The Tax-Deferred Exchange

Is the end of Section 1031 on the horizon?

BY AMBER BUSCH

WHILE MOST PEOPLE outside the public accounting field are not able to recite tax code sections, those who work in the real estate industry are likely familiar with Section 1031.

As a refresher, Section 1031 of the Internal Revenue Code allows property owners to defer gain from the sale of property when they exchange it for like-kind property. Under this code, the gain is not recognized until the replacement property is sold. If the replacement property is exchanged for other like-kind property, however, the property owner can continue to defer the gain recognition.

A Brief History

The concept of trading land goes back hundreds of years to when property owners bartered with one another. Tax-deferred exchanges were officially included in the Revenue Act of 1921, which allowed two parties to simultaneously exchange property without recognizing gain. In 1979, the Starker decision expanded the rules to accommodate exchanges, known as forward exchanges, that did not close on the same day. In 1984, an amendment to the Internal Revenue Code imposed the 45- and 180-calendar-day limits. Under this amendment, owners were required to identify a potential replacement property by the 45th calendar day, post closing, and complete the exchange within the 180th calendar day, post closing.

When Section 1031 was enacted, it had three purposes. First, it prevented unfair taxation of ongoing property investments. When property owners reinvested sale proceeds and retired debt into new property, they did not have the cash to pay taxes resulting from the gain. Thus, forcing the taxpayer to pay the tax would have been unfair. Second, Congress wanted to encourage active reinvestment; the deferral of gain through reinvestment encourages taxpayers to replace and upgrade their property. The third purpose was for administrative convenience, which ceased to be relevant years ago, as deferred exchanges have becoming increasingly complex.

The Issue

Recently, the Obama Administration's 2017 fiscal year budget proposed a $1 million limit per taxpayer on the annual deferral of capital gain. In addition, the budget renders art and collectibles ineligible for gain deferral.

The U.S. Department of Treasury notes that Section 1031 deferral had historically been justified on the basis that valuing exchanged property is difficult, which is no longer a valid argument. Most exchanges are complex three-party exchanges, facilitated by a qualified intermediary.

These types of exchanges were not contemplated when the provision was enacted. In addition, the U.S. Department of Treasury believes that the ability to exchange unimproved real estate for improved real estate encourages "permanent deferral" by allowing taxpayers to continue the cycle of tax-deferred exchanges.

This is not the first time that changes to Section 1031 have been proposed. Tax-deferred exchanges have been part of tax reform proposals in both the Senate and House of Representatives for several years.

Proponents of Section 1031 note that a repeal of tax-deferred exchanges will cause a decline in real estate values, as it discourages investors from selling and reinvesting in other property. Instead, investors will invest in more liquid, non-real estate investments with faster returns. Further, proponents argue that owners who have acquired property through like-kind exchanges do not have cash to pay the tax. As a result, it would be unfair for property owners to pay tax on the gain when they did not receive cash during the transfer.

With the upcoming change in administration, no one knows what the future holds for Section 1031. For the time being, tax-deferred exchanges are an excellent tool for real estate investors. They allow owners to defer payment of capital gains tax when selling property and reinvest the proceeds in like-kind property. However, the rules can be complex. Managing them correctly is vital to taking advantage of this longtime tax code benefit. If you are considering entering into a tax-deferred exchange, make sure to consult your tax adviser.

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