

# Like Kind Exchanges in Georgia

*Presented by*

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## LIKE KIND EXCHANGES IN GEORGIA

- I. Section 1031 of the Internal Revenue Code.
  - A. Section 1031 of the Internal Revenue Code of 1986 provides for nonrecognition of gain or loss with respect to the exchange of property held for productive use in a trade or business or for investment solely for property of Alike kind@ which is to be held for productive use in a trade or business or for investment.
    1. The taxpayer must relinquish an interest in real or personal property and certain types of property are ineligible for Section 1031 treatment.
    2. The taxpayer can do a simultaneous exchange or a deferred exchange. In a deferred exchange, the taxpayer may acquire the replacement property up to 180 days after the closing of the relinquished property.
    3. The taxpayer=s basis in the relinquished property carries over (with certain adjustments) to the replacement property and the taxpayer recognizes no gain on the disposition of the relinquished property, except to the extent the taxpayer receives Aboot@(nonqualifying property) in the transaction.
    4. In deferred exchanges, the use of a qualified intermediary prevents the taxpayer from being in constructive receipt of the sales proceeds of the relinquished property.
  - B. Methods of Exchanging Property.
    1. Two-Party Exchanges.
      - (a) Straight exchange where the parties each desire to acquire the other=s property.
      - (b) Simultaneous conveyance of property by each party to the other.

(c) If necessary, one-way cash payment by one party to the other to equalize value or take into account liabilities against a property.

(d) Single settlement agent.

2. Deferred Exchange.

This is the most common arrangement for Section 1031 exchanges. The Internal Revenue Service (IRS) has issued a safe harbor deferred exchange procedure, involving the following steps, that works fairly well in most situations.

(a) The taxpayer wishing to utilize Section 1031 (your customer) enters into a contract to sell his relinquished property. This sales contract includes an exchange cooperation clause.

(b) The taxpayer hires your financial institution as a qualified intermediary. Your financial institution and the taxpayer enter into a Qualified Intermediary and Escrow Agreement.

(c) The taxpayer assigns the sales contract for the relinquished property to your financial institution as a qualified intermediary and the buyer of the relinquished property is so notified.

(d) The qualified intermediary provides direct deeding instructions to the taxpayer and, at closing, the taxpayer executes a deed to his relinquished property directly to the buyer of the relinquished property.

(e) The buyer's money from the sale of the relinquished property goes directly from the settlement agent to the qualified intermediary to be held in escrow in an interest bearing or non-interest bearing account.

(f) The taxpayer has 45 days from the closing of the relinquished property to identify in writing potential replacement property to the qualified intermediary. This 45-day period cannot be extended. The taxpayer may identify up to three (3) properties without regard to any additional restrictions. If a taxpayer identifies more than three (3) properties, then the total value of all identified property cannot exceed 200% of the value of the relinquished property, unless the taxpayer actually acquires 95% (in value) of all the properties identified. The identification of potential replacement property must be fairly specific. For example, identifying a condominium unit in

the Sandpiper Condominiums@ in Panama City, Florida, is probably not sufficient. The taxpayer should identify a particular or specific unit. Also, within the 180 day exchange period, the taxpayer must acquire substantially the same property as he identified. If the identification rules are violated, Section 1031 does not apply to the transaction and the taxpayer must recognize 100% of the gain on the sale of the relinquished property.

- (g) The taxpayer enters into a contract to buy replacement property from its owner (seller of the replacement property) with an exchange cooperation clause in the contract.
- (h) The taxpayer assigns the contract to acquire the replacement property to the qualified intermediary and the seller of the replacement property is so notified. The qualified intermediary may pay earnest money to the seller or his agent for the replacement property from the escrow proceeds it is holding from the sale of the relinquished property.
- (i) The qualified intermediary gives direct deeding instructions to the seller of the replacement property and the seller executes a deed to the replacement property to the taxpayer.
- (j) The qualified intermediary pays the seller of the replacement property from the escrowed funds (through settlement agent).
- (k) The acquisition of the replacement property must be completed within 180 days from the closing of the relinquished property (or, if earlier, by the due date of the tax return for the year of the sale of the relinquished property, including extensions of the tax return). This 180-day replacement property acquisition period also cannot be extended.

3. The relinquished property and the replacement property must be Alike kind@.

- (a) Alike kind@ refers to the nature or character of the property and not its grade or quality. Real property is not Alike kind@ to personal property. Examples of like-kind real property include the following:
  - (i) Raw land, held by the taxpayer for investment, speculation, or appreciation.
  - (ii) Improved real property held by the taxpayer for investment, rental or production of income.

- (iii) Real property used by the taxpayer in a trade or business, such as an office or warehouse building or a farm.
- (b) A fee simple interest in land is of like-kind to a leasehold interest in land with a remaining term of at least 30 years.
- (c) Because personal property is not like kind to real property, if the taxpayer disposes of farmland and acquires furnished investment real property such as a furnished vacation home, the furnishings are personal property and are not like kind to the real property. Therefore, gain must be recognized to the extent of the value of the furnishings.

4. The Holding Purpose Requirement.

- (a) Section 1031 applies to exchanges of like kind property (with certain exceptions) held by the taxpayer for productive use in a trade or business or for investment.
- (b) The relinquished property must be held by the taxpayer for productive use in a trade or business or for investment at the time of the exchange and the taxpayer must intend to hold the replacement property for productive use in a trade or business or for investment at the time of acquisition.
- (c) Trade or business property can be exchanged for investment property and investment property can be exchanged for trade or business property.
- (d) The determination of whether property is held by the taxpayer as trade or business property or as investment property is made at the time of the exchange. It is essentially a factual determination based on objective factors indicating whether the taxpayer had the requisite intent at the time of the Adisposition@ of the relinquished property and at the time of the acquisition of the replacement property.
- (e) The period of time that the relinquished property or the replacement property has been (or will be) held by the taxpayer is an important factor. The longer the property has been so held, the more it indicates that the property was held for the requisite purpose. The shorter the period the taxpayer holds the property, the more important it is to have additional factors indicating that the requisite purpose was present at the relevant time.

5. The Exchange Requirement.

- (a) Section 1031 applies to exchanges of like kind property held for the requisite purpose or use. An exchange occurs when the taxpayer conveys property (the relinquished property) to the same party from whom the taxpayer acquires replacement property. This concept underlies the necessity of using a qualified intermediary if the exchange is not a simultaneous two-party exchange. If the taxpayer follows the rules set forth by the IRS, then the taxpayer is treated as if he conveyed his relinquished property to the same party (the qualified intermediary) from whom the taxpayer acquired the replacement property.
- (b) The Qualified Intermediary and Escrow Agreement entered into between the taxpayer and the qualified intermediary allows the taxpayer to avoid constructive receipt of the sales proceeds by restricting the taxpayer's ability to receive, pledge, borrow or otherwise obtain the proceeds from the sale of the relinquished property.
- (c) Also, to defer 100% of the gain on the disposition of the relinquished property, whoever conveys the relinquished property must acquire the replacement property. For example, if husband owns and conveys the relinquished property for \$200,000.00, but husband and wife, jointly, acquire the replacement property at a cost of \$200,000.00, then the husband has only acquired \$100,000.00 of replacement property. In the same vein, if husband and wife, jointly, own and convey relinquished property for \$200,000.00 and wife alone acquires replacement property for \$200,000.00, then husband has conveyed property worth \$100,000.00 and has acquired no replacement property.
- (d) On occasion, the relinquished property is owned by a partnership or LLC which has some partners or members who want to participate in a Section 1031 exchange with their share of the property, but other partners or members who want to receive cash for their interest in the property. As indicated above, to conduct a Section 1031 exchange, the taxpayer must convey relinquished property that has been held for investment or for productive use in a trade or business. Under these facts, the partnership or the LLC, not its partners or members, has held the relinquished property. One way to deal with this issue is to liquidate the partnership and distribute the property to the partners in undivided interests which would then be held by the former partners

as tenants in common. The owner who wishes to utilize a Section 1031 exchange for his portion of the sale proceeds would need to hold his interest in the property for investment and to conduct himself regarding his interest in the property in such a way to be able to demonstrate that he is holding his interest in the property for investment (rather than for sale) at the time of the transaction in the event the transaction is examined by the IRS.

6. The Amount of Gain To Be Recognized.

- (a) It is important to understand the rules relating to the amount of gain on the disposition of the relinquished property which must be recognized when less than 100% of the net sales proceeds from the sale of the relinquished property is invested in replacement property. If a taxpayer purchases property for \$100,000.00, he will have an income tax basis of \$100,000.00 in such property. If the property appreciates in value to \$250,000.00 and the taxpayer sells the property for \$250,000.00 and does not undertake a Section 1031 exchange, the taxpayer's realized gain is \$150,000.00, all of which must be recognized and reported on the taxpayer's income tax return. However, if the taxpayer undertakes a Section 1031 exchange and acquires replacement property of a like kind at a cost of at least \$250,000.00, none of the \$150,000.00 realized gain will be recognized because the entire gain will be deferred pursuant to Section 1031. However, if the taxpayer acquires replacement property at a cost of only \$200,000.00, realized gain will have to be recognized to the extent that the net sales proceeds from the sale of the relinquished property (\$250,000.00) exceed the cost of the replacement property (\$200,000.00). Thus, \$50,000.00 of the gain from the sale of the relinquished property must be taken into account as income.
- (b) Furthermore, assume the taxpayer has a \$100,000.00 basis in his relinquished property, which he sells for \$250,000.00. Assume further that the replacement property costs only \$100,000.00. In that case, the entire \$150,000.00 of gain must be recognized. Thus, if the taxpayer does not acquire replacement property with a cost which at least exceeds his income tax basis in the relinquished property, Section 1031 generally has the same effect as an outright sale of the property.
- (c) The foregoing rules apply regardless of whether the taxpayer has a mortgage on the relinquished property. To be able to defer 100% of the realized gain on the disposition of the relinquished property, the

taxpayer must acquire replacement property at a cost of at least 100% of the net amount realized from the sale of the relinquished property, not merely his Equity in the relinquished property. Thus, if a taxpayer owns relinquished property with a fair market value of \$300,000.00 subject to a \$200,000.00 mortgage and engages in a Section 1031 exchange, he will receive \$300,000.00 for his relinquished property, \$100,000.00 in cash (assume no deferred payments), and \$200,000.00 in the form of debt relief. Only \$100,000.00 from the transaction will be initially escrowed with the qualified intermediary. However, in order for the taxpayer to defer 100% of the gain on the sale of the relinquished property, the taxpayer must acquire replacement property at a cost of at least \$300,000.00. Accordingly, the taxpayer must not only utilize and reinvest the \$100,000.00 in net sales proceeds paid to and held by the qualified intermediary, but he also must put up another \$200,000.00 of cash (or borrow \$200,000.00) in connection with the acquisition of replacement property for at least \$300,000.00 if he wants to defer all of the gain.