

## Not So Kind Exchanges

Based on Code Section 1031(a) of the Internal Revenue Code of 1986

Amended by R. Kevin Cross, MST, EA

Oliver Wendell Holmes<sup>1</sup> would have perhaps been at a loss for prose in response to the possibility to accomplish nonrecognition of gain from an exchange of property. Suffice it to say, he would have at a minimum presented a rhetorical statement much like Justice Cardozo<sup>2</sup> did. And at the very least, he may have shaken his head at the subsequent possibility to achieve tax-free transfer to an heir through a step-up in basis.<sup>3</sup> Yet all this is currently available to the taxpayer as it should be, contrary to a very minority opinion.<sup>4</sup>

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a “like-kind” which is to be held for productive use in a trade or business or for investment as per IRC §1031.<sup>5</sup>

There are five facets for a transaction (or exchange) to qualify for tax deferral treatment (thus no recognition of gain or loss) affectionately referred to as a “like-kind exchange.”<sup>6</sup> The five facets are:

- An exchange of property must occur.
- Property must be held for productive use.
- Property must be used in a trade or business or for investment.
- Property must be exchanged solely for property of like-kind.
- Property must be held (no specification as to the length – but held for a duration nonetheless).

Behind this code section is the theory that a taxpayer should not be currently taxed when he or she is merely continuing his or her investment in “like” property.<sup>7</sup> Yet unless the

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<sup>1</sup> “Taxes are what we pay for a civilized society,” quoted by the Honorable Supreme Court Justice Oliver Wendell Holmes in 1904.

<sup>2</sup> Justice Cardozo’s observation that in difficult questions of deductibility “Life in all its fullness must supply the answer to the riddle” *Welch v. Helvering*, 209 U.S. 111, 115 (1933).

<sup>3</sup> The general rule is that the basis of property acquired from a decedent is the fair market value of the property at the date of the decedent’s death – as per IRC §1014(a).

<sup>4</sup> “I am disturbed by the breadth of the majority opinion” as stated by Robert J. Kelleher of the U.S. District Court for the Central District of California (the liberal 9<sup>th</sup> Circuit) in the dissent in *Weissman v. Commissioner*, 55 AFTR 2d 85-539 (1984)

<sup>5</sup> All references to section numbers, hereinafter cited, are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

<sup>6</sup> IRC §1031(a)(1), “No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.”

<sup>7</sup> Code Arranged Explanations ¶10,314.

nonrecognition rules are followed in the strictest sense, the transaction will fail regardless of the intentions of the parties.<sup>8</sup>

The following case studies will attempt to tackle a few, quite possibly common, situations which cause the code, regs., and case law to be examined closer, so as to yield the correct<sup>9</sup> outcome.

### **Case Study 1 – Ups & Downs Racing Stables and Dewey, Cheatum & Howl Breeding Farms**

Ups & Downs Racing Stables enter into a transaction with Dewey, Cheatem, & Howl Breeding Farms to exchange two racing mares (potential broodmare prospects) in exchange for a two-year old colt, a racing prospect. The two potential broodmare prospects have lifetime earnings of \$32,482 and \$55,887, respectively. Each consists of a strong pedigree, and the basis in each mare is zero due to full depreciation. The broodmare prospects have a value of \$25,000, and \$50,000, respectively. The breeder of the two-year old colt values the unnamed racing prospect at \$100,000. Each has agreed to exchange without any boot.

#### ***Does this exchange qualify as a like-kind exchange as per IRC §1031 of the IRC of 1986, as amended, regulations, and case precedence?***

The form of the transaction appears to follow the letter of the code<sup>10</sup> in that there was an exchange of property held for productive use or investment. Depreciable tangible personal property (as defined in the Reg<sup>11</sup>) gives further clarification to the term ‘like-kind.’ The term “like class” is used interchangeably<sup>12</sup> and elaborates further to state that unless property is exchanged within a class, no “like-kind” nonrecognition will be gained.<sup>13</sup> As per asset class 01.1 – *Agriculture*, specifically livestock, breeding horses and race horses fall within this class<sup>14</sup>.

Therefore, it appears at first blush that this transaction must be valid and nonrecognition attained. However, according to IRC 1031(e), and elaborated upon in Reg 1.1031(e)-1,<sup>15</sup> an exchange of “livestock” (which a horse whether breeding or race would specifically apply as per Rev. Proc. 87-57) of different sexes would cause a recognition of gain or loss, and the nonrecognition rules of IRC 1031 would not apply.

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<sup>8</sup> *Lincoln, Chad, (1998) TC Memo 1998-421, RIA TC Memo ¶9842.*

<sup>9</sup> Legislative intent or as the Honorable Supreme Court Justice Stevens stated in *Commission v. Soliman* (91-998), 506 U.S. 168 (1993) – “The Court today steps blithely into territory in which several courts of appeal and the tax court, whose experience in these matters is much greater than ours, have learned not to tread; in doing so it reads into the statute a limitation Congress never meant to impose”.

<sup>10</sup> IRC §1031(a)(1) *In general.*

<sup>11</sup> Reg §1.1031(a)-2. *Additional rules for exchanges of personal property.*

<sup>12</sup> Reg §1.1031(a)-2(b)(1) *General rule.*

<sup>13</sup> Reg §1.1031(a)-2(b)(1) “Depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class.”

<sup>14</sup> Rev. Proc. 87-57 – *ADR Class life schedule for farm property - Description of assets included.*

<sup>15</sup> Reg §1.1031(e)-1. *Exchanges of livestock of different sexes.*

In our case, two mares (female horses) will be exchanged for one colt (a male). Thus, the holding in this case will yield recognition of gain. I suppose the moral of the story is “Don’t look a gift horse in the mouth” or in more practical terms “Don’t look under the horse, for it may cause a taxable event upon exchange.” I wonder what would have been the outcome if the mares were in fact geldings?

### **Case Study 2 – Cole Ecter and Ana N. Vestor (You’ve Got Mail!)**

As fate may have it, Cole Ecter and Ana N. Vestor met in an investors chat room on the Internet.<sup>16</sup> Cole is a part-time, solo tax practitioner and avid collector of gold coins (U.S. Indian Head \$5, 10, and 20 coins specifically). Ana is a collector of gold coins too (how coincidental). She enjoys South African Krugerrands which she’s been buying since a child. Even though gold value has declined in the last decade she has quite a gain on paper. Cole enjoys the old numismatic-type coins (but has no Krugerrands), and Ana enjoys the bullion-type coins (but has no Indian Heads). Both Cole and Ana’s investments have increased in value quite nicely, yet they are both concerned about capital gains. Conversely, their respective bases are quite low.

Cole has convinced Ana that a like-kind exchange would work for them to avoid the recognition of gain on the transfers.

#### ***Does this exchange qualify as a like-kind exchange as per IRC §1031 of the IRC of 1986, as amended, regulations, and case precedence?***

Unfortunately for the “you’ve got mail” couple, a rather lengthy note (no email from Uncle Sam yet) from the IRS can be expected due to the fact that the exchanged property violates an IRS revenue ruling.<sup>17</sup> True exchanged assets must be of a “like class;” and a “like class” property must be within the same general “asset class;”<sup>18</sup> and gold coins would logically be within the same general “asset class.”

However, an investment in numismatic-type coins as Cole has made and the bullion-type coins as Ana has made are actually dissimilar. The holding in the Revenue Ruling refines the two seemingly similar assets to two very different classes.

“Similarly, in this case, although the coins appear to be similar because they both contain gold, they actually represent totally different types of underlying investment, and therefore, are not of the same nature or character. The bullion-type coins, unlike the numismatic-type coins, represent an investment in gold on world markets rather than in the coins themselves. Therefore, the bullion-type coins and the numismatic-type coins are not property of like kind.”<sup>19</sup>

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<sup>16</sup> Both Cole and Ana have AOL Instant Messenger service and found each other browsing the profiles section of the members section.

<sup>17</sup> Rev. Rul. 79-143, 1979-1 CB 264.

<sup>18</sup> Rev. Proc. 87-56, 1987-2 CB 674.

<sup>19</sup> Quoted from “LAW AND ANALYSIS” of Rev. Rul. 79-143, 1979-1 CB 264, IRC Sec(s). 1031.

As chance may have it, Cole and Ana will not avoid the great tax burden their electronic love affair has cultivated (although only taxed at capital gains rates). The tax bite may cause these love birds to run a fowl (so to speak).<sup>20</sup>

### **Case Study 3 – Ima Procrastinator and Kyle Tryanything, CPA**

Ima Procrastinator read on the Internet that she could exchange her Hollywood motel on the famous Federal Highway (Main Street USA) for half a mountain with log cabins on it in the Blue Ridge Mountains of Tennessee. She contacted her accountant, Kyle Tryanything, CPA, and requested that she handle the exchange. She agreed and arranged for the exchange. On December 25, 2001, she sold the property through Kyle, and she traveled to the foothills of Tennessee to shake hands with the nice, honest gal who was going to sell her the mountain haven. On April 15, 2002, Ima timely filed her 2001 U.S. federal income tax return electronically and received confirmation that it was accepted. On May 25, 2002, Ima, through her accountant, purchased the Tennessee property.

***Does this exchange qualify as a like-kind exchange as per IRC §1031 of the IRC of 1986, as amended, regulations, and case precedence?***

Ima's transaction is the classic (albeit flawed) attempt at a deferred exchange,<sup>21</sup> three-party exchange, or a triangular exchange.<sup>22</sup> This occurs when the taxpayer is unable to find a party or property immediately for a two-way exchange, or the transferring party finds a buyer that wants the property for cash only and does not want to "trade" properties, so to speak. It can also be attractive for multiple cash/property transactions where one party may want cash or to pay cash, and another to receive a combination of both cash and property.<sup>23</sup>

However, there are three issues that deny this deferral. First, the issue of the aggressive CPA.<sup>24</sup> She may have in good faith represented the taxpayer in this matter, but form over substance will prevail. In this type of transaction, the form supersedes the substance. Unless absolute strict adherence to the method or rule for nonrecognition is followed, the transaction will fail.

Kyle attempted to be a qualified intermediary,<sup>25</sup> but as a result of her being Ima's accountant within the 2-year period ending on the date of the transfer, Kyle has in fact

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<sup>20</sup> As Cole is a solo tax practitioner, he may be a solo "chat-room" practitioner on or about April 15 next year as the tax liability is chatted about.

<sup>21</sup> "Deferred" as stated in description of Reg. §1.1031(k)-1.

<sup>22</sup> Page 475, 2002 CCH Federal Taxation Comprehensive Topics, Copyright 2001, CCH Incorporated.

<sup>23</sup> Code Arranged Annotations ¶ 10,315.01(15). Three-cornered transactions. "Taxpayer's exchange of property with broker for property bought by broker from third party was nontaxable, although the broker sold taxpayer's property to fourth party, and with proceeds bought property that he transferred to taxpayer. Taxpayer's only transaction was exchange of properties with broker."

<sup>24</sup> Adds new meaning to "discretion is the greater part of valor."

<sup>25</sup> U.S. Treasury Regulation (herein referred to as Reg) §1.1031(k)-1(k)(2) – Definition of a disqualified person - "The person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate

become a disqualified person and has negated this transaction as a like-kind. A qualifying intermediary is not considered the agent of the taxpayer.<sup>26</sup> An intermediary enters into a written agreement with the taxpayer (the exchange agreement) and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.<sup>27</sup> Kyle may have followed the steps to appear to be a qualified intermediary but was disqualified because of the accountant relationship.

The second issue comes from the disqualifying identification of the property when Ima decided to “shake hands” instead of following the reg which states the identification of the property of the replacement property is identified only if it is unambiguously described in the written document or agreement.<sup>28</sup> Even though Ima intended on purchasing the property and visually identified the property within the 45 day window.<sup>29</sup> The Code is specific as to any property received by the taxpayer shall be treated as property which is not like-kind if such property is not identified (in writing) on or before the 45th day after the date on which the taxpayer transfers the property<sup>30</sup>.

The third issue is the violation the 180 day provision,<sup>31</sup> even though the 180 days had not expired on the date of closing—May 25, 2002—no extension was filed. Therefore, the exchange had to have occurred by April 15, 2002.

*Special thanks to attorney and “1031” specialist Jan Nieman, LLM, of Lamont & Neiman, P.A. for mentoring me in the area of three-cornered tax exchanges.*

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agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph (k)(2), performance of the following services will not be taken into account.”

<sup>26</sup> Reg §1.1031(k)-1(g) Safe Harbors

<sup>27</sup> Reg §1.1031(k)-1(g)(4)(iii)(A)&(B). *Qualified intermediaries.*

<sup>28</sup> Reg §1.1031(k)-1(c)(3), “*Description of replacement property.* Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building). Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambiguously described if it is described by a specific make, model, and year.”

<sup>29</sup> IRC §1031(a)(3)(A).

<sup>30</sup> *Ibid.*

<sup>31</sup> Code Section §1031(a)(3)(B)(i) – States that “*such property is received after the earlier of the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (ii) the due date (determined with regard to extension) for the transferor’s return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.*”

**About the Author:**

*R. Kevin Cross, MST, EA, focuses his practice on tax controversy issues. He holds a Bachelors degree in accounting, and a Masters degree in taxation. He has been an enrolled agent since 1994, and is a Fellow of the National Tax Practice Institute. He is a member of the IRS Speakers Cadre for Florida, and has been appointed to both the Florida Institute of Certified Public Accountants Committee on Federal Taxation, and the Florida Institute on Federal Taxation Conference. He is frequently heard fielding tax questions on two radio stations in Fort Lauderdale and Miami. In 1989, he founded and continues to lead Sir Tax, a tax and accounting practice; areas of practice in addition to controversy issues include strategic tax planning for professionals, start-up businesses, not-for-profit entities, and the equine industry.*