The Tax Treatment of Like Kind Exchanges

Selling or exchanging business or investment property usually leads to a taxable capital gain or loss. For example, if a share of stock or a building or other asset used in a business is sold for more than its cost basis, the sale generates a taxable capital gain. However, the tax otherwise due can be deferred when certain business or investment property is exchanged for property of a "like-kind" in ways that comply with the tax rules.[1] The traditional prototype case involved direct exchanges, e.g., the owner of an apartment building exchanged it for another apartment building that was more suitable. Over time, the definition of eligible exchanges has been expanded. In recent years, most like kind exchanges of real estate have involved complex three-party transactions facilitated by qualified intermediaries. In addition, the most common like-kind exchanges are now those involving the trade-in of vehicles for replacement vehicles and vehicle fleets, e.g., by rental car companies, farmers, and businesses.

The deferral of capital gains tax allowed by the like-kind exchange rules is not currently considered a tax expenditure in the Federal Budget. While measures of economic income generally include capital gains each year as they accrue, the Federal Budget accepts the current system of not taxing capital gains until they are "realized" as part of the baseline tax system against which tax expenditures are measured. In contrast, like-kind exchanges are considered to be a tax expenditure by the Joint Committee on Taxation (JCT). Like the Federal Budget, the JCT accepts the realization-based system for capital gains in its baseline tax and therefore does not consider deferral of tax on capital gains to be a tax expenditure. However, the JCT considers like-kind exchanges to be a tax expenditure because such exchanges allow deferral of tax beyond the year of exchange. For Fiscal Year 2014, the JCT estimated a tax expenditure of $5.7 billion for corporations and $3.0 billion for individuals (including pass-through businesses) for the like-kind exchange provision. Both the JCT and the Federal Budget consider the preferential rates for long-term capital gains to be a tax expenditure.

How the Provision Works

Under this provision, no gain or loss is recognized if a taxpayer exchanges eligible property for property of a like kind. The taxpayer is required to recognize capital gain or loss, however, to the extent that the taxpayer receives money or non-like kind property in the exchange. Both the relinquished and the like-kind property must be held for productive use in the taxpayer's trade or business or for investment. The provision does not apply to property held for sale (inventory property) or to financial assets such as stock, bonds and partnership interests. After the exchange, the taxpayer retains the original basis (increased by any non-like property received or cash paid by the taxpayer as part of the transaction). Thus, the taxpayer has a reduced amount of future depreciation that offsets part of the deferred gain. Additional requirements include rules that limit the time period to complete the exchange.[2]

[1] Like kind exchanges are governed under Section 1031. Other provisions that allow deferral of recognition of capital gain or loss include carryover basis for gifts, losses in wash sales, contributions of property to a partnership, involuntary conversions such as fire, theft and condemnation, and certain business reorganization transactions.
[2] The replacement property must be identified within 45 days after the first property is relinquished and acquired by the earlier of (1) 180 days after the transfer of the relinquished property or (2) the due date (including extensions) for the taxpayer's tax return for the year in which the property is relinquished. In certain more complex transactions, taxpayers can have up to 360 days to complete a transaction.

Office of Tax Analysis
U.S. Department of the Treasury
2014

Since direct exchanges of real estate are difficult to arrange, most exchanges of real estate are three-party (aka deferred) like-kind exchanges. In a typical three-party exchange, taxpayer A would like to exchange a rental property for the rental property of taxpayer B. Taxpayer B, however, does not want taxpayer A's rental property, but would like some third property owned by taxpayer C. Working through a qualified intermediary, taxpayer A's property is sold for cash used to buy the property of taxpayer C. The property acquired from taxpayer C is then exchanged for B's property. Under general tax rules, these transactions would be taxable events. In a like-kind exchange, the qualified intermediary holds the cash (and any non-qualified property) received from selling the rental property of taxpayer A in a trust account and uses it to acquire the property of taxpayer C. Taxpayers A and B would not be taxable on their exchange of qualified property, but capital gain would be taxable up to the amount of any cash or ineligible property received in the exchange. The basis of taxpayers A and B in their new property would be their original basis plus the amounts of any cash paid for the replacement property and taxable capital gain from the receipt of cash or ineligible property.

History and Rationales for the Provision

The original provision was enacted in 1921 along with other major changes to capital gains rules and has therefore been in existence almost since the beginning of the income tax.[3] One of the arguments for not treating the exchange of like-kind property as a realization event is that the taxpayers were continuing their on-going investment in the same business activity rather than cashing in their investment. In addition, Congress recognized that the dramatic increase in tax rates on capital gains during World War I had created substantial lock-in effects that greatly interfered with normal business transactions.[4] Exchanges of property would be discouraged because there wouldn't be enough money left after paying the capital gains tax to purchase a replacement property of comparable value. Persuaded by these arguments, Congress has allowed capital gains taxes to be deferred in such exchanges since 1921 with only modest changes in the rules.

Types and Amounts of Like Kind Exchanges

The types and amounts of capital gains deferred in like-kind exchanges in 2007 are reported in the table below.[5] C corporations (subject to the corporate income tax) deferred $25.8 billion in capital gains in 2007. Over half of this amount reflected transactions related to vehicles,

[3] While capital gains were initially taxed at the same rates as other income, the Revenue Act of 1921 created a new 12 1/2 percent alternative maximum tax rate on capital gains for assets held longer than two years. In addition to the new rate, the 1921 Act limited the deduction of capital losses and required recognition of capital asset sales and exchanges except in the case of like-kind exchanges, certain business reorganizations, and involuntary conversions due to fire and theft.

[4] The increase in the top income tax rate from 7 percent to 77 percent to help finance World War I efforts created strong lock-in effects: taxpayers realized few capital gains but had strong incentives to realize capital losses. To limit the revenue losses, Treasury issued regulations in 1919 that sales of capital assets would not be recognized for tax purposes unless cash was received. The 1921 Act reversed this approach by requiring recognition of all exchanges except in specified situations.

[5] Tax year 2007 is the most recent year not significantly affected by the financial and real estate crises and also the most recent year for which consistent data are available for all types of taxpayers.

including replacement of vehicle fleets by rental car firms and other types of firms with large truck or auto vehicle fleets. In addition, banks are thought to be significant users of this provision in the context of vehicle leasing programs. Partnerships reported about $35.6 billion of deferred capital gain. In contrast to C corporations, real estate transactions accounted for nearly 90 percent of the deferred gains of partnerships in 2007.[6]

For tax year 2007, individual taxpayers deferred $21.2 billion of capital gain using the like-kind provision. Nearly half of this amount was deferred capital gain on residential rental properties and most of the rest was business real estate and land. In total, real estate accounted for over 90 percent of the amount of gains deferred by individuals. The largest number of transactions, however, involved business personal property, primarily involving trade-ins of trucks and other leased vehicles used for business or farm purposes for replacement vehicles.

As shown in the data appendix, gains deferred by partnerships dropped dramatically from $35.6 billion in 2007 to only $6.1 billion in 2010 due to the effects of the recession on real estate. In contrast, gains deferred by corporations increased from $25.8 billion to $29.3 billion because the decline in real estate was more than offset by a dramatic increase in like-kind exchanges of vehicles.

Deferred Capital Gains in Like-Kind Exchanges in 2007

Industry	Amounts (millions of dollars)			Percent of Total Deferred Gains		
	C Corporations	Partnerships	Individual Returns	C Corporations	Partnerships	Individual Returns
Agriculture	91	577	649	0.4	1.6	3.1
Mining	176	0	0	0.7	0.0	0.0
Oil & Gas	1,598	306	49	6.2	0.9	0.2
Construction	195	15	0	0.8	0.0	0.0
Manufacturing	1,128	7	0	4.4	0.0	0.0
Vehicles	13,374	842	0	51.8	2.4	0.0
Transport	741	14	50	2.9	0.0	0.2
Communication	481	1,229	0	1.9	3.5	0.0
Wholesale-Retail	638	293	0	2.5	0.8	0.0
Finance	3,781	512	0	14.7	1.4	0.0
Real Estate	3,197	31,394	19,724	12.4	88.2	92.8
Services & Misc.	402	722	921	1.6	1.1	4.3
All	25,801	35,580	21,265	100.0	100.0	100.0

Note: Types of deferred gains for C corporations and partnerships are based on the industry of the firm. Data on asset types is not available because most businesses state "Available upon request" on their capital gains forms. Individual deferred gains are based on transactions in the IRS SOI 2007 Sales of Capital Assets study.

[6] While the tables are based on the industry of the partnership, analysis of like-kind exchange transactions reported on e-filed partnership returns for 2009 showed that 76 percent of the deferred gains were real estate. The largest percentages of transactions, however, were for farm equipment (33%), cars and trucks (30%) and real estate (18%).

Data Appendix

Like-Kind Exchanges and Deferred Gains of C Corporations and Partnerships (in millions), 2007 and 2010										
C Corporations										
2007										
Industry / Primary Business Activity	Number of Firms	FMV Like-kind received	Total FMV received	Basis on property given up	Realized gains	Ordinary income recognized	Capital gains recognized	Deferred gains	All net capital gains	% of Deferred Gains
Agriculture	2,529	303	337	212	126	0	34	91	92	0.4
Mining	128	222	223	46	178	1	1	176	290	0.7
Oil & Gas	264	2,897	3,135	1,239	2,182	409	164	1,598	7,741	6.2
Construction	4,265	593	623	425	228	1	31	195	860	0.8
Manufacturing	2,106	2,182	2,325	1,051	1,274	21	125	1,128	6,394	4.4
Vehicles	1,110	20,752	20,810	8,605	13,489	47	10	13,374	331	51.8
Transportation	24	236	259	36	944	174	34	741	177	2.9
Communication	214	709	751	231	543	4	38	481	3,499	1.9
Wholesale-Retail	2,867	1,337	1,404	705	718	16	64	638	5,916	2.5
Banks & Finance	190	4,484	5,650	2,017	3,782	106	17	3,659	14,029	14.2
Insurance	462	304	305	182	123	0	2	122	3,649	0.5
Real Estate	1,185	4,957	5,116	1,832	3,350	16	137	3,197	1,153	12.4
Services & Misc.	2,334	755	815	412	467	21	43	402	902	1.6
All	17,678	39,729	41,754	16,994	27,404	815	701	25,801	45,033	100.0
2010										
Agriculture	2,280	362	366	266	100	0	4	96	84	0.3
Mining	168	136	138	47	93	0	1	91	128	0.3
Oil & Gas	101	3,728	4,224	1,209	3,023	98	395	2,530	7,348	8.6
Construction	1,997	212	216	144	72	3	0	69	67	0.2
Manufacturing	1,223	579	604	356	278	8	18	252	565	0.9
Vehicles	853	28,690	28,697	9,196	24,405	972	3	23,411	164	79.9
Transportation	28	206	208	83	179	2	4	172	39	0.6
Communication	102	40	62	22	86	24	0	62	209	0.2
Wholesale-Retail	2,006	769	813	415	436	15	37	384	1,464	1.3
Banks & Finance	144	2,166	3,231	1,366	1,939	50	0	1,889	1,108	6.4
Insurance	572	32	79	48	67	0	0	67	1,815	0.2
Real Estate	695	423	438	277	235	0	15	218	47	0.7
Services & Misc.	2,527	221	244	187	57	1	2	54	422	0.2
All	12,697	37,565	39,319	13,616	30,970	1,174	479	29,295	13,461	100.0
Partnerships										
2007										
Industry / Primary Business Activity	Number of Firms	FMV Like-kind received	Total FMV received	Basis on property given up	Realized gains	Ordinary income recognized	Capital gains recognized	Deferred gains	All net capital gains	% of Deferred Gains
Agriculture	4,733	936	940	359	581	0	4	577	39	1.6
Mining	133	15	15	15	0	0	0	0	0	0.0
Oil & Gas	55	943	951	615	314	8	0	306	43	0.9
Construction	1,513	93	359	246	113	0	98	15	11	0.0
Manufacturing	224	33	33	27	7	0	0	7	5	0.0
Vehicles	1,259	985	988	397	846	2	2	842	46	2.4
Transportation	136	136	136	122	14	0	0	14	0	0.0
Communication	134	1,319	1,334	307	1,242	3	11	1,229	3	3.5
Wholesale-Retail	502	618	700	332	368	6	69	293	33	0.8
Banks & Finance	412	978	984	647	518	0	6	512	507	1.4
Real Estate	7,626	65,298	69,147	34,013	35,192	35	3,762	31,394	1,696	88.2
Services & Misc.	906	840	844	561	396	2	3	391	722	1.1
All	17,634	72,195	76,431	37,641	39,592	56	3,956	35,580	3,104	100.0
2010										
Agriculture	5,062	1,389	1,420	825	595	1	27	567	93	9.3
Mining	28	35	35	15	20	0	0	20	165	0.3
Oil & Gas	150	349	796	199	649	10	399	240	424	3.9
Construction	659	37	37	49	-12	0	0	-12	0	-0.2
Manufacturing	402	48	53	38	16	0	2	13	1	0.2
Vehicles	626	5,589	6,129	3,303	2,848	53	494	2,301	-1	37.6
Transportation	525	306	306	228	78	0	0	78	-1	1.3
Communication	24	354	429	174	255	34	40	181	0	2.9
Wholesale-Retail	648	178	181	91	99	2	2	95	4	1.6
Banks & Finance	152	176	179	93	86	0	2	83	228	1.4
Real Estate	2,948	9,595	10,351	7,536	2,969	1	457	2,511	561	41.0
Services & Misc.	2,047	195	226	147	79	2	29	48	8	0.8
All	13,272	18,253	20,142	12,697	7,682	104	1,452	6,126	1,482	100.0

Note: Categories of deferred gains are based on the industry or primary business activity of the firm. Vehicles includes firms that manufacture, sell, lease or rent cars, trucks and other vehicles. Data on asset types is not available because many businesses state "Available upon request" on their capital gains forms. Dollar amounts are in millions of dollars.