



1031 exchanges and like-kind real estate interests - by William Lopriore

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Internal Revenue Code Section 1031 allows for the deferral of capital gain tax if property held for productive use in a trade, business or for investment is exchanged for property of “like-kind.” For real estate, the definition of “like-kind” is quite broad, allowing exchanges between and among several different types of investment property, including land, commercial property, industrial buildings, retail stores and apartments. The sale of less than a fee interest may also qualify for tax-deferral under §1031 if certain criteria are met. For example, leasehold interests exceeding 30 years and certain oil and gas interests can be considered “like-kind” to other real estate.

Development rights can, in certain cases, be exchanged under §1031 for fee interests in real property. In Private Letter Ruling 200805012, the IRS reached this conclusion basing its decision on the fact that the development rights were “effectively perpetual in nature,” where state and local law did not specify an expiration period. The IRS also cited various factors allowing them to reach the assumption that development rights are, under applicable state and local law, interests in real property.

The IRS has issued several private letter rulings finding that certain types of conservation and agricultural easements are “like-kind” to real estate. A conservation easement is a voluntary agreement entered into by landowners conveying certain rights and generally limiting the type or amount of development on their property, while still retaining ownership of the land. Generally, for 1031 exchange purposes, a conservation easement needs to be perpetual in nature and considered an interest in real estate under state law in order to be considered “like-kind” to real estate. The land owner may receive cash or a charitable deduction in return for granting the easement. When cash is received, a 1031 exchange may be a good option to defer the capital gains taxes on those proceeds.

A 1031 exchange opens many investment opportunities. You are not limited to only exchanging fee interests for other fee interests. There are many other possibilities, including development rights, conservation easements, leasehold interests and water rights.

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