



2023 Annual Conference Like-Kind Exchange

1

Objectives



- At the end of this course, you will be able to:
 - Identify the elements of a like-kind exchange
 - Calculate realized gain from a like-kind exchange
 - Calculate recognized gain from a like-kind exchange
 - Calculate the basis of property acquired in a like-kind exchange
 - Complete Form 8824, *Like-Kind Exchanges*

2

2

§1031s in General



3

3

IRS Definition



- Like-kind exchange is when a taxpayer exchanges *real property** used for business or held as an investment solely for other business or investment property that is the same type or “like-kind.”
- Generally, if a taxpayer makes a like-kind exchange, gain is not recognized under §1031.
 - Gain may be *realized* but not *recognized*.
- * Per TC&JA!

4

4

IRS Theory



- The idea is that if a taxpayer exchanges one business or investment asset for another business or investment asset, and no cash is generated by this transaction, then the gain should not be subject to taxation.
- Otherwise, the business owner might have to liquidate other assets in order to pay tax on the exchange...and that would be bad for business.
- All that said, the process isn't necessarily easy.

5

5

A Little History



- LKE rules originally passed in 1921 as §202(c)
- Qualified Intermediary use approved in 1935
- Starker decision in 1979 (non-simultaneous exchange)
- TC&JA eliminated non-real property exchanges until 2026
- After 2026....?



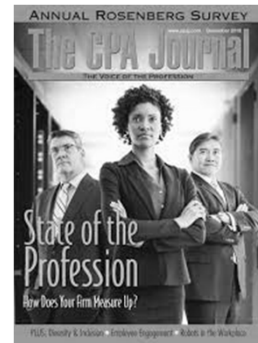
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Currently

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- Today, an entire industry has arisen around these exchanges
- Approximately 250,000 exchanges are filed annually with a total value approaching \$74B *CPA Journal October 2016*



7

Pros and Cons

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- It's a good thing if tax can be deferred to a lower income year or possibly forever aka defer, defer, defer, die
- Maybe **not** a good thing if the year of the exchange is a low-income year and future years are high-income years!



8

8

Swap Till You Drop!



Property A exchanged for Property B, gain of \$50K deferred.



Property B exchanged for Property C, total gain of $\$70K + \$50 = \$120K$ deferred



Property C exchanged for Property D, total gain of $\$80K + \$70K + \$50 = \$170K$ deferred



Recognize \$170K of gain (or die)

9

9

Mandatory



- Note that if §1031 applies, nonrecognition of the gain is **MANDATORY**.
- If you don't want §1031 to apply, sell the property and use the proceeds to buy the new asset.
- But note that a sale and subsequent purchase from the sale dealer may be reclassified by the IRS as an exchange.

10

10

Types of Exchanges



- Deferred Exchange aka Starker Exchange
 - Sell and then follow the timeline to get replacement properties
- Reverse Exchange aka Reverse Starker Exchange
 - Buy the replacement property and follow the timeline to sell your property
- Improvement/Construction Exchange
 - Sell your property and defer full amount into new property, must be structured this way from the start
- Simultaneous Exchange
 - Two people swap properties directly
- The taxpayer touch not touch any cash until the exchange is complete!

11

11

Qualified Intermediary



- Starker and Reverse Starkers require the use of a QI.
- The role of the QI is to step into the exchanger's position and to prevent the exchanger's access to funds transferred during the exchange process so as not to violate the like-kind clause.
- QI is allowed to sell the taxpayer's property, collect the funds from the sale and then use those funds to acquire replacement property for the taxpayer.



12



Who CAN'T Be a QI?



- QI can't be:
 - Related to the taxpayer (siblings, spouse, ancestors, descendants)
 - Related to an agent of the taxpayer
 - An agent of the taxpayer who within the 2-year period ending on the date of the transfer of the first of the relinquished properties is:
 - An employee of the taxpayer
 - Accountant or attorney of the taxpayer
 - Investment banker, investment broker, real estate agent/broker of the taxpayer
 - Person who represents the taxpayer in another purchase or sale of property

13

13

Exchange Accommodation Titleholder



- An Exchange Accommodation Titleholder (EAT) is used to complete a reverse exchange or improvement exchange.
- In a reverse exchange, the EAT holds legal title to either the relinquished or replacement property until the relinquished property can be conveyed to a buyer.



14

14

Relinquisher = Acquirer



- Generally, the person relinquishing a property also needs to be the person acquiring a new property.
- Single member LLC qualifies as an individual.
- Partnerships (limited and general), S corporations, C corporations, Trusts and most tax-paying entities can utilize §1031 as long as the exchange doesn't result in a change in the taxpayer!
- Taxpayer cannot exchange a property held in his own name for a property to be held in an S Corp or vice versa.

15

15

Death of a Taxpayer



- It may happen that a taxpayer passes away at a point in time after the sale of the relinquished property and before the purchase of replacement property.
- If the exchange is not completed, the estate would be taxed on the gain from the sale.
- Despite the fact that the decedent and his estate are not the same taxpayer, the IRS regulations allow the estate to continue the exchange transaction and receive deferral.



16

16

Holding Period



- There is no IRC mention of a required holding period, but experts often maintain that the property should be held for one year before or after the exchange...
- But intent is crucial!
- If taxpayer **acquires** property with the **intent** of exchanging it, this property is not considered to have been held for use in a trade or business, or for investment.
- *Barker, Francis vs. U.S.*, the District Court agreed with the IRS, denying like-kind exchange treatment to a farmer who bought a restaurant and on the same day exchanged it for the farmland.

17

17

Exchange Expenses



- Closing costs paid:
 - Brokerage commissions
 - Attorney fees
 - Deed preparation fees
 - Transfer fees
 - Escrow fees
 - Title policy premiums
- Doesn't include loan origination fees, property taxes, mortgage interest, expenses required to obtain funds

18

18

Boot

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- Boot refers to non-like-kind property that is transferred as part of an otherwise tax-free exchange
- Can be cash, unlike property and obligations (net liabilities)
- A taxpayer may pay boot or receive boot
- (We'll talk more about boot shortly.)



19

19

Realized vs Recognized

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- **Realized** gain is the total of all money received plus the FMV of any property/services received minus adjusted basis of the property given up.
- **Recognized** gain is usually the same as realized gain, but not for §1031 exchanges! Recognized gain is what gets put in the tax return.
- §1031 **defers** the recognition of gain.
- (And we'll talk a lot more about gain today.)

20

20

What Properties Qualify?



- Like-kind exchange properties requirements
 - Must be same nature or character
 - May be improved or unimproved (buildings may be exchanged for land)
 - Must both be within U.S. or both outside U.S. (U.S. property is not like-kind with non-U.S. property)
 - May differ in grade/quality
- There is no limit on the number of times or frequency with which taxpayers may perform these exchanges.

21

21

What Won't Qualify?



- §1031 properties must be held for business or investment purposes
 - Cannot be personal property or even real property used personally
 - Cannot be vacation home
 - Cannot be inventory (lookin' at you, flippers)
 - Cannot be partnership interest even if partnership holds qualifying property
 - Cannot be stock, securities, digital assets, certificates of trust, beneficial interest, evidence of indebtedness (IOUs)

22

22

Like-Kind Example #1



- Alice owns a rental duplex in Boston.
- She'd like to exchange that duplex for 10 acres of land in Colorado.
- No problem.



23

23

Like-Kind Example #2



- Gretchen owns a rental duplex in Hamburg.
- She'd like to exchange that duplex for a rental flat in London.
- No problem.



24

24

Like-Kind Example #3



- Gretchen owns a rental duplex in Hamburg.
- She'd like to exchange that duplex for 10 acres in Colorado.
- Now we have a problem.
- Why? Because U.S. property is not like-kind with non-U.S. property!



25

QUIZ



- Which client(s) might qualify for a §1031 exchange?
- Alice owns a rental in Boston; she'd like to exchange it for 10 acres of land in Colorado.
 - Marie owns a rental in Paris; she'd like to exchange it for a rental apartment in Greece.
 - Connor owns a rental in Paris; he'd like to exchange it for 10 acres in Colorado.
 - Barb has a car she uses 100% for business; she'd like to exchange it for a newer car to be used 100% for business.
 - Bob has 2 Bitcoin; he'd like to exchange both of them for Ethereum.

26

26

Vacation Homes and Principal Residences



27

27

What About Vacation Homes



- Principal residences cannot be exchanged...but what about vacation homes?
- Good news and bad news!



28

Vacation Home Court Case



- *Moore v. Commissioner*, taxpayers exchanged their vacation homes.
- They argued that the vacation homes were investments because they were expected to appreciate in value.
- Because the homes had never been rented out and were used solely for personal pleasure, §1031 treatment was denied.
- (That's the bad news.)

29

29

Rev Proc 2008-16 Safe Harbo



- However, there is a safe harbor rule for vacation homes!
- (That's the good news.)



30

30

Rev Proc 2008-16 Safe Harbor



- The relinquished dwelling unit must be owned by the taxpayer for at least 24 months immediately prior to the exchange.
- In each of the 12 months prior to the exchange, the taxpayer must rent the dwelling to another person at a fair rental value for at least 14 days.
- In each of the 12 months prior to the exchange, the taxpayer must not have personal use exceeding the greater of 14 days or 10% of the rental days.
- Both relinquished and acquired properties must meet the standards for the safe harbor to apply.

31

31

Rev Proc 2008-16 Safe Harbor



- The same rules apply for the 24 months following the exchange with the new property!!
- In each of the 12 months **after** the exchange, the taxpayer must rent the replacement dwelling to another person at a fair rental value for at least 14 days.
- In each of the 12 months **after** the exchange, the taxpayer must not have personal use of the replacement dwelling exceeding the greater of 14 days or 10% of the rental days.

32

32

Rev Proc 2008-16 Safe Harbor



- Adam owns Lake Cabin A; he'd like to exchange it for Lake Cabin B.
- He owned Lake Cabin A for more than 2 years before the exchange.
- During the 12 months prior to the exchange, he rented it out at FMR for 50 days and used it personally for 11 days.
- During the 12 months prior to that, he rented it at FRV for 210 days and used it personally for 21 days.
 - Personal use did not exceed 10% of rental days, so Adam is still good.
- Adam meets the safe harbor rules....so far.

33

33

Rev Proc 2008-16 Safe Harbor



- After the exchange, he rents out Lake Cabin B for 55 days and uses it personally for 16 days.
- Whoops!
- He has now failed the safe harbor test.



34

34

§1031 Principal Residence?



- Taxpayer acquires a rental through a §1031 exchange and then moves into it as a personal residence, then wants to sell it and use §121 exclusion!
- American Jobs Creation Act of 2004 states that the principal residence acquired in a like-kind exchange must be held for 5 years before §121 can be used!



35

QUIZ

- Megan's London rental has an adjusted basis of \$500K, FMV \$800K.
- She'd prefer to own a rental in San Antonio, Texas.
- Do you recommend a §1031 exchange?
- If so, why? If not, why not?



36

36

QUIZ

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- Rob's rental in Baltimore was purchased for \$300K; his adjusted basis is \$250K.
- The FMV of the rental is now \$200K.
- He'd like to buy a rental in Tucson.
- Do you recommend a §1031 exchange?
- If so, why? If not, why not?

37

QUIZ

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- Barb's home in Savannah was purchased for \$300K, adjusted basis is now \$275K, FMV is \$500K.
- She'd like to live in Raleigh instead.
- Do you recommend a §1031 exchange?
- If so, why? If not, why not?

38

QUIZ

- Alan's rental in Florida was purchased for \$450K, adjusted basis is now \$425K, FMV is \$550K.
- Alan is planning to move to Taos, New Mexico; it would be easier for him to manage a rental there.
- Do you recommend a §1031 exchange?
- If so, why? If not, why not?



39

QUIZ

- Maxine has a vacation home at Lake Tahoe, adjusted basis \$200K, FMV \$375K.
- It was rented out for a week last year and she used it personally for 3 months.
- It was vacant the rest of the time
- Now she thinks she'd prefer to spend her summers at a beach house in Hawaii.
- Do you recommend a §1031 exchange?
- If so, why? If not, why not?



40

Starker Exchanges



41

41

Starker v. United States



- The term "Starker exchange" comes from a series of 1970s court cases involving Starker family members who bravely went where no one had gone before in creating a tax-deferred exchange.
- The Starkers conveyed timber land in return for a promise that the buyer would provide a suitable replacement property within five years.
- Surprisingly, the court granted exchange status to this long-deferred trust arrangement, thereby giving birth to the "Starker exchange" in 1979.
- In 1991, safe harbor regulations were added – specifically the 45-day identification period and the 180-day exchange period.

42

42

The Starker Process Begins



- The QI utilizes an EAT to purchase the relinquished property so the taxpayer can take direct title to the replacement property.
- Taxpayer's intent must be to complete a tax-deferred exchange.
- Within 5 days of title being transferred to the QI, there must be a written agreement establishing the intent of the taxpayer and stating that the QI will be treated as the beneficial owner of the property for federal tax purposes.

43

43

The Starker Process: 45 Day Timeline



- Within 45 days of the EAT receiving the title, the taxpayer must identify in writing the identity of the property he will relinquish.
- More than one replacement property may be identified.
- Property must be clearly described but need not be the legal description.
- An address will usually do the trick, but legal description for vacant land.
- Not the tax preparer's problem to watch the clock!



44

The Starker Process: 180 Day Timeline



- The *exchange period* begins on the date the relinquished property is transferred and must end on the earlier of:
 - 180 days later OR
 - The due date of the tax return, including extensions, for the year in which the relinquished property is transferred



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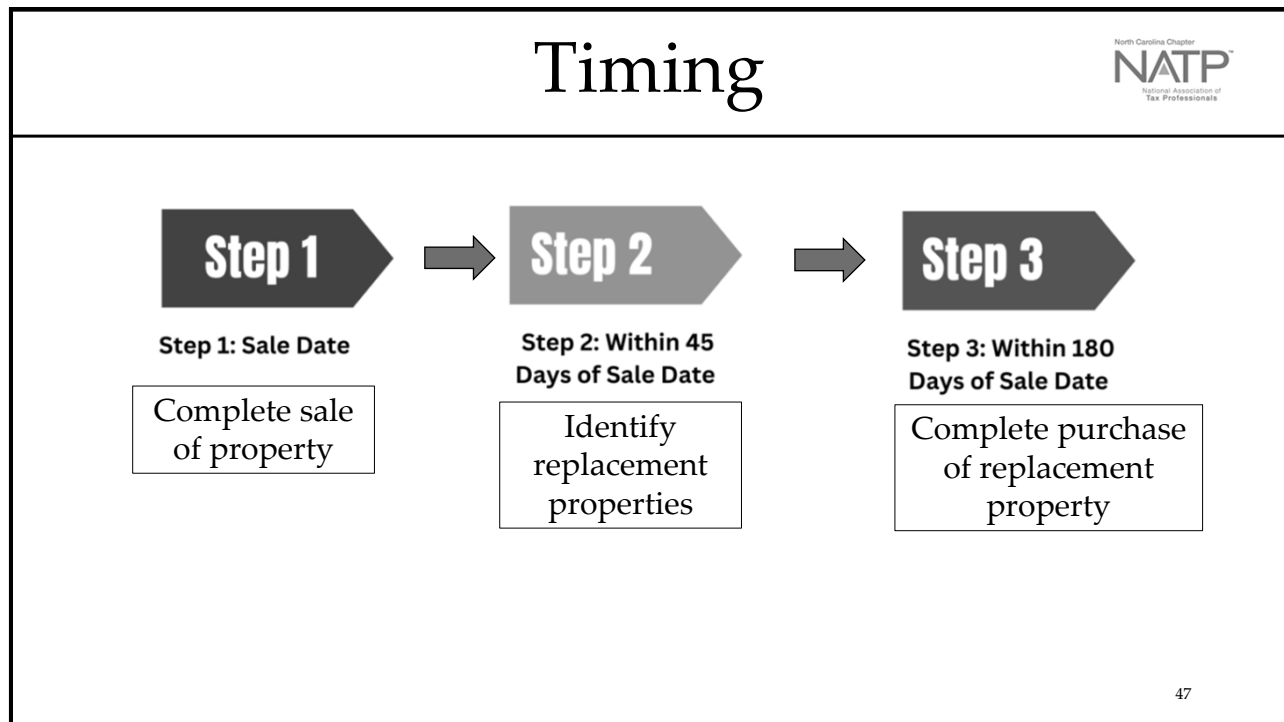
Timing Example



- James relinquished a piece of land on December 1st.
- The clock has started. He has a 45-day identification period and a 180-day exchange period.
- The 180-day period ends on May 30th of the following year
- However, the tax return is due on April 15th!
- So, the required completion date for the exchange is April 15th **unless** the tax preparer extends the return...in which case the due date is May 30th.

46

46



47

The Three Rules

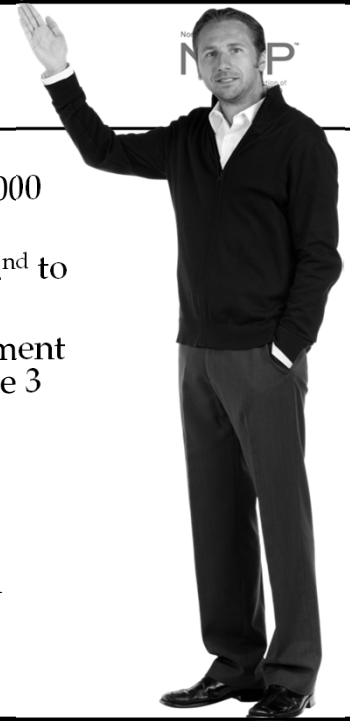
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- There are limitations as to the replacement properties that may be identified!
- 3 limitation tests:
 - 3 regardless of FMV as long as taxpayer closes on at least one of them (3 property rule)
 - Unlimited if total FMV **identified** is **less** than 200% of FMV of relinquished property (200% rule)
 - Unlimited if purchaser **acquires** properties valued as **at least** 95% of the FMV of the properties identified (95% rule)
- You must meet one of these tests!

48

Example - Max

- Max transfers unencumbered real property FMV \$100,000 (Property A) on May 18th.
- Max is required to identify like-kind property by July 2nd to meet the 45-day deadline.
- Max identifies Properties B, C and D in a written document that he signs and delivers. As of July 2nd, the FMV of the 3 properties are:
 - Property B = \$75,000
 - Property C = \$100,000
 - Property D = \$125,000
- Only 3 properties have been identified, so FMV isn't an issue.



49

Example – Ellen

- Ellen transfers unencumbered real property FMV \$6.5M (Property A) on May 18th.
- Ellen is required to identify replacement property by July 2nd to meet the deadline.
- Ellen identifies Properties B, C, D and E in a written document. As of July 2nd, the FMV of the 4 properties are:
 - Property B = \$6.6M
 - Property C = \$3.5M
 - Property D = \$5.5M
 - Property E = \$700K

\$16.3M total



50

Example – Ellen (cont.)

- Ellen has identified 4 properties, so she fails the 3-property test.
- \$16.3M is 250% of Property A so Ellen fails the 200% test.
- She would have to acquire properties of at least 95% of the total FMV of all properties identified in order to meet the last test.
 - Since 95% of \$16.3M is \$15.485M, she must acquire property with FMV totaling at least that amount!



51

51

Example – Ellen (cont.)

- Luckily, Ellen acquired Properties B, C, and D before the 180-day period ended.
- The deal for Property E didn't go through.
- She has acquired $\$6.6\text{M} + \$3.5\text{M} + \$5.5\text{M} = \15.6M in property, which is more than 95% of the properties identified, so she passes that final test!



52

52

Reverse Starker



53

53

Reverse Starker



- Reverse Starker aka reverse exchange occurs when the replacement property is parked with a 3rd party until the property to be relinquished is identified and arrangements are completed.
- Property is parked with an EAT under a QEAA.
- The IRS treats the EAT as the beneficial owner for federal tax purposes as long as there is a QEAA

54

54

Reverse Starker Example



- Laura found a duplex she likes and wants to trade her rental for it. She enters into a QEAA with an EAT. Then:
 - Laura borrows money and gives the money to the EAT, who uses the loan proceeds to purchase the duplex.
 - Laura and the EAT exchange the duplex and the rental and the EAT owns the rental while Laura finds a buyer for it.
 - Within 180 days, Laura finds Luke, who will purchase the rental.
 - The EAT sells the rental to Luke and then returns the advanced funds to Laura, who pays the EAT for their services.

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Reverse Starker Timing



- Identification of other property:
 - Must be identified in writing within 45 days
 - The clock starts when relinquished property is transferred
 - If multiple properties are involved, the clock starts on the earliest transfer
- Must be parked with QI no more than 180 days!!
- Not the tax preparer's problem to watch the clock!
- (Sound familiar? Yep, just like the Starker!)



56

56

Related Party



57

57

Related Party Issues



- When an exchange is completed with a related party, the IRS pays special attention.
- Related party is siblings, spouse, ancestors, lineal descendants, person and corp owned more than 50%, 2 corps in same controlled group, grantor and fiduciary of a trust, many more!



58

58

Related Party Issues



- 2-year recapture rule!
 - If property is disposed of within 2 years, gain must be recognized!
 - Exception if it can be shown that the transaction was not made to avoid tax



59

59

Related Party Issues



- As long as both parties wait two years before selling to a 3rd party, there are no issues at all.
- **There is no requirement that the taxpayer have a non-tax avoidance motive in doing a Related Party Swap if the taxpayers are patient for two years.**



60

60

Disclosure of Related Party



Part II Related Party Exchange Information

8	Name of related party	Relationship to you	Related party's identifying number
Address (no., street, and apt., room, or suite no.; city or town; state; and ZIP code)			

9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of any part of the like-kind property received from you (or an intermediary) in the exchange? Yes No

10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? Yes No

If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is not the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24 unless one of the exceptions on line 11 applies.

11 If one of the exceptions below applies to the disposition, check the applicable box.

a The disposition was after the death of either of the related parties.

b The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.

c You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes. If this box is checked, attach an explanation. See instructions.

Form 8824 must be filed in year of exchange PLUS next 2 years following the exchange!

Realized and Recognized Gain



What I Really Care About



- This is all really interesting, but what we tax preparers care about is reporting recognized gain and determining the basis of the new property
- But recognized gain is the lesser of realized gain or boot received, so we have to calculate those first!
- So 4 things:
 1. **Realized gain**
 2. **Boot**
 3. **Recognized gain**
 4. **New property basis**



63

63

Realized vs Recognized



- The whole point of the §1031 exchange is to have **realized** gain but not **recognized** gain.
- **Realized** is what the taxpayer actually made on the deal.
- **Recognized** is what will be “recognized” on the tax return.
- The §1031 exchange operates so that not all the **realized** gain has to be **recognized**!

64

64

Realized and Recognized Gain



• Realized gain =

- Selling price
- Minus adjusted basis
- Minus selling expenses

• Recognized gain =

- Lesser of boot received or
- Realized gain

65

65

Boot Reminder



- Boot is money or unlike property received
- May also be a reduction of liabilities
- **Realized** gain must be **recognized** to the extent of money and FMV of unlike property received!
- Taxable aka recognized gain is the lesser of:
 - Realized gain
 - Cash + FMV of unlike property recv'd – exchange expenses



66

Giving and Getting (the) Boot



- When boot is **given**, the giver is deemed to have received property in an amount equal to the FMV of the boot.
- When boot is **received**, the exchange is likely to no longer be completely tax-free. Gain will be recognized on the lesser of boot received or realized gain.

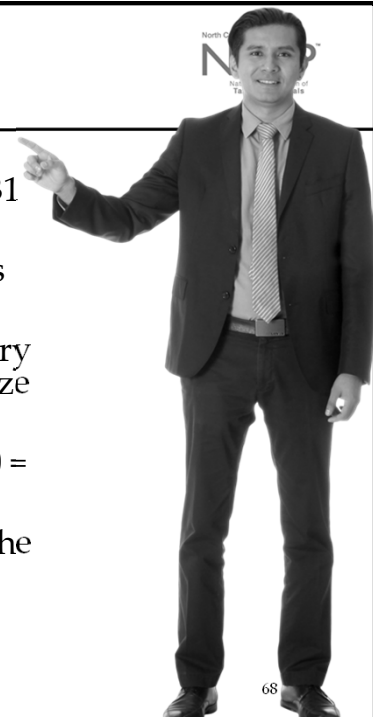


67

Boot Example



- Steve and Gary exchange land in a §1031 exchange.
- Steve's adjusted basis is \$20,000, FMV is \$24,000
- Gary's land is worth only \$19,000 so Gary also gives Steve \$5,000 in cash to equalize the FMVs.
- Steve's realized gain is $\$24,000 - \$20,000 = \$4,000$, and he got \$5,000 of boot!
- Steve's recognized gain is the lesser of the realized gain or the boot.



68

68

Assumption of Liabilities



- Liabilities assumed by the **transferee** is considered boot received by the **transferor**.
- Liabilities assumed by the **transferor** is considered boot received by the **transferee**.
- But liabilities may be NETTED.
- So, if the transferor assumed more liabilities than the transferee, no boot has been received by the transferor.

69

69

Netting Example



- Diane exchanged an apartment complex with a FMV of \$150K for Dave's office building with FMV of \$235K.
- The apartment had a \$25K mortgage; the office building had a \$110K mortgage.
- Diane assumed the office building mortgage; Dave assumed the apartment complex's mortgage.
- Diane relinquished a mortgage of \$25K and assumed a mortgage of \$110K, for a net liability assumption of \$85K.
- Diane doesn't have boot because she got more liability than she gave! (But Dave does.)

70

70

Realized & Recognized Gain



- Tammy exchanges a rental building for a duplex and a car.
- The adjusted basis of the rental was \$100K, FMV \$150K, mortgage balance \$35K.
- The FMV of the duplex was \$140K, mortgage balance \$35K, FMV of the car \$10K
- What's Tammy's realized gain, recognized gain, and basis in the duplex?



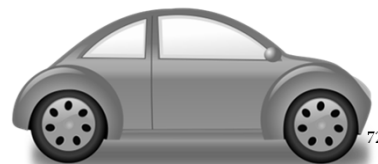
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71

Tammy's Realized Gain



- Tammy received \$185,000 of economic benefit:
 - \$150,000 worth of property received
 - Plus \$35,000 worth of liability given up
- Tammy gave up \$135,000 of economic benefit
 - \$100,000 worth of property relinquished
 - Plus \$35,000 worth of liability taken on
- Liabilities net out
- Net difference is \$50,000
- This is Tammy's realized gain



72

72

Tammy's Boot Received



- Remember that debt is also boot!
- Tammy received \$35,000 worth of debt relief plus non-like-kind property (the car) of \$10,000, total \$45,000
- Tammy took on \$35,000 worth of debt
- Net boot received is \$10,000



73

Tammy's Recognized Gain



- Net boot received is \$10,000
- Realized gain is \$50,000
- Recognized gain is the lesser of the two: \$10,000



74

QUIZ



- True or false?
 - a. Realized and recognized gain are the same.
 - b. Liabilities may be netted in order to determine which exchange participant received boot.
 - c. Recognized gain is the greater of boot received or gain realized.
 - d. Recognized gain is the lesser of boot received or gain realized.

75

75

Basis



76

76

New Property Basis



- New property basis equals:
 - Adj basis of transferred property
 - PLUS Boot paid, exchange expenses paid
 - PLUS Gain recognized on exchange
 - MINUS Boot received
 - MINUS Loss realized on exchange

77

77

Tammy's New Property Basis



- Back to Tammy! Her new property basis equals:
 - Adj basis of transferred property = \$100,000
 - PLUS Boot and exchange expenses paid = \$35,000
 - PLUS Gain recognized on exchange = \$10,000
 - MINUS Boot received = (\$10,000 + \$35,000 = \$45,000)
 - MINUS Loss realized on exchange = \$0
- $\$100,000 + \$35,000 + \$10,000 - \$45,000 = \$100,000$
- Because the liabilities netted out and she recognized the boot as gain, the basis in the new property is the same as the basis in the old property.



78

78

Giving Boot Example



- Janice transfers rental property and stock in exchange for another rental property.
- The property has adjusted basis of \$25K and FMV of \$26K.
- The stock has adjusted basis of \$6K and FMV of \$4K.
- In exchange, Janice receives rental property with FMV of \$30K.
- **Because she gave boot of \$4K, Janice is deemed to have received \$4K worth of real estate.**
- Janice has a LOSS of \$2K (\$6K - \$4K) on the transfer of the stock.
- What's her basis in the new property?

79

79

Giving Boot Example (cont.)



- New property basis equals:

• Basis of transferred property	\$25K + \$6K
• PLUS Additional costs incurred	\$0
• PLUS Gain recognized on exchange	\$0
• MINUS Money received	\$0
• MINUS Loss realized on exchange	<u>- \$2K</u>
• Equals new basis!	\$29K



80

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New Property Basis



- When a loss is realized on like-kind property and property **other** than like-kind property is received in the exchange, no loss is recognized. The boot received reduces the basis of the like-kind property received.



I'm
important
no matter
what!

81

81

New Property Basis Example



- Lisa relinquished land with a basis of \$45K for land with a FMV of \$30K plus \$10K in cash.
- She's actually worse off by \$5K, right? She gave up \$45K and only got \$40K.
- This loss is realized but not recognized.
- Instead, her basis in the new land is reduced! $\$45K - \$10K = \$35K$.



82

82

Depreciation



83

83

Split Basis



- Reg. §1.168(i)-6 explain how to depreciate MACRS property acquired in a like-kind exchange.
- The regulations adopt a modified form of the split basis concept detailed in Notice 2000-4.
- When applied, split basis treats the remaining basis from the relinquished asset as one component of basis of the acquired asset, and it treats any additional basis as a newly acquired asset.
- So there may be two assets (split basis) where before the exchange there was only one asset.
- The components are tracked and depreciated separately.

84

84

Two Components of Split Basis



- “Exchange basis” is the depreciable basis in the replacement property determined after calculating year-of-disposition depreciation....usually equal to the basis of the relinquished property after year-of-disposition depreciation.
- “Excess basis” is any **additional** depreciable basis, typically the amount of additional consideration paid.
- Note that only this excess portion is eligible for §179 and bonus depreciation, assuming it is qualifying property.

85

85

Depreciating Excess Basis



- Any excess basis in the replacement property is treated as property that is placed in service in the year of replacement.
- The depreciation allowance for the depreciable excess basis is determined by using the applicable recovery period, depreciation method and convention prescribed under the MACRS rules for the replacement property at the time of replacement. [Reg. §1.168(i)-6(d)(1)]

86

86

Multiple Properties



- If one asset is exchanged for multiple assets, the carryover basis has to be allocated between the new assets by purchase price.
- \$700K of new property received, one for \$300K and one for \$400K, we would split the carryover basis between the two new properties.
- If carryover basis was \$100,000, we'd allocate 3/7 to the \$300K property and 4/7 to the \$400K property.

87

87

Recovery Period



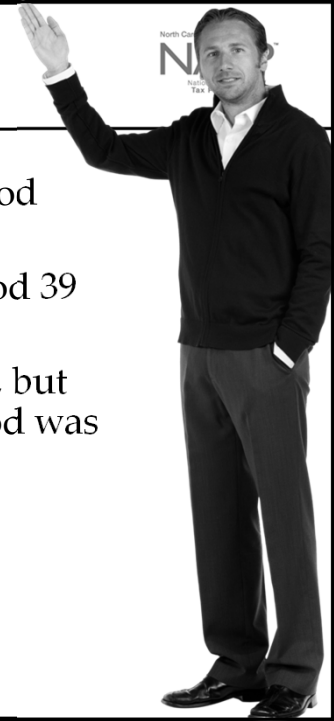
- Recovery period for replacement property same as for relinquished property?
 - Use the same recovery period.
- Recovery period for replacement property longer from relinquished property?
 - Use **longer** recovery period.
- Recovery period for replacement property shorter from relinquished property?
 - Use relinquished property recovery aka the **longer** recovery period.

88

88

Recovery Period/Method Example #1

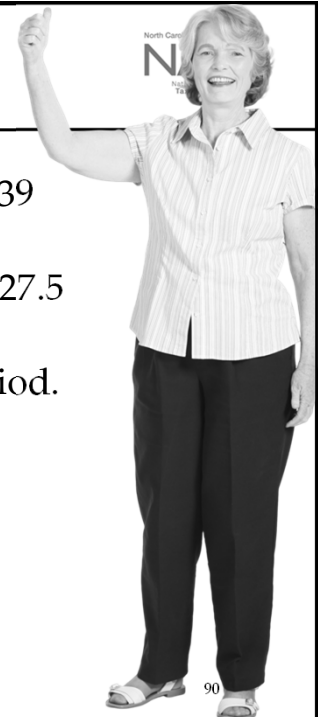
- Mark has a residential rental property, recovery period 27.5 years.
- He §1031's it for commercial property, recovery period 39 years.
- Mark can depreciate the new property over 39 years, but the start date is the date that the original rental period was placed in service.



89

Recovery Period/Method Example #2

- Michelle has a commercial property, recovery period 39 years.
- She §1031's it for a residential rental, recovery period 27.5 years.
- Michelle will continue using the 39-year recovery period.



90

Recovery Period Comparison



- \$100,000 carryover basis from commercial real estate given up
 - Has been depreciated for 30 years, so 9 years left
- \$60,000 excess basis from new commercial real estate
 - Has not been depreciated at all, so we start depreciating that \$60,000 over 39 years

91

91

Recovery Period Comparison



- Using split basis method:
 - \$100,000 carryover basis with 9 years left = \$11,111 annual depreciation
 - \$60,000 excess basis with 39-year life = \$1,538 annual depreciation
 - Combined annual depreciation is \$12,649 for the first 9 years, then \$1,538 thereafter
- Not using split basis method:
 - \$160,000 combined basis with 39-year life = \$4,103 annual depreciation for 39 years

92

92

Electing Out of Split Basis



- Taxpayers can elect to treat the adjusted basis of the exchanged property as if disposed of at the time of the exchange and treat both the exchange basis and the excess basis for the acquired property as if placed in service the **later** of the date acquired or the date of the disposition of the exchanged property.
- Cost segregation study may then be done on the entire basis; otherwise only excess basis is available for the cost seg.
- If this election is made, §179 is not available for the new asset.

93

93

Electing Out of Split Basis



- The election to opt out is made by the due date (including extensions) of the return for the year of replacement.
- To make the election, figure the depreciation deduction for the new property in Form 4562, Part III. For listed property, use Part V.
- Attach a statement indicating “Election made under §1.168(i)-6(i)” for each property involved in the exchange or involuntary conversion.
- The election must be made separately by each party acquiring replacement property (for example, by the partnership, by the S corporation or by the common parent of a consolidated group).
- Once made, the election cannot be revoked without IRS consent.

94

94

Mixed-Use Property



95

95

Mixed-Use Property



- Business portion of a mixed-use property may qualify for §1031
 - Exchange of a personal residence containing a home office
- Exchange of a duplex where one side was a personal residence and the other side was a rental typically is split into two sales – personal residence sale and a sale of a rental...but the rental piece can qualify for §1031 and the personal residence can qualify for §121!



96

96

Mixed-Use Property



- The following procedures apply:
 - §121 exclusion is applied prior to §1031
 - §121 does not apply to gain attributable to depreciation after 5/6/97
 - §1031 can apply to gain attributable to depreciation after 5/6/97
 - Boot is only taken into account to the extent that it exceeds gain excluded under §121
 - Gain excluded under §121 is treated as recognized gain, so basis of replacement property is increased by that excluded gain.

97

97

Form 8824



98

98

3 Parts

- Part I – Information on the Like-Kind Exchange
 - Property descriptions, dates for acquisition, transfer, ID and receipt
- Part II – Related Party Exchange Information
 - Completed only if the exchange involves a related party
- **Part III – Realized Gain or (Loss), Recognized Gain, Basis of Like-Kind Property**
 - **This is the meat of the form, where the details are reported; gains, losses and basis are determined.**



99

Example #1 The Harrisons

North Carolina Chapter
NATP
 National Association of
 Tax Professionals

- Joe and Jane Harrison own an apartment complex in Idaho
- They want to sell the Idaho apartment and buy a working ranch in Arizona.
- Is this like-kind?
- Both held for business/investment, so yes!

100

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Example #1 The Harrisons



- Apartment complex was purchased in 1990
- Original basis was \$300,000 (10% allocated to land)
- \$270,000 building now completely depreciated
- New roof cost \$73,741
 - \$23,741 taken in depreciation, adj basis of roof is \$50,000
- Adjusted basis: \$30,000 (land) + \$50,000 (roof) = \$80,000
- Current value is \$1.5M and they don't want to pay tax on sale!!
- You recommend §1031 exchange for the ranch

101

101

Example #1 The Harrisons



- Apartment complex is put up for sale
- Buyer for apartment found before ranch found
- Engaged services of QI
- Closed on apartment 12/1/2022 for \$1.5M
- The money is held by the QI!
- Four Arizona ranches are identified in writing within the 45 days

102

102

Example #1 The Harrisons



- Ranch #1 falls through
- Ranch #2 no longer available
- Offer is made on Ranch #3
 - \$1.7M, closing date May 22, 2023 + \$200K paid at close
 - 173 days from apartment close, pretty tight but we made it!

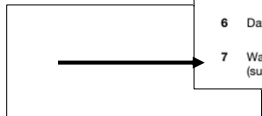


103

Harrison's Form 8824, Part I



Internal Revenue Service		Go to www.irs.gov/Form8824 for instructions and the latest information.		Sequence No. 109	
Name(s) shown on tax return Joe and Jane Harrison			Identifying number		
Part I Information on the Like-Kind Exchange					
<small>Note: Generally, only real property should be described on lines 1 and 2. However, you may describe personal property transferred prior to January 1, 2018, as part of an exchange subject to the like-kind exchange transition rule described in the instructions, and/or real property on lines 1 and 2, if you are filing this form to report the disposition of property exchanged in a previously reported related party like-kind exchange. If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.</small>					
1	Description of like-kind property given up:	Apartment complex 123 Cold Ave Helena, MT			
2	Description of like-kind property received:	Mesquite Ranch, AZ			
3	Date like-kind property given up was originally acquired (month, day, year)	3	2/1/1990		
4	Date you actually transferred your property to the other party (month, day, year)	4	12/1/2022		
5	Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written identification requirement	5	1/10/2023		
6	Date you actually received the like-kind property from other party (month, day, year). See instructions	6	5/22/2023		
7	Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III			<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	



104

104

Harrison's Form 8824, Part II



Part II Related Party Exchange Information

8 Name of related party Relationship to you Related party's identifying number
Address (no. street, and apt., room, or suite no.; city or town; state; and ZIP code)

9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of any part of the like-kind property received from you (or an intermediary) in the exchange? Yes No

10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? Yes No

If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is not the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24 unless one of the exceptions on line 11 applies.

11 If one of the exceptions below applies to the disposition, check the applicable box.

a The disposition was after the death of either of the related parties.

b The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.

c You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes. If this box is checked, attach an explanation. See instructions.

105

105

Harrison's Form 8824, Part III



Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: If you transferred and received (a) more than one group of like-kind properties, or (b) cash or other (not like-kind) property, see **Reporting of multi-asset exchanges** in the instructions.

Note: Complete lines 12 through 14 **only** if you gave up property that was not like-kind. Otherwise, go to line 15.

12 Fair market value (FMV) of other property given up. See instructions	12	
13 Adjusted basis of other property given up	13	
14 Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale	14	
Caution: If the property given up was used previously or partly as a home, see Property used as home in the instructions.		
15 Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions	15	\$0
16 FMV of like-kind property you received	16	\$1,700,000
17 Add lines 15 and 16	17	\$1,700,000
18 Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15. See instructions	18	\$280,000
19 Realized gain or (loss). Subtract line 18 from line 17	19	\$1,420,000
20 Enter the smaller of line 15 or line 19, but not less than zero	20	\$0
21 Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions	21	\$0
22 Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions	22	\$0
23 Recognized gain. Add lines 21 and 22	23	\$0
24 Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions	24	\$1,420,000
25 Basis of like-kind property received. Subtract line 15 from the sum of lines 18 and 23. See instructions	25	\$280,000

\$80,000 + \$200,000

106

106

Larry's §1031

- Larry bought a principal residence for \$210,000.
- He used it as his home from Year 1 to Year 4.
- From Year 4 to Year 6, he rented it out and claimed depreciation of \$20,000.
- In Year 6, the FMV of the house was \$470K.
- In Year 6, Larry exchanged the house for another rental with FMV of \$460K. He also received \$10K cash.
- What's Larry's tax situation?



107

Larry's §1031

- Larry received \$460K worth of house + \$10K cash = \$470K.
- His adjusted basis in the relinquished property was \$210K - \$20K = \$190K.
- His realized gain is thus \$470K - \$190K = \$280K.
- Gain excluded under §121 is \$250K; gain deferred under §131 is \$30K; includes depreciation to be recaptured.
- Basis in the new property is \$190K (adj basis of old property) + \$250K deferred gain - \$10K boot received = \$430K.



108

Larry's Form 8824



Boot is excluded by §121!!

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received		
Caution: If you transferred and received (a) more than one group of like-kind properties, or (b) cash or other (not like-kind) property, see Reporting of multi-asset exchanges in the instructions.		
Note: Complete lines 12 through 14 only if you gave up property that was not like-kind. Otherwise, go to line 15.		
12 Fair market value (FMV) of other property given up. See instructions	12	
13 Adjusted basis of other property given up	13	
14 Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale	14	\$0
Caution: If the property given up was used previously or partly as a home, see Property used as home in the instructions.		
15 Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions	15	\$10,000
16 FMV of like-kind property you received	16	\$460,000
17 Add lines 15 and 16	17	\$470,000
18 Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15. See instructions	18	\$190,000
19 Realized gain or (loss). Subtract line 18 from line 17	19	\$30,000
20 Enter the smaller of line 15 or line 19, but not less than zero	20	\$0
21 Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions	21	\$0
22 Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions	22	\$0
23 Recognized gain. Add lines 21 and 22	23	\$0
24 Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions	24	\$30,000
25 Basis of like-kind property received. Subtract line 15 from the sum of lines 18 and 23. See instructions	25	\$430,000

121-exclusion \$250,000

Questions?

