

Like-Kind Exchanges: Deferral Is Not Always the Best Option

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When taxpayers sell real estate and replace it with like-kind property, Sec. 1031 gives them the opportunity to defer taxation on the gains they may have on their transactions. Anytime there is an opportunity to defer tax costs, tax practitioners and their clients automatically tend to assume that they should take advantage of the opportunity. However, in the case of like-kind exchanges, it is not always in the taxpayer's best interest to elect to defer the recognition of gain on realty.

In order to qualify for a like-kind exchange on realty, taxpayers usually must engage the services of an intermediary at the cost of an agency fee, and they are under a relatively stringent time constraint for finding a replacement property. Moreover, deferral of tax on the gain results in a limited basis in the qualified replacement property, which, in turn, limits the amount of depreciation deductions available to the taxpayer on the qualified replacement property over its cost recovery period.

When the tax rates on a taxpayer's gain from the sale of realty are substantially lower than the marginal tax rate on the ordinary income that he or she could shelter with depreciation deductions on newly acquired property, the taxpayer may

be better off forgoing deferral of tax on the gain. In such instances, the taxpayer would have a higher depreciable basis in the acquired property and thereby have a larger net tax savings over time from the higher depreciation deductions.

This article examines whether deferral of the recognition of gain under the like-kind exchange provisions of Sec. 1031 is more advantageous for a taxpayer than recognition of the gain considering the lower capital gains tax rate, the tax on unrecaptured Sec. 1250 gain, and the taxpayer's marginal tax rate.¹ It also examines other factors that taxpayers should consider when determining whether to undertake a like-kind exchange. Illustrations compare the tax consequences of deferring the tax on the gain from a sale of real estate through a like-kind exchange with the tax consequences of recognizing gain on the sale of real estate, paying taxes on that gain, and deducting a

¹ In addition to the federal tax factors discussed in this article, taxpayers should also consider any state taxes that might affect the tax cost of the sale or exchange transaction.

larger amount of depreciation on property acquired with the sales proceeds.

Sec. 1031 Overview

Only “property held for productive use in a trade or business or for investment”² is eligible for deferral of gain or loss under Sec. 1031, and deferral is available only to the extent that eligible property is “exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.”³ Taking advantage of the deferral provisions of Sec. 1031 can prove especially troublesome for taxpayers who hold real estate for investment or productive use in a trade or business and also hold other real estate properties as inventory. For example, a real estate investor/dealer who buys properties with the intent of repairing and reselling them, but also buys properties to rent, must be able to clearly distinguish between his or her inventory and his or her rental properties.

Exchanges of any “stock in trade or other property held primarily for sale”⁴ (emphasis added) are ineligible for gain deferral under Sec. 1031. This provision renders real estate bought merely to “flip” through a resale ineligible for like-kind exchange treatment. The tax on the gain from the sale of rental real estate, however, should be eligible for deferral through a like-kind exchange of the property.

Simply holding a property out for rental before ultimately selling it is unlikely to constitute persuasive evidence that the property was rental property rather than property held primarily for sale. If the primary purpose for initially acquiring property was to resell it, then it would seem unlikely that renting the property out while it is being marketed would convince the IRS that gain from the sale of the property would qualify for gain deferral under Sec. 1031 since the deter-

mination must be based on the *primary* purpose for which the property was held.⁵

Sec. 1031 specifically excludes a number of other categories of property from eligibility for deferral of recognition of gain. Those categories include stocks, bonds, and notes;⁶ other securities or evidence of indebtedness or interest;⁷ interests in a partnership;⁸ certificates of trust or beneficial interests;⁹ and choses in action.¹⁰ In addition to the broad limitations on what types of property qualify for deferral of recognition of gain under Sec. 1031, there are also some specific statutory provisions concerning what constitutes like-kind property.

For example, livestock of different sexes are not considered like-kind property even if they are of the same breed.¹¹ Certain exchanges between related parties that would have qualified as like-kind exchanges had the parties not been related are not considered to be like-kind exchanges for purposes of Sec. 1031.¹² Exchanges of U.S. realty or personal property used primarily in the United States for realty located outside the United States or personal property used primarily outside the United States are not considered to be like-kind exchanges under Sec. 1031, regardless of how similar the exchanged properties are.¹³

Although the exclusions and restrictions contained in Sec. 1031 undoubtedly reduce the number of like-kind exchanges that would otherwise take place annually, the section does include provisions that help facilitate the execution of a like-kind exchange. It is usually difficult, if not impossible, for the owner of eligible real property who would like to enter into a like-kind exchange to find another owner of attractive eligible real property who is interested in exchanging real estate. Sec. 1031 includes provisions that permit the use of an intermediary to enable taxpayers

EXECUTIVE SUMMARY

- Many taxpayers assume that the gain deferral provided by a like-kind exchange always makes a like-kind exchange of an eligible property more advantageous from a tax standpoint than a sale of the property. However, depending on a taxpayer's situation, a like-kind exchange may not be better from a tax standpoint than a sale of the property followed by a purchase of new property.
- In comparing a like-kind exchange of properties with a sale or purchase of property, the taxpayer must take into account the difference in depreciation deductions after the two transaction forms, the value of the deferral of the recognition of gain in a like-kind exchange, and the administrative costs of the like-kind exchange.
- The absolute amount of tax savings provided by the deferral of gain in a like-kind exchange and the present value of those savings can be dramatically affected by changes in the taxpayer's marginal tax rates, the overall rates of tax on ordinary income and capital gains, and the taxpayer's rate of return on investments.

2 Sec. 1031(a)(1).

3 Id.

4 Sec. 1031(a)(2)(A).

5 Id.

6 Sec. 1031(a)(2)(B).

7 Sec. 1031(a)(2)(C).

8 Sec. 1031(a)(2)(D).

9 Sec. 1031(a)(2)(E).

10 Sec. 1031(a)(2)(F). Choses in action are rights “not reduced to possession but recoverable by bringing and maintaining an action,” such as the right of a creditor to be paid. *Ballentine's Law Dictionary* (Lawyers Co-operative Publishing 1969).

11 Sec. 1031(e).

12 Sec. 1031(f).

13 Secs. 1031(h)(1) and (2).

to overcome this lack of “double coincidence of wants.”

Using an Intermediary to Effect a Like-Kind Exchange

Taxpayers who wish to engage in a Sec. 1031 like-kind exchange have the option of entering into an agreement to sell their property and assigning the sales contract to a “qualified intermediary.” In accordance with the provisions of Sec. 1031 and the regulations thereunder, the intermediary will complete the sale and hold the proceeds in escrow until the seller identifies a qualified replacement property. Once the taxpayer identifies the replacement property, the intermediary pays for it using the funds from the sale of the original property. In order for a replacement property to be considered received in exchange for the property that the intermediary sold on behalf of the owner, the taxpayer must identify the property “on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange.”¹⁴ In addition, the replacement property must actually be received by “the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or the due date (determined with regard to extension) for the transferor’s return for the taxable year in which the transfer of the relinquished property occurs.”¹⁵

The Costs of a Like-Kind Exchange Intermediary, Default, and Decision

The use of an intermediary is often the only way for a taxpayer to make a qualifying like-kind exchange and defer recognition of gain under the provisions of Sec. 1031. Exchangers should generally expect to incur a minimum fee of \$700 for a single complete transaction for the services of a qualified intermediary.¹⁶ The intermediary will have control of the

proceeds from the sale of the exchanger’s property from the time of the sale until the time of purchase of the replacement property. The intermediary usually deposits the proceeds from the sale into an escrow account for the benefit of the exchanger and holds them until needed to purchase qualified replacement property. Even if the taxpayer does not find qualified replacement property, the intermediary will generally hold the funds for the full 180-day period, thereby rendering them unavailable to the exchanger.

The fee charged by the intermediary is one of the costs associated with a like-kind exchange. In addition, during the exchange period only the intermediary has access to and control of the proceeds generated by sale of the exchanger’s original property. Consequently, there are costs and risks associated with the exchanger’s inability to access those sales proceeds. In the event that the intermediary becomes insolvent with those proceeds in its possession, they could be entirely lost.

There is, however, some measure of protection for the exchanger. Intermediaries usually transfer the sales proceeds that they are holding to a separate bank account for each exchanger while awaiting instructions from the exchanger to complete the purchase of qualified replacement property. Deposit into a separately identifiable bank account offers very limited protection. The Federal Deposit Insurance Corporation (FDIC) will generally insure such accounts only up to a maximum of \$250,000 per owner.¹⁷ Exchangers should be aware of this limited protection and understand that in the event of bank failure, the \$250,000 maximum coverage for such accounts may be inadequate. Moreover, intermediaries usually choose their banking relationships. Exchangers should ensure that intermediaries deposit sales proceeds into banks that are adequately capitalized and offer the greatest degree of safety regard-

less of whether the intermediary has a relationship with the bank.

Another potential cost associated with the like-kind transfer is the possibility that the exchanger will exercise poor judgment in choosing a replacement property due to the time constraints placed on the transaction. Exchangers must identify qualified replacement property or properties within the 45-day period and complete the purchase transaction within the requisite 180 days allowed to close the transaction. If an identified qualified replacement property becomes unavailable, or the negotiations go poorly, the exchanger could be faced with imminent expiration of the 180-day period for closing. He or she could therefore be forced to meet the less-than-favorable demands of a seller or forgo the like-kind exchange altogether. While default and decision costs are difficult to quantify, and there may be little likelihood of a particular exchanger actually realizing these costs, the exchanger should consider them, along with the payment of fees to an intermediary, as potential costs associated with a like-kind exchange.

Limited Cost Recovery Deduction

When a taxpayer postpones recognition of gain by exchanging a property for a like-kind property, “the basis [of the property received in exchange] shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange.”¹⁸ The result of this provision is that the amount of any unrecognized gain is not considered part of the basis of the property received and therefore is not included in the basis of the qualified replacement property for purposes of depreciation.

Taxpayers who enter into a sale and subsequent purchase of real property used in a trade or business will recognize gain,

14 Sec. 1031(a)(3)(A).

15 Sec. 1031(a)(3)(B).

16 Minimum fee charged by one of the largest asset preservation companies in the United States, Asset Preservation, Inc.

17 The maximum FDIC coverage per account, per entity, was increased from

\$100,000 to \$250,000 by the Emergency Economic Stabilization Act of 2008, P.L. 110-343. The increase is set to expire December 31, 2009, and, unless Congress takes further action, the maximum coverage will return to \$100,000.

18 Sec. 1031(d).

if any, realized at the time of sale. However, a taxpayer can take cost recovery deductions on the newly acquired real property to the extent that it is depreciable. While it is true that the tax savings attributable to depreciation will be spread over a period of years and the tax on the recognition of gain will be immediate, in certain instances the tax savings from depreciation deductions taken over time could more than offset the tax recognized on the gain. This positive result over the cost recovery period for real property is due in large part to the preferential rates imposed on real property capital gains.

Consider that for real property used in a trade or business and held for more than a year, any gain attributable to a reduction in basis due to straight-line depreciation deductions (which is the only type of depreciation currently available for real property), allowed or allowable, is unrecaptured gain under Sec. 1 and is subject to a 25% tax rate.¹⁹ Any further gain attributable to an appreciation in value of the real estate is taxed as long-term capital gain, which is currently taxed at a maximum rate of 15%. A taxpayer that chooses to reinvest the proceeds from the sale of real property in another parcel of real property used in a trade or business or used as rental property can depreciate the eligible portion of its basis and shelter ordinary income taxed at a rate as high as 35%. Given the lower rates on gains realized from the sale of real property, postponing recognition of the gain may not result in the greatest tax benefit. The following example illustrates this point.

Example 1: Taxpayer *R* has several residential rental properties that he has acquired over a period of several years. Among them is a property adjacent to a dress shop. *N*, the owner of the dress shop, would like to expand the storage area of her store. She offers to buy the house next to the store that *R* owns. The house, which *R* acquired for \$50,000 (\$40,000 building + \$10,000 land), has been depreciated for 17.5 years, and *R*'s basis in the property is \$24,545. *N* offers to pay \$125,000 for the house plus

all closing costs. *R* accepts the offer. *R*'s marginal tax rate is 35%. *R* has owned this property long enough to qualify for the more favorable long-term capital gains tax rate.

If *R* chooses to sell his property and defer recognition of the gain through a like-kind exchange, he can postpone recognition of the \$100,455 gain from the sale of the house to *N*. If *R* uses the sales proceeds to buy qualified replacement property for \$125,000, he would have a carryover basis of \$24,545 in the replacement property. His depreciable basis would be \$14,545 (\$24,545 total basis less the \$10,000 basis in the land). Since *R* must continue to depreciate the newly acquired residential rental realty using the straight-line method over the remaining 10-year recovery period, his depreciation on his replacement property would be limited to \$1,455 ($\$40,000 \div 27.5$) per year (Regs. Sec. 1.168(i)-6(c)(3)(ii)). The annual depreciation would generate a tax savings of \$509 ($\$1,455 \times .35$), assuming that the depreciation deduction does not result in a nondeductible loss from passive rental activity.

On the other hand, if *R* were to recognize the gain from the sale of his original property and use the sales proceeds to purchase a similar property, he would pay \$17,614 [$(\$25,455 \text{ unrecaptured gain} \times .25) + (\$75,000 \text{ capital gain} \times .15)$] in federal tax on the gain from the sale. He would, however, be allowed to depreciate \$105,000 (\$125,000 cost of the newly acquired property less an assumed value of \$20,000 for the land), which would generate a cost recovery deduction of \$3,818 ($\$105,000 \div 27.5$) per year. The annual depreciation deduction would generate a tax savings of \$1,336 ($\$3,818 \times .35$) per year for *R* for 27.5 years, if the depreciation deduction did not result in a nondeductible loss from his passive rental activities.

Assume that *R* holds the replacement property for the entire 27.5-year cost recovery period. If we further assume a 4% rate of return and compare the sale versus exchange alternatives for *R*, the pres-

ent value of the net difference in annual tax savings of \$827 [$\$1,336$ (tax benefit from depreciation on \$105,000) – \$509 (tax benefit from depreciation of the \$24,000 remaining basis)] during the first 10 years of the 27.5-year recovery period is \$6,708, and \$11,205 during the 17.5 years thereafter, for a total of \$17,913. However, to fully compare the sale and purchase transactions to the like-kind exchange alternative, this net tax savings must be reduced by the taxes that would be paid on the gain recognized at the time of sale, \$17,614, and increased by the \$700 intermediary fee avoided. The result is that the net savings from the like-kind exchange is \$999 less than the savings realized over time if *R* had not made the like-kind exchange election.

Under the alternatives above, at the end of 27.5 years, *R*'s basis in his replacement or newly acquired property would be \$10,000 and \$20,000, respectively, representing the cost allocated to the land. However, if *R* completes the transaction as a like-kind exchange and at the end of 27.5 years sells the replacement property for *at least* \$125,000 after fully depreciating it, only \$40,000 (\$50,000 acquisition price of the original property less \$10,000 value attributed to the land) of the \$115,000 gain would be classified as unrecaptured gain. The entire gain of \$105,000 will be Sec. 1250 unrecaptured gain if *R* chooses not to enter into a like-kind exchange, recognizes the gain on the sale of the original property, and at the end of 27.5 years sells the newly acquired property for *at least* \$125,000.

In the event that both the long-term capital gains tax rate and the tax rate on unrecaptured gain are unchanged at the end of 27.5 years, the additional 10% tax avoided (25% rate on unrecaptured gain less the 15% capital gains tax rate) on \$65,000 of gain ($\$105,000 - \$40,000$) if a like-kind exchange is elected will be \$6,500. Because *R* would have to wait 27.5 years to realize this tax savings, it has a present value of \$2,210, assuming a 4% rate of return. Considering this future additional tax savings when the qualified replacement property is sold at the end of

¹⁹ Sec. 1(h)(1)(D).

the cost recovery period, the net savings from electing like-kind exchange would be \$1,211 (\$2,210 – \$999) more than the tax savings realized over time when the like-kind election is not made. However, in this particular case the present value of the tax on the \$10,000 additional gain that *R* will recognize at the end of 27.5 years would reduce the total net tax savings under the like-kind exchange alternative to \$701. (See Exhibit 1.)

By choosing to enter a like-kind exchange, *R* defers the tax he would otherwise pay if he sold the real property. His out-of-pocket cost is limited to the \$700 exchange fee paid to an intermediary. The present value of the tax benefit associated with the lower annual depreciation deduction for the remaining 10 years is \$4,129. If *R* chooses to sell the real property and use the proceeds to purchase other real property and elects not to enter into a like-kind exchange, he incurs an immediate tax cost of \$17,614. However, he is allowed a larger annual tax benefit from depreciation, and the present value associated with the tax benefit from the higher annual cost recovery deduction is \$22,042.

In Example 1, *R* held the replacement/newly acquired property for the entire 27.5-year cost recovery period. However, owners frequently dispose of a property before the end of the 27.5-year cost recovery period. Example 2 illustrates the effect on the net tax savings when an investor chooses to dispose of the replacement/newly acquired property before the end of the cost recovery period.

Example 2: Assume the same facts as in Example 1. Further assume that *R* sells the newly acquired property or the qualified replacement property after holding it for 10 years.

If *R* elected *not* to enter into a like-kind exchange and pay the federal income tax on the gain at the time of the sale of his original property, his depreciable basis in the newly acquired property would be \$105,000 (\$125,000 cost less \$20,000 attributed to the land). His annual depreciation would have been \$3,818 per year for each of the

Exhibit 1: Sale or exchange net present value calculation in Example 1

	Sale	Like-kind exchange
Time of sale or exchange		
Tax cost	\$(17,614)	
Exchange transfer cost		\$ (700)
Depreciation tax benefit		
Original property		4,129
Replacement property	22,042	
Net present value	4,428	3,429
Difference	999	
Subsequent sale for \$125,000		
Present value of gain recognized	(8,925)	(7,225)
Net present value giving consideration to sale	(4,497)	(3,796)
Difference		701

Note: Replacement property is held for entire cost recovery period. There is 100% reinvestment in like-kind property, a 4% discount rate, and a 35% marginal tax rate.

10 years that he held the property. The annual depreciation deductions would have resulted in annual federal tax savings of \$1,336 each year, assuming a 35% marginal tax rate and that the annual depreciation deduction did not result in nondeductible loss from passive rental activity. The present value of the \$13,360 total tax savings over the 10-year period would be \$10,836, assuming the same 4% rate of return used in Example 1.

In Example 1, the present value of the federal income tax savings from the higher amount of depreciation was greater than the immediate tax cost incurred when a like-kind exchange was not elected. However, if *R* sells the newly acquired property at the end of 10 years, the net tax benefit from the higher depreciation will be significantly less. The \$10,836 present value of the additional tax savings when a like-kind exchange is not elected is not enough to offset the \$17,614 tax incurred at the time of sale of the original property. Given the shorter holding period, the sale-purchase transaction would have a net tax cost of \$6,778.

A sale of the newly acquired property for *at least* \$125,000 after 10 years would result in a net gain of \$38,180 (\$125,000 cost – \$86,820 basis). The entire \$38,180 gain would be unrecaptured gain subject to the 25% tax rate under current tax law,

resulting in a tax of \$9,545 on the sale of the newly acquired property. The present value of this tax cost in 10 years is \$6,448. If *R* contemplates a sale of the newly acquired property in 10 years, the relevant total net cost to consider is \$13,226 (\$6,778 + \$6,448).

However, if *R* enters into a like-kind exchange and holds the replacement property for 10 years, his tax savings attributable to the depreciation deductions taken during the 10-year period would be \$509 per year, for a total of \$5,090. The \$5,090 total tax savings realized over the 10-year period would have a present value of \$4,129, assuming the same 4% rate of return used in Example 1 above. When the \$700 paid to an intermediary to affect the like-kind exchange is taken into account, the net present value of the savings over the 10-year period is reduced to \$3,429 (\$4,129 – \$700).

Now assume that *R* sells the replacement property received in the like-kind exchange at the end of 10 years for *at least* \$125,000. At the time of sale, his basis in the property would be \$10,000 (\$24,545 carryover basis less \$14,545 depreciation taken for 10 years). The gain on the sale would be \$115,000 (\$125,000 – \$10,000). Under current tax law, \$40,000 of the gain would be Sec. 1250 unrecaptured gain, subject to a 25% tax rate, resulting in a \$10,000 tax liability; \$75,000

of the proceeds would be long-term capital gain subject to a 15% tax rate, resulting in a tax liability of \$11,250. *R* would recognize a combined total tax of \$21,250 on the gain from the sale of the replacement property. The present value of this tax cost is \$14,356. If *R* contemplates a sale of the replacement property in 10 years, the relevant total net cost to consider is \$10,927 (\$14,356 – \$3,429).

In the above sale illustrations, the tax liability from the sale of the qualified replacement property would be \$11,705 (\$21,250 – \$9,545) greater than the tax liability from the sale of the newly acquired property. As indicated above, *R* will not realize this tax cost for 10 years. Assuming a 4% rate of return, the present value of the \$11,705 higher tax cost from the sale of qualified replacement property is \$7,908. When combined with the \$3,429 net present value of the tax savings determined above resulting from an investment in qualified replacement property, the present value of the cost associated with the like-kind exchange transaction is \$4,479 (\$7,908 – \$3,429), which is \$2,299 (\$6,778 – \$4,479) less than the present value of the tax cost associated with the decision not to enter a like-kind exchange transaction. (See Exhibit 2.)

Both Examples 1 and 2 involve modestly valued real property. Consequently, the tax savings achieved by choosing the option that minimizes taxes is not large. If a multimillion-dollar property or numerous transactions involving modestly valued properties had been involved, the savings or costs would be multiplied accordingly. The additional gain from a subsequent sale at an amount beyond the \$125,000 acquisition price would be treated the same under both alternatives.

Bonus Depreciation

In the above examples, *R* has an opportunity to exchange or sell residential real estate. If the property is nonresidential real estate, the taxpayer must consider other factors that could affect the amount and timing of depreciation deductions

Exhibit 2: Sale or exchange net present value calculation in Example 2

	Sale	Like-kind exchange
Time of sale or exchange		
Tax cost	\$(17,614)	
Exchange transfer cost		\$ (700)
Depreciation tax benefit		
Original property		4,129
Replacement property	10,836	
Net present value	(6,778)	3,429
Difference	(10,207)	
Subsequent sale for \$125,000		
Present value of gain recognized	(6,448)	(14,356)
Net present value giving consideration to sale	(13,226)	(10,927)
Difference		2,299

Note: Replacement property is held for 10 years. There is 100% reinvestment in like-kind property, a 4% discount rate, and a 35% marginal tax rate.

available on the newly acquired realty. The Economic Stimulus Act of 2008²⁰ extended the first-year bonus depreciation deduction available on qualified property, which is generally personal property but also includes some leasehold improvements.²¹ Under the provisions of the act, for one year only, taxpayers may take an additional first-year depreciation deduction of 50% of the adjusted basis for such property.

In the event that the taxpayer has an opportunity to place newly acquired nonresidential real property into service before the act's extended provisions expire, qualified leasehold improvements should be identified. Under the appropriate circumstances, it may be prudent to conduct or commission a cost segregation study to identify components of the nonresidential realty that a taxpayer could classify as personalty eligible for the first-year bonus depreciation. It is apparent from the above examples that if the property in question was nonresidential realty and the taxpayer was able to avail himself of bonus depreciation for the newly acquired property, the choice of the sale alternative would be the most attractive in either case.

The Uncertainty Factor Changes in Tax Rates

In Example 2 above, the taxpayer would realize greater savings over time from a like-kind exchange. This is due in large part to the preferential 15% federal tax rate on long-term capital gains in effect at the end of the 10-year holding period. Given the current federal budget crisis and calls for higher taxation of wealthier taxpayers, a reduction in the higher individual tax rates seems improbable and an increase in those rates would appear to be more likely.

If the long-term capital gains tax rate in Example 2 were to increase by five percentage points to 20%, *R* would incur an additional \$3,750 in taxes on the \$75,000 capital gain recognized on the sale of qualified replacement property acquired in a like-kind exchange. When reduced to its present value of \$2,302, this additional tax cost is a 24% increase in the present value of the costs associated with the sale of the qualified replacement property—an increase that makes electing a like-kind exchange less attractive than the alternative.

Changes in the tax rates imposed on unrecaptured gain as described in Sec. 1

²⁰ Economic Stimulus Act of 2008, P.L. 110-185, §103.

²¹ Sec. 168(k). The special allowance is available for certain property acquired after December 31, 2007, and before January 1, 2010 (the provision was

extended through 2009 by the American Recovery and Reinvestment Act of 2009, P.L. 111-5).

will also affect a determination of the net tax savings under both alternatives. The taxpayer who chooses to recognize gain from a sale rather than enter into a like-kind exchange will have more unrecaptured gain at the end of the cost recovery period or at time of sale. Increases in the tax rate on unrecaptured gain will make Sec. 1031 like-kind exchanges more attractive, and reductions in that tax rate will make them less attractive.

Choosing the Rate of Return for Calculating Present Value

Yet another source of uncertainty is the 4% rate of return assumed in the calculation of the present value of future tax savings. For some taxpayers, this may be unrealistically high. If the rate of return is lower, the present value adjustment will be lower, causing the future tax savings to have a higher present value. Of course, the converse is also true: If the rate of return is higher, the present value adjustment would be higher, resulting in lower net values for future tax savings.

The appropriate rate of return for taxpayers who replace the real estate they sell with other real estate would be the anticipated rate of appreciation of the replacement/newly acquired property. It is possible for a taxpayer to actually realize a negative rate of return on real estate should it suffer a decline in value. Certainly if there is a significant probability that real estate prices are inflated and are about to adjust downward, a taxpayer would clearly be far better off paying the taxes on the gain from a sale and waiting for prices to bottom out rather than acquiring replacement property in the face of a declining market just to postpone taxation of gain.

Anticipating the Taxpayer's Marginal Tax Rate

Because depreciation for newly acquired properties is calculated using the

properties' cost as their basis, taxpayers may save taxes over time by choosing not to enter into a Sec. 1031 like-kind exchange. The impact of the higher de-

preciation deduction depends on the marginal rate on the income that taxpayers can shelter with the deduction. In the examples above, it is assumed that *R*'s marginal tax rate is 35%—i.e., the income *R* was able to shelter from taxation due to the higher depreciation allowed would have been taxed at 35%. The tax benefit would be lower for taxpayers in lower tax brackets.

Another potential cost associated with the like-kind transfer is the possibility that the exchanger will exercise poor judgment in choosing a replacement property due to the time constraints placed on the transaction.

If *R* were in a lower tax bracket, the tax benefit of the higher depreciation on the newly acquired property would be lower, and in Example 1 the like-kind exchange may have been the better alternative. On the other hand, Congress might increase tax rates, particularly for higher-income earners who are more likely to have discretionary income available to invest in real estate. The result would be that taxpayers in the higher tax brackets who do not choose to defer gain recognition by means of a Sec. 1031 like-kind exchange would realize increased tax savings from having more depreciation with which to shelter income that would have otherwise been taxed at higher marginal rates.

Even a return to the individual income tax rates that were in effect prior to the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 would have a significant impact on a comparison of the tax benefits between electing to defer recognition by means of a Sec. 1031 like-kind exchange and not electing such a deferral. Prior to the 2003 act, both the highest tax rate of 39.6% and the

second highest tax rate of 36% exceeded the current highest marginal U.S. tax rate. The 36% tax bracket, which began at \$115,000 of taxable income for single taxpayers and \$140,000 for married taxpayers filing a joint return, reached many taxpayers who were not among the highest U.S. income earners.²² The next to the lowest marginal income tax bracket in the United States prior to the 2003 act was 28%, and it started at \$22,100 of taxable income for single taxpayers and \$36,900 for married taxpayers filing joint returns.²³

Conclusion

Using the provisions of Sec. 1031 to defer the tax on gain realized from the sale of real estate may not be the best decision for every taxpayer. The use of a third-party intermediary is usually necessary to complete a Sec. 1031 like-kind exchange. Taxpayers should consider the costs associated with turning substantial sums of money over to an intermediary to effect the exchange. When taxpayers use intermediaries to carry out the like-kind exchanges, they can sell their real estate properties, replace them later, and still qualify for tax deferral on their gains. However, Sec. 1031 allows taxpayers only 45 days in which to identify qualified replacement property. This relatively short period may cause some taxpayers to select their replacement property hastily and make poor selections or pay too much for the qualified replacement property that they buy.

A disadvantage to deferring the recognition of gain from the sale of realty is that the taxpayer must reduce the basis of the qualified replacement property by the

²² Sec. 1, prior to amendment by the Jobs and Growth Tax Relief Reconciliation Act of 2003. ²³ *Id.*

amount of the deferred gain and continue to depreciate the qualified replacement property over the remaining useful life of the original property. This limited basis for replacement property results in substantially smaller depreciation deductions than would otherwise be allowed had the taxpayer recognized gain from the sale of the original property and purchased other real estate. The lower cost recovery deductions result in smaller amounts of ordinary income being sheltered.

When a taxpayer holds replacement or newly acquired property for the full cost recovery period, the net saving is greater when the taxpayer does not elect a like-kind exchange. When a taxpayer chooses to dispose of the replacement or newly acquired property before the end of the cost recovery period, the tax benefit from the higher depreciation deduction is reduced. In such instances, electing to enter into a like-kind exchange may be the more favorable alternative.

Taxpayers in the highest marginal tax brackets who elect to defer gains through a like-kind exchange will likely realize limited net tax benefits over time from such an election. Generally, taxpayers with income taxed at a more moderate marginal tax rate will realize the greatest net savings from the like-kind exchange provisions. Furthermore, if taxpayers anticipate that the long-term capital gains tax rate and/or the tax rate on unrecaptured Sec. 1250 gain will increase significantly before the replacement property is likely to be sold, or that real estate values will fall significantly in the near future, they would probably be wise not to defer their gains from the sale of real property.

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EditorNotes

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