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**Section 1031 Deferred Like-Kind Exchanges of Real Estate**

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In the last several years with increasing values and sale prices of real estate, the “Like-Kind Exchange” has been used by many sellers to defer taxes on the gain received. Deferred Exchanges under Section 1031 became accepted by litigation in the 1970’s and were codified in the late 1980’s. Basically, a Section 1031 Tax-Deferred Exchange allows for a seller of property to defer income taxes on the gain it receives in the sale of property so long as it purchases another like-kind property. Generally, when one sells property, they must pay income tax (whether it be long-term capital gains if the property is held for more than one year or short-term gain which is comparable to the ordinary income tax rate) upon the sale of a piece of property. If a seller is selling a piece of property (the Relinquished Property) and intends on replacing that property with another property (the Replacement Property), the seller can defer the income tax if done properly and if the strict Rules and Regulations of the Internal Revenue Code are followed.

Section 1031 of the Internal Revenue Code states that “No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.”

In order for a Section 1031 Tax-Deferred Exchange to be successful, the property sold and purchased must be “like-kind.” Property is only tax deferred to the extent that the property exchanged is exchanged for property of “like-kind”. Like-kind refers to the nature of the character of property, not its grade or quality. Real property can qualify even if it is unimproved, so you can in fact, as long as it meets the other tests of like-kind, exchange improved property for unimproved property, or do the reverse. You cannot exchange one class of property for a different class of property (personal property). All real property is like-kind as long as it meets the other tests in Section 1031. Ineligible property includes stock in trade or other property held primarily for sale, stocks, bonds and notes, or other securities or evidence of indebtedness, interest in partnerships, and certificates of trust for beneficial interest. A seller of real estate cannot sell real estate and exchange it for personal property such as stocks or bonds. Both properties to be exchanged must be used in a trade or business or for investment. Thus, a personal residence does not qualify as exchange property.

In order to accomplish an exchange, planning must take place prior to the sale of the Relinquished Property. Strict time periods must be followed; within 45 days from date the Relinquished Property is sold, the seller must identify the potential Replacement Property. In addition, the seller must settle and close on that Replacement Property within 180 days from the settlement date when seller sold his property. The seller must establish his intent to do a Section 1031 Exchange prior to the first sale, typically by a paragraph added to the Purchase and Sale Agreement. A Section 1031 Exchange Agreement must be entered into between the seller and a

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Section 1031 Qualified Intermediary. Under a Section 1031 Tax-Deferred Exchange, the seller may not receive the sales proceeds from the sale of the Relinquished Property directly. Instead, a Section 1031 Qualified Intermediary receives the funds and holds the funds until the seller has identified and closed on the Replacement Property. Any receipt of the sales proceeds by the seller can taint the Section 1031 Tax-Deferred Exchange and void it. Additionally, the Qualified Intermediary must be non-affiliated and non-related to the person seeking the Section 1031 treatment. Thus, a seller, when contemplating selling his property, should plan accordingly. This would consist of conferring both with his attorney and accountant to determine how much potential gain he may incur. As always, it is advantageous to seek the advice of a competent attorney who practices in this area as well as an appropriate tax advisor.

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