

Date: June 16, 1994

Subject: Like Kind Exchange with assumption of debt by both sides

Background

Your client proposes to transfer “old” property worth \$15 million with \$5 million in equity (\$10 million debt) for similar “new” property worth \$15 million with \$500,000 in equity (\$14.5 million in debt). To equalize the equities, the taxpayer will receive \$4.5 million in cash from the counter-party.

Executive Summary

As this transaction is structured, the \$4.5 million will be deemed “**boot**” received on the transaction. Gain, will thus be realized for this amount assuming that the taxpayer’s basis on the “old” property is \$10.5 million or less. The cash “boot” **cannot be reduced** by the difference between the liability received (\$14.5 million) over the liability which the counter-party assumed (\$10 million).

Alternatively, the taxpayer has two options to structure this deal to achieve the dual objectives of receiving cash without any negative tax implications. First, the taxpayer can re-mortgage the “old” property prior to the transfer for an additional \$4.5 million, thus negating the need for the cash boot. The same result would be achieved if the counter-party uses the \$4.5 cash to pay down the existing mortgage on the “new” property.

Under both of the above scenarios, it might be prudent to wait a reasonable time before & after the exchange in order to avoid the IRS invoking the “step transaction” doctrine.

Like Kind Exchanges in general

In order to effectuate a valid like kind exchange the taxpayer must:

- Transfer “property”.
- Held in a trade/business or investment property.
- In exchange for “like kind” property, held in the same manner as the property transferred.

These provisions are not applicable to property held for sale or to securities dealers. Like kind refers to the nature or character of the property, not the grade or quality. Real estate is **defined very broadly** under these rules and thus almost any real estate will pass muster.

Here, the taxpayer is transferring real estate which is “property” held for “investment” for similar property which will also be held for investment. Thus, the transaction should pass muster under these rules except that there are a number of provisions that could cause gain recognition. The most important concerning the issue of **boot received**.

Like kind miscellaneous provisions

1) Exchange with related party

If property is exchanged with a related party, there is no immediate gain recognition, but when the related party sells the property to a third party, this triggers immediate gain recognition.

2) **Step transaction doctrine**

The service may challenge an otherwise valid like kind transaction by arguing that the steps immediately proceeding and following the transaction should be collapsed. In our case, the service may argue that the re-financing was undertaken merely to avoid tax. There is conflicting authority on this issue.

3) **3 corner transaction**

The use of a third part to effectuate these deals is very common. The best example is when the taxpayer wants a non-taxable exchange but the party who has the desired property wants cash. The third party buys the desired party for cash and exchanges it for the taxpayers property. The taxpayer equalizes the transaction with a cash payment to the third party who uses the funds for the purchase.

4) **Future exchange**

Property can be transferred by property that the taxpayer can choose in the future as long as the property received is I.D.'d within 45 days and received within 180 days. The taxpayer can also receive some assurances from the counter-party that suitable property will be found without destroying the tax free exchange.

Boot Received

Gain is recognized on transactions to the *extent of* “boot” received. Boot is defined as cash or other non “like kind” property received on the transaction. Under the regulations, the excess of the liabilities relieved of over the liabilities assumed is also “boot”. The amount can, however, be reduced by the amount of cash/property “boot” transferred.

Cash boot can **never** be reduced by the excess of the liabilities assumed over the liabilities transferred. Thus, the taxpayer will be **taxed on the \$4.5 million boot** as the deal is currently structured.

