange must be held by the taxpayer. If the taxpayer sells the received property shortly after the exchange, the IRS could attempt to disqualify the original exchange on the basis that the property received was not used in the taxpayer's trade or business.

The following example illustrates the potential abuse: A enters into a like kind exchange with B on Dec. 1, 2002, and then sells the property received from B on Jan. 1, 2003, thus deferring the recognition of gain until 2003.

Section 1031 states that a taxpayer who enters into a like kind exchange with a related party must hold the received property for at least two years after the exchange in order to maintain nonrecognition treatment; thus a change in use more than two years after the exchange should not cause a loss of nonrecognition treatment.

Holding periods of less than two years should also be permissible in the case of an exchange with a nonrelated party; however, the business lawyer should ask the client whether she has any intention of disposing of the replacement property in the near future. If such a disposition seems likely, the advice of a tax lawyer may be advisable.

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