



# "Like Kind" Property

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## INTRODUCTION

The most common exchanges of like-kind property involve real estate for other real estate. Tax deferral resulting from an exchange allows deferment of tax on the disposition of property being relinquished. Gain is not eliminated, but is reflected in the adjusted basis of the replacement property. Although the gain is not eliminated (except with the death of the taxpayer), the benefits of exchanging are numerous. It should be remembered there is no substitute for good tax planning to determine whether or not an exchange can benefit a specific transaction. A portion of I.R.C. §1031 reads the qualifying property must be "exchanged solely for property of a like-kind." The term "like-kind" is one of the most widely confused concepts by investors.

## DEFINITION OF LIKE KIND

Many investors who erroneously think it means similar in use (i.e., tri-plex for tri-plex, ranch for ranch, hotel for hotel). Actually, "like-kind" constitutes almost any real property with the exceptions of personal residences, personally used vacation or 2<sup>nd</sup> homes (there are special rules for these) and dealer properties (inventory). Property which qualifies as being like-kind for non-recognition of gain treatment is defined under I.R.C. §1031 as either (1) held for productive use in a trade or business or (2) held for investment. Both the property transferred and the property received must be held for productive use in a trade or business or for investment, though the use of the replacement property can be different from the use of the relinquished property. For example, an investor can exchange out of bare land held for investment and into property held for business purposes such as a hotel. As you can see, property that qualifies under §1031 is very broadly defined. There is tremendous flexibility for the astute investor.

## DEFINITION OF HELD FOR PRODUCTIVE USE

This requirement is not specifically defined in either the tax code or the regulations. Over the years, the courts have established certain guidelines for property which qualifies as property being held for productive use in a trade or business. The ownership of real property and its rental for income are considered property held for productive use in a trade or business. Income producing agricultural property such as an orchard, farm or timberland would also qualify under this definition.

## DEFINITION OF HELD FOR INVESTMENT PURPOSES

Property held for investment is defined in the regulations as unproductive real estate held by one, other than a dealer, for future use or future realization of the increment in value and not primarily for sale (Regs. Section 1.1031(a)-1(b)). The Regulations further state whether the real property is improved or unimproved is not material and is relevant only to its kind or class. In other words, non-income producing real property such as raw land can be considered property held for investment purposes and could be exchanged for income producing, improved property. This requirement is not specifically defined in either the tax code or the regulations. Over the years, the courts have established certain guidelines for property which qualifies as property being held for productive use in a trade or business. The ownership of real property and its rental for income are considered property held for productive use in a trade or business. Income producing agricultural property such as an orchard, farm or timberland would also qualify under this definition.

## LEASEHOLD INTERESTS

The regulations have established that a leasehold interest of 30 years or more is considered sufficient to qualify as real property. Therefore, a lease hold of 30 years or longer can be exchanged for an ownership interest in real property. What about a 30-year lease which has 15 years remaining? The leasehold interest will not qualify because a remaining term of 15 years is not considered long enough to qualify as real property under either case law or the regulations. If, on the other hand, the leasehold interest contains an option for an extension of the term, which is extremely favorable, or the option has been properly exercised to a term of 30 years or more, tax court cases show it might still qualify as an interest in real property.

## **DEALER PROPERTY – THE HELD FOR RESALE TRAP**

Property held primarily for sale or resale and not for investment or productive use in a trade or business will not be considered qualifying property for non-recognition of capital gain treatment under I.R.C. §1031. Careful attention must be given to the facts and circumstances of each contemplated exchange. Intent is of primary importance. Dealers cannot benefit from the provisions of I.R.C. §1031 when selling property they have treated as inventory. What about a person who is not a dealer but may have acquired property for the sole purpose of its eventual re-sale? Or land exchanged for improved property needing repairs and subsequently sold within a short period of time suggesting the property was acquired primarily for re-sale? Persons planning an exchange after acquiring property for speculation or as a 'fixer-upper' may find themselves in the position of being given dealer status. The property would then be considered non-qualifying property since it is neither held for productive use in a trade or business nor for investment.

Holding the property for a longer time to establish a different intent is one way to help to avoid this determination. Typically an audit of the exchange transaction will take place approximately two to three years after the disposition of the relinquished property. This allows the Internal Revenue Service ample opportunity to review all of the surrounding factual data in making a determination as to the intent of the Exchangor.

## **CAN A DEALER EXCHANGE?**

The use of 1031 is for property held for investment, not property held primarily for resale. There are a number of indicators the service will look at to determine whether a property was held for investment or for inventory for resale. Ultimately the Exchangor's accountant or tax preparer will determine whether or not an investment qualifies for 1031 tax treatment.

*This material is provided for informational purposes only and is not to be construed as tax advice. The reader is strongly advised to speak with a tax consultant before attempting to employ any of the concepts stated herein.*

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