
General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals



Department of the Treasury
March 2014

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MODIFY LIKE-KIND EXCHANGE RULES FOR REAL PROPERTY

Current Law

When capital assets are sold or exchanged, capital gain or loss is generally recognized. Under section 1031, however, no gain or loss is recognized when business or investment property is exchanged for “like-kind” business or investment property. As a result, the tax on capital gain is deferred until a later realization event, provided that certain requirements are met. The “like-kind” standard under section 1031, which focuses on the legal character of the property, allows for deferral of tax on the exchange of improved and unimproved real estate. Certain properties, including stocks, bonds, notes or other securities or evidences of indebtedness are excluded from nonrecognition treatment under section 1031.

Reasons for Change

There is little justification for allowing deferral of the capital gain on the exchange of real property. The difficulty in valuing exchanged property is a primary historical justification for 1031 deferral. However, this rationale has limited appeal. For the exchange of one property for another of equal value to occur, taxpayers must be able to value the properties. In addition, many, if not most, exchanges affected by this proposal are facilitated by qualified intermediaries who help satisfy the exchange requirement by selling the exchanged property and acquiring the replacement property. These complex three party exchanges were not contemplated when the provision was enacted. They highlight the fact that valuation of exchanged property is not the hurdle it was when the provision was originally enacted. Further, the ability to exchange unimproved real estate for improved real estate encourages “permanent deferral” by allowing taxpayers to continue the cycle of tax deferred exchanges.

Proposal

The proposal would limit the amount of capital gain deferred under section 1031 from the exchange of real property to \$1,000,000 (indexed for inflation) per taxpayer per taxable year. The proposal limits the amount of real estate gain that qualifies for deferral while preserving the ability of small businesses to generally continue current practices and maintain their investment in capital. Treasury would be granted regulatory authority necessary to implement the provision, including rules for aggregating multiple properties exchanged by related parties.

The provision would be effective for like-kind exchanges completed after December 31, 2014.