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Consider the Legal Structure When Selling Commercial Real Estate

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If you've ever sold a piece of commercial real estate, you know that the payment of capital-gains taxes may be a daunting issue. Some advance legal considerations and planning might help structure the deal so that payment of capital-gains taxes are deferred until the time when you eventually sell your final property.

BY ALOK VIDYARTHI

Owners of appreciated commercial real estate may be able to defer payment of capital gains taxes by using a like-kind (tax-deferred) exchange, rather than a sale. The concept behind a like-kind exchange is that property owners exchange similar commercial properties, as opposed to selling and buying them, and receive a capital-gains tax deferral, presumably because the Internal Revenue Service is trying to encourage like-kind exchanges as an investment vehicle.

There are some requirements to meet the conditions to qualify for the status as a valid like-kind exchange:

Property

Generally, all types of property, real and personal, qualify for a like-kind exchange and tax-deferred treatment. However, there are certain types of property that don't qualify, such as interests in partnerships.

Purpose

Property can be considered for a like-kind exchange if it's been owned and used in a trade or business or for investment. The same must be true for the property that's being acquired.

Like-Kind

The properties subject to a like-kind exchange must also be similar in nature and characteristics. For example, real property is like-kind to other real property, but real property is not like-kind to personal property.

Exchange

The relinquished property and the replacement property must be exchanged with each other, as opposed to the relinquished property being sold and the replacement property being purchased. To distinguish a like-kind exchange transaction from a sale and purchase transaction, certain "qualified" intermediaries must be used (e.g., a title company), primarily to hold transaction proceeds and possibly the title to property for the exchanger's benefit.

Forward and Reverse Exchanges

There are two different situations in which like-kind exchanges occur — forward and reverse. While forward exchanges have been in existence for years, reverse exchanges are relatively new and expand the opportunity for commercial property capital-gains taxes to be deferred.

A forward exchange is one in which certain qualifying property is sold and the cash proceeds are held by the qualified intermediary until such time as the cash proceeds are used to purchase a qualifying piece of replacement property. A reverse exchange is one in which qualifying replacement property is purchased and the title held by a qualified intermediary until such time as a similar property for sale is later relinquished.

Safe Harbors

There are certain compliance requirements called safe harbors. In like-kind property exchanges, these safe harbors may provide some protection from Internal Revenue Service challenges. These safe harbors apply to deferred exchanges for the most part.

In a forward exchange, the person making the exchange of property must identify the replacement property within 45 days of the closing on the relinquished property, and then must close on the replacement property within 180 days after the the closing on the property that's being given up. In a reverse exchange, the person exchanging properties must identify the relinquished property within 45 days of the closing on the replacement property and then must close on that property within 180 days.

If the compliance requirements of the safe harbors are not satisfied, that doesn't necessarily mean that the IRS will challenge the transaction, but the level of risk to the person making the exchange is heightened.

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