R. Kymn Harp

Shareholder | Chicago
(312) 456-0378 | RKHarp@rsplaw.com

Before Closing: Consider A Tax-Deferred Exchange

If commercial real estate is being sold and the seller is planning to buy again, the seller should seriously consider a tax-deferred exchange. So long as the closing has not yet occurred, it is not too late. Why pay taxes on sale proceeds when it's not necessary? Invest those funds as equity instead.

What Is A Tax-Deferred Exchange?

Section 1031 of the Internal Revenue Code allows any real estate in the United States held for investment or for use in the taxpayer's trade or business to be exchanged for other like-kind property without payment of federal income taxes. Most state tax codes provide likewise. There are technical rules for completing the exchange, but it is a straightforward process with clear-cut rules expressly authorized by law.

Taxes that can be deferred include all capital gains taxes, all depreciation recapture taxes, all passive-investment taxes (so called "Obamacare taxes"), and, in most cases, state income taxes. In many circumstances, these taxes can add up to over 30%. Why not reinvest those funds in another like-kind property instead, and continue to receive an investment return on those funds?

How Is Like-Kind Property Defined?

A concept that is often misunderstood is “like-kind” property. The definition is much broader and simpler that some might expect. Basically, any real estate located in the United States and held for investment or for use in the taxpayer’s trade or business can be exchanged for any other United States real estate held for investment or for use in the taxpayer’s trade or business, without paying taxes.

That means, for example, an apartment building could be exchanged for a warehouse, retail store, or farm, and vice versa. Vacant land held for investment could be exchanged for a shopping center. An apartment building could be exchanged for an office building. The physical use of the real estate is not what makes it like-kind; rather, all real estate located in the United States is like-kind to all other real estate located in the United States. Likewise, foreign real estate is like-kind to other foreign real estate, but it is not like-kind to United States real estate.

The condition is that the real estate being sold must have been held for investment or for use in the taxpayer’s trade or business, and the real estate being acquired must likewise be acquired for investment purposes or for use in the taxpayer’s trade or business.

Are There Time Constraints?

At the time of closing, the taxpayer does not need to know exactly what property will replace the property being sold. The taxpayer has 45 days to identify potential replacement property, and up to 180 days after closing to acquire the replacement property. A key, however, is that the selling taxpayer cannot come into physical or constructive possession of the sale proceeds during the

exchange period. To satisfy this condition, the seller will designate a qualified intermediary to hold the funds under an exchange trust agreement. This can be done quickly, often within a day or two before closing if necessary. Although the seller/taxpayer does not have the right to access the funds during the exchange period, the seller/taxpayer does have the right to direct the qualified intermediary to apply the funds toward the taxpayer's purchase of any replacement property which is identified by the taxpayer during the 45-day identification period.

For all taxes to be deferred, the entire sale proceeds of the real estate being sold must be used to acquire the replacement property. For this purpose, "sale proceeds" includes all cash received at closing and any mortgage indebtedness that was paid off.

Advantages and Disadvantages

There are many advantages and not many disadvantages to structuring a sale as a tax-deferred exchange. The rules are technical but not very difficult to apply. It has virtually no impact on the buyer and provides extraordinary benefits to the seller.

For a broker, an exchange provides a direct lead-in to the next transaction, with an opportunity to broker the purchase of replacement property of equal or greater value that must close within 180 days.

Our tax code provides this benefit; it is up to real estate professionals to take advantage.