Financial, Legal & Tax Advisory

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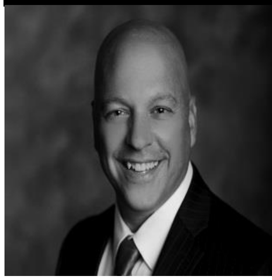

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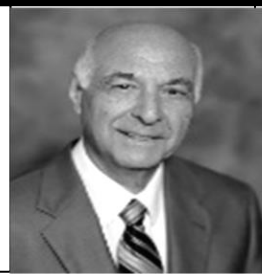

Dr. Bart A. Basi, Senior Advisor of the Center for Financial, Legal & Tax Planning, Inc., is an expert on closely-held companies, an attorney, and CPA. He is a member of the American Bar Association's Tax Committees on Closely-Held Businesses and Business Planning.

1031 Exchange Explained

As a result of the Tax Cuts and Jobs Act (TCJA), the trading of like-kind personal property for other personal property is now considered a taxable event. Before the TCJA, 1031 exchanges applied to more than just real estate (franchise licenses, aircraft, equipment, etc.). In response to this change, taxpayers had numerous inquiries about the definition of "real property," including whether a like-kind exchange would fail if incidental personal property was received. Under Section 1031 of the United States Internal Revenue Code (26 U.S.C. § 1031), a taxpayer is eligible to defer their recognition of capital gains and related federal income tax liability when exchanging certain types of property. This is a process known as a 1031 exchange. However, it is extremely important to note that the gain will not be eliminated, it is only deferred.

When broadly stated, a 1031 exchange is a swap of one investment property for another. Most swaps are taxable as sales, although if you meet the requirements for 1031, you can either have no tax or limited tax due at the time of the exchange. This gives you the ability to change the form of your investment without cashing out or recognizing a capital gain. You are then able to allow your investment to grow tax-deferred. There is no limit on the frequency of engaging in a 1031 exchange, you can simply roll over the gain from one piece to another and another and another, etc. The definition of real property also includes any permanent structures such as buildings, roads, and bridges.

Real property, such as a structural component of an inherently permanent structure (i.e., walls, doors, and wiring) also qualifies under Section 1031. The regulations happen to provide a list of structures that qualify as real property, as well as factors that must be used to determine if the property is considered an inherently permanent structure. Even if a property happens to not be listed in the proposed regulations, it can still be considered real property, based upon a consideration of all the facts and circumstances. Certain fixed assets often accompany real property and must be analyzed to determine whether they are part of the real property.

Generally, machinery or equipment is not inherently known as a permanent structure and as a result, it is not real property, unless it serves an inherently permanent structure and does not produce or contribute to the production of income other than for the use or occupancy of space. Comparatively, some structural components may be personal property rather than real property for the same reason. Taxpayers may perform a functional test for these structural components to determine whether they serve an inherently permanent structure. For example, an argument can be made that under the Treasury regulations, a natural gas line to a furnace may be real property, but a similar gas line to a fryer and oven is not. We can also take a moment to discuss incidental personal property. If a taxpayer happens to receive office furnishings in addition to an office building, does that make the Section 1031 exchange invalid?

Based on the Treasury Department and its regulations, the answer would be NO. Personal property can be considered incidental to the acquisition of real property whenever the personal property is customarily transferred together with an acquired real property and the personal property's fair market value (FMV) does not exceed 15% of the FMV of the real property. However, the gain will have to be recognized equal to the lesser of the realized gain on the relinquished property or the FMV of the acquired personal property.

Section 1031 exchanges can become over-complicated for no good reason. If a taxpayer sells a relinquished investment property and then purchases a replacement investment property within the applicable period using a qualified intermediary, the transfer will often be valid within the eyes of the Internal Revenue Service. Some other nuances and documents are required to facilitate the exchange, but these are the very basic and barebone requirements to facilitate a successful Section 1031 exchange. Is your business looking towards selling real estate and reinvesting into other real estate? Contact the professionals at The Center for Financial, Legal, and Tax Planning, Inc. Our office is extremely knowledgeable concerning the real estate, legal, and accounting portions of a 1031 exchange and we'd love to assist you in deferring your capital gain taxes. Please contact us at (618) 997-3436.

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