Trading Spaces
Common Mistakes in a Like-Kind Exchange

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Real estate professionals are likely familiar with the basic rules of like-kind exchanges, in which sellers of real property may defer the gain on the sale of real estate if they reinvest the sale proceeds in other like-kind real property (a similar property that can be exchanged without incurring any tax liability). The idea that a seller can defer potential gain from the sale of real estate by reinvesting into other real estate sounds like a great idea, at least at first. Later, when mistakes occur, what seemed like an easy real estate swap becomes a nightmare. A failed exchange places the seller in a double bind. The seller has reinvested all of the sale proceeds from a sale into other property, but he still owes tax on gains from the sale.

An exchange of property can be simultaneous, but the seller typically hires an intermediary (called a "qualified intermediary") who acts as a middleman to facilitate the real estate swap. The process usually goes like this. The seller sells a piece of property. The qualified intermediary receives and holds the sale proceeds while the seller locates a replacement, like-kind, real property. Once a replacement property is found, the seller instructs the qualified intermediary to purchase it. Essentially, the purpose of the qualified intermediary is to avoid the seller having receipt of the sale proceeds. If the seller receives the sales proceeds of the first property, she loses the benefits of a like-kind exchange.

Takeaway

The like-kind exchange is one of the most tax-favored transactions, but many technical requirements must be met for the exchange to work. Sellers are confronted with an array of risks that can lead to a failed exchange transaction, but they achieve the favorable tax benefits of a like-kind exchange if they have good advisors and follow the rules.

Under a like-kind exchange, the seller must identify replacement property within 45 days after the sale of the first property (known as the identification period) and acquire the replacement property within 180 days after the sale (known as the replacement period), or sooner if the tax return is due.

The following are mistakes commonly seen in botched like-kind exchanges.

Mistake No. 1: Waiting Too Late

Benefiting from a like-kind exchange takes advance planning. Real estate attorneys and title officers can talk for days about sellers who miss the opportunity to make a like-kind exchange by not realizing the opportunities until they arrive for closing.

When a seller walks into closing and realizes only then that she could have protected the gain on the sale by purchasing like-kind property, it is too late.

Mistake No. 2: Failing to Identify Replacement Property Correctly and Timely

The seller has 45 days to identify replacement property—a short amount of time to identify, negotiate, underwrite, finance, and complete due diligence for the purpose of property.

Sellers commonly lose track of time and do not have a clear idea when the 45-day period ends. It begins on the date the seller sells his property and ends at midnight on the 45th day after that property is sold. The seller could fail to realize that the 45th day could end on a holiday or weekend. If he wishes to benefit from a like-kind exchange, he should mark specific deadlines on a calendar.

Another common mistake is for a seller to identify only one replacement property, but then revoke the identification near the end of the 45-day period and miss the deadline. If there's a possibility the seller might revoke an identification, he should leave ample time to select another potential replacement property before the deadline.

The seller is subject to two critical rules on identifying multiple replacement properties:

- the three-property rule, and
- the 200 percent rule (for more than three properties).

Under the three-property rule, the seller can identify up to three properties as potential replacement properties without any concern over the values of the properties. Under the 200 percent rule, the seller may name more than three potential replacement properties, but the combined value of those properties cannot exceed 200 percent of the value of the sold property.

The seller should plan for the likelihood that he will change his mind about a designated property and run over the 45-day limit by naming multiple potential replacement properties.

Mistake No. 3: Failing to Compute the Exchange Period Correctly

As previously discussed, the seller has 45 days to identify replacement property and 180 days to close on the purchase of the property. The exchange period begins on the date the seller transfers the relinquished property and ends at midnight on the 180th day. Usually that is ample time to close, but several problems can occur.

For instance, the 180th day could land on a holiday or weekend when title companies are closed, thus preventing the closing from happening. Another potential problem is the 180-day period can end early if the tax return for the year is due. The cut-off period for the tax return filing would mean an exchange that started late in the tax year could pose a risk if the seller files her tax return on March 15 or April 15.

Mistake No. 4: Selecting a Less-Than-Qualified Qualified Intermediary

Participation in a like-kind exchange is not a time for working with amateurs, so sellers should use only a reputable and experienced qualified intermediary. Unfortunately, the marketplace for qualified intermediaries is unregulated, so it would be easy for the seller to select an inferior one.

The qualified intermediary holds large sums of money, and there are highly publicized stories of less-than-scrupulous qualified intermediaries mismanaging or even losing exchange funds. A seller whose exchange funds become unavailable faces not only losing the funds for the replacement purchase, but also a potential breach of contract lawsuit for failing to complete the exchange.

The qualified intermediary requirements are formal and precise, and a qualified intermediary can take actions or cut corners that expose the seller to the risk of a botched like-kind exchange. Some have been known to play games with the identification rules by switching pages in the documentation to enable the seller to identify replacement property after the 45-day period expires. Sellers could face the risk of tax fraud if they play along with these scams. There are strict rules preventing a qualified intermediary from distributing or making proceeds available to the seller before the end of the 45-day period.

Most reputable title companies or banks maintain a qualified intermediary business staffed with competent personnel. In addition, there are many capable private qualified intermediaries unaffiliated with a title company or bank. Some real estate attorneys also serve as qualified intermediaries.

Mistake No. 5: Relying on Amateur Intermediaries' Tax Advice

Receiving flawed tax advice from amateur intermediaries or financial institutions is another common mistake. Taxpayers involved in a like-kind exchange are often tempted to follow advice from staff of the intermediary or from other financial institutions, perhaps from someone who is neither an accountant nor an attorney but who nevertheless gives tax advice.

The tax requirements of a like-kind exchange are technical and require careful consideration. For example, a seller identifying a replacement property meets Treasury regulations only if the document identifying the replacement property is a "written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either . . ." Is an email sufficient for this designation requirement? How is the email signed? Should DocuSign be employed to attach signatures to a document? Is the seller better off designating property with a signed document, converting it to a PDF file, then emailing the PDF? If there is a defect in the signature, such as a misspelling, is the document still acceptable? If there is no signature on the email other than the conventional email signature block, will the IRS or the courts respect it?

Again, these issues illustrate the technical nature of the exchange requirements, and taxpayers should rely on experienced and knowledgeable advisers, not amateur intermediaries or financial institutions, for guidance.

Mistake No. 6: Selling or Exchanging Property Not Held for Investment or Used in Trade or Business

One of the core rules of a like-kind exchange is that the property sold and the replacement property must both be investment properties or trade or business properties. Sellers make mistakes when they lose sight of these fundamental rules.

For example, personal-use property such as a residence will likely fail as transferred or replacement property. Sellers often try to convert residential or vacation property into investment property or trade or business property by offering it as a rental prior to an exchange. The IRS provides a safe harbor for exchanging or acquiring a second home or residential property in an exchange. One rule requires 24-month ownership before or after the exchange, minimizing personal use to 14 days or 10 percent of the number of days the property is rented at fair market value during the year.

Sellers wanting to include personal-use property in an exchange should proceed with caution.

Mistake No. 7: Trying to Exchange Property Held in a Partnership or LLC

Another common mistake occurs when sellers try to exchange property held by a partnership or LLC. The seller might be in a partnership or LLC with others, some of whom want to undertake a like-kind exchange, while others do not. A like-kind exchange concerns the exchange of real property, not partnership or LLC interests. If the seller wishes to exchange property held in a partnership or LLC, she should arrange for transfer of the property from the partnership or LLC and undertake the exchange acting as an individual owner.

Mistake No. 8: Acquiring Property from a Related Party

Sellers often attempt a like-kind exchange with a related party. Generally, this is ill-advised without attention to the detailed holding period rules. The IRS is concerned about financial chicanery or parties playing games by dealing with related persons.

The like-kind exchange rules permit an exchange with a related party, but they impose a time requirement of 24 months. This means both the seller and the related party must hold title to the property acquired in the exchange for a minimum of 24 months. If either party disposes of the acquired property prematurely, both parties lose the favorable tax treatment of an exchange.

If a related party dies, the parties are relieved of the 24-month rule. The parties are not subject to the restriction if either experiences an involuntary conversion, such as a destruction of property by a severe storm.

The definition of who is related is not straightforward. For individuals, related parties include a spouse, brothers, sisters, ancestors, and lineal descendants. If one owns more than a 50 percent interest in a corporation or partnership, then the corporation or partnership is the related party. There are many facets to identifying who is a related party, and sellers should proceed carefully.

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