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Few people in the business community are aware that, under current tax laws, it is still possible to sell certain types of real estate without paying tax. The technique is referred to as a tax-free like-kind exchange and has been used successfully for decades. It is specifically sanctioned by the IRS.

A tax-free like-kind exchange is simply a method by which a property owner trades one property for another without having to pay any capital gains tax on the transaction. Without engaging in an exchange, a property owner is taxed on any gain realized upon sale of the property. In an exchange, the tax is deferred until some time in the future.

## RULES AND REGULATIONS

In order to qualify for a tax-free like-kind exchange, the property owner must carefully follow the requirements of Section 1031 of the Internal Revenue Code. In an exchange, a property owner simply disposes of one property and acquires another property. If structured properly, the owner can report the transaction as an exchange and not taxable, rather than as a taxable sale.

There is still a great deal of confusion in the general business community about the laws concerning exchanges. In 1991, the IRS passed regulations that simplified exchanges. The regulations no longer require two parties who want to exchange each other's properties, nor does title to the exchange properties have to pass simultaneously.

## 180-DAY DEFERRAL PERIOD PROVIDES FLEXIBILITY IN STRUCTURING TRANSACTION

Under the new regulations, the typical exchange works as follows: First, the property owner sells his or her property. The net sales proceeds must be received by a person or entity referred to as a qualified intermediary. The qualified intermediary holds the funds in trust in an interest-bearing account. The selling property owner then has 45 days to identify in writing up to three pieces (more under certain circumstances) of real estate that he or she may want to buy. This property is normally referred to as the replacement property.

In order to fully avoid any gain, the replacement property should be more expensive than the property that was sold. Finally, using the money from the qualified intermediary, the property owner must complete the purchase of one of the three properties within 180 days of the date the property was sold.

Not every exchange will qualify as tax-free. In order to qualify, the real estate that the property owner sells and the real estate that is subsequently bought both must be investment-type property or held for use in the property owner's trade or business.

Generally, real estate is classified as investment property or as being used in a trade or business if it is not purchased for use or used as the property owner's residence. Many people can even have their resort property qualify as investment property because they rent the property out for all but a couple of weeks of each year.

#### ATTENTION TO DETAILS IMPORTANT

Because exchanges are so favorable to taxpayers, the IRS scrutinizes them carefully. In order to properly structure the exchange, important legal documents must be in place before the property owner sells the initial real estate. Also, other legal documents must be signed at different stages in the transaction. A misstep in any of these legal requirements can negate the whole tax deferral.

Before deciding whether to take part in an exchange, the taxpayer should consider the advantages, disadvantages and business considerations. For example, if the property owner does not want to buy a replacement property, then an exchange is certainly not a viable option. Proper planning with a qualified tax attorney will give the property owner the flexibility to achieve many of his or her objectives.