Real Property Like-kind Exchanges

Since 1921, the tax law has recognized that the exchange of one property held for investment or business use for another property of a like-kind results in no change in the economic position of the taxpayer and, therefore, should not result in the immediate imposition of tax. This concept is codified today in section 1031 of the Internal Revenue Code, and it is one of many non-recognition provisions in the Code that provide for deferral of gains.

Background

The original like-kind exchange rule goes back to the Revenue Act of 1921, which allowed investors to exchange securities and property that did not have a "readily realized market value." This rather broad rule was eliminated in 1924 and replaced in 1928 with one permitting the deferral of gain on the like-kind exchange of similar property. With limited exceptions, Congress has largely left the like-kind rule unchanged since 1928.

Section 1031 applies to both real and personal property. The tax on any gain from the exchange is deferred and in return the taxpayer carries over the basis of the original property to the new property, losing the ability to take depreciation at the higher exchange value. Gain is immediately recognized to the extent any cash is received as part of the exchange.

Policy Rationale

The like-kind exchange rules are based on the concept that when one property is exchanged for another property there is no receipt of cash that gives the owner the ability to pay taxes on any unrealized gain. The deferral is limited and does not extend to investments that are liquid, readily convertible to cash, and easy to value, such as securities and inventory. Section 1031 distinguishes between illiquid assets, such as real estate, and readily tradable investment interests. The person who exchanges one property for another of like-kind has not really changed his economic position. Rather, he is in a nearly identical position to the holder of an asset that has appreciated or depreciated in value, but who has not yet exited the investment. Under longstanding tax policy, the mere change in value of an asset, without realization of the gain or loss, does not generally trigger a taxable event. In such situations, the proper tax treatment is to defer recognition of any gain and maintain in the new property the same basis as existed in the exchanged property. This is similar in concept to other non-recognition, tax deferral provisions in the tax law that reflect basic, long-standing policies about the nature of gain realization, applicable, for example, when property is exchanged for stock , when property is exchanged for an interest in a partnership, and when stock is exchanged for stock or property pursuant to a corporate reorganization.

Economic and Social Benefits of Real Property Like-Kind Exchanges

The like-kind exchange is a basic tool that lubricates the smooth functioning of the real estate market in the U.S. today. Allowing capital to flow more freely among investments facilitates commerce and supports economic growth and job creation. Real estate owners use section 1031 to efficiently allocate capital to its most productive uses. It enables owners to reposition portfolios, exchange peripheral assets for core assets, realign property by geography or real estate sector to improve operating efficiencies, and manage risk. It also facilitates a more dynamic real estate sector that supports more reinvestment in real estate and a higher level of construction activity.

A recent Joint Committee on Taxation (JCT) staff analysis provides concrete evidence regarding the incentives that current-law like-kind exchange rules provide to support investment. According to the JCT staff, the *tax expenditure estimate* of like-kind exchanges, which does not capture taxpayer response to changes in law, is $98.6 billion over five years. In contrast, the *revenue estimate* from repealing like-kind exchanges, which does take into account behavioral response, is $9.3 billion over five years. This ten-fold reduction suggests that repealing like-kind exchanges would simply cause taxpayers to delay transactions and that current-law is functioning just as intended, namely to facilitate the free-flow exchange of property so that it may be used in the most productive manner possible.

It is also critical to note that data beyond that provided by JCT bears out the key role that like-kind exchanges play. According to the commercial real estate information company CoStar, from 1999 to 2005, tax-deferred exchanges represented approximately 32 percent of apartment building transactions, and 20 percent of office building transactions in the largest 15 markets. In some markets, the majority of commercial real estate transactions in that period involved the use of like-kind exchanges.

Additionally, like-kind exchange rules provide positive benefits that go beyond simply facilitating the exchange of property. These rules lead to lower levels of leverage and debt in real estate transactions. The buyer of replacement property in a like-kind exchange is more likely to have a higher down payment because drawing out the cash proceeds from exchange sales results in immediate tax liability.

The like-kind exchange rules also positively affect local government budgets since more frequent turnover of real estate generates significant transfer and recording fees. Finally, section 1031 is often a critically important means of facilitating conservation real estate transactions involving important open spaces and/or significant environmentally sensitive properties that may be exchanged for other privately held like-kind property, such as adjacent farmland or ranchland. These types of transactions help to achieve the public benefit of securing the protection of environmentally significant land and open space for the future.