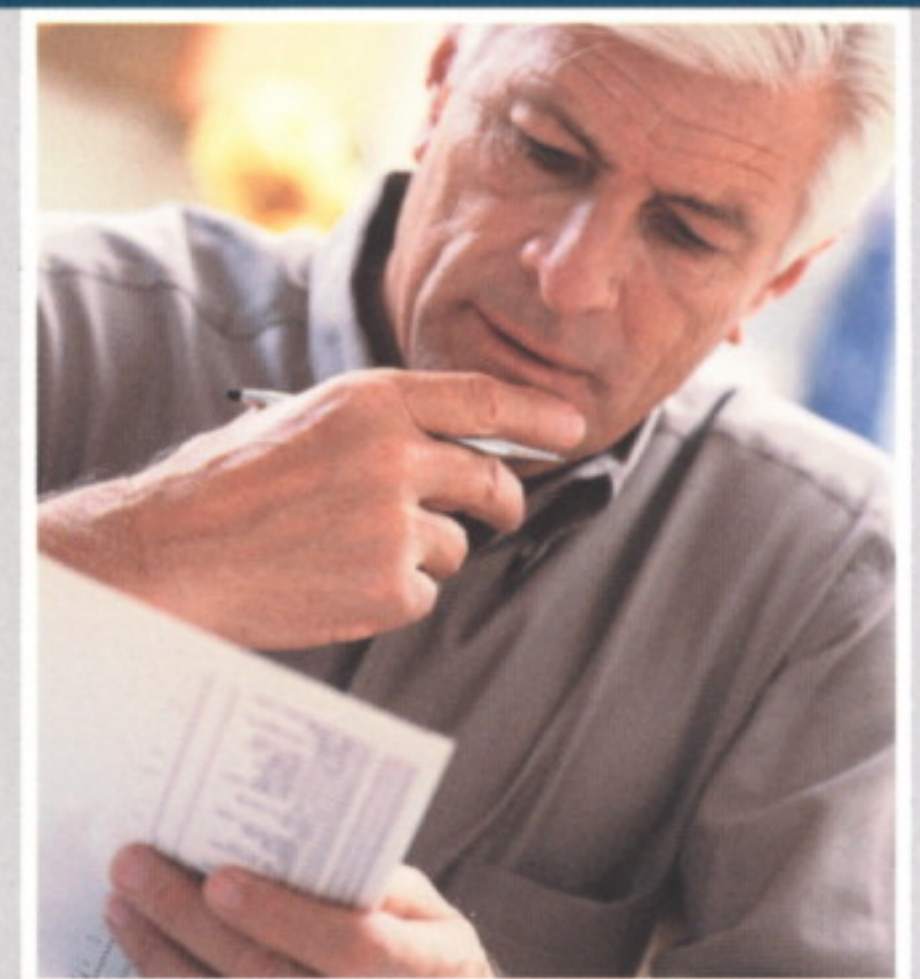


Like-Kind Exchanges

Who Can Benefit?



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Like-Kind Exchange Safe-harbor

The last few decades have seen a rapid increase in real property values throughout the country. Many taxpayers who own office space, raw land or other investment real estate may be reluctant to sell their property when faced with the resulting capital gains tax consequences. Section 1031 of the federal tax code provides a method of structuring a sale of qualifying property followed by a purchase of "like-kind" property as a tax-deferred or like-kind exchange. Tax-deferred exchanges have gained popularity throughout the last decade after regulations were introduced in 1991 allowing a delayed exchange under the Qualified Intermediary safe harbor. If structured in advance with a Qualified Intermediary, the taxpayer has 45 days after the relinquished property closing to identify replacement property, and 180 days to actually close on the replacement property.



Tax benefit

A properly structured like-kind exchange allows the taxpayer to relinquish his old property and acquire replacement property without recognizing taxable gain. Instead of paying capital gains taxes on the sale, the taxpayer acquires new property with its basis reduced in an amount corresponding to the gain he deferred.

For illustration purposes, assume that a taxpayer acquired raw land fifteen years ago that he now intends to sell for \$500,000. The property is debt-free and the original purchase price of that property was \$200,000. He wants to use the sales proceeds from the land to acquire a new office building for \$650,000. If structured as a sale rather than an exchange, he would pay state and federal capital gains taxes of at least **\$80,000 that could have been avoided**. After taxes, he would have \$420,000 equity to invest in new property, borrowing the additional \$230,000. If, however, he structured a like-kind exchange, he would transfer the old property for \$500,000 and the entire \$500,000 equity would be used towards equity in the new property, reducing his loan to \$150,000. The tax-deferral is almost like an interest-free loan from the government.

Besides saving taxes, what other financial planning reasons motivate an exchange?

- ❑ **Change the type of property owned.** As illustrated above, a taxpayer may want to change the kind of real property he owns. The definition of "like-kind" is a common exchange misconception. In real property exchanges, any real property used for business or investment is "like-kind" to any other real property that is also used for business or investment. But, the business or investment use of the property need not be identical. For example, this enables a taxpayer who owns raw land to take advantage of a tax-deferred exchange, trading it for income-producing rental property. Or, a taxpayer may want to exchange residential rental property for more lucrative office or retail rental property.
- ❑ **Change the property's location.** Many taxpayers structure an exchange to physically move their qualifying property. Structuring an exchange would enable a taxpayer to move his office to a more suitable location without immediate tax consequences. Or, if a taxpayer moves geographically from one city or state to another, he could also relocate his qualifying investment or business real property without triggering recognition of the capital gain in the property he relinquishes. This technique is particularly useful for owners of rental property who move to another geographic area and want the ease of managing local property.

- **Leverage.** Some taxpayers use tax-deferred exchanges to leverage their equity in one property, buying multiple replacement properties. For example, a real estate investor began several years ago with one rental house. After a few years, she exchanged that house for three rental houses, tripling her rental income. Subsequent exchanges have substantially increased her portfolio of investment properties.

- **Retirement planning.** A common strategy used among taxpayers planning for retirement is to exchange business or investment property for qualifying rental property. After a few years of qualifying use, the taxpayer may be able to convert the rental property to personal use as his residence. If used thereafter as a principal residence, the taxpayer may ultimately be able to exclude the recognition of gain under the capital gain exclusion for the sale of principal residences.

- **Reverse Exchange Safe-harbor.** In September 2000, IRS Revenue Procedure 2000-37 expanded the provisions of Section 1031 to permit reverse exchanges. In a reverse exchange, the taxpayer utilizes an *Exchange Accommodation Titleholder* to “park” the new property for a maximum period of 180 days until the taxpayer’s old property sells. The taxpayer then structures a simultaneous exchange with a Qualified Intermediary to acquire the replacement property from the Exchange Accommodation Titleholder. Although more complex and expensive to structure than a straightforward like-kind exchange, the taxpayer may consider a reverse exchange if his relinquished property closing is delayed, or if he hasn’t yet found a buyer before he must acquire the replacement property.



How do I plan for an exchange?

To properly structure an exchange, a taxpayer should seek expert tax advice from a knowledgeable tax or real estate attorney. He should also consult his CPA to discuss tax and basis calculations and reporting requirements. Choosing a competent, experienced Qualified Intermediary company is another essential ingredient for a successful exchange. As the taxpayer’s exchange partner, the Qualified Intermediary must hold the taxpayer’s sales proceeds for the purchase of the replacement property. If the taxpayer is in constructive receipt of those sales proceeds, his exchange will fail. The experienced Qualified Intermediary will understand the tax code restrictions to help prevent the taxpayer’s constructive receipt of exchange funds.

Other important considerations when choosing a Qualified Intermediary include whether or not they provide fidelity bonding, offer interest on the exchange proceeds, offer document preparation, deadline reminders, and a paper-trail for accounting or audit purposes. Like-kind exchange transactions offer excellent avenues for deferring capital gains taxes. **Any taxpayer who owns investment or business property should consider this technique before selling property.**

For more information about like-kind exchange transactions, contact Investors Title Exchange Corporation at (800) 724-8791, or visit our web-site at www.1031itec.com.

ITEC specializes in assisting taxpayers with 1031 exchange transactions nationally and serves as Qualified Intermediary for hundreds of exchanges annually. ITEC is owned by Investors Title Company (ITC) and is based at the parent company’s headquarters in Chapel Hill, North Carolina. Its sister subsidiaries, Investors Title Insurance Company and Northeast Investors Title Insurance Company, provide title insurance in 25 states throughout the country.

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