1031 EXCHANGES

THE TAX CUTS AND JOBS ACT'S CHANGES TO EXCHANGES OF REAL PROPERTY AND PERSONAL PROPERTY

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Generally, 1031 exchanges arise in the context of commercial real estate transactions. (This is how the majority of attorneys are familiar with this concept). 1031 exchanges were also used in the purchase and sale of personal property,[1] but were much less common in my experience and came with greater statutory restrictions. Understanding how to assist your clients and the recent updates to the Internal Revenue Code provisions affecting 1031 exchanges, pursuant to the Tax Cuts and Jobs Act (TCJA) is essential for clients wishing to utilize this tool.

A 1031 exchange is a process of exchanging property pursuant to Section 1031 of the code—hence, it is commonly referred to as a "1031 exchange." A properly structured 1031 exchange is a tax deferral vehicle. It permits a property owner to sell property and purchase replacement property, utilizing the proceeds from the property that was sold within certain timeframes,[2] while deferring all capital gains taxes. In order for a taxpayer to obtain the tax-deferring benefits of a 1031 exchange, certain other requirements must be met, including the requirement that an exchange be for a like-kind of property and that a qualified intermediary be used. In a 1031 exchange, the taxpayer may be the seller or the purchaser of the property, depending on the type of exchange.

In the context of commercial real estate, the exchange of like-kind property is the exchange of real property,[3] held for productive use in a trade or business, or for investment, for another. However, the real property being exchanged need not be the exact same kind (e.g., raw land can be exchanged for raw land; raw land can also be exchanged for an industrial property, as long as the industrial property is used in a trade or business or for investment). Several kinds of real property can be exchanged for one another, including, but not limited to raw land, developed land, retail, office and industrial property, apartment complexes and residential rentals.

In the exchange of personal property, the code provisions defining the like-kind personal property

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that could be exchanged were far more restrictive than the code provisions applicable to real property. First, the personal property being exchanged needed to be tangible (i.e., personal property that can be held or moved—not intangible personal property, such as the good will of a business or a trademark). Further, in order for the tangible personal property being sold to be considered like-kind with the tangible personal property being acquired, it needed to be in the same "General Asset Class"[4] or have the same six-digit code found in the North American Industry Classification System (NAICS).[5]

A qualified intermediary is also necessary to facilitate a proper 1031 exchange. The qualified intermediary is not the seller or purchaser of the property, but rather a third party to the exchange. In order to facilitate the 1031 exchange, the qualified intermediary enters into an exchange agreement with the taxpayer defining the qualified intermediary's duties and obligations, and setting forth the taxpayer's rights regarding the money or property held by the qualified intermediary. The exchange agreement permits the qualified intermediary to:

1. Acquire the property being sold by the taxpayer;
2. Acquire the property being purchased from the seller;
3. Transfer the property being sold to the purchaser; and
4. Transfer the property being purchased to the taxpayer.

With the passage of the TCJA on December 22, 2017, the laws governing 1031 exchanges changed. The TCJA eliminated 1031 exchanges for personal property by revising Section 1031 of the code to replace the more general references to "property" with "real property." Beginning in 2018, the 1031 exchange of personal property is no longer permitted; however, personal property exchanges that were commenced on or before December 31, 2017 (through either the closing on relinquished property or acquisition of replacement property) may still be completed in 2018.

The change in the law to eliminate the exchange of personal property will also affect 1031 exchanges involving real property. Commercial real estate transactions often involve the purchase and sale of real property and personal property, which varies depending on the kind of real property being sold. For example, the purchase and sale of a hotel may include the real property, the building and the furniture within the building. Based on the recent changes to the 1031 exchanges laws (and in the event a taxpayer wishes to utilize a 1031 exchange in this transaction), the purchase price needs to be broken down between the amount of the purchase price being paid to acquire the real property and building, and the amount of the purchase price being paid to acquire the personal property.

The goal in a 1031 exchange is for the taxpayer to avoid paying taxes now and deferring them to later. Although most real estate attorneys are not tax attorneys or accountants, we still have obligations to assist our clients in achieving this goal. Best practices in commercial real estate transactions involving 1031 exchanges should include the following:

1. Speak to a reputable qualified intermediary[6] in order to understand the process of a 1031 exchange;
2. Understand and outline the steps of the 1031 exchange with respect to the timeframes and tasks that need to be completed by the qualified intermediary and the attorney;
3. Ensure that the transactional documents for the purchase and sale identify the portion of the purchase price applicable to the real property;
4. Ensure that both sides to a transaction are aware of the 1031 exchange; and
5. Ensure that the exchange agreement and all other necessary documents are prepared and ready prior to the closing of the first property. **NL**

1. Personal property is everything that is subject to ownership and not considered real estate (see note 2). *Black's Law Dictionary*, 6th Edition (1990). For example, personal property includes money and goods, like bank accounts, vehicles and equipment.
2. The timeframe for completing a 1031 exchange is 180 days from the date the first property is sold, subject to a replacement property being identified not later than 45 days after the first property is sold. This article is not intended to focus on exchange and/or identification periods or forward or reverse exchanges.
3. Real property is land and, generally, whatever is erected, growing on or affixed to the land. *Black's Law Dictionary*, 6th Edition (1990).
4. General Asset Classes are defined in 26 CFR 1.1031(a)-2.
5. The North American Industry Classification System is the standard used by Federal statistical agencies in classifying business establishments for the purpose of collecting, analyzing and publishing statistical data related to the U.S. business economy. https://catalog.data.gov/dataset/north-american-industry-classification-system-naics.
6. Our office uses Carmine DiFulvio at First American Exchange Company for 1031 exchanges. DiFulvio is a Certified Exchange Specialist.

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