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Tax Enlightenment: Section 1031 Like-Kind Exchange

- Daniel Currie, MST Student

Definition and Popularity

A popular strategy used by taxpayers to defer capital gain taxes on the sale of business or investment property is to use a like-kind exchange (also known as a “1031 exchange”). No gain or loss is recognized on the exchange provided that such property is exchanged solely for property of a *like kind* which is to be held either for use in a trade or business or for investment.¹

In general, if a taxpayer transfers property to another party in a like-kind exchange during the current tax year, the taxpayer defers the gain (or loss) on the exchange and must file IRS Form 8824 with their tax return for that tax year.² This filing requirement is one which includes taxpayers that are either an individual, a corporation, or a partnership.

The frequency of Form 8824 being filed is illustrated in the chart below which was prepared using statistical data provided by the IRS.³ The dollar amount indicates the amount of gains deferred as reported on Form 8824. According to this data, individuals reported deferred gains from years 2009 through 2013 of \$26.85 billion. In that same five-year span corporations reported \$154.51 billions of deferred gain and partnerships reported \$62.02 billions of deferred gains on Form 8824. Although this most recently published data does not include the most recently completed four calendar years (2014-2017), this information clearly demonstrates that many taxpayers are taking advantage of Section 1031 for significant tax deferral.

Form 8824*	Individuals		Corporations		Partnerships	
	Frequency	Amount**	Frequency	Amount**	Frequency	Amount**
2013	216,581	\$7,863,355	87,921	\$39,077,461	24,711	\$27,456,146
2012	174,580	\$7,834,355	79,454	\$38,124,028	16,949	\$15,680,311
2011	156,930	\$3,871,938	76,479	\$20,601,736	20,807	\$9,213,893
2010	146,526	\$2,723,076	60,883	\$31,026,428	17,501	\$6,126,371
2009	129,907	\$4,562,209	56,022	\$25,678,583	20,248	\$3,541,254
Total	824,524	\$26,854,933	360,759	\$154,508,236	100,215	\$62,017,975

*All data are estimates based on samples; some companies file multiple Forms 8824.

¹ IRC §1031(a)(1).

² Internal Revenue Service, Publication 544, Sales and Other Dispositions of Assets for use in preparing 2017 Returns. Retrieved from <https://www.irs.gov/pub/irs-pdf/p544.pdf>.

³ SOI Tax Stats – Purpose and Function of Statistics of Income (SOI) Program Retrieved from <https://www.irs.gov/statistics/soi-tax-stats-purpose-and-function-of-statistics-of-income-soi-program>.

**From 8824, line 24, Realized gain (or loss); all amounts are in thousands of dollars.

The Details of Sec. 1031 (Pre-TCJA)

A like-kind exchange does not meet the non-recognition rules if one kind or class of property is exchanged for another kind or class. This means that a taxpayer, under the rules before the TCJA, could (although it was not elective) use the non-recognition rules in an exchange if, for example, the taxpayer exchanged certain real property for like-kind real property or certain personal property for like-kind personal property. If, however, the exchange satisfied the requirements for non-recognition treatment as being an exchange of like-kind and the taxpayer also transferred (or received) property that was not like-kind, the exchange could still potentially qualify as tax-free (or partially tax-free).⁴ In other words, a taxpayer that transfers property, where a gain is *realized*, could avoid a current taxable event by exchanging solely in property that is like-kind, but if the exchange is not solely for property of like kind, then the transaction may not potentially qualify as tax-free. If non-like-kind property (“boot”) is *received* by the taxpayer, then gain is *recognized* based on the lesser of the *realized* gain or the value of the boot received. On the other hand, if boot is *given* to the other party and (1) the only boot given is in the form of cash, then no gain is recognized, or (2) if non-cash boot is given to the other party, then gain is potentially recognized based on the difference between the non-cash boot’s fair market value and the taxpayer’s basis in the property right before the exchange – if the fair market value exceeds the basis. While not common, in realized *loss* situations, losses cannot be recognized if boot is received, but losses can potentially be recognized if non-cash boot is given to the other party and the property’s fair market value is less than the taxpayer’s basis in the property.

Under the Sec. 1031 rules before the TCJA, there were three different classes of property to determine whether an exchange of property satisfies the requirement for being a reciprocal exchange: (1) depreciable tangible personal property, (2) intangible and non-depreciable personal property, and (3) real property. A transaction would not meet the like-kind exchange requirement if, for example, a taxpayer exchanged equipment (depreciable tangible personal property) for a vacant lot of land (real property).

There were additional requirements for depreciable tangible personal property in a like-kind exchange. An exchange of depreciable tangible personal property for other depreciable tangible personal property must have been within the same general asset class or within the same product class to be considered like-kind.⁵

There were also additional requirements for intangible personal property or non-depreciable personal property in a like-kind exchange. For an exchange of intangible (or non-depreciable) personal property for other intangible (or non-depreciable) personal property to meet the like-kind requirement generally depends on the nature and character of the rights involved and also on the nature or character of the underlying property to which the intangible (or non-depreciable) personal property relates.⁶

⁴ Reg. §1.1031(a)-1(a)(2).

⁵ Reg. §1.1031(a)-2(b).

⁶ Reg. §1.1031(a)-2(c).

The like-kind requirements were more liberal in an exchange of real property than other property. The grade or quality, such as improved real estate or unimproved real estate, is not a factor as to whether real property qualifies as like kind.⁷ In other words, a vacant lot of land exchanged for a commercial building would generally meet the like-kind requirement in a section 1031 exchange.

Changes Made to Sec. 1031 by the TCJA

For exchanges completed after December 31, 2017, personal property no longer qualifies for tax-deferral under Section 1031 under P.L. 115-97, the law known as the Tax Cuts and Jobs Act (TCJA). To meet the requirements of section 1031 for tax-deferral, an exchange completed after December 31, 2017 must be for like-kind *real* property that is not held primarily for sale.⁸ If an exchange of real property completed after December 31, 2017 includes personal property, the receipt of the personal property will be considered the receipt of “other property” or boot.

Many qualified 1031-exchanges do not occur simultaneously. In a reverse exchange, the replacement (new) property is received first and the old (relinquished) property is later given to the other party. On the other hand, in a forward exchange, the old property is relinquished first with the replacement property received at a later date. Under the “transition rule,” in a situation where the non-simultaneous exchange straddles tax years, the effective date for determining whether the exchange is subject to the changes made by P.L. 115-97, is based on whether or not the replacement property (in a reverse exchange) is received or the relinquished property (in a forward exchange) is given up on or before December 31, 2017. If either scenario applies, then the pre-TCJA rules apply.⁹ If the effective date of the exchange is *after* December 31, 2017, the exchange is subject to the new law and thus personal property would not qualify as like-kind property. Of course, this transition rule regarding when the new real property limitation for transactions involving a Sec. 1031 would apply for non-simultaneous exchanges, is still subject to the identification and relinquishment / replacement time periods (to be discussed later).

Real Property vs Personal Property

An essential question for exchanges completed after December 31, 2017 then becomes: *Is the property classified as real property or personal property?* This question must be answered for both the relinquished property and the replacement property, to determine whether the exchange satisfies the real property limitation.

State law creates legal interests and rights of property and separates property into these two broad categories of real or personalty.¹⁰ In California, personal property is considered “movable” and real property is considered “immovable”.¹¹ Furthermore, land and anything that is affixed to

⁷ Reg. §1.1031(a)-1(b).

⁸ Committee Report 10,311.00089, PL 115-97, 12/22/2017.

⁹ P.L. 115-97, Section 13303.

¹⁰ *Morgan vs. Commissioner*, 60 S. Ct. 424 (1940).

¹¹ Cal. Civ. Code §657.

land is real property.¹² California further defines personal property as every kind of property that is not real property.¹³

State law characterizations of property is a factor, but not the sole determinative factor for purposes of section 1031. In the Tax Court case of *Peabody Natural Resources Co. vs. Commissioner*, 126 T.C. 261 (2006), the court held that coal supply contracts, which were a part of a section 1031 like-kind exchange of gold mines for coal mines, did not constitute personal property (boot) in the exchange even though the supply contracts were also a contract for the sale of goods under New Mexico law.¹⁴ Instead, the court considered the state law classification to be less significant than factors bearing on the nature and character to which the bundle of rights relate, which in this case is the ownership of realty made up of mine land coal reserves.

An example provided in IRS Chief Counsel Advice 201238027 demonstrates further that an exchange of two natural gas pipelines, one in State A classified as personal property and the other in State B classified as real property are, in fact, like-kind for the purposes of section 1031 since the basic nature and character of the property is a significant factor, rather than simply being overridden by a state law classification.¹⁵

Furthermore, although property classifications, such as those by the state law, are an important consideration for the like-kind determination of section 1031, there are other considerations such as whether the property is an inherently permanent structure affixed to real property and whether the property is transferred as part of the land. Additionally, consideration should be given to the respective interests in the properties, including the duration of such interests, the rights involved, including whether the nature of such rights is merely ancillary, the nature of the title conveyed, and any other factor bearing to the nature and character of the properties.

Although the distinction between section 1245 and section 1250 property is needed for depreciation purposes, it is not necessarily determinative for section 1031 purposes. In other words, the facts and circumstances that bear to the nature and character of the property will still triumph the property classification that was assigned for depreciation purposes.

Additional Fundamentals of Sec. 1031

The non-recognition of gain or loss applies if certain requirements under section 1031 are met.¹⁶ One of the “exchange” requirements is that like-kind property must be both given up as relinquished property and received as replacement property. The transfer of property is normally made using a qualified intermediary (QI), also known as an Accommodator or a Facilitator, who in most circumstances is the one required to initially acquire and transfer the relinquished property and replacement property between the two parties.¹⁷

In regard to the basis of like-kind property received in a like-kind exchange, the replacement property has a carryover tax basis if no gain or loss is deferred in the transaction. In situations

¹² Cal. Civ. Code §658.

¹³ Cal Civ. Code §663.

¹⁴ 126 T.C. at 278.

¹⁵ CCA 201238027, April 17, 2012.

¹⁶ IRC §1031.

¹⁷ Treas. Reg. §1.1031(k)-1(g)(4).

where there is a deferral, the basis in the replacement property is generally the value of the replacement property less the deferred gain (or plus any deferred loss). Other factors that could be involved in the basis calculation include any liability assumed, liability relieved, non-like-kind property assumed, or non-like-kind property given up.

In a deferred forward exchange, in order for section 1031 to apply, the potential replacement property must be identified (with certain requirements) on or before the 45th day after the transfer of the relinquished property.¹⁸ This 45-day period is known as the “identification period”.¹⁹

Additionally, in a deferred forward exchange, the replacement property must be received after the earlier of 180 days succeeding the transfer of the relinquished property or the due date of the taxpayer’s tax return.²⁰ This 180-day period is also known as the “exchange period”.²¹ The exchange period is determined with a properly filed extension which means that if the exchange period is expected to extend beyond the original due date of the tax return, the taxpayer must have a properly filed extension for the property to have the full 180-day exchange period. A properly filed extension is one that must be granted.²²

Both the identification (45-day) and the exchange (180-day) periods are set by the statute and therefore, are not eligible for any type of extension, except in situations where the exchange is impacted by a Presidentially Declared Disaster.

For reverse exchanges, sometimes known as reverse “Starker” transactions, where the transfer of the replacement property is completed before the transfer of the relinquished property, the IRS has issued a safe harbor rule under Rev. Proc. 2000-37. The safe harbor provides that the IRS will not challenge either the qualification of the replacement property (or the relinquished property), or the treatment of the exchange accommodation titleholder (EAT) as the beneficial owner of the property so long as the property is held in a “qualified exchange accommodation arrangement” (QEAA).²³ In these transactions, property is “parked” with the accommodation party under a permissible agreement, and although not required to follow the rules under section 1031(a)(3), there still must be genuine intent of a like-kind exchange and must accomplish such transaction within a short period of time. The safe harbor under Rev. Proc. 2000-37 will not apply if the taxpayer receives the replacement property before initiating a QEAA.²⁴

Considerations for Sec. 1031 with Personal Property: Years 2018 and Later

Although the new tax law will undoubtedly create some questions by tax practitioners dealing with their clients’ like-kind exchanges completed in 2018 or planned to be completed in 2018 or later, the concept for determining whether the properties meet the real property limitation will depend on the facts and circumstances.

¹⁸ IRC §1031(a)(3)(A).

¹⁹ Treas. Reg. §1.1031(k)-1(b)(1)(i).

²⁰ IRC §1031(a)(3)(B).

²¹ Treas. Reg. §1.1031(k)-1(b)(1)(ii).

²² *Christensen vs. Commissioner*, 81 AFTR 2d 98-1627, CA9 (1998).

²³ Rev. Proc. 2000-37, 2000-2 CB 308.

²⁴ Rev. Proc. 2004-51, 2004-2 CB 294.

In a multi-asset exchange that meets the requirements of an exchange of real property, but which also includes what *may* be classified as personal property, such as for either state law purposes or for federal depreciation purposes, proper planning should address which properties specifically qualify under section 1031 and which ones will be boot. Although the rules for exchanges of multiple properties under Treas. Regulation §1.1031(j)-1 have not been amended to reflect the changes made under P.L. 115-97, real property in a multiple property exchange would presumably be included in one exchange group. The receipt of property that is not classified as real property will therefore not be included in the exchange group, and not permitted to be transferred without the recognition of gain or loss. In other words, the party that receives property that is not like-kind will be deemed to have received boot in an amount equal to its fair market value, and the party that gives up the other property may either recognize gain to the extent the boot's fair market value exceeds the adjusted basis, or loss to the extent that the adjusted basis exceeds the fair market value.²⁵

Many taxpayers have been and will continue using cost segregation studies to classify certain property as section 1245 (personal property) assets to utilize shorter useful lives for depreciation purposes. In situations where these taxpayers later exchange real property that qualifies for section 1031, there may be multiple assets involved, some of those being section 1245 assets, which although classified as such for depreciation purposes, may or may not meet the real property classification for section 1031 purposes. Proper planning should be made in these situations to identify which properties are considered as meeting the like-kind requirements under section 1031(a).

The popular strategy of tax-deferred exchanges should be expected to continue despite the new real property limitations. Although further guidance to better clarify the definition of real versus property in the context of these transactions may be needed, it will remain important for taxpayers and those involved with these arrangements to carefully review the like-kind exchange rules and then interpret how these rules should apply to their unique set of facts and circumstances.

²⁵ Treas. Reg. §1.1031(d)-1(e).