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**TO: Clients of the Stanley Law Firm**

**RE: Like Kind Exchanges**

The following is a brief summary of the rules applicable to a like kind exchange, also called a deferred exchange or a “1031 exchange”. This memorandum is meant to provide basic information on like kind exchanges, and is not intended to serve as a comprehensive discussion of all issues involved in a like kind exchange. **Each exchange is unique and presents specific challenges that must be addressed before tax deferral can be achieved. You should contact your tax advisor about the particular details of and issues related to your exchange.**

Like Kind Exchange Basics. The government allows taxpayers to defer gain from the sale of real property “held for trade or business or for investment” when the proceeds are reinvested pursuant to the like kind exchange rules in other real property the taxpayer intends to “hold for trade or business or for investment” purposes. The underlying premise behind a like-kind exchange is that you are exchanging properties of similar nature, or of “like kind,” rather than liquidating your investment. Thus, you are allowed to defer the gain to some later point in time when you ultimately dispose of the property in a taxable transaction.

The term “like kind” has a very broad meaning in the context of real estate. Improved or unimproved real estate held for investment or business purposes normally will constitute like kind property to any other real estate, improved or unimproved, to be held for investment or business purposes. As a result, when selling real estate, you have flexibility when searching for replacement property. For example, you could sell a farm for a rental building or a rental condominium for an unimproved lot to be held for investment. Note that the replacement property must be used for investment or business purposes; you cannot use the like kind rules to defer gain if you are purchasing property that you intend to use as your personal residence or other purely personal use real estate. You may not be able to use a like kind exchange if the property being sold or purchased is a second home or vacation home; you should consult your tax advisor on this issue.

A much more difficult determination is whether property being sold has been “held for trade or business or for investment” purposes, or whether property being acquired is to be held for such purposes. The IRS looks at the taxpayer’s intent at the time of sale or purchase. Thus, if you purchase a condominium with the intent to hold it as a rental property but two months later decide to sell the property because of rapid appreciation in the value of the property, the exchange should qualify for tax deferral, but the IRS could challenge your intentions, as they perceive it. **Note: If you purchase replacement property with the speculative intent to “flip” the property soon after purchase to make money off rapid price appreciation, you are purchasing the property “primarily for sale”, not with the intent to “hold” it for investment, and your exchange will not qualify for tax deferral.**

Note: if you are exchanging property that is not just real estate, such as when you exchange the land, building, equipment and inventory used in a business, the definition of “like kind” becomes much more complex and you should work closely with your tax advisor on the details of the exchange.

The simplest form of exchange is a simultaneous transfer of like-kind properties between two parties; however, it is highly uncommon to find two parties willing and able to swap properties. The more common form of exchange is the multi-party “deferred exchange”. There are several types of deferred exchanges, but all involve a variation of using a third party who is responsible for receiving the sales proceeds from your property and reinvesting the proceeds in replacement property you select. If this structure is utilized and you satisfy the other like kind requirements, the Internal Revenue Service will recognize the transaction as a tax-deferred exchange of like kind property instead of a sale of the property.

Completing an Exchange. There are several steps to accomplishing an exchange using an escrow agent. First, you must enter into an exchange agreement with an unrelated third party (the “agent”). We have several agents we can recommend, but would be glad to work with another agent if you have one in mind. After closing on the property you are selling (the “relinquished property”), the agent holds the proceeds pending your purchase of other property (the “replacement property”). The proceeds will be invested in a bank account or other short-term investment vehicle pending reinvestment, with any interest earned being payable to you or on your behalf at the end of the exchange period. You have 180 days to complete the purchase of “like kind” replacement property from the date of closing on the relinquished property.

There are two steps in acquiring replacement property. First, you must identify potential replacement property within 45 days from the date of closing for the relinquished property (note: if you find and purchase replacement property within this 45-day period, there is no need to identify property).

The identification must be delivered to the agent within the 45-day period. The government allows you to identify either: (1) up to three potential replacement properties of any value, or (2) any number of properties not exceeding in the aggregate 200% of the fair market value of the property you sold.

Second, you must close on one or more identified properties within 180 days from the closing date of the relinquished property. You will enter into a contract for sale for the replacement property. The agent then will transfer funds to the closing attorney and direct the seller of the replacement property to deliver title to the property to you. Any shortfall between the purchase price and escrow funds must be paid by you. On the other hand, excess funds remaining in the escrow account will be paid to you after the exchange period is over.

Partial Reinvestment of Proceeds. If you do not completely reinvest the proceeds of your sale in one or more replacement properties through the like kind exchange, you will recognize gain to the extent of the proceeds not reinvested (but not to exceed the gain realized), and you will be taxed on the gain recognized. Therefore, you should plan carefully if you decide to reinvest less than all of your proceeds. We recommend you reinvest all of your proceeds unless you have consulted with your accountant or other tax advisor about the partial recognition of gain.

Special Requirement for Nonresident Sellers. Generally speaking, when a seller who is not a South Carolina resident sells real estate located in South Carolina, the settlement agent at closing must withhold 7% of the reported gain and remit the withholding to the South Carolina Department Revenue.

That said, state income tax on the gain from the sale can be deferred by a like kind exchange if certain rules are followed. If you are a nonresident seller, you should discuss the special requirements with our office or your tax advisor to ensure your sale is not subject to South Carolina income tax.

Debt. If you are selling property subject to a mortgage, there are special rules that require you to replace the debt with a loan on the replacement property being purchased. Failure to place a loan on the replacement property will trigger the recognition of gain on your transaction, just as if you did not fully reinvest the proceeds from the sale. You should consult with your tax advisor if you are selling property that secures debt.

Construction Exchanges. Occasionally, clients wish to use their proceeds to build improvements on property they already own or intend to buy. The like kind rules prohibit the use of proceeds to build improvements on property you already own. On the other hand, the use of proceeds to build on property you intend to purchase is allowed, though the rules are quite complex. If you think you will enter into a “construction exchange”, you must notify your tax advisor so the structure of the exchange can be planned carefully and the proper type of agent selected to assist with accomplishing the exchange.

Related Parties. If replacement property is purchased from a related person or entity, special rules determine whether the transaction qualifies as a like kind exchange. In addition, in the normal like kind exchange, there is no minimum holding period; however, when a related party is involved, you must hold the property for two (2) years or lose the tax deferral and recognize income and pay tax from the sale of the relinquished property. If you think you might be involved in a related party transaction, you need to talk with your tax advisor.

Tax Reporting. In addition to observing the like kind exchange formalities, clients must also report the like kind exchange to the IRS and South Carolina Department of Revenue. The exchange is reported as an attachment to the client’s income tax return, on Form 8824, “Like Kind Exchanges”. The exchange must be completed by the time the income tax return is filed; if the exchange is not completed by the deadline for the tax return, the return must be extended until the exchange is completed.

This memorandum seeks to give you basic information on the like kind exchange process. It is not an exhaustive review; you should contact your tax advisor with any questions.

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