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Like-Kind Exchanges for Real Estate Investors

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Real estate investors have various “tools” in their investment “toolboxes” which can be used to increase both the net value and diversity of a real estate portfolio. One powerful “tool” is the Like-Kind Exchange, also known as Section 1031 of the Internal Revenue Code or the “1031 Exchange”.

Tax obligations are a major obstacle to the creation and retention of wealth, as most real estate transactions have tax consequences. The Internal Revenue Code (IRC) requires a taxpayer to pay tax on a real estate transaction where the fair market value (FMV) of property received (e.g., cash) is greater than the adjusted basis of a property given up (i.e., investment real property). In other words, if a real estate investor sells an investment property for an amount greater than its adjusted basis, the difference between the sale price of the property and the property’s adjusted basis will be subject to capital gains tax. (The “basis” of an asset is generally its cost. However, basis may be adjusted over the course of time due to various events. The basis of property must be increased by capital expenditures and decreased by capital returns. Increases in basis have the effect of reducing the amount of gain realized or increasing the amount of realized loss. Decreases in basis have the effect of increasing the amount of realized gain or decreasing the amount of loss.)

Although the general rule is that a real estate investor must recognize a capital gain on the sale of investment real property where the FMV of the property sold is greater than the property’s adjusted basis, IRC section 1031 provides taxpayers with a mechanism to defer recognition of the gain to the extent that the investment property which is given up is exchanged for a property of “like-kind”.

Like-kind property is alike in nature or character, but not necessarily in grade or quality. Real property is of like-kind to all other real property, except for foreign real property. Examples include single family residence for apartment building, or commercial building for parking lot. A lease of real property for 30 or more years is treated as real property.

“Boot” is all property which does not qualify for Section 1031 treatment. Boot includes cash received, net liability (e.g., mortgage) relief, and the FMV of other non-qualified property received.

The basis in property acquired in a like-kind exchange is equal to: adjusted basis of property given + gain recognized + boot given (cash, liability incurred, other property) - boot received (cash, liability relief, other property).

An exchange of like-kind properties must be completed within the earlier of 180 days after the transfer of the exchanged property or the due date (including extensions) of the transferor’s tax return for the taxable year in which the exchange occurred. Also, the replacement property must be identified as such not later than 45 days after the date on which the transferor transfers the property. The identification of multiple replacement properties is permitted. Special rules apply to exchanges between “related” parties.

Earle Law Offices provides trial and appellate litigation, as well as non-litigation, legal services in the areas of business law, family law, real estate law, tax law, and trusts and estates.

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Mr. Earle received his law degree from the Santa Clara University School of Law, where he served as an Editor of the school's Law Review, and where he received awards for academic excellence. He received his undergraduate degree, with honors, in business administration from the University of La Verne.

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