

Repeal of the Personal Property Like-kind Exchange (... or, the Swap of §1031 for Increased Bonus Depreciation and Expensing)



Christopher Rogers
crogers@mwlaw.com
(479) 464.5651

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One of the lesser discussed items in the recently enacted Tax Cuts and Jobs Act ("TCJA") has been the change to Section 1031, limiting the like-kind exchange provisions to exchanges of real property only.

Section 1031 of the Internal Revenue Code provides an exception to the general gain recognition rules and allows a taxpayer selling property to defer paying tax on gain if the taxpayer reinvests the proceeds in like-kind property as part of a qualifying like-kind exchange.

As part of the TCJA, section 1031(a)(1) was amended to read as follows:

1031(a)(1) In general. No gain or loss shall be recognized on the exchange of *real* property held for productive use in a trade or business or for investment if such *real* property is exchanged solely for *real* property of like kind which is to be held either for productive use in a trade or business or for investment. [Changes so section 1031(a)(1) are in italics – the addition of the word "real" in referring to property.]

Additionally, section 1031(a)(2), which listed property that was specifically excepted out of section 1031 treatment, was amended to delete numerous references to personal property, and now reads as follows:

1031(a)(2) Exception for real property held for sale. This subsection shall not apply to any exchange of real property held primarily for sale.

So, as of January 1, 2018, like-kind exchanges of personal property are no longer permitted. As a further consequence, the incredibly well reasoned Treas. Reg. §1.1031(a)-2, Additional Rules For Exchanges of Personal Property, became less relevant. [On a personal note, I was the principal author of Prop. Reg. §1.1031(1)-2 while serving as an attorney-advisor for the Assistant Chief Counsel, Internal Revenue Service (National Office).]

The 1031 regulations concerning personal property were drafted to very narrowly define what constitutes like-kind personal property -- the definition of like-kind personal property being divided into (i) General Asset Classes and (ii) Product Classes based on the North American Industry Classification System -- as opposed to the broad characterization of like-kind afforded real property (essentially, real property is like-kind with any other real property). Treas. Reg. §1.1031(a)-1(c) provides, in part:

1.1031(a)-1(c) Examples of exchanges of property of a "like kind." No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a **truck for a new truck or a passenger automobile**

for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate. ... (Emphasis mine.)

So, while raw land is like-kind with a commercial strip center; a heavy general purpose truck is not like-kind with a passenger vehicle.

At first glance, the repeal of the application of §1031 to personal property may seem to be a big deal, further limiting (eliminating) the ability to defer tax on the exchange of personal property. However, the TCJA made two additional changes that actually, in the end, result in more liberal treatment to a disposition of personal property and re-investment in other personal property, even if the exchanged properties are not of a like-kind. These are:

(1) Increase in Bonus Depreciation – the TCJA modified the bonus depreciation rules under §168(k) to allow businesses to immediately deduct 100% of the cost of qualified property (generally being: tangible personal property with a recovery period of 20 years or less, computer software, and probably, if/when a technical corrections bill is passed, qualified improvement property).

The new bonus depreciation rules apply to new and used property (prior bonus depreciation law did not apply to the purchase of used property), provided such property was not previously used by the taxpayer and was not acquired from a related party.

The 100% bonus depreciation deduction is available through December 31, 2022, then drops by 20% per year to 0% after January 1, 2027.

(2) Increase in § 179 limitations – the TCJA increased the maximum amount a taxpayer can expense under §179 to \$1,000,000 (from \$520,000).

The §179 deduction is phased out if the amount of §179 property the taxpayer places in service during any one year exceeds a certain amount. This phase-out amount was increased to \$2,500,000 (from \$2,070,000).

The \$1,000,000 and \$2,500,000 amounts are indexed for inflation.

So, for example, assume Client exchanges a passenger vehicle (FMV \$30,000, depreciated basis of \$0) for another passenger vehicle (FMV of \$30,000), with both vehicles being used in Client's active business.

- Under prior law, the exchange would have qualified as a like-kind exchange as the exchanged properties are in the same General Asset Class (automobiles, GAC 00.22). The result would have been that Client recognized no gain on the disposition of the old passenger vehicle, and would have a \$0 basis in the new passenger vehicle.
- Under current law, the exchange does not qualify as a like-kind exchange so Client would recognize ordinary income of \$30,000 on the sale of the passenger vehicle. However, because of the 100% bonus depreciation, Client will also receive a \$30,000 ordinary income tax deduction on the purchase of the passenger vehicle, and would then have a \$0 basis in the new passenger vehicle. So the net-net is the same.

If instead Client exchanges a heavy general purpose truck (FMV \$30,000, depreciated basis of \$0) for a passenger vehicle (FMV of \$30,000).

- Under prior law, the exchange would not have qualified as a like-kind exchange as the properties were in different General Asset Classes (heavy duty trucks, GAC 00.242, automobiles, GAC 00.22). Client would have ordinary income of \$30,000, which would have been partially offset by a 50% bonus depreciation deduction associated with the purchase of the passenger vehicle.
- Under current law, because of the increase in bonus depreciation – Client would recognize ordinary income of \$30,000 on the sale of the heavy general purpose truck, but also would receive a \$30,000

ordinary income tax deduction on the purchase of the passenger vehicle, and would then have a \$0 basis in the new passenger vehicle.

There are also multiple asset exchanges that are primarily exchanges of real property, but contain smaller exchanges of personal property. For example, assume Client owns an office building for which Client, pursuant to a cost segregation study, re-characterized some of what would have been considered as real property to personal property for depreciation purposes. Client sells the office building which is now made up of both real property and personal property for income tax purposes.

- Under prior law, Client could have exchanged into a new building with similar components and fit many of the exchanged personal property items into the same General Asset Classes or Product Classes, rolling the personal property gain (ordinary income recapture) into the newly acquired components.
- Under current law, Client can exchange into a new building with similar components, recognize gain on sale of the personal property components, and receive an offsetting ordinary income tax deduction for the purchase of the new personal property components.

So, the net-net is that the 100% bonus depreciation deduction provides Client an equal or better result than the like-kind exchange benefits previously available Client.

Note also that because of 100% bonus depreciation and the increased amount that can be expensed under §179, a cost segregation study with respect to newly acquired real estate with personal property components can provide significant tax benefits.

There are still instances where personal property exchanges would have resulted in no tax under the prior personal property like-kind exchanges rules, but do not qualify for either the bonus depreciation or §179 expensing, so the repeal of §1031 for personal property exchanges does have some impact. Nonetheless, these types of personal property exchanges were rare, such as an exchange of like-kind intangibles or an exchange of nondepreciable personal property (personal property held for investment, not in an active trade or business).

The bottom line is that, notwithstanding one's sentimental attachment to the personal property exchange regulations, the TCJA's repeal of like-kind exchange treatment of personal property used in an active trade or business is more than offset by the increases in bonus depreciation and section 179 expensing. At least temporarily.