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Property Exchange Rules Offer Tax Opportunities for Hotel Owners

Abstract
One strategy often overlooked by hospitality owners in developing cost-saving strategies is the use of like-kind exchanges to acquire property. The author reviews some alternative methods of like-kind exchanges, which may not only provide new business opportunities for the hospitality owner, but lucrative tax benefits as well.

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Property Exchange Rules Offer Tax Opportunities for Hotel Owners

by
John M. Tarras

One strategy often overlooked by hospitality owners in developing cost-saving strategies is the use of like-kind exchanges to acquire property. The author reviews some alternative methods of like-kind exchanges, which may not only provide new business opportunities for the hospitality owner, but lucrative tax benefits as well.

Today's aggressively competitive business environment has forced many changes within the hospitality industry and the constant restructuring of hotel properties. In many cases, financing new hotel properties has also become increasingly difficult. Thus, it's more important than ever that hospitality business owners be creative wherever possible in developing cost-saving strategies to achieve their goals.

An exchange of hotels, or an exchange of business property for a desired hotel property, is one creative means of acquiring a new property. This method can offer unique planning opportunities for the hospitality or business owner who wishes to relocate to another market. It can also provide significant tax savings for a new owner, since appreciated property can be exchanged without incurring any tax on the appreciated gain. The deferral of the gain is what makes these like-kind exchanges such a valuable tool for hotel owners.

For example, a hotel owner in New York may wish to retire to Florida, but remain active in the business. The individual might be able to find a property suitable to his needs in Florida, which has an ambitious young owner anxious to relocate to a potentially faster-growing market in New York. The two get together, simply exchange properties, and completely avoid tax liability on the appreciated gains of the two hotels.

Other valid reasons for engaging in a like-kind exchange might be to reposition one's property into a different market, obtain property that will allow for expansion, allow investors into the hotel business

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with the exchange of different property, or to allow a hotel owner to leave the hospitality business and obtain other business property without paying any capital gain tax.

Exchanges Used in Estate Planning

Business owners may also have non-business reasons for exchanging property under IRS like-kind exchange rules. It's commonly used in estate planning to defer taxes on appreciated property. For example, an owner would be required to pay substantial capital gains tax in an out-and-out sale of property that had significantly appreciated in value over the years. However, if the owner exchanges the property for property at another desirable location, all capital gain taxes are deferred until the property is eventually sold. In some cases, in fact, the gain on the property may never be taxed if the owner dies before it is sold and the property is passed on to the heirs.

IRS stepped-up basis rules allow heirs to inherit property at the fair market value of the property at the time of the owner's death. This applies even if the deceased owner had very little basis left in the property. Thus, if the heirs sell the property at fair market value shortly after the owner's death, there is no gain to report. In this case, the basis equals the value of the property. This is known as receiving property that has been "stepped-up" to its fair market value at the time of death. Of course, estate taxation is a difficult, complex area of the law. A business owner getting on in years would be wise to talk to his tax advisor as to whether the use of like-kind exchange as an estate planning tool would be advantageous or not in his or her specific circumstance.

There are several important reasons why the hotel industry is ideal for using business options such as like-kind exchanges. For one, the hotel industry is considered a specialized component of real estate and is treated very favorably under like-kind rules. Secondly, the hotel industry is subject to market saturation. Therefore, there are a great many excellent hospitality properties operating in the market, providing a multitude of possibilities for an owner wishing to exchange properties to enter a desired market or better fit his or her strategic goals.

Like-kind Exchange Is Reciprocal

A like-kind exchange is a reciprocal transfer of property, as distinguished from a transfer of property for money only.[1] But an exchange can occur even where cash (boot) is part of the consideration, if the transaction otherwise qualifies as a like-kind exchange.[2] Like-kind property must be both given up and received in the exchange in order to satisfy the exchange requirements.

There are several requirements that must be met for a taxpayer to take advantage of a like-kind exchange. The exchanged property must be

- held for the productive use in a trade or business, or for investment[3]
- exchanged solely for property of a like-kind, which is to be held for either productive use in a trade or business, or for investment[4]

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If a taxpayer has a qualified like-kind exchange transaction in any given year, he or she is required to file the transaction on IRS Form 8824, along with his or her regular tax return.

Property Must Be of the Same Class

Whenever making business decisions in accordance with the Internal Revenue Code, it is imperative to look closely at the language to determine the exact meaning of the statutes. For instance, like-kind means nature or character of the property.[5] It does not refer to its grade or quality. Thus, one class of property cannot be exchanged for another class.[6]

This means that real estate cannot be exchanged for personal property.[7] However, when real property is exchanged for real property, it does not matter whether the property is similar, or even if one of the properties is unimproved. Thus, the exchange of vacant land for a hotel would qualify under the like-kind exchange rules. The existence or lack of improvements merely affects its grade or quality, not its class.

The following examples of exchanges have been held to have qualified as like-kind transactions:

- rental housing for farm property[8]
- commercial building for a condominium interest in a newly constructed commercial building[9]
- real property subject to a lease for real property not subject to a lease; the existence of the lease affects the grade and quality of the property, rather than its nature and character[10]

Consequently, a hotel could be exchanged for a different type of business real estate and be within the like-kind exchange guidelines. For example, a hotel owner could exchange his property for a bowling establishment. The transaction would still qualify under the like-kind exchange rules, because both the properties are classified as real estate.

Certain Properties Do Not Qualify

There are certain properties that do not qualify for tax free exchange. They include such things as inventory stocks, bonds, and partnership interests,[11] since it must be property similar in nature or character to the transferred property, notwithstanding differences in grade or quality as shown in the above examples.

However, there are cases as well when real estate exchanges are not considered as like-kind exchanges. Listed below are some circumstances when a real estate transaction will fail to qualify under the like-kind exchange rules:

- Foreign property is never considered like-kind property under the like-kind exchange rules.[12]
- Sale of an apartment building in which the taxpayer used the

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proceeds from the sale and other property to acquire a like-kind property does not qualify; the fact that the taxpayer first sold the property invalidated any exchange opportunities.[13]

The IRS rules regarding property exchange transactions are mandatory, not optional.[14] In a transaction structured as an exchange, all gain must be deferred on the property. This is generally good strategy, but in some instances deferred tax gain may not be advantageous to a business owner.

Strict Requirements Apply

One of the biggest controversies involving like-kind exchanges occurs when exchanges are deferred, or do not take place at the same time. Because the Supreme Court stated in the now famous *Starker* case[15] that exchanges do not have to occur at the same time to qualify as like-kind, Congress acted in 1984 to stipulate exchange time limits.[16] It wasn't until 1991, however, that the IRS finally got around to issuing regulations that provided rules for complying with the deferred like-kind exchange requirements.[17]

A deferred exchange is defined as an exchange in which, under the terms of the agreement, the taxpayer transfers qualified property (relinquished) and, after the transfer, receives qualified property (replacement property).

Strict requirements have been established concerning when exchanged property must be identified and accepted in the exchange for the like-kind to qualify as tax free. The property will not qualify as like-kind property if either of the following applies:

- The replacement property is not identified as property to be received in the exchange within 45 days after the date on which the transferor transfers the old property (the identification period requirement).[18]
- The replacement property is not received by the earlier of 180 days after the date on which the transferor relinquishes the old property; or by the due date (including extensions) for the transferor's tax return for the taxable year in which the old property is transferred (the exchange period requirement).[19]

The deferred exchange rule might work if, for example, on May 17, pursuant to a deferred exchange agreement, hotel owner Astor transfers his 100-room hotel property with a fair market value of $200,000 to Baker for a hotel property to be identified later. On or before July 1, the end of the 45-day identification period, Astor is required to identify the like-kind replacement property to be received from Baker. Astor must then receive from Baker on or before November 13 (180-day receipt requirement) the property identified as the like-kind replacement property.

Neither party can extend the above limitation periods for any reason. Therefore, if a hotel owner fails to identify replacement property

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or take possession of the replacement within the required time limit, the transaction will not be treated as a like-kind exchange. The gain on the transaction would thus be taxable.[20]

In order for a hotel owner to properly identify any replacement property, he or she must send a description of the property in writing to the qualified parties before the end of day 45. If the replacement property is transferred to the hotel owner before day 45, the identification requirement is satisfied.

The hotel owner can identify more than one property when using the deferred exchange method. A hotel owner can, subject to the three-property and 200 percent rules, identify more than one replacement property, regardless of the number of properties he has relinquished in the same exchange. Under the three-property rule, a hotel owner can select up to three properties without regard to their aggregate fair market value. Alternatively, a hotel owner, under the 200 percent rule, can select any number of properties as long as their aggregate fair market value does not exceed 200 percent of the aggregate fair market value of all the relinquished properties.[21]

Therefore, Astor on May 17 transfers his 100-room hotel valued at $200,000 to Baker. On or before July 1, Astor is required to formally recognize the like-kind replacement property. Astor identifies three potential hotel replacement properties (Properties #1,#2, and #3) in a written document that he signs and personally delivers to Baker on June 28. The written designation also provides that Astor will orally inform Baker by August 1 which of the three identified hotel properties he wants to receive. Since Astor did not choose more than three properties, all three have been properly identified before the end of the identification period. It does not matter if the aggregate fair market value (i.e., $500,000) exceeds 200 percent of the fair market value of the relinquished property ($400,000).

Related Party Transfers Have Special Rules

Frequently transfers occur between family members. There is a special two-year holding period requirement for exchanges between related parties. This rule requires the hotel owner to report to the IRS on the property in the sale year of the like-kind transaction and again at the end of the two-year holding period.[22] The related party rule does not bar like-kind exchanges between related partners; it merely imposes a two-year holding period.

Related parties for purposes of this rule include most family members and corporations in which the party holds more than 50 percent ownership. Special rules also govern transactions between partnerships and their partners.[23]

There are three exceptions to the two-year waiting rule permitting a holder to claim a non-recognition provision for the like-kind exchange:

- any disposition of the property after the death of either the taxpayer or the related person

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• any disposition that is caused outside the control of the taxpayer, such as an involuntary conversion

• any disposition to the satisfaction of the IRS that the main purpose was not to avoid income tax on the transaction.[24]

Any taxpayer who feels he or she may qualify for an exception to the general rule must attach an explanation to his or her tax return explaining the qualifying exception.

Basis of Exchange Must Be Determined

Generally, the basis of property acquired in a like-kind exchange is the same as the basis of the property transferred. There is an exception, however, if money (called boot by accountants) or certain debt is involved.[25]

Many times in a like-kind exchange the properties will not be equal. The taxpayer may receive or give money, or other property, to equalize the transaction. The basis of property received in a like-kind exchange is the same as the property given up.

If money or other property not of a like-kind (boot) is received in the exchange, gain is recognized, but only to the extent of the money or boot received.[26] If a party to the exchange assumes debt on the property, or acquires property from the taxpayer subject to a liability, then the debt assumption will be treated as boot.[27]

It is important to remember that even if the taxpayer receives boot and shows a loss, the loss is not recognized under like-kind exchanges.[28] Therefore, the taxpayer needs to be careful to analyze the transaction in terms of the possibility of realizing a loss. If a loss is probable, the trade needs to be structured so that the transaction does not qualify as a like-kind.

A simple example will demonstrate how to recognize gain when boot is received. An individual receives $5,000 in cash and property with a fair market value of $9,000, for a total consideration of $14,000. This individual gives up property with a cost of $8,000, for an actual gain of $6,000. That leaves a gain to be recognized of $5,000.

The same rules apply to recipients who receive money or property not qualifying as like-kind exchange property in a deferred exchange.

When a person gives boot, instead of receiving boot, the non-recognition rules still apply to the person giving the boot. However, a taxpayer could recognize gain if certain non-qualified property is given as boot in the exchange.

Assumption of Liabilities Is Boot

A common practice is to give and receive property subject to a mortgage. The assumption of a liability or a transfer subject to a liability is treated as boot. The taxpayer who assumes a liability or accepts property subject to a liability receives boot.[29]

If each party to an exchange assumes the liability of the other party, the liabilities assumed by one party are offset against those

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assumed by the other. Only the excess is treated as part of the boot given or received. The following example will help explain how debt exchanges work:

Hotel owner "A" in New England owns a property that has an adjusted basis of $80,000. It is subject to a $70,000 mortgage. He makes an exchange with hotel owner "B" for realty on another hotel in Florida worth $120,000, which is subject to a $50,000 mortgage. In addition, "A" receives $10,000 in cash. The gain hotel owner "A" recognizes on the exchange is $30,000, computed as follows:

Hotel owner "A" received:	
Property worth	$120,000
Cash	10,000
Mortgage on hotel given in exchange (treated as cash received)	70,000
Total consideration received	$200,000

Hotel owner "A" gave in exchange:	
Hotel at its adjusted basis	$80,000
Mortgage on property received (treated as cash paid)	50,000
Total given	$130,000
Maximum recognizable gain to "A"	$70,000

However, in this scenario, the amount of gain recognized is limited to the net cash received by hotel owner "A." Counting the mortgage on the property given as cash received and the mortgage on the property received as cash paid, or $30,000, it computes as follows:

Mortgage on property given up by hotel owner "A"	$70,000
Mortgage on property received by hotel owner "B"	$5,000
Net reduction of hotel owner's "A" indebtedness	$20,000
Cash paid to hotel owner "A"	10,000
Gain recognized by hotel owner "A"	$30,000

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Tax Basis Must Be Determined

The final calculation a hotel owner needs to make in analyzing a like-kind exchange is to determine the tax basis for the properties. The tax basis is the value that the IRS recognizes when and if a property is sold. Generally speaking, the basis of the new property is the same as the property exchanged. However, if boot was given or received in the exchange, the basis on the new property could be affected.

If any gain is recognized due to receipt of money or other boot, the basis of all the property received is adjusted to include the old property, increased by the gain recognized and decreased by the money received.[30]

If a loss is realized, but not recognized in an exchange in which a taxpayer receives money or other boot, the basis of all the property received is the adjusted basis of the old property, decreased by the money received.

The following is a simple formula for determining basis of property acquired in a like-kind exchange:

Adjusted basis of old property ...	$....
Add:	
Cash or non-like-kind property given	$....
Gain recognized	$....
Total	$....
Deduct:	
Cash or non-like kind property received	$....
Loss recognized on non-like property given (excess of adjusted basis over trade-in allowance)	$....
Basis of new property	$....

Finally, a hotel owner must carefully examine his basis to determine if the property transferred will actually result in the deferral of a gain, and not a loss. This is an important concept to remember because there are situations when it might be more beneficial for a business owner to structure such a transaction so that it is taxable. In this case, the hotel owner will want to intentionally avoid meeting the like-kind exchange requirements because the rules are not optional.

For example, a hotel owner may want to recognize gain because he or she has just recently experienced a loss, which could be offset by a gain on the trade. This will result in the hotel owner getting a higher basis for the property received, which will, in turn, result in larger depreciation deductions.

The like-kind exchange rules are a valuable planning tool often overlooked by hospitality owners. Like-kind exchanges allow property relocation without recognizing any taxable gain on appreciated real

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estate. Like-kind exchanges can also be used as a strategy for family members wishing to exchange properties to better position family holdings. Finally, the like-kind exchange can be a valuable estate planning tool.

Since step-up rules regarding estates value inherited property at fair market value at the time of an owner's death, taxes on his or her deferred gain may never be realized. Although like-kind tax rules appear complicated, the opposite can be true. The rules actually allow a lot of flexibility in choosing different properties to exchange. In addition, since any recognizable gains are usually very minor compared to deferred gain on appreciated property, the tax benefits could be substantial.

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