How to Save Taxes by Using a "Like-Kind" Exchange

A "like-kind" exchange is a popular and frequently used method of deferring taxation upon the disposition of a piece of property. In a like-kind exchange, property held as an investment or for productive use in a trade or business is exchanged for another piece of property of the same nature or character (but not necessarily of an equivalent grade or quality). The exchange must consist of tangible property, for example, real estate. Securities or evidences of indebtedness and partnership interests are not eligible for like-kind exchange treatment. Exchanging properties which are of a different kind or class is not a "like-kind" exchange.

In its simplest form, the transaction might take the form of a direct exchange by "A" of a piece of rental property for a similar piece of rental property owned by "B."

However, sometimes "B" will be interested in acquiring "A's" property but owns no property in which "A" is interested. In this situation, "A" can transfer property to "B" and direct "B" to purchase another property which "A" would like to own. "B" purchases that property and transfers it to "A" in exchange for the property "A" transferred to "B."

In order to qualify as a like-kind exchange, the transaction must meet the following requirements:

1.) The property must be received by "A" in the exchange must be identified within 45 days after the transfer of the property from "A" to "B" in the exchange, and,

2.) The like-kind property must be received by "A" within 180 days after the date of transfer or, if earlier, before the due date for filing "A's" federal income tax return for the tax year (not including extensions).

If only like-kind property is received in an exchange, no taxable gain or loss will be reported for federal income tax purposes as a result of the exchange regardless of tax basis in and value of the respective properties.

However, if in addition to like-kind property, cash or other property is received which is different in kind or class from the property transferred (in other words, nonlike-kind property, often referred to as "boot"), any gain realized in the exchange will be taxable to the extent of the sum of the amount of cash and the fair market value of the nonlike-kind property received. Any loss realized in such an exchange may not be taken into account in calculating federal income tax.

If a transferor receives only like-kind property but transfers cash or other nonlike-kind property as part of the exchange, the nonrecognition rules apply only to the like-kind properties, but not to the "boot."

A like-kind exchange can provide substantial tax savings. Prior to any transaction, transferors should examine the details of the transaction to see if the disposition of property can be made according to the rules of a like-kind exchange. Your accountant or tax advisor can be helpful in completing the transaction making certain that it passes muster with the Internal Revenue Service.

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