# PENNSYLVANIA DEPARTMENT OF REVENUE

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**SUT Bulletin 2006–01**

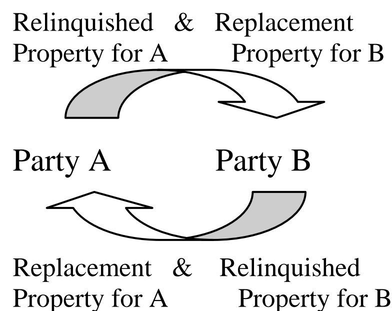
## PENNSYLVANIA TAX TREATMENT OF IRC § 1031 LIKE-KIND EXCHANGES

### IRC § 1031 Like-Kind Exchanges

Under federal tax rules, gain or loss is recognized upon the disposition of property, including dispositions involving an exchange of property.[1] Internal Revenue Code Section 1031 is an exception to the general rule, which provides that the recognition of gain or loss can be deferred under certain circumstances when property held for productive use in a trade or business or for investment is exchanged for property of a like kind and is held for productive use in business or investment.

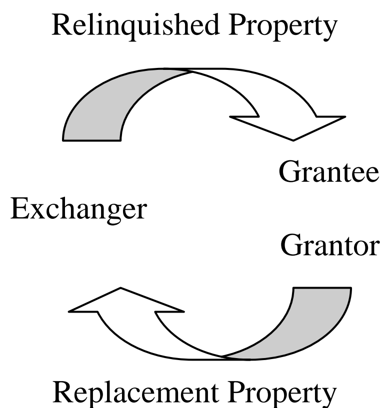
The properties in an IRC § 1031 like-kind exchange are known as the "relinquished property" and the "replacement property". The property that the taxpayer disposes is the relinquished property. The property that the taxpayer acquires to replace the relinquished property is the replacement property.

In its truest sense, an exchange occurs when there is a reciprocal giving and receiving of properties or mutual interests between two parties (i.e., a trade). In a trade, an exchange occurs for each party to the transaction. Each party experiences a relinquishment and replacement.




[1] See IRC § 1001 for recognition of gain or loss rules for dispositions of property.

However, an exchange does not have to be a reciprocal transfer of mutual interests. It can be limited to one party. In this context, the transaction involves a mere replacement of one property for another rather than a true exchange. Such transactions require three parties—a grantor, a grantee and an exchanger.




Whether the exchange is a "trade" or a mere "replacement," a true exchange only occurs when there is a simultaneous transfer of the relinquished and replacement properties. However, under IRC § 1031, federal tax law indulges in a fiction. An exchange of properties will be recognized even when the transfer does not occur simultaneously as long as the transfers occur within specifically defined statutory periods.[2] These exchanges are known as "deferred exchanges".

In deferred exchanges, additional parties to the exchange may be utilized. These additional parties are known as qualified intermediaries (QIs) or exchange accommodation titleholders (EATs). See Treas. Reg. § 1.1031(k)-1(g)(4) and Rev. Proc. 2000-37. QIs and EATs serve to broker and facilitate the exchanges. In some exchanges they actually acquire and hold the properties being exchanged, either relinquished or replacement. Deferred exchanges involving QIs and EATs can also be referred to as multi-party transactions or exchanges or "parking" transactions.

One example of a deferred exchange is a "reverse *Starker* exchange", which utilizes an EAT. In this exchange, the EAT is utilized to acquire the replacement property for the exchanger prior to the disposition of the relinquished property. After the exchanger transfers the relinquished property, the EAT conveys the replacement property to the exchanger. Such an exchange is structured as follows:

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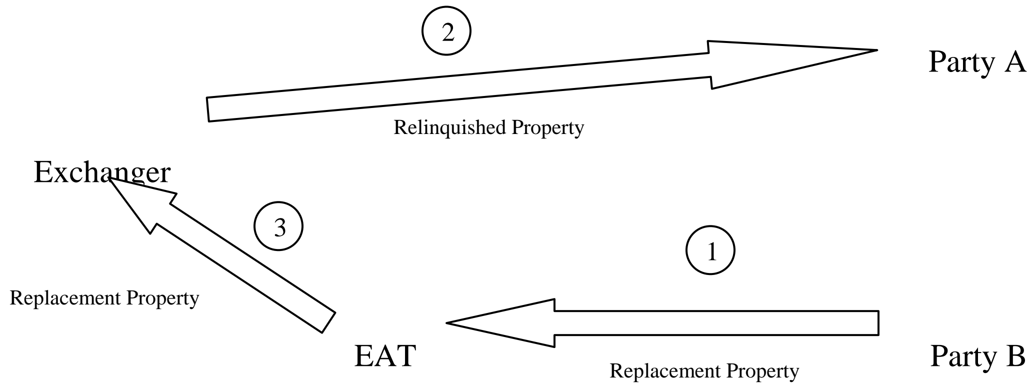
[2] See Treasury Regulations related to "identification and exchange periods". Treas. Reg. § 1.1031(k)-1(b).




Regardless of the manner in which an IRC § 1031 like-kind exchange is structured, all exchanges contemplate the deferral of gain or loss for federal income tax purposes on the disposition of the relinquished property.

**PA PIT Treatment of § 1031 Exchanges**

One of Pennsylvania's taxable classes of income is net gains or income from the sale, exchange or other disposition of property.

The gain or income from the disposition of property is equal to the value of that which is received reduced by a taxpayer's adjusted basis in the disposed property. 61 Pa. Code § 103.13. A taxpayer's basis in property is to be determined in accordance with accepted accounting principles, 72 P.S. § 7303(a)(3), but generally a taxpayer's basis is his cost, 61 Pa. Code § 103.13(c).

Pennsylvania personal income tax law does not contain a provision analogous to IRC § 1031. Therefore, exchanges of property that result in gain or income are generally subject to tax. However, the Department has determined that gain or loss on like-kind exchanges does not have to be recognized at the time of the exchange if a taxpayer's method of accounting permits the deferral of gain from a like-kind exchange. For example, APB Opinion 29 provides for non-recognition of gain or loss on certain like-kind exchanges for taxpayers who consistently use GAAP principles of accounting. A taxpayer must use the method of accounting on a consistent basis and the method of accounting must clearly reflect his income. A taxpayer may not change his method of accounting just to obtain a tax benefit for a particular transaction. Nevertheless, the deferral of gain or income associated with like-kind exchanges is the exception.

**PA RTT Treatment of § 1031 Exchanges**

IRC § 1031 exchanges involving real estate have implications for Pennsylvania realty transfer tax purposes.

Documents that effectuate or evidence the transfer of title to real estate are subject to

Pennsylvania realty transfer tax. 72 P.S. § 8102-C. Consequently, if title to Pennsylvania real estate is conveyed in an IRC § 1031 exchange, the document of conveyance is subject to tax.

In simple exchanges involving a trade of properties, Pennsylvania realty transfer tax is due on the document of transfer for each property. The tax on each transfer is rarely a disputed issue.

In a multiparty exchange, a QI or EAT is interposed between the ultimate grantor and grantee of relinquished or replacement properties. As a result, two transfers are required in order to convey the real estate between the grantor and ultimate grantee (a transfer from the grantor to the QI or EAT and a subsequent transfer from the QI or EAT to the ultimate grantee). As a result, multiparty deferred exchanges can result in multiple impositions of tax on the same property, either relinquished or replacement.

Many taxpayers and tax practitioners erroneously believe that a QI or EAT serves as an agent or straw party in a multiparty deferred exchange in order to facilitate the exchange. Those taxpayers and practitioners argue that a transfer from a QI or EAT is entitled to the realty transfer tax exclusion for documents that effectuate or evidence the transfer of title to real estate from an agent or straw party to a principal. See 72 P.S. § 8102-C.3(11).

The agent or straw party exclusion is not applicable to QI or EAT transfers, however. In order to obtain the deferral of gain or loss for federal income tax purposes, there must be an "exchange" of property as provided under IRC § 1031. An exchange cannot occur if a taxpayer owns or holds title to both the relinquished and replacement property at the same time. Therefore, in multiparty deferred exchanges, the QI or EAT cannot be an agent or straw party. In all agency or straw party relationships the agent or straw party acts in lieu of and for the principal. When an agent or straw party purchases property for a principal, he holds title to the property for the mere benefit of the principal. As a result, ownership of the property is imputed to the principal. In a multiparty deferred exchange, if ownership of real estate held by a QI or EAT can be imputed to the taxpayer, as would be the case in an agent or straw party relationship, the taxpayer would be considered to be the owner of both the replacement and relinquished property as the same time. Therefore, there could be no exchange and the taxpayer would not qualify for the IRC § 1031 deferral of gain. For these reasons, federal tax law precludes a QI or EAT from being an agent or straw party of the taxpayer.[3]

Because all multiparty exchanges in which the QI or EAT takes title to the real estate being exchanged are structured to obtain the deferral of gain or loss under IRC § 1031, practitioners always structure such transactions so that QIs and EATs are the actual owners of the relinquished or replacement property so that ownership is not imputed to the taxpayer. This actual ownership is evidenced by the fact that a QI or EAT can hold title to real estate for a substantial period of time. Further, exchange agreements often contain provisions that create a

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[3] See Treas. Reg. §§ 1.1031(b)-2 and 1.1031(k)-1(g)(4)(i), which specifically state that a QI is not considered an agent of the taxpayer; see also Rev. Proc. 2000-37, § 4.02(1), which provides that an EAT must acquire "qualified indicia of ownership" (legal title or other indicia of ownership equivalent to a beneficial ownership).

landlord/tenant relationship between the QI or EAT and the taxpayer. Financing for the purchase of replacement property is often obtained from financial institutions through the QI or EAT rather than the taxpayer. Some exchange agreements between QIs or EATs and taxpayers will even contain puts and calls for the real estate. All of those items are contrary to the existence of an agent or straw party relationship between the QI or EAT and the taxpayer.

Structuring multiparty deferred exchanges in this manner obtains for a taxpayer the deferral of gain or loss on the exchange for federal income tax purposes, but it precludes the application of the agent or straw party exclusion for Pennsylvania realty transfer tax purposes.

## PA SUT Treatment of § 1031 Exchanges

Since Pennsylvania sales and use tax law defines a sale at retail as any transfer for consideration of the ownership, custody or possession of tangible personal property, sales and use tax applies when a party makes a like-kind exchange of tangible personal property. If the party making a like-kind exchange obtains the replacement property from a vendor who will take the property to be exchanged in lieu of the whole or any part of the purchase price of the property, the vendor is permitted to reduce the purchase price by the amount the vendor allowed the purchaser for the trade-in. Pennsylvania sales and use tax law, however, requires that the trade-in occur at the same time as the purchase.

If an exchange occurs through the use of a qualified intermediary and the property to be exchanged is eligible for the isolated sale exemption, the sale to the intermediary is not subject to tax. The replacement property "purchased" from the qualified intermediary, however, is subject to tax if the purchaser has no valid exemption reason and the qualified intermediary is a vendor of tangible personal property if the intermediary engages in 1031 exchanges as a business. The replacement property's "purchase price" may not be reduced by the amount the intermediary allows for the property traded-in unless the intermediary accepts the property traded-in in lieu of all or part of its "purchase price" of the replacement property and the intermediary "purchases" the property traded-in at the same time it "sells" the replacement property to the party making the trade-in.