
General Explanations
of the
Administration's Fiscal Year 2016
Revenue Proposals



Department of the Treasury
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MODIFY LIKE-KIND EXCHANGE RULES FOR REAL PROPERTY AND COLLECTIBLES

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. Exchanges of art and collectibles for investment are eligible for deferral of gain under section 1031.

Reasons for Change

There is little justification for allowing deferral of the capital gain on the exchange of real property or art and collectibles. Historically, section 1031 deferral has been justified on the basis that valuing exchanged property is difficult. However, 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 They highlight the fact that valuation of exchanged property is not the hurdle it was when the provision was originally enacted.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 million (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. In addition, art and collectibles would no longer be eligible for like-kind exchanges. 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, 2015.