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Deferring Tax upon the Disposition of Real Estate



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Like-kind exchanges – In general

For the person holding appreciated real estate property who wants to dispose of it and replace it with other property, a like-kind exchange can effectively defer tax on the disposition of appreciated real estate. While a taxpayer who sells appreciated property must generally recognize the gain or loss from the sale and pay taxes on any resulting gain in the year of sale, the like-kind exchange provisions of Internal Revenue Code (IRC) §1031 provide that no gain or loss will be recognized when appreciated property held for productive use in a trade or business (or for investment) is exchanged for like-kind property that will also be held for productive use in a trade or business (or for investment). Recognition of the gain is then deferred until the property received in the exchange is disposed of in a subsequent taxable transaction.

Like-kind exchanges are valuable tools utilized for purposes of deferring the recognition of income. If done properly, no income tax should result from a like-kind exchange. Because the Tax Cuts and Jobs Act of 2017 (TCJA) narrowed the type of property that qualifies for like-kind exchange treatment for exchanges completed after December 31, 2017, the nonrecognition of gain or loss under the like-kind exchange rules is now limited to the exchange of real property that is not held primarily for sale.

Qualifying property

Several requirements must be met to qualify for like-kind exchange treatment. As §1031 only applies to real property, any personal property transferred in a like-kind exchange is considered separately bought and sold, with undeferrable gain on the sale. If the taxpayer also receives money, relief from debt, or nonqualified property in the exchange, the gain is taxable to the extent of such money, debt relief, and the fair market value (FMV) of the disqualified property.

Qualifying relinquished and replacement property must satisfy two core requirements: (1) the property must be real property, and (2) the two types of property must be of like-kind to one another. Treasury Regulations §1.1031(a)-1(b) state that the words "like-kind" refer to the nature or character of property, and courts generally hold that to mean virtually any real property is of like-kind to virtually any other real property, regardless of whether improved or unimproved. In sum, the TCJA made the key inquiry in most cases the examination of what constitutes real property.

The final regulations classify property as real property for Sec. 1031 purposes if the property is:

- Classified as such under the state and local law test, subject to certain exceptions;
- Specifically listed as real property in the final regulations; or
- Considered real property based on all the facts and circumstances.

In addition to updating the definition of real property, the IRS finalized a rule providing that exchange funds can be used to purchase real property that contains incidental personal property. Personal property is incidental to real property acquired in an exchange if (1) in standard commercial transactions, the personal property is typically transferred together with the real property, and (2) the aggregate FMV of the incidental personal property transferred with the real property does not exceed 15% of the aggregate FMV of the replacement real property.

Deferred exchanges

A key requirement under the regulations is that the transaction must be structured as an exchange—not as a sale followed by a purchase. Taxpayers cannot receive sale proceeds and later use them to buy new property. Instead, they must either complete a direct property-for-property exchange or use a qualified intermediary to facilitate the transaction so that it qualifies as an exchange for tax purposes. A deferred exchange occurs when the relinquished property is transferred before the replacement property is identified. To qualify for a deferred exchange, a replacement property must be identified within 45 days of transferring the property. If a property is not identified within 45 days, the transaction will fail.

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 fair market value 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.

Lastly, the replacement property must be received by the sooner of 180 days of the transfer, or the due date of the income tax return, including extensions, for the year in which the property is relinquished.

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.

Is there a required holding period?

Taxpayers must intend to hold both the relinquished and replacement properties for business or investment purposes. While there is no fixed minimum holding period (except in related-party transactions), the taxpayer's intent at the time of the exchange is critical. If the taxpayer intends to hold the property for qualifying use at the time of the exchange, the transaction will generally be respected—even if circumstances change afterward. The IRS and tax courts evaluate this intent based on the facts and circumstances surrounding the exchange.

For related-party exchanges, if either party disposes of the exchanged property within two years, the tax deferral is generally disallowed unless an exception applies. A related person includes family members (*e.g.*, spouse, siblings, ancestors, and lineal descendants) and certain entities with shared ownership interests, as defined in IRC §§267(b) and 707(b). Exceptions to the denial of like-kind treatment are provided in the event of death, compulsory or involuntary conversion, or a showing that the transaction did not have the avoidance of federal income tax as one of its principal purposes.

Who can participate and how is it reported?

All property owners – whether individuals, partnerships, corporations, and disregarded entities (such as single-member LLCs) – may use like-kind exchanges, provided all statutory and regulatory requirements are met. All like-kind exchanges must be reported on IRS Form 8824, which provides details of the properties exchanged and the deferred gain and is filed with the taxpayer's return for the year of the exchange.

This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. New York Life Insurance Company, its agents and employees may not give legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies. These materials are prepared by The Nautilus Group®, a service of New York Life Insurance Company, and are made available to all Nautilus Group member agents, and as a courtesy, to select agents of New York Life Insurance Company.
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