THE NAUTILUS GROUP®

Deferring Tax upon the Disposition of Real Estate

Deferring Tax Upon the Disposition of Real Estate

Like-kind exchanges – In general

Like-kind exchanges under Internal Revenue Code §1031 allow a taxpayer who owns appreciated real estate to defer federal income tax when disposing of that property and acquiring other qualifying real property. Ordinarily, the sale of appreciated property results in recognition of gain and payment of tax in the year of sale. In contrast, when real property held for use in a trade or business or for investment is exchanged solely for like-kind real property to be held for similar purposes, recognition of gain is deferred until the replacement property is later disposed of in a taxable transaction.

Following the Tax Cuts and Jobs Act of 2017, like-kind exchange treatment is limited to exchanges of real property that is not held primarily for sale. Like-kind exchanges defer tax, they do not permanently eliminate it.

Qualifying property

Section 1031 applies only to real property. Any personal property transferred as part of an exchange is treated as sold separately and may trigger currently taxable gain. If the taxpayer receives cash, debt relief, or other nonqualifying property, gain is recognized to the extent of the lesser of the realized gain or the value received.

Both the relinquished property and the replacement property must constitute real property and must be of like kind. Like kind refers to the nature or character of the property, not its quality. As a result, virtually all U.S. real property is considered like kind to other U.S. real property, whether improved or unimproved.

Under the regulations, real property includes property treated as real property under state or local law, property specifically listed in the regulations, and property that qualifies as real property based on all relevant facts and circumstances. Incidental personal property may be included if it is customarily transferred with the real property and does not exceed 15% of the fair market value (FMV) of the replacement property.

Deferred and reverse exchanges

A like-kind exchange must be structured as an exchange rather than a sale followed by a purchase. The taxpayer cannot receive or control the sale proceeds and typically must use a qualified intermediary. In a deferred exchange, the relinquished property is transferred first, and the replacement property is acquired later.

Replacement property must be identified within 45 days of the transfer of the relinquished property. The taxpayer may identify up to three properties without regard to value, any number of properties with an aggregate value not exceeding 200% of the relinquished property's value, or any number of properties if at least 95% of the identified value is ultimately acquired.

The replacement property must be received by the earlier of 180 days after the transfer of the relinquished property or the due date, including extensions, of the taxpayer's income tax return for that year.

In a reverse exchange, the replacement property is acquired before the relinquished property is transferred. An exchange accommodation titleholder temporarily holds title to the replacement property while the taxpayer completes the sale of the relinquished property, generally within 180 days.

Holding period considerations

The taxpayer must intend to hold both properties for business or investment purposes. There is no fixed minimum holding period, except in related-party transactions. Intent is determined based on the facts and circumstances at the time of the exchange.

In related-party exchanges, tax deferral is generally denied if either party disposes of the property within two years, unless an exception applies. Exceptions include dispositions due to death, involuntary conversion, or situations where tax avoidance was not a principal purpose of the transaction.

Eligible taxpayers and reporting

Individuals, partnerships, corporations, and disregarded entities may use like-kind exchanges if all requirements are satisfied. Each exchange must be reported on IRS Form 8824 and filed with the taxpayer's federal income tax return for the year of the exchange.

To satisfy the 45-day identification requirement, the taxpayer may:

- Identify up to three properties of any value, or
- Identify more than three properties so long as their combined FMV does not exceed 200% of the relinquished property's FMV, or
- Identify any number of properties, provided the taxpayer acquires at least 95% of the total identified FMV.

The replacement property must be received within 180 days of the transfer or by the income tax return due date (including extensions) for the year the property is relinquished, whichever comes first.

In contrast to a deferred exchange, a reverse exchange occurs when replacement property is acquired before the original property is transferred. An exchange accommodation titleholder (EAT) holds the new property for up to 180 days while the taxpayer arranges the sale of the original property.