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Overview of 1031 Like-Kind Exchanges for Farmers

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> This document provides a general overview of tax-deferred property exchanges under § 1031 of the Internal Revenue Code. This information should not be used to answer specific questions about income tax problems. It is critical for farmers to find expert, individualized advice when confronted with income tax issues.

Introduction

Generally, when a person sells or otherwise disposes of property, a gain or loss is "recognized" for tax purposes. This results in federal income tax consequences in the year the property changes hands. For example, if a taxpayer owns an apartment complex with a value (adjusted for tax purposes) of $100,000 and sells that property for $175,000 in cash, the realized gain of $75,000 is considered part of that taxpayer's income. The taxpayer owes federal income tax on that gain as of the date of the sale.

Section 1031 of the Internal Revenue Code provides an exception to this general rule, making certain *exchanges* of property not immediately taxable.[1] These exchanges are referred to as "1031 exchanges" or "like-kind exchanges." In a proper 1031 exchange, the taxpayer trades property that is currently held for investment or business use (including farming) in exchange for similar, or "like-kind," property. If the exchange complies with the requirements of § 1031, the taxpayer receives a deferral of the income tax consequences associated with the transfer. Thus, a 1031 exchange results in no immediate federal income tax consequences for the taxpayer. Instead, any income tax consequences of the exchange are deferred until the taxpayer "cashes out" of the like-kind investment.

To give a simple example, if the taxpayer who owns the apartment complex with a tax value of $100,000 exchanges that property for another real estate investment, such as a shopping center valued at $175,000, this would qualify as a 1031 exchange. The realized gain of $75,000 in value is not immediately recognized for tax purposes, and the taxpayer has no income tax consequences in the year of the exchange.

History and Purpose

The tax benefits of 1031 exchanges have existed, in some form, since 1921. However, in the 1970s, taxpayers began to see changes in regulations and court decisions that broadened the scope and flexibility of these exchanges. And, in recent years, the size of the 1031 marketplace has grown significantly.

The legislative rationale for these tax-deferred exchanges is that the exchange of an asset for a similar asset represents a continuing investment that should not be taxed at the time of the exchange. As long as a taxpayer continues to re-invest in like-kind property, the tax consequences are deferred. Some investors are able to defer these taxes indefinitely. Because of current rules governing taxes at death, if a person holds the investment property until death, the gain or loss from a 1031 exchange might never be recognized for income tax purposes.

What Qualifies as a Like-Kind Exchange Under § 1031

Section 1031's tax deferral provision applies whenever three specific requirements are met. First, the properties being transferred in the exchange must be "held for productive use in a trade or business or for investment." Second, the properties exchanged must be of a "like kind." Finally, the transfer of the property must qualify as an "exchange." The remainder of this document will explain each of these three requirements in more detail.

A. "Property held for productive use in a trade or business or for investment"

To qualify as a 1031 exchange, both the property given up and the replacement property received must be held for investment or for productive business use by the person seeking 1031 treatment.[2] According to the Internal Revenue Service (IRS), machinery, buildings, land, trucks, and rental units are all examples of property that may qualify for a 1031 exchange.[3]

This means that a 1031 exchange cannot apply to property used for non-business purposes, such as a family home or a personal car. The language of § 1031 also specifically excludes:

- stock in trade or other property held primarily for sale, such as inventories, real estate held by dealers, and livestock held for sale in the ordinary course of business;
- stocks, bonds, notes, securities, or other evidences of indebtedness or interest;
- partnership interests;
- certificates of trust or beneficial interest; and
- choses in action.

Whether property is held for investment or productive business use is determined at the time of the exchange, on an asset-by-asset basis.

B. Property of "like kind"

Like-kind property is property of the same nature or character. To be like kind, the properties do not necessarily need to be of the same grade or quality.[4]

1. Real property

Real property qualifies as like kind to other real property regardless of most dissimilarities.[5] Therefore, an apartment complex may be exchanged for a shopping center, urban real estate may be exchanged for a ranch or a farm, and developed real estate qualifies as like kind to raw land.

2. Personal property

Personal property held for investment or business use may also qualify for like-kind treatment when exchanged for other personal property. Examples of eligible personal property might include office furniture, computer systems, trucks used in a farming operation, or other non-real estate assets used in business or for investment.

The rules defining what like kind means for personal property exchanges are more restrictive than the broad rule that real property is like kind to almost all other real property. Personal property exchanges may get § 1031 treatment only if the property is like kind or "like class."[6] Under the like class definition, certain personal property may qualify for § 1031 treatment if the properties are within the same "General Asset Class" or the same "Product Class."[7] These "classes" refer to pre-set categories that have established definitions outside the § 1031 context.[8] The IRS has established thirteen General Asset Classes for items frequently used in business. In addition, Product Classes are identified by six-digit codes in Sectors 31 through 33 of the North American Industry Classification Manual (NAICS Manual).

Personal property that does not fit within any of these pre-defined classes can still be part of a 1031 exchange if the properties are in fact like kind.[9]

Much of the personal property used in a farm business is included in a single Product Class for farm machinery and equipment. Specifically, the NAICS Product Class 333111 includes combines, cotton gin machinery, feed processing equipment, fertilizer equipment, planters, plows, farm tractors, haying machinery, milking machines, and poultry feeding and watering equipment.[10] Therefore, any exchange of property within this class for another item listed in this class will receive like-kind treatment. For example, the exchange of a combine for a planter would qualify for like-kind treatment.

3. Livestock

There are some special rules for livestock. First, to reiterate an important point from above, livestock held "primarily for sale" in the ordinary course of business cannot be subject to § 1031 treatment, because this kind of property is categorically excluded by the statute.[11] Second, the statute specifically states that livestock of different sexes are not like-kind property.[12]

Therefore, same-sex livestock not held for regular sale (for example, breeding stock) may be exchanged if they are like kind. Under the current regulations, there is no clear guidance as to what constitutes like kind for livestock. However, experts have argued that a grade beef cow is probably like kind to a purebred registered beef cow because they differ only in grade or quality. Conversely, a dairy cow is probably *not* like kind to a beef cow because dairy and beef cows are entirely different types of livestock.[13]

C. "Exchange" of Property

Finally, to be eligible for § 1031 treatment, the like-kind property must be exchanged. In other words, the transaction must be a transfer of property for property, rather than a transfer of property for money that is then used to buy replacement property. Thus, a taxpayer who simply sells property and then reinvests that money in similar property in a separate, independent transaction does not qualify for a 1031 exchange.

For a property transaction to qualify as an exchange, the taxpayer must not actually or constructively receive money or non-like-kind property in full payment for the transferred property.[14] Money is considered actually or constructively received when the money is credited to the taxpayer's account or otherwise made effectively available for the taxpayer to access and use.

Within these restrictions, § 1031 is not limited to just a straightforward swap between two property owners. There are several legal mechanisms, many of them considered "safe harbors" by the IRS, through which a successful exchange can be accomplished.[15] These types of mechanisms allow a taxpayer to relinquish property to one person and ultimately receive replacement property held by an entirely different seller. They also permit a taxpayer to complete an exchange of property over time, with the taxpayer relinquishing property first, and then later selecting and receiving replacement property.

To accomplish these types of exchanges, taxpayers must set up careful transactions, often involving complicated security agreements, a qualified escrow account, a qualified trust, or an agreement with a qualified intermediary who acts on the taxpayer's behalf to accomplish the transfer.

When planning an exchange over time, it is important to know that § 1031 does impose strict and specific time limits.[16] The taxpayer must identify the replacement property within 45 days of the date the original property is transferred. In addition, the replacement property must be received by the earlier of (1) 180 days after the transfer of the taxpayer's property; or (2) the due date, including extensions, of the taxpayer's tax return for the year in which the transfer occurred.

In some instances, an exchange may still qualify for like-kind treatment if the replacement property is not yet in existence or is being produced at the time it is identified as the replacement property.[17] This may include real property improvements being constructed or personal property being produced.

Also, in some cases, a taxpayer can receive replacement property before relinquishing the property to be given up.[18] This is considered a reverse exchange and is somewhat more complicated to execute.

Taxpayers should be aware that exchanges between related parties are subject to additional rules.[19] For these rules, a taxpayer is considered "related to" family members and corporations or partnerships in which the taxpayer is a majority owner.[20] Generally, § 1031 treatment is unavailable if the exchanged property is disposed of, by either related party, within two years of the exchange.[21]

§ 1031 Exchange Controversy

Property exchanges under § 1031 have been the subject of some recent controversy. Critics argue that the tax incentives for making 1031 exchanges have driven increases in purchases of farmland by non-farmers and, as a result, increases in farm values. They contend that buyers who purchase land to complete a 1031 exchange make offers with a significant buying advantage over competitors because 1031 purchasers have tax-free income, rather than post-tax income, at their disposal. Critics also argue that the strict timelines for completing 1031 exchanges have fueled more frenzied purchasing, thereby increasing the amounts paid for replacement property. These arguments are based largely on anecdotal evidence.

Possible reform suggestions range from eliminating 1031 exchanges entirely to extending the time period in which replacement property must be identified and received. More farm-specific proposals include changing the like-kind standard to define farmland as being unlike other real property, so that urban real estate could not be exchanged for farmland, or vice versa. Additionally, some proposals would require a period of material participation in the farming operation when farmland is purchased as replacement property in a 1031 exchange.

Additional Information

Although like-kind exchanges that satisfy the requirements of § 1031 do not have immediate tax consequences, they must be reported to the IRS on Form 8824. IRS Publication 544, "Sales and Other Dispositions of Assets," provides additional information on the execution of like-kind exchanges.

To order IRS forms and publications, call 1-800-829-3676. These documents are also available on the IRS's Web site at www.irs.gov.

Endnotes:

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[1] 26 U.S.C. § 1031.

[2] 26 C.F.R. § 1.1031(a)-1(a) (2006).

[3] Internal Revenue Service, *Sales and Other Dispositions of Assets*, Publication 544 (For Use in Preparing 2005 Returns) at 11, available at www.irs.gov/pub/irs-pdf/p544.pdf.

[4] 26 C.F.R. § 1.1031(a)-(1)(b) (2006).

[5] 26 C.F.R. § 1.1031(a)-1(b), (c)(2) (2006). There may be some exceptions—for example, leases with less than 30 years left to run may not be like-kind to full property ownership rights. *See* 26 C.F.R. § 1.1031(a)-1(c)(2) (2006).

[6] 26 C.F.R. § 1.1031(a)-2(a) (2006).

[7] These classes apply only to depreciable tangible personal property. 26 C.F.R. § 1.1031(a)-2(b) (2006). Intangible personal property is eligible for § 1031 treatment only if it is in fact like kind. 26 C.F.R. § 1.1031(a)-2(c) (2006).

[8] 26 C.F.R. § 1.1031(a)-2(b)(2), (3) (2006).

[9] 26 C.F.R. § 1.1031(a)-2(b)(1), 2(c)(1) (2006).

[10] 2002 US NAICS Manual, available at www.census.gov/naics.

[11] 26 U.S.C. § 1031(a)(2)(A).

[12] 26 U.S.C. § 1031(e).

[13] *See generally* Roger A. McEowen and Neil E. Harl, *Selected Farm and Small Business Tax Issues*, 10 *Drake J. Agric. L.* 57, 101 (2005).

[14] 26 U.S.C. § 1031(b); 26 C.F.R. § 1.1031(k)-1(f) (2006). If the taxpayer receives some money or non-like-kind property in partial payment for the transferred property, only that portion of the exchange is immediately taxable, and gain is realized just to the extent of the money or the fair market value of the non-like-kind property received. 26 C.F.R. §§ 1.1031(a)-1(a)(2), 1.1031(b)-1(a) (2006). This taxable portion of the transaction is informally referred to as the "boot."

[15] 26 C.F.R. § 1.1031(k)-1(g) (2006).

[16] 26 U.S.C. § 1031(a)(3); *see also* 26 C.F.R. § 1.1031(k)-1 (2006).

[17] 26 C.F.R. § 1.1031(k)-1(e) (2006).

[18] *See* Rev. Proc. 2000-37 *as modified by* Rev. Proc. 2004-51.

[19] 26 U.S.C. § 1031(f).

[20] 26 U.S.C. § 1031(f)(3) (citing 26 U.S.C. §§ 267(b), 707(b)(1)).

[21] 26 U.S.C. § 1031(f)(1). There are exceptions to this disqualification rule where the disposition is due to death or an involuntary conversion, or where the IRS is satisfied that neither the exchange nor the subsequent disposition was primarily motivated by a tax avoidance purpose. 26 U.S.C. § 1031(f)(2).