

Nontaxable Exchanges

Chapter 13

Nontaxable vs. Tax-Free Transactions

- ▶ Nontaxable transaction
 - Realized gain/loss not currently recognized
 - Recognition is postponed to a future date
 - Basis, potential depreciation recapture, and holding period carry over
- ▶ Tax-free transaction
 - Nonrecognition of gain is permanent

©2011 Money Education

13-2

Section 1031 – Like-Kind Exchange

- ▶ If property is exchanged for like-kind property,
 - No gain or loss is recognized
 - If the property is held
 - For productive use in a trade or business
 - As an investment
- ▶ Mandatory!

©2011 Money Education

13-3

Section 1031 - Qualified Assets

- ▶ Assets held for trade or business
- ▶ Assets held for production of income

- ▶ Note: Personal use assets (e.g., personal residences) do NOT qualify for like-kind exchange treatment. However, personal residences are afforded special tax treatment.

©2011 Money Education

13-4

Section 1031 Does Not Apply To

- ▶ Personal use assets
- ▶ Inventory
- ▶ Partnership interests
 - GP, LP, LLC
- ▶ Securities
 - Stocks, bonds, notes, interests in partnerships, certificates of trust or beneficial interests
- ▶ Goodwill

©2011 Money Education

13-5

Assets that Qualify for Like-Kind Exchange Treatment

- | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| ▶ Assets held for trade or business. |
| ▶ Assets held for production of income. |
| Note: Personal use assets (e.g., personal residences) do NOT qualify for like-kind exchange treatment. However, personal residences are afforded special tax treatment. |

©2011 Money Education

13-6

Like-Kind Property

- Interpreted very broadly
 - Same nature and character
- Real Estate
 - Improved for unimproved realty qualifies
 - U.S. realty for foreign realty does **not** qualify
 - Foreign realty for foreign realty qualifies
- Tangible Personalty
 - Must be within the same general business asset or product class
 - U.S. for foreign personal property does **not** qualify
 - Livestock of different sexes does not qualify

©2011 Money Education

13-7

Exchange of Like-Kind Property Example

Mark inherited a piece of raw land from his great-grandfather, and decided to convert that property to an income-producing property. Mark later traded his raw land for an apartment building of equivalent value.

Since he engaged in an exchange of like-kind property (realty for realty), the gain he realized on the raw land as of the date of the sale will be deferred into the apartment building under Section 1031.

©2011 Money Education

13-8

Exchange of Like-Kind Property Foreign Real Estate Example

Reese owns a hotel in Salem, Massachusetts. She has always wanted to own real estate abroad, and an opportunity arose for her to purchase the Killarney Hotel in Ireland. Both properties are worth the same amount of money, so Reese trades her hotel in Salem for the Killarney Hotel.

Despite the fact that both of the properties were used in a trade or business or for the production of income, U.S. and foreign real estate are not like-kind assets, and therefore Reese must recognize any gain she realizes on the Salem hotel in the year of the transfer.

©2011 Money Education

13-9

Exchange of Like-Kind Property Tangible Depreciable Personal Property Example

Cody exchanges a widget making machine for a desk that he plans to use in the same trade or business. Both assets were depreciable tangible property, so to qualify for like-kind exchange treatment, they must be of the same general asset category or product class.

Machinery and office equipment are not considered to be the same class, so any gain realized on the machine must be recognized in the year of the exchange.

Non-Simultaneous Exchange

- The proceeds from the sale of the original property must be held by an escrow agent (the proceeds may not be received by the property owner wishing to engage in the 1031 exchange).
- A replacement property must be identified within 45 days of the sale of the original property.
- The closing on the replacement property must take place by the earlier of (1) 180 days from the sale of the original property, or (2) the due date (including extensions) of the tax return for the year the original property was sold.

Related Party Exchanges

- **Deferred gain is recognized in year of disposition if:**
 - Exchange occurs between related parties
 - Related party disposes of the property within 2 years
- **Does not apply if:**
 - Either party dies before sale
 - Tax avoidance is not a motivation
- **Related party**
 - Brothers and sisters (whole or half blood or adopted)
 - Spouses (results in carryover basis)
 - Ancestors
 - Descendants

Like-Kind Exchange Related Party Example 1

David, owner of a large apartment building, engaged in a like-kind exchange with his son, Lewis, who owned a smaller rental property. Part of the gain on David's large apartment building was deferred in a like-kind exchange under 1031 into the new, smaller property. The next year, Lewis announced that he sold the apartment building he received in a like-kind exchange.

Since Lewis was a related party, and he disposed of the property received in the like-kind exchange within 2 years of the transfer, David will be required to recognize any remaining gain he realized on the transfer of the large apartment building in the same year.

©2011 Money Education

13-13

Like-Kind Exchange Related Party Example 2

Louise owns 55% of the equity interest in Cimbel Corporation. Louise and Cimbel agree to transact a like-kind exchange of a high-rise condominium owned by Cimbel for a warehouse owned by Louise. Louise subsequently sells the high-rise condominium 18 months later.

Cimbel will be required to recognize the deferred gain on the transfer of the high-rise condominium since Louise is a related party (a taxpayer who owns more than 50 percent of the equity interest in the corporation) and the property received in the like-kind exchange was sold within two years of the original exchange transaction.

©2011 Money Education

13-14

The Investment Solution



If properties change, but the investment solution stays the same, and nothing is taken out, Section 1031 allows deferral of the gain.

©2011 Money Education

13-15

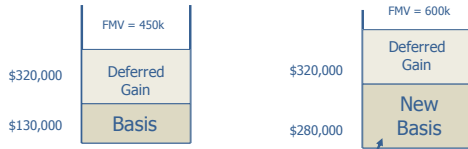
Trading Up

Current Property

- FMV \$450,000
- AB 130,000

New Property

- FMV \$600,000
- AB ?



Add \$150,000 to the solution!

©2011 Money Education

13-16

Boot

- ▶ Cash or other *non-like-kind property* (at FMV) received in a like kind exchange
 - Including debt relief

Tax Consequences

- Boot is recognized to the extent of the gain
- Loss is NOT recognized on exchanges involving boot – instead, a basis reduction occurs

- ▶ The transferor of property classified as boot may recognize gain or loss

©2011 Money Education

13-17

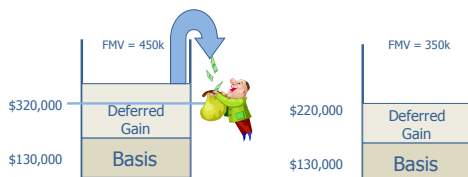
Trading Down

Current Property

- FMV \$450,000
- AB 130,000

New Property

- FMV \$350,000
- AB ?



Withdraw \$100,000 (Boot) from the solution!
Must recognize \$150,000 gain.

©2011 Money Education

13-18

Like-Kind Exchange Boot Example

- Zak and Vira exchange equipment of same general business asset class
 - Zak: Basis = \$25,000; FMV = \$40,000
 - Vira: Basis = \$20,000; FMV = \$30,000
 - Vira also gives securities: Basis = \$7,000; FMV = \$10,000
- Results
 - Zak has a \$10,000 recognized gain; \$25,000 basis in the new equipment, \$10,000 in the securities
 - Vira has a \$3,000 recognized gain; \$30,000 basis in the new equipment

©2011 Money Education

13-19

Assumption of Debt Example

Reilly and Ryan engage in a like-kind exchange. Reilly transfers real estate with a fair market value of \$400,000 and an adjusted basis of \$250,000 to Ryan. Ryan transfers real estate worth \$500,000 and an adjusted basis of \$200,000, plus a \$100,000 mortgage on the property, to Reilly. Including the mortgage, the exchange is an equivalent economic value transfer.

The following slides illustrate the tax consequences for Reilly and Ryan.

©2011 Money Education

13-20

Assumption of Debt Example (cont.)

Reilly			
Before Exchange (Old Property)		After Exchange (New Property)	
FMV	\$400,000	FMV*	\$500,000
Basis	250,000	New Basis	350,000
Potential Gain	\$150,000	Potential Gain	\$150,000
		+ \$100,000 Mortgage	

Boot \$100,000 (mortgage) to Ryan.
Reilly adds mortgage to old basis to get new basis.

Ryan			
Before Exchange (Old Property)		After Exchange (New Property)	
FMV*	\$500,000	FMV	\$400,000
Basis	200,000	Carryover Basis	200,000
Potential Gain	\$300,000	Potential Gain	\$200,000
*Subject to Mortgage			

Boot \$100,000 (mortgage) to Ryan.
Recognized gain equal to debt relieved of \$100,000.

©2011 Money Education

13-21

Assumption of Debt Example (cont.)

Since Reilly was trading up, there is no recognized gain. Reilly's basis equals his basis in his original investment, plus the \$100,000 in debt that he assumed in the Section 1031 exchange.

Reilly will have to pay the \$100,000 debt back with after-tax dollars, so the full amount of the loan will increase his basis in the investment solution. After the transaction, Reilly has a building with a fair market value of \$500,000 and an adjusted basis of \$350,000.

©2011 Money Education

13-22

Assumption of Debt Example (cont.)

Ryan traded down in this transaction – he gave up a property with a fair market value of \$500,000 and received a like-kind property with a fair market value of \$400,000. Ryan's side of the transaction can be illustrated as follows:

Ryan will be able to defer part of his gain under Section 1031, but the portion of the transaction that represents liability relief will be recognized. Instead of simply transferring the liability, Ryan could have received \$100,000 in cash in the transaction, and paid off the outstanding debt. If Ryan had received the \$100,000 in cash, it would have been treated as boot and would be taxable to the extent of the gain. The tax result should not be different when liabilities are relieved.

©2011 Money Education

13-23

Losses on Section 1031 Exchanges Example

Ten years ago, Keegan purchased a residential rental property for \$200,000. He has taken \$70,000 in depreciation deductions over his holding period, resulting in an adjusted basis of \$130,000. The fair market value of the property is \$120,000.

Keegan engages in a Section 1031 Exchange for a new property worth \$100,000, and receives cash in the amount of \$20,000.

©2011 Money Education

13-24

Losses on Section 1031 Exchanges Example (cont.)

The transaction could be illustrated as follows:

Before Exchange (Old Property)		After Exchange (New Property)	
FMV	\$120,000	FMV	\$100,000
Basis	130,000	New Basis*	110,000
Potential Loss	(\$10,000)	Potential Loss	(\$10,000)
Cash Boot \$20,000.		* Basis reduced by Boot	
No Gain or Loss Recognized.			

©2011 Money Education

13-25

Tax Consequences of a Section 1031 Exchange

- Determine whether your client is trading up or down. Clients who receive only like-kind property in the exchange will not have any current income tax consequences. The basis that they have in their investment solution, however, will be increased by any additional capital investment made in the investment solution.
- The party trading down (receiving less like-kind property than given up) will be required to recognize gain to the extent of boot received. If boot exceeds gain, the amount in excess of gain is treated as a return of capital.
- Debt relief is treated as boot, requiring gain recognition for the party no longer responsible for paying back the loan. The party assuming the debt will increase their basis in the replacement property by an equal amount.
- Losses realized in a like-kind exchange are not recognized until the replacement property is sold. The taxpayer's basis in the replacement property equals the fair market value of the property received in the exchange plus the disallowed loss.

©2011 Money Education

13-26

Section 1033 – Involuntary Conversions

- Natural disasters, theft, seizure, condemnation, or sale or exchange under threat of condemnation of property
 - A voluntary act by taxpayer is not an involuntary conversion
- Permits (does not require) nontaxable treatment of gains if
 - Amount of reinvestment in replacement property equals or exceeds the amount realized
- Usually associated with eminent domain

©2011 Money Education

13-27

Section 1033 – Involuntary Conversions

- ▶ Replacement property must be
 - Similar in function or use as involuntarily converted property
 - Acquired within a specified time period
 - Time period starts when involuntary conversion or threat of condemnation/governmental action occurs
 - Time period ends a specified number of years from the end of the year in which the event occurred
 - Natural Disasters: 2 years
 - Condemnation/Governmental Action: 3 years
 - Presidentially Declared Disaster: 4 years

©2011 Money Education

13-28

Functional Use Test Example

Dylan owned a warehouse in New Orleans that he used to store his company's product for distribution to customers. A hurricane destroyed the warehouse and Dylan used the insurance proceeds to purchase a new warehouse to store his company's product for distribution to customers.

Since the replacement property had the same functional use (warehouse facility for his company) as the original property, Dylan will be able to defer recognition of gain. Had Dylan invested the insurance proceeds in manufacturing facilities, in rental properties, or in any property which could be "used" in a different capacity, he would be required to recognize gain at the time of conversion.

©2011 Money Education

13-29

Taxpayer Use Test Example

Dylan owned a warehouse in New Orleans that he leased to several local businesses. After sustaining damage in several hurricanes in the past, it was completely destroyed by Hurricane Katrina. Dylan decided that he did not want to reinvest in New Orleans, but instead took his insurance proceeds and purchased an apartment building in Michigan. Both of the properties were rental properties.

Since Dylan was an owner-investor in the old warehouse and also in the new apartment building, he will be able to defer recognition of the gain if he purchases the apartment building within the statutory period.

©2011 Money Education

13-30

Direct Conversions

- Occurs when converted property is replaced instead of purchased
- Non-recognition treatment is mandatory
 - Basis and holding period in replacement property same as converted property
- To avoid non-recognition, fail the time period test

©2011 Money Education

13-31

Direct Conversion Example

Kay owned a summer house in Florida. The State of Florida condemns the property, giving Kay a piece of beach-front property in a resort location that has a value of \$600,000 within the statutory period. While Kay's original property was only worth \$375,000, none of the gain on the conversion will be recognized, because there was a direct conversion of the property.

©2011 Money Education

13-32

Choosing to Recognize Gain Example

Rich owned a vacation home in Avalon, NJ that was destroyed by a storm surge on August 1, 2009. Rich believes that Congress will increase capital gains rates in the near future due to pressing budget concerns. Instead of buying a replacement property, Rich waits until the statutory period expires, and triggers recognition of gain. He pays capital gains tax rates at 15%.

If Congress does raise capital gains rates, as Rich suspects, and capital gains tax rates increase to 25%, he may save a significant amount of money in taxes.

©2011 Money Education

13-33

Indirect Conversions

- Involuntary conversion rules are elective
- Gain recognized to extent amount realized (usually insurance proceeds) exceeds investment in replacement property
- Basis in replacement property is its cost, less deferred gain
- Holding period includes that of converted property

©2011 Money Education

13-34

Involuntary Conversion

- ▶ Involuntary conversion rules do not apply to:
 - Loss related to business and production of income properties
 - Personal casualty and theft losses (subject to \$100 floor and 10% AGI limit)
 - Personal condemnation losses are not recognized

©2011 Money Education

13-35

Involuntary Conversions of Principal Residence

- Gain from casualty, theft, or condemnation may be
 - Deferred as involuntary conversion (Section 1033), or
 - Excluded as sale of residence (Section 121)

©2011 Money Education

13-36

Section 1035 – Insurance Policies Nonrecognition Treatment

This type of contract:

Life Insurance

Modified Endowment Contract

Annuity

May be exchanged for:

Life Insurance
Modified Endowment Contract
Annuity

Modified Endowment Contract
Annuity

©2011 Money Education

13-37

Section 1035 Nonrecognition vs. Recognition

- When an insurance product that would be tax free is exchanged for an insurance product that creates ordinary income, there is no immediate recognition of gain.
- When an insurance product that creates ordinary income is exchanged for an insurance product that would be tax free, there is immediate recognition of gain.

©2011 Money Education

13-38

Exchange of Life Insurance Contract for Annuity Contract Example

Charles owns a life insurance policy that he no longer needs. Charles exchanges the life insurance policy for an annuity. The exchange of policy will not cause recognition of gain since Charles is exchanging a tax-free contract for an ordinary income contract.

©2011 Money Education

13-39

Exchange of Annuity Contract for Life Insurance Contract Example

Charles owns an annuity contract. He has decided he does not need the annuity contract to provide retirement income and converts the annuity contract into a life insurance contract. He paid \$30,000 for the annuity contract that is now worth \$100,000.

Charles cannot avoid the \$70,000 realized gain when he surrenders the annuity to purchase the life insurance contract (a tax-free contract).

Section 1036 – Corporate Recapitalizations

Scott owns 100% of Emerald Isle, Inc., and would like to begin to gift shares to his children to help facilitate his estate plan. Scott is concerned, however, about the influence that his children's spouses may have on his children, and does not want to have to worry about the in-laws creating problems for the business. Prior to gifting shares of stock to his children, Scott recapitalizes the corporation, and receives one voting share and 9 non-voting shares of common stock for every 10 shares of common stock he currently holds in the company. He gives the non-voting shares to his children, and keeps the voting shares. Scott will not be required to recognize gain on the recapitalization, since he exchanged common stock for other common stock in the same corporation.

Section 1038 – Reacquisitions of Real Property

Daniel, a recently retired small business owner, decided to sell his office building to his daughter, Ashley. Daniel needs to supplement his retirement income, so he sells the office building to Ashley on an installment sale basis. Daniel's gain on the building was \$1,000,000, which, per the amortization schedule, will be recognized in \$100,000 increments over the 10-year installment note.

Three years after the office building was sold, Ashley declares bankruptcy and defaults on the note. Daniel repossesses the building in satisfaction of the note. At the time he repossessed the building, he had recognized \$300,000 of the \$1,000,000 gain under the installment reporting provisions, leaving \$700,000 of gain that still needs to be recognized. Since Daniel repossessed the building, IRC Section 1038 will allow him to defer the remaining \$700,000 gain until he sells the building.

Section 1041 – Transfers Between Spouses

- ▶ ALL transfers between spouses and incident to a divorce result in
 - Carryover basis
 - Carryover holding period

©2011 Money Education

13-43

Transfer Between Spouses Example

Sal and Priscilla are getting divorced. As part of the divorce settlement, Priscilla receives a vacation home worth \$800,000 that the couple paid \$300,000 for many years earlier. Priscilla's basis in the home is \$300,000. If she sells the property, she will recognize gain to the extent any sale proceeds from the home exceed this amount.

©2011 Money Education

13-44

Section 121 - Gain on Sale of Principal Residence

- ▶ Gain can be exempted from income up to
 - \$500,000 for MFJ
 - \$250,000 for all others
- ▶ **Requirements:**
 - **Owned** and **used** as principal residence for 2 out of the last 5 years
 - A one-year stay in a nursing home facility counts towards the 2-year requirement
 - Exclusion can be used only once every 2 years

©2011 Money Education

13-45

Exemption Rules for Spouses

- For MFJ, the \$250,000 exemption is increased to \$500,000 if:
 - Either spouse meets the 2-year ownership requirement,
 - Both spouses meet the 2-year use requirement,
 - Neither spouse is ineligible due to the sale of another principal residence within the prior 2 years

©2011 Money Education

13-66

Section 121 Exclusion Example

Pat and Dee recently married. About four years prior to their marriage, Pat purchased a townhouse which the couple used as their residence after they were married. Knowing that they would purchase a new residence when they started their family, Pat never added Dee's name to the title of the property.

Three years after they were married, they decided to start their family and look for a new home. When the townhouse is sold, Pat and Dee may exclude up to \$500,000 of the gain from the sale since Pat met the ownership test (he owned the principal residence for two years) and both Pat and Dee met the use test (they both used the residence as a principal residence for two out of the last five years).

©2011 Money Education

13-67

Partial Section 121 Exclusion

- ▶ A taxpayer can qualify for a reduced exclusion if sale is due to:
 - Change in employment,
 - Change of health, or
 - Other unforeseen circumstance
- ▶ Exclusion based on the period of ownership between the last sale and the current sale

$$\text{Max Exclusion Amount} \times \frac{\text{Number of Qualifying Months}}{24 \text{ months}} = \text{Partial Exclusion}$$

©2011 Money Education

13-68

Special Rules – Section 121

- ▶ If a home used as the taxpayer's principal residence was acquired in a like-kind exchange within 5 years of sale, the Section 121 exclusion is **NOT** available
- ▶ Section 121 does not shield depreciation recapture from income tax

©2011 Money Education

13-49

Life Insurance Death Benefits

- ▶ Not subject to income tax
 - Unless the policy has been transferred for consideration (The **Transfer for Value** Rule)
- ▶ Exceptions to the Transfer for Value
 - Insured
 - Corporation in which insured is shareholder
 - Partnership in which insured is partner
 - Partner of insured
 - Transferee who takes transferor's basis

©2011 Money Education

13-50

Life Insurance Policy Loans

- ▶ Borrowing does not trigger taxable income provided that the policy remains in force for the lifetime of the insured
- ▶ If surrendered, the amount borrowed will be treated as part of the distribution upon surrender and subject to income taxation

©2011 Money Education

13-51

**Roth IRA, Roth 401(k),
and Roth 403(b)**

▶ **Characteristics**

- Contributions are taxable (funded with after-tax dollars)
- Distributions are tax free

▶ **Requirements**

- Account in existence for 5 years
- Distribution after age 59½
