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Limitation of Use of 1031 Exchanges Limit Nonrecognition of Gain

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by Kelly F. O'Donnell

Business owners have long taken advantage of the tax deferral benefits of so-called "1031 exchanges" or "like-kind exchanges." Generally, an exchange of property, like a sale, is a taxable event. However, Section 1031 of the Internal Revenue Code (the "Code") allows owners to defer recognition of a gain on property held for productive use in a trade or business, or for investment, when it is exchanged for property of a "like kind" which is to be held for productive use, or investment, as the case may be.

For example, an exchange of a luxury yacht or private jet for a yacht or jet classified as "like kind," if done pursuant to the parameters of Section 1031 of the Code, could defer any gain until the yacht or jet is sold or transferred in an otherwise taxable event. Of course, if the business owner merely continued to exchange the yacht for like kind equipment, such deferrals on taxable gain could continue for a significant amount of time. Since 2008, vehicle lessors have been able to exchange their fleet of vehicles for another fleet of vehicles at the end of their lease term to take advantage of 1031 exchange rates. This technique can produce tax savings compared to the more standard method of selling off each car and purchasing new cars subject to tax. Although lessors still bear the tax burden of depreciation recapture, to the extent the property has depreciated, lessors can avoid the tax on cash that would be received on the sale of the used vehicles, and instead reinvest such savings in the next fleet of vehicles.

Prior to the Tax Cuts and Jobs Act signed into law in December of 2017, business owners could use a 1031 exchange for (1) depreciable tangible personal property (such as computer equipment or heavy construction equipment), (2) intangible or nondepreciable personal property (such as copyrights and trademarks), and (3) real property. While the vast majority of 1031 exchanges pertained to real estate, many companies and individuals took advantage of the

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tax deferrals available through a 1031 exchange for heavy equipment and valuable vehicles, such as construction equipment, yachts, and jets.

The Tax Cuts and Jobs Act amended Section 1031 of the Code to limit its application to *real property* only. Effective December 31, 2017, like kind exchanges of personal property will no longer be eligible for the gain deferral benefits of a 1031 exchange, and swaps of such property will incur tax on gains going forward. The Joint Conference Report for the Tax Cuts and Jobs Act estimates the changes to Section 1031 will increase federal tax revenues by $31 billion over the next ten years. Business which have typically taken advantage of high value like-kind exchanges of personal property, such as construction companies, airlines, and rental car companies, will be most impacted by these changes. This amendment is permanent, and is not set to sunset at the end of ten years as many other changes to the Tax Cuts and Jobs Act are.

Companies who previously took advantage of such 1031 exchanges should start planning now to seek alternative tax deferral or savings strategies, such as the temporary full expensing deduction set to expire in 2022.

If you have any questions regarding the content of this alert, please contact Kelly F. O'Donnell or any of the attorneys in our Tax Law Practice.

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