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Decoding the Tax Cuts and Jobs Act – Part II: IRC § 1031 and Tax Deferred Exchanges Take a Haircut

By Larry Brant and Steven Nofziger on 1.10.18 | Posted in 1031 Exchanges, Legislation, Like-Kind Exchanges, Tax Planning

BACKGROUND

On February 21, 2014, then House Ways and Means Committee Chairman Dave Camp (R-Michigan) issued a discussion draft of the "Tax Reform Act of 2014." The proposed legislation spanned almost 1,000 pages and contained some interesting provisions, including repealing IRC § 1031, thereby prohibiting tax deferral from like-kind exchanges. Not only would taxpayers have been impacted by this proposal, but it would have turned the real estate industry upside down. Qualified intermediaries would have been put out of business. Likewise, title and escrow companies, as well as real estate advisors specializing in exchanges, would have been adversely affected by the proposal.

Former President Barack Obama released his 2015 written budget proposals 11 days after Chairman Camp's tax reform discussion draft was made public. Many of the provisions of these proposals were similar. Both the Obama Administration and Chairman Camp wanted to significantly curtail IRC § 1031. Unlike Chairman Camp, who wanted to entirely eliminate IRC § 1031 exchanges, President Obama proposed placing a deferral limit of $1 million (indexed for inflation) per taxpayer annually on IRC § 1031 exchanges. The cap, however, only expressly applied to real property exchanges. Consequently, it appeared the Obama administration proposed to leave personal property exchanges under IRC § 1031 intact.

Fast forward to 2016. No tax reform legislation had gained enough traction to even come close to being enacted into law. Nevertheless, President Obama's attack on IRC § 1031 continued. In its 2017 budget proposal, the Obama White House further expanded its quest to limit the application of IRC § 1031 by proposing that the $1 million limitation apply to both personal and real property exchanges. In addition, the 2017 budget proposal sought to totally exclude certain personal property, collectibles and art, from the definition of "like kind."

We are not sure any real logic or significant tax policy supported President Obama's last proposal to limit the application of IRC § 1031. Rather, the proposal appeared to be solely aimed at tax revenue generation. According to the Treasury, tax revenues would have increased by $47.3 billion over 10 years if the proposal had been enacted into law.

With a new President in the White House, things are changing, especially relating to IRC § 1031. While tax reform has always been at the forefront of President Trump's agenda, there were no signs of repealing or curtailing IRC § 1031 remaining from the prior administration.

TAX CUTS AND JOBS ACT

The recently enacted Tax Cuts and Jobs Act ("TCJA") modifies IRC § 1031. The changes started with Section 3303 of the House proposal which, at least to our surprise, modified IRC § 1031 to limit its application to real property (all real property other than real property held by the taxpayer as inventory). The legislative history tells us that this proposed change was intended to continue the eligibility for like-kind treatment any real property that was otherwise eligible for tax deferral under prior law. In other words, going forward, personal property would not be eligible for tax deferral under IRC § 1031.

The Senate version of the bill retained Section 3303 of the House bill without modification. The Conference Committee followed the Senate with respect to Section 3303. As a result, the TCJA, as signed by President Trump, adopted the House bill's proposed limitation to IRC § 1031.

The TCJA's changes apply to exchanges completed after December 31, 2017. For exchanges (forward and reverse), however, commenced on or before December 31, 2017, the old law will apply. In order to be considered commenced on or before the end of 2017, however, the relinquished property in the case of a forward exchange must have been disposed of by the taxpayer by the end of 2017, and the replacement property, in the case of a reverse exchange, must have been received by the taxpayer by the end of 2017.

The revision to IRC § 1031 comes with good and bad news. The good news includes the fact that IRC § 1031 is likely simplified by this law change. The complex personal property exchange rules contained in Treasury Regulation § 1.1031(a)-2 dealing with product classes and general asset classes are no longer needed and can be eliminated. In addition, the complex rules provided in IRS guidance, including Revenue Procedure 87-56, 1987-2 CB 674, and Chief Counsel Advice 200911006, are no longer relevant.

The bad news may not be crystal clear to taxpayers and their advisers. On careful examination and reflection, it is evident that this change to the Code creates several significant traps for the unwary, including unwanted results arising from:

1. Interaction with the TCJA's temporary expensing provisions;
2. Ancillary personal property will likely constitute taxable "boot" in exchanges; and
3. Timing issues.

Interaction with Temporary 100% Cost Recovery (Expensing) Rules:

The TCJA provides new 100% cost recovery expensing provisions. However, the TCJA's beefed-up expensing provisions have a limited shelf life. Without further change to the Code, they will expire after 2026. In contrast, the change to IRC § 1031 is a so-called permanent change to the Code.

If the 100% cost recovery expensing provisions expire at the end of 2026 and personal property exchanges are not re-born for IRC § 1031 purposes, taxpayers that routinely acquire and dispose of personal property used in their trade or businesses (e.g., fleets of vehicles, airplanes, ships and/or machinery), may find themselves in a world of hurt. Prior to 2018, businesses such as airlines and/or rental car companies, routinely disposed of automobiles or airplanes that they wished to retire and acquired new automobiles or airplanes in tax deferred exchanges under IRC § 1031. If the automobiles or airplanes can be expensed by the taxpayer under the robust new cost recovery expensing rules, all is generally good even in light of the new limitations put on IRC § 1031. After 2026, however, if the cost recovery expensing rules go away, these taxpayers will be faced with potentially large gains from the disposition of these depreciated assets. Without further change to the Code, there will be no way to defer the gain.

Ancillary Personal Property as Taxable "Boot"

Under the TCJA, taxpayers desiring to conduct an IRC § 1031 exchange with real property that also includes ancillary personal property need to pause for cause. For example, consider a taxpayer who wishes to exchange a 300-unit apartment complex for a 450-unit apartment complex. While both properties constitute real property, the personal property that goes along with the real property cannot be ignored, especially under the new law. In the case of an apartment complex, lots of items of personal property likely exist (e.g., washers, dryers, dishwashers, stoves, drapes, tools, landscaping equipment, office equipment and furniture, recreation room furniture, and pool equipment). Under the new law, the personal property cannot be swept under the rug. It is, by definition, taxable "boot" in the exchange. A reasonable allocation of the transaction proceeds to the personal property is required and income must be reported from the disposition of such property.

Timing Considerations

Timing is always important in the world of tax. With this change to IRC § 1031, timing is more important than ever before for taxpayers. If a taxpayer disposes of personal property in one tax year and then purchases replacement property qualifying for 100% cost recovery under the new TCJA rules in the succeeding tax year, the timing could be problematic for the taxpayer. In that instance, the timing would create taxable income for the taxpayer in tax year one, some of which could be characterized as capital gain and some of which could be characterized as ordinary income resulting from depreciation recapture. Nevertheless, the taxpayer's deduction

resulting from the purchase of the replacement property will not be available to it until tax year two. **Caution is advised.**

Stay tuned! We will be reporting on numerous other changes to the Code under the TCJA.

Tags: Code Section 1031, cost recovery, Decoding the Tax Cuts and Jobs Act, IRS, personal property, President Obama, real property, Tax Cuts and Jobs Act, Tax Deferral, Tax Procedure, Tax Reform, Tax Reform Act of 2014, taxable boot