

Like-Kind Exchanges Can Defer Tax on U.S. Real Estate Sales

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We have discussed many times in this column the fact that foreign persons and entities are generally subject to U.S. income tax on any gain realized from the sale or other disposition of U.S. real property interests. In particular, where a corporation owns U.S. real estate, the potential tax liability may be considerable, as corporations are not entitled to a special reduced long-term capital gains rate. On the other hand, a properly arranged, documented and effectuated "swap" of U.S. real estate for one or more "like-kind" properties under Internal Revenue Code Section 1031 can under appropriate circumstances result in a theoretically indefinite deferral of the tax that otherwise would be due upon a sale of the property. The like-kind exchange rules apply to numerous other types of property, but by far the most common exchanges involve U.S. real estate.

Code Section 1031 provides for the nonrecognition of gain or loss upon the exchange of certain types of "like-kind" property. In the real estate context, the "like-kind" standard is very broad. Many different types of real estate may thus be successfully exchanged for another, so long as they are held either for productive use in a trade or business or for investment. Although the actual tax due (if any) in a like-kind exchange must be calculated using a special formula, a general rule of thumb is that if the seller receives any cash from the initial closing that is not utilized to acquire the "swap" property, any gain realized by the seller is taxable up to the amount of such cash "boot." A similar "boot" rule applies in the event the transferred property is subject to a mortgage that is assumed by the buyer, subject to an offset for any mortgage on the replacement property that is assumed by the seller. Significantly, if property is sold and the proceeds are unconditionally paid to the seller, it is too late for the seller to then attempt a Code Section 1031 exchange, and thus advance planning is mandated to take advantage of these rules.

Like-kind exchanges can either occur through closings held on the same day for the relinquished and replacement properties, or through deferred transactions involving separate closings tied together by appropriate agreements and other documentation. In a deferred exchange, the proceeds of the sale of the transferred property must be received by and held in a qualifying escrow or similar arrangement to be ultimately utilized to acquire the replacement property. Although there are significant restrictions upon who or what may act in such a capacity, a number of banks, title companies and specialized entities are available to act as a "qualified intermediary" for a fixed fee.

The replacement property or properties must be identified within 45 days of the sale of the relinquished property, with the closing(s) then in general occurring within 180 days of such sale. If and when the replacement property is later sold, the seller's gain or loss on such sale is calculated based in part upon the adjusted tax basis of the seller's original property. In certain cases, it may be possible for all of the parties involved in the various property transfers to successfully consummate a like-kind exchange.

Numerous other special rules and variations thereof must be carefully followed in order to have a successful like-kind exchange. For example, U.S. real estate cannot be exchanged for foreign real estate. However, for many U.S. real estate owners, these rules provide a tremendous opportunity to dispose of highly appreciated real estate without incurring an immediate tax, so long as reinvestment of the sales proceeds is desired in lieu of "cashing-out."