

## WHAT IS LIKE-KIND PROPERTY?

*Myth Busted: "Like-kind" means ANY real property can be Exchanged for ANY real property. Don't get caught with the assumption that land can't be exchanged for an apartment building.*

The term Like-Kind appears in the Internal Revenue Code (IRC) in connection with Section 1031 Tax Deferred Exchanges and also in connection with Section 1033, Involuntary Conversions. Its largest application is in Tax Deferred Exchanges. When applied to a Tax Deferred Exchange, the term "Like-Kind" is a term of art that simultaneously means four things:

### Location, Type, Use, and Value

#### Location of Property:

For a property to be Like-Kind to another property, both must be *located* in the United States (the 50 states, or Washington, DC), or both must be *located* outside the United States. The US possessions are outside the United States.

For example, Colorado property is Like-Kind to New Mexico property, but not Like-Kind to Canadian property. British property is Like-Kind to French property, but not Like-Kind to New York property.

#### Type of Property:

### What Qualifies for an Exchange?

**Any real property that is held for investment purposes:**

- Land (even land that is part of your residence)
- Single-Family Dwellings
- Multi-family Dwellings
- Condos
- Co-ops
- Second Homes— Must Follow Rules!
- Strip Malls
- Office Buildings
- Apartment Buildings
- Commercial Buildings Of All Types



For a property to be Like-Kind to another property, both must be of the *same type*. Real Property is Like-Kind to all other Real Property, and the degree of improvement of each is immaterial. For example, vacant land is Like-Kind to a condominium.

The like-kind test is more stringent for Personal Property. For an article of Personal Property (i.e.: a backhoe) to be Like-Kind to another article of Personal Property, both must appear in the same 6-digit product code category of

the North American Industry Classification System (NAICS). The first digit must be a "3"; the second digit may be a "1, 2, or 3", and the last digit may not be a "9".

The NAICS Code for a backhoe is 333120 (Construction Machinery Manufacturing). Examples of other items in this category that are of Like-Kind to a backhoe are bulldozers, off-highway trucks and road graders. See [www.census.gov/naics](http://www.census.gov/naics).

The Personal Property rules are lengthy and complex, and a full treatment is beyond the scope of this QI Forum.

### Use of Property:

For a property to be Like-Kind to another, both properties must *be used by the taxpayer in a Trade or Business*, or for Investment. Trade or Business Property and Investment Property are but two of the four broad types of property addressed by the IRC, the other two are Personal (Use) Property and Dealer Property. Personal (Use) Property is property used by the taxpayer for personal purposes, for example, a residence or vacation home, or a personal automobile. Dealer Property is property that the taxpayer "deals in", meaning property that is held primarily for sale such as lots, spec houses, or motor vehicles. Personal (Use) Property and Dealer Property may not be exchanged, but Trade or Business Property and Investment Property can be exchanged. Both properties do not have to be the same use either: The given (Relinquished) property can be used by the Taxpayer for an Investment, for example vacant land, and the received (Replacement) property can be used by the Taxpayer in Trade or Business, for example, as a rental condominium.

### Value of Property:

The last element comprising the definition of Like-Kind is the *value* of the property. For one property to be of Like-Kind to another, the values of each must match. This doesn't require a one-for-one or property for property match; it's the value of what's being sold matched against what is being acquired.

Many properties can be exchanged for one property or vice-versa. The term "value" means the price that a willing, third party Buyer pays for the given (Relinquished) property, less transaction costs such as real estate commissions, legal and title fees, and transfer taxes. The term "value" also means the price that you are expected to pay for the received (Replacement) property, plus transaction costs such as buyer brokers, legal and title fees, and transfer taxes.

If the prices of the two properties don't match, to the extent there is a disparity, then property of an *Unlike Kind* will be subject to tax. This property is termed "Boot" or sometimes "Boot Property" and can be anything from cash to debt relief to personal property items added to make the transaction balance. Only the person receiving Boot pays taxes on it. *The goal in an exchange is to go even or up in value.*

### Summary:

Four elements must be simultaneously present for two properties to be of a Like-Kind with one another. They both must be in the US or both outside of the US, they both must be of the same type, both must have been used as the Taxpayer's investment or in trade or business, and both must be comparably valued. Section 1031 Tax Deferred Exchanges, when structured properly, avoid the receipt of un-like-kind property and exposure to taxable boot.