Like-Kind Exchanges Hold Tax Traps For The Unwary

By Libin Zhang  (April 17, 2019, 6:25 PM EDT)

The Tax Cuts and Jobs Act[1] generally provided a new 20% deduction for an individual’s ordinary income from certain pass-through trades and businesses in 2018 through 2025. The TCJA also reduced the availability of tax-free like-kind exchanges.

The interaction between like-kind exchanges and the new pass-through business income deduction creates some traps for the unwary. Deal timing is particularly important, because an exchange that straddles two taxable years may cause the taxpayer to lose some or all of the deduction for the first year.

Internal Revenue Code Section 1031 Like-Kind Exchanges

In a Section 1031 like-kind exchange, the taxpayer recognizes no taxable gain or loss when disposing of certain relinquished property and acquiring an equal or greater amount of qualifying replacement property. The like-kind exchange dates back to the Revenue Act of 1921, which allowed investors to exchange tax-free all securities and properties that did not have a “readily realized market value.” This somewhat broad rule has been narrowed over the years, most recently when the TCJA eliminated like-kind exchanges for personal property.

As a result of the TCJA, in 2018 and later, Section 1031 allows only like-kind exchanges of real property held for investment or productive use in a trade or business. The type of real property is generally irrelevant, so that a building may be exchanged for land or long-term leasehold interests.

Property within the United States, however, may only be exchanged for other U.S. property, and foreign property may only be exchanged for foreign property — for unclear geopolitical reasons, Puerto Rico and American Samoa are not part of the United States for this purpose, whereas the U.S. Virgin Islands, Guam and the Northern Mariana Islands are considered within the United States.

Prior to the late 1970s, like-kind exchanges generally had to be simultaneous transfers of the two properties. Case law[2] and later the Deficit Reduction Act of 1984 allowed deferred like-kind exchanges, whereby a taxpayer may generally dispose of its relinquished property, identify its replacement property — or properties — within 45 days and acquire the replacement property within 180 days of the initial disposition.
The deferred exchange rules fostered multiparty transactions using “qualified intermediaries,” which basically permit the sale of the relinquished property to one party and the purchase of replacement property from a different party at a later time. Exchanges may also be done in reverse, where the taxpayer uses a qualified intermediary-like entity to acquire the replacement property first and sell the relinquished property later.

Example: A taxpayer sells its relinquished property on Nov. 1, 2018, and causes the qualified intermediary to receive the sales proceeds. The taxpayer identifies its replacement property by Dec. 16, 2018, and acquires the replacement property by April 30, 2019, with the qualified intermediary’s proceeds. No gain is recognized on the 2018 disposition if all the Section 1031 rules are met.

A taxpayer who is exchanging depreciable personal property cannot do a like-kind exchange, but any recognized gain may be reduced by a bonus depreciation deduction equal to 100% of the replacement property’s purchase price. However, bonus depreciation starts to phase down in 2023 and generally disappears after 2026, unless extended by future legislation.

The end of like-kind exchanges is more problematic for a taxpayer who would like to exchange nondepreciable personal property, such as precious metals and artwork, for other nondepreciable property of a like-kind. The gain cannot be deferred under Section 1031 nor reduced by any bonus depreciation from the purchase. However, the taxpayer may be able to invest an amount equal to the gain in a qualified opportunity fund, which allows the gain to be deferred until 2026 and up to 15% of the gain to be exempt from federal taxation.

The TCJA also disallows like-kind exchanges of FCC licenses, patents, digital currencies and other intangible property.

The Internal Revenue Service provided helpful relief in Revenue Procedure 2019-18, by allowing professional sports teams to exchange player contracts and draft picks tax-free by deeming those assets to have zero value.

Pass-Through Business Income Deduction

The TCJA enacted new Section 199A, which generally allows a 20% deduction in 2018 through 2025, for an individual’s ordinary income from certain trades and businesses, including real property rental businesses. For a lower income taxpayer, the 20% deduction is mostly available for all trades or businesses, but there are two restrictions for higher income taxpayers.[3]

The first restriction denies the Section 199A deduction for specified service trades or businesses, such as law, accounting, health, consulting, asset management, and other service professions, as well as securities and commodities dealing, day trading, and sports team ownership.

More relevant for real estate businesses is the second restriction, which provides that the Section 199A deduction from a trade or business is generally limited to 50% of the W-2 wages of that trade or business, or — if greater — 2.5% of the unadjusted basis of certain depreciable property used in that trade or business plus 25% of its W-2 wages.

The unadjusted basis is generally the cost of the property and is sometimes known by the acronym UBIA — unadjusted basis immediately after acquisition. Complex rules govern the period during which the taxpayer may continue to use the unadjusted basis of each property.
Example: A taxpayer owns residential real property used in a rental trade or business, which generated $1.2 million of net taxable income in 2018. The property uses a management company and therefore has no W-2 wages. The taxpayer may claim her full $240,000 pass-through business income deduction if she has at least $9.6 million of unadjusted basis in the property’s building, because the deduction is capped at 2.5% of the unadjusted basis.

The statute provides that the amount of the business’s unadjusted basis of depreciable property is determined as of the end of the business’s taxable year. As a result, if a taxpayer disposes of its relinquished property in one taxable year and acquires the replacement property early in the next year in a like-kind exchange, the taxpayer technically does not have any unadjusted basis in depreciable property for the first year.

Example: Same as the above example, except that the taxpayer disposes of the residential property on Nov. 1, 2018. She acquires her replacement real property in a like-kind exchange on April 1, 2019. Although the taxpayer earned $1 million of rental income in 2018 and would normally claim a $200,000 Section 199A deduction, she has no unadjusted basis in depreciable property as of Dec. 31, 2018, and may not be allowed any such deduction in 2018.

If a partnership engages in a like-kind exchange that straddles two taxable years, it is unclear what the partnership should report to each partner as the partner’s share of the partnership’s year-end unadjusted basis. A tax preparer in this situation may consider the ample use of footnotes on each Schedule K-1 and let the partner figure it out.

A similar issue once existed in a different partnership context. For technical reasons, a partnership must sometimes maintain a certain level of indebtedness on its assets in order not to trigger taxable gain for its partners. Guidance from the U.S. Department of the Treasury provides that the indebtedness amount is normally determined at year end.

A partnership that engages in a like-kind exchange straddling two taxable years might not have any indebtedness at the end of the first year, before it acquires debt-encumbered replacement property in the second year, which could trigger gain for the partners. In Revenue Ruling 2003-56, the Treasury issued a taxpayer favorable rule that deems the partnership to have the indebtedness of its replacement property for the entire exchange period, in order to prevent the partnership from falling short on maintaining its indebtedness amount.

Other Basis Issues and Conclusion

If a taxpayer does acquire replacement property in a like-kind exchange, the final Section 199A regulations provide that the taxpayer’s unadjusted basis in the relinquished property generally continues as unadjusted basis in the replacement property. This permits the taxpayer to claim the Section 199A deduction in the acquisition year and later years, such as in 2019 in the above example, to the extent that the replacement property is depreciable property and not land.

The final regulations, released in February 2019, reversed a less favorable rule in the August 2018 proposed regulations that would have reduced the taxpayer’s unadjusted basis after every like-kind exchange or other nonrecognition transaction. Extensive outreach and comments by the Real Estate Roundtable, Federation of Exchange Accommodators, National Association of Real Estate Investment Trusts, American Institute of Certified Public Accountants, U.S. Chamber of Commerce, International
Council of Shopping Centers, National Multifamily Housing Council, National Association of Home Builders and other groups led to the more favorable final regulations.

In contrast, there has been less attention and commentary on the unfavorable Section 199A consequences for a like-kind exchange that straddles two taxable years. The taxpayer may lose all of its Section 199A deduction in the first year, absent any statutory or regulatory relief to the contrary.

Unless favorable guidance is forthcoming, affected partnerships and other taxpayers should carefully consider the timing of their like-kind exchanges within their business constraints: A disposition of the relinquished property in late 2018 may be better off delayed until January 2019, and conversely the acquisition of replacement property may best be done before year end. Of course for the same reasons, the buyer or seller of the other property may also want to own depreciable property at its year end, which may result in intense negotiations.

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[3] A higher income taxpayer includes a married couple filing jointly in 2018 with taxable income above $315,000. The two restrictions are phased in over an income range that may result in marginal federal income tax rates of over 64%. See generally Libin Zhang, Marginal Income Tax Rates of the Passthrough Business Deduction, 159 Tax Notes 1139 (May 21, 2018).