
General Explanations
of the
Administration's Fiscal Year 2016
Revenue Proposals



Department of the Treasury
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MODIFY LIKE-KIND EXCHANGE RULES FOR REAL PROPERTY AND COLLECTIBLES

Current Law

When capital assets are sold or exchanged, capital gain or loss is generally recognized. Under section 1031, however, no gain or loss is recognized when business or investment property is exchanged for “like-kind” business or investment property. As a result, the tax on capital gain is deferred until a later realization event, provided that certain requirements are met. The “like-kind” standard under section 1031, which focuses on the legal character of the property, allows for deferral of tax on the exchange of improved and unimproved real estate. Certain properties, including stocks, bonds, notes or other securities or evidences of indebtedness are excluded from nonrecognition treatment under section 1031. Exchanges of art and collectibles for investment are eligible for deferral of gain under section 1031.

Reasons for Change

There is little justification for allowing deferral of the capital gain on the exchange of real property or art and collectibles. Historically, section 1031 deferral has been justified on the basis that valuing exchanged property is difficult. However, for the exchange of one property for another of equal value to occur, taxpayers must be able to value the properties. In addition, many, if not most, exchanges affected by this proposal are facilitated by qualified intermediaries who help satisfy the exchange requirement by selling the exchanged property and acquiring the replacement property. These complex three-party exchanges were not contemplated when the provision was enacted. They highlight the fact that valuation of exchanged property is not the hurdle it was when the provision was originally enacted. Further, 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.

Proposal

The proposal would limit the amount of capital gain deferred under section 1031 from the exchange of real property to \$1 million (indexed for inflation) per taxpayer per taxable year. The proposal limits the amount of real estate gain that qualifies for deferral while preserving the ability of small businesses to generally continue current practices and maintain their investment in capital. In addition, art and collectibles would no longer be eligible for like-kind exchanges. Treasury would be granted regulatory authority necessary to implement the provision, including rules for aggregating multiple properties exchanged by related parties.

The provision would be effective for like-kind exchanges completed after December 31, 2015.

REPEAL PREFERENTIAL DIVIDEND RULE FOR PUBLICLY TRADED AND PUBLICLY OFFERED REAL ESTATE INVESTMENT TRUSTS (REITS)

Current Law

REITs are allowed a deduction for dividends paid to their shareholders. In order to qualify for the deduction, a dividend must not be a “preferential dividend.” For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference. Previously, a similar rule had applied to all regulated investment companies (RICs). Section 307 of the Regulated Investment Company Modernization Act of 2010 repealed application of that rule for publicly offered RICs.

Reasons for Change

The original purpose of the preferential dividend rule in 1936 was to prevent tax avoidance by closely held personal holding companies. The inflexibility of the rule can produce harsh results for inadvertent deviations in the timing or amount of distributions to some shareholders. Because an attempt to compensate for a preference in one distribution produces a preference in a second offsetting distribution, it is almost impossible to undo the impact of a prior error. As applied to publicly traded REITs and publicly offered REITs, the rule has ceased to serve a necessary function either in preventing tax avoidance or in ensuring fairness among shareholders. Today, for these shareholders, corporate and securities laws bar preferences and ensure fair treatment.

Proposal

The proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs. That is, the preferential dividend rule would not apply to a distribution with respect to stock if:

1. As of the record date of the distribution, the REIT was publicly traded; or
2. As of the record date of the distribution:
 - a. The REIT was required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Act of 1934;
 - b. Not more than one-third of the voting power of the REIT was held by a single person (including any voting power that would be attributed to that person under the rules of section 318); and
 - c. Either the stock with respect to which the distribution was made is the subject of a currently effective offering registration, or such a registration has been effective with respect to that stock within the immediately preceding 10-year period.

The Secretary would also be given explicit authority to provide for cures of inadvertent violations of the preferential dividend rule where it continues to apply and, where appropriate, to require consistent treatment of shareholders.

The proposal would apply to distributions that are made (without regard to section 858) in taxable years beginning after the date of enactment.