

Proposed Like-Kind Exchange Limitation Raises Mismatch Concerns

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By Nathan J. Richman

The limitation on like-kind exchanges proposed in the House Republicans' tax reform bill raises several mismatch questions when compared to the temporary expensing provision regarding timing and property classification, potentially placing a burden on such taxpayers as fast food franchisees, practitioners say.

The Tax Cuts and Jobs Act ([H.R. 1](#)), introduced November 2 by House Ways and Means Committee Chair Kevin Brady, R-Texas, would amend [section 1031](#) to [limit like-kind exchanges to real property](#).

"In five years, when the expensing sunsets for these expensable assets, there will be a tax cliff," said Suzanne Goldstein Baker of Investment Property Exchange Services Inc. When it comes time to replace assets expensed during the five-year period of full expensing, those assets will have zero basis and there will be no method to defer gain without like-kind exchanges, she said. The concern is that after expensing expires, the limitation on the availability of like-kind exchanges to stimulate transactions would result in increased tax lock-in and longer asset holding periods because taxpayers would want to avoid recapture gain on expensed assets with zero basis, she said.

[Section 1031](#) allows taxpayers to preserve their capital and manage their cash flows efficiently, Baker said.

Adam Handler of PwC said the mismatch between temporary expensing and a permanent limitation of like-kind exchanges could exacerbate a reduction in investment that may occur after full expensing expires. "Like expensing, [section 1031](#) is a consumption tax feature of the code that encourages investment," he said.

The [section-by-section summary](#) of the House bill points out that sequential exchanges can lead to deferral of gain until an individual owner dies and "escape taxation entirely if the property's basis is stepped up to its fair market value." The summary implies that the full expensing provision of the bill, drafted to end after five years, would cover the same ground for tangible personal property no longer eligible for like-kind exchange deferral.

Baker said that intangible property such as broadcast spectra, restaurant franchises, and licenses and nondepreciable property such as artwork may not be addressed by either the proposed full expensing or the limited like-kind exchange provisions in the House bill, despite qualifying for like-kind exchange under the current version of [section 1031](#).

Handler said that in addition to concerns about the treatment of personal property ineligible for

expensing, taxpayers are concerned about whether the states will follow the expensing rule. If they do not, “taxpayers may still need or want to do like-kind exchanges on personal property for state tax purposes,” he said.

David Shechtman of Drinker Biddle & Reath LLP said that intangible property would be significantly affected because those assets are stuck with 15-year amortization, rather than expensing, and have no ability to make like-kind exchanges. For instance, if a fast-food franchisee sells some of its stores as part of a plan to buy others for geographic consolidation purposes, the bulk of the value in those sales gets allocated to intangible franchise rights, he said. Under the bill’s like-kind and expensing provisions, that taxpayer “is going to get hit with a pretty hefty tax bill,” he said.

Shechtman said that the definition of real property is another open question because the provision does not provide one. He said that the detailed rules for real estate investment trusts under [section 856](#) might be one possibility. “And then there has always been a [section] 1031 issue of, ‘Does state law govern; is it dispositive or just instructive as to what is real estate?’” he added.

Further, there may be another sort of mismatch where some oil and gas property might qualify for the limited like-kind exchange rules as real property but also still qualify for expensing, Shechtman said.

Big Sigh

Shechtman said that the real estate exchange intermediary world gave a “fairly big sigh of relief . . . that real estate survived” under the House’s plan. Many observers had placed even odds on full repeal of [section 1031](#), he said. While real estate exchanges make up the vast majority of exchange transactions by volume, the repeal of [section 1031](#) for personal property would generate substantial revenue because of program exchanges for vehicles and big-ticket items like aircraft under current law, he said.

Despite the mismatches of the expensing proposal with the permanent like-kind exchange reduction, Shechtman said that he did not expect a strong lobbying push for personal property exchanges [in the Senate bill](#). Rather than place the whole section back under consideration, “people are probably willing to live with temporary expensing and personal property repeal at this point,” he said.

The [2014 tax reform bill](#) from former Ways and Means Chair Dave Camp would have [fully repealed section 1031](#). The House Republican “A Better Way” [tax reform blueprint](#) was [silent on like-kind exchanges](#), but proposed permanently allowing full expensing, excluding only land.

Effective Dates

The effective date of the provision states that the limitation would take effect for exchanges completed after December 31, 2017. However, the transition rule exempts exchanges with exchanged property disposed of or replacement property received by December 31. By

contrast, the transition rule from the Camp bill would have allowed taxpayers to complete exchanges under binding contracts entered into before the effective date to be completed up to two years after the effective date.

Baker said that the tax reform bill's transition rule works because it is consistent with the current law treatment of exchanges, in which taxpayers start at the end of one tax year and finish early in the next one, before filing the first year's tax return. She added that the latest bill's transition rule is not open to abuse and should be more administrable than what was in the Camp bill.

Handler said that the new transition rule would apply straightforwardly to forward exchanges in which the old property is relinquished before the replacement property is acquired. However, there is some ambiguity in applying it for reverse exchanges, where the taxpayer first locates the replacement property, because taxpayers usually use an intermediary to acquire the replacement property, which is known as parking, rather than directly acquiring it, he said.

Shechtman said that the replacement property part of the transition rule would be superfluous if it did not include parking transactions commenced before year-end, and the rules of statutory construction generally prohibit those interpretations. In that case — where the transition rule would apply to any exchange begun by the end of 2017 — the transition rule seems to subsume the effective date rule, he added. "I suspect you may see a lot of artwork exchanges and intangible property exchanges commenced in the next two months."

Clarification, November 7, 2017: The descriptions of Handler's comments have been updated for clarity.