Recent Trends in Like-kind Exchanges

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Abstract

Like-kind exchanges enable taxpayers to defer capital gains taxes when certain types of property are exchanged rather than sold. The deferred gains from such exchanges have grown over the years, peaking at over $100 billion before the onset of the Great Recession. Equally noteworthy, the share of corporations of these exchanges has increased in recent years, with much of the corporate deferred gain concentrated in certain sectors and accounted for by a relatively small number of firms. Contrary to the conventional wisdom, exchanges are not typically dominated by real estate transactions and, in recent years, corporations have accounted for over half of deferred gains.

Keyword: Capital gains tax, deferral JEL: D1, D2, H2, H3

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1. Introduction

The sale or exchange of business or investment property usually leads to a taxable capital gain or loss. For example, if a share of stock or a building or other asset used in a business is sold for more than its cost or basis, the sale generates a taxable capital gain. As an exception to this general rule, however, the tax code provides for the tax otherwise due to be deferred when certain business or investment property is exchanged for property of a "like-kind" nature.[1]

Traditional like-kind exchanges typically involved the direct swapping between two property owners. As an example, the owner of an apartment building exchanges it for another apartment building that was in a more suitable location. But over time, the definition of eligible exchanges has been expanded and that of "like-kind" relaxed. In recent years, most like kind exchanges of real estate have involved complex three-party transactions facilitated by qualified intermediaries. In another example, the legal distinction between cars and vehicles classified as "light trucks" has been blurred.[2]

This paper traces recent trends in like-kind exchanges by type of property and business organizational form. The volume of deferred gains grew over the years peaking at over $100 billion in 2006, before the onset of the Great Recession. Contrary to the conventional wisdom, exchanges are not typically dominated by real estate transactions. Indeed, the most common like-kind exchanges are now those involving the "trade-in" of vehicles for replacement vehicles and vehicle fleets, e.g., by rental car companies, farmers, and businesses. In recent years, the corporate sector has become the largest beneficiary of the tax treatment, accounting for over half of deferred gains. This is primarily due to the retrenchment of real estate activities, which had greater effects on the activities of individuals and partnerships. In addition, much of the deferred

[1] Like kind exchanges are governed under Section 1031. Other provisions that allow deferral of recognition of capital gain or loss include carryover basis for gifts, losses in wash sales, contributions of property to a partnership, involuntary conversions such as fire, theft and condemnation, and certain business reorganization transactions.
[2] See Internal Revenue Service Private Letter Ruling No. 2009-12004 (PLR 200912004). Lipton and Gruen (2010) survey the recent state of the art, while Zarb (2007) discusses like-kind exchanges for corporate jets.

gain is concentrated in a few sectors of the economy and accounted for by a relatively small number of businesses.

Section 2 provides background information on how like-kind exchanges work and a summary of the legislative history of the tax treatment of such exchanges. Section 3 reviews the trend in exchanges and the deferred gains over a period of 15 years through 2012. Section 4 concludes.

2. Background on Like-kind exchanges

2.1 How like-kind exchanges work

With like-kind exchanges, no gain or loss is recognized if a taxpayer exchanges eligible property for property of a like kind. However, capital gain or loss is recognized to the extent that the taxpayer receives cash or some other non-like kind property in the exchange. Both the relinquished and the like-kind properties exchanged must be held for productive use in the taxpayer's trade or business or for investment. The provision does not apply to property held for sale (inventory property) or to financial assets such as stock, bonds and partnership interests. After the exchange, the taxpayer retains the original basis (increased by any non-like property received or cash paid by the taxpayer as part of the transaction). Thus, the taxpayer has a reduced amount of future depreciation that offsets part of the tax benefits of deferred gain. Additional requirements include rules that limit the time period to complete the exchange.[3]

A like-kind exchange can be particularly useful in deferring gains on depreciable property. For example, consider a business vehicle such as a pickup truck or a tractor. Assuming every few years the taxpayer wants a new vehicle, a like-kind exchange might be a useful approach. If the taxpayer has expensed the vehicle under Section 179 or taken advantage of bonus depreciation, the vehicle might not have any tax basis remaining. A 4-year old vehicle might be worth $10,000 and a taxpayer who sold it would recognize a $10,000 capital gain. If the taxpayer traded in that vehicle for $10,000 toward purchasing a new vehicle costing $40,000, however, that $10,000 gain could be deferred. The depreciable basis in the new vehicle is calculated as the basis in the old vehicle plus the cash paid at purchase time. Thus, in this example, the taxpayer could depreciate the $30,000 contributed to complete the transaction. The benefit of deferring the tax on the $10,000 of capital gains typically exceeds the present value of the loss in depreciation deductions over the life of the acquired asset. This process can be repeated every few years for another newer business vehicle.

Since direct exchanges of real estate are difficult to arrange, most exchanges of real estate are three-party (aka deferred) like-kind exchanges. In a typical three-party exchange, taxpayer A would like to exchange a rental property for the rental property of taxpayer B. Taxpayer B, however, does not want taxpayer A's rental property, but would like some third property owned by taxpayer C. Working through a qualified intermediary, taxpayer A's property is sold for cash used to buy the property of taxpayer C. The property acquired from taxpayer C is then exchanged for B's property. Under general tax rules, these transactions would be taxable events. In a like-kind exchange, the qualified intermediary holds the cash (and any non-qualified property) received from selling the rental property of taxpayer A in a trust account and uses it to acquire the property of taxpayer C. Taxpayers A and B would not be taxable on their exchange of qualified property, but capital gain would be taxable up to the amount of any cash or ineligible property received in

[3] The replacement property must be identified within 45 days after the first property is relinquished and acquired by the earlier of (1) 180 days after the transfer of the relinquished property or (2) the due date (including extensions) for the taxpayer's tax return for the year in which the property is relinquished. In certain more complex transactions, taxpayers can have up to 360 days to complete a transaction. See Joint Committee on Taxation (1984).

the exchange. The basis of taxpayers A and B in their new property would be their original basis plus the amounts of any cash paid for the replacement property and taxable capital gain from the receipt of cash or ineligible property.

2.2 Legislative history

The original provision was enacted in 1921 along with other major changes to capital gains taxation rules and has therefore been in existence almost since the beginning of the income tax.[4] One of the arguments for not treating the exchange of like-kind property as a realization event is that the taxpayers were continuing their on-going investment in the same business activity rather than cashing in their investment. In addition, Congress recognized that the dramatic increase in tax rates on capital gains during World War I had created substantial lock-in effects that greatly interfered with normal business transactions.[5] Exchanges of property would be discouraged because there wouldn't be enough money left after paying the capital gains tax to purchase a replacement property of comparable value. Persuaded by these arguments, Congress has allowed capital gains taxes to be deferred in such exchanges since 1921 with only modest changes in the rules.

3. Recent trends in Like Kind Exchanges

As shown in the figure 1, the total amount of deferred gain by all taxpayers increased dramatically from 1998 through 2006. More specifically, it increased from $25.7 billion in 1998 to $102.8 billion in 2006 before dropping to $33.8 billion in 2009 and partially recovering to $57 billion by 2012. Indeed, the deferred gains of partnerships dropped dramatically from $35.6 billion in 2007 to a low of only $3.9 billion in 2009 due to the effects of the recession on real estate. In contrast, deferred gains by corporations decreased from $25.8 billion to $23.3 billion over these two years because the decline in real estate was largely offset by an increase in like-kind exchanges of vehicles. By 2010, deferred gains of corporations of $29.3 actually exceeded 2007 levels because of a further increase in vehicle exchanges to $23.4 billion. Like-kind exchange activity by partnerships, which is much more dependent on real estate, recovered from the 2009 low point, but deferred gains remained at less than half 2007 levels by 2012.

The reduction in exchanges observed after 2006 is largely explained by the onset of the Great Recession and its deleterious effects on the real estate industry. The slowdown in activity of C corporations in 2010 and beyond is potentially partially explained by the availability of generous depreciation deductions introduced in 2010 and 2012 that induced some businesses to reduce their like-kind exchange activities. The benefits of the 100 percent bonus depreciation introduced in 2010, for example, were perceived to be greater than the benefits of deferral for some firms.[6]

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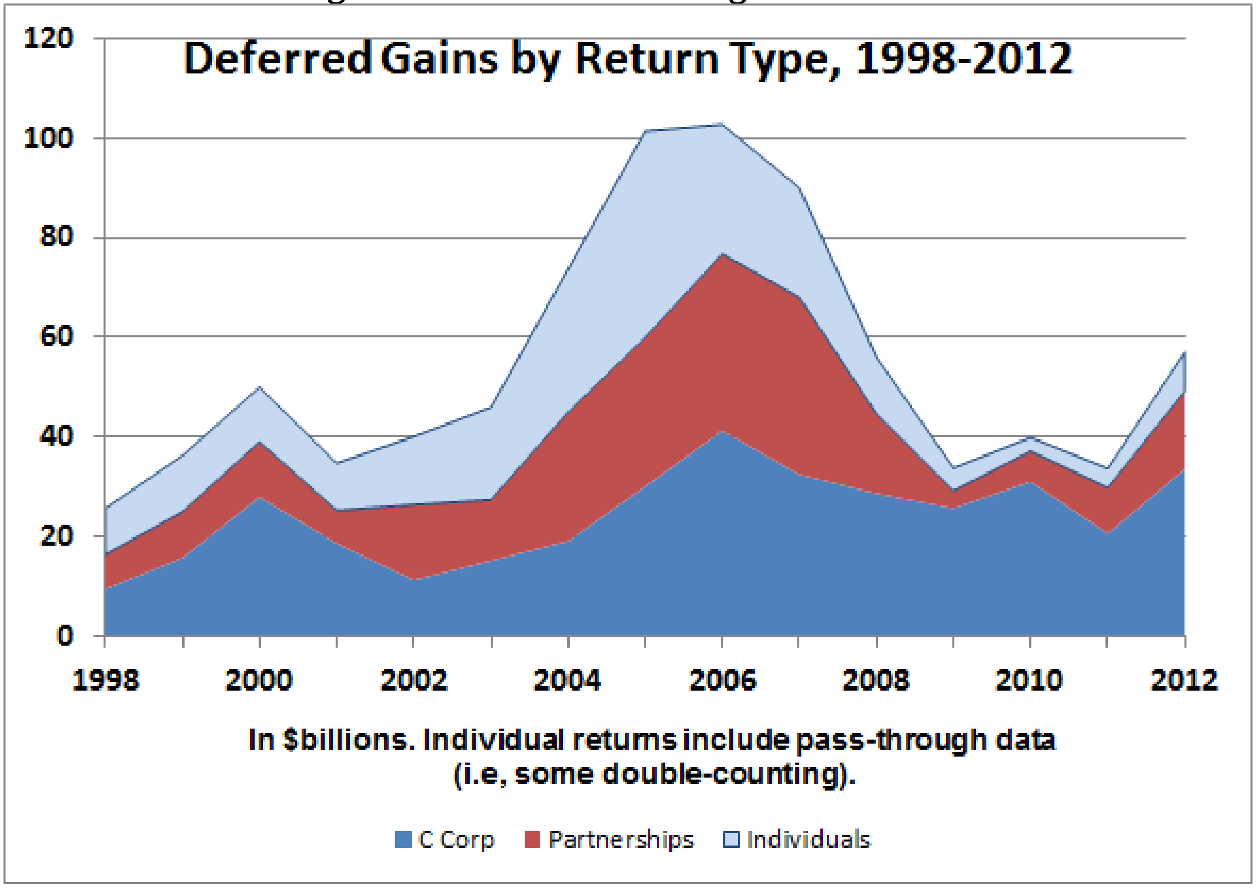
[4] While capital gains were initially taxed at the same rates as other income, the Revenue Act of 1921 created a new 12 1/2 percent alternative maximum tax rate on capital gains for assets held longer than two years. In addition to the new rate, the 1921 Act limited the deduction of capital losses and required recognition of capital asset sales and exchanges except in the case of like-kind exchanges, certain business reorganizations, and involuntary conversions due to fire and theft. See Blakey (1922) for an early perspective.

[5] The increase in the top income tax rate from 7 percent to 77 percent to help finance World War I efforts created strong lock-in effects: taxpayers realized few capital gains but had strong incentives to realize capital losses. To limit the revenue losses, Treasury issued regulations in 1919 that sales of capital assets would not be recognized for tax purposes unless cash was received. The 1921 Act reversed this approach by requiring recognition of all exchanges except in specified situations. Historical rationales are discussed in Jenson (1985), Kornhauser (1987) and Shaviro (1992).

[6] For example, Hertz included the following statement in its 2013 Annual Report, page 93, Item 7 (income taxes). "In August 2010, we elected to temporarily suspend the U.S. car rental LKE [like-kind exchanges] Program allowing cash proceeds from sales of vehicles to be utilized for various business purposes, including paying down existing debt obligations, future growth initiatives and for general operating purposes. From August 2010 through year end 2011,

Figure 1: Like-kind exchanges: 1998-2012



As shown in Table 1 below, C corporations and partnerships differ in the types of firms with the largest amounts of deferred gains. C corporations (subject to the corporate income tax) deferred $33.5 billion in capital gains in 2012 using like-kind exchanges. About 70 percent of this amount reflected transactions related to vehicles, including replacement of vehicle fleets by rental car firms and other corporations with large truck or auto vehicle fleets. In addition, banks are also thought to be significant users of this provision in the context of vehicle leasing programs through dealership networks so the percentage of use for vehicles is even higher. Partnerships reported about $35.6 billion of deferred capital gain. In contrast to C corporations, real estate transactions accounted for 51 percent of the deferred gains of partnerships in 2007. Vehicles were the second largest category for partnerships, accounting for one-third of the amount of deferred gain by partnerships[7]

While the table shows that about 17,000 C corporations reported like-kind exchange transactions, this was only about 1 percent of the 1.6 million of all C corporations. And even among these corporations, the amounts of deferred gains are highly concentrated. Similarly, only 10,551 partnerships or about one-third of 1 percent reported any like-kind exchange transactions out of the nearly 3.4 million that filed 2012 returns.

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recognized tax gains on vehicle dispositions resulting from the LKE suspension were more than offset by 100% tax depreciation on newly acquired vehicles. The U.S. car rental LKE Program was reinstated on October 15, 2012. During 2012 the allowable 50% bonus depreciation helped offset tax gains during the period of LKE suspension."

[7] In 2007, however, real estate transactions accounted for nearly 90 percent of the deferred gains of partnerships, which is the more typical pattern. The deferred capital gains of partnerships were $35.6 billion in 2007, suggesting that much of the drop in deferred gains was in real estate and that real estate activity had not recovered to 2007 levels by 2012.

Table 1. Partnerships and C Corporations with Deferred Capital Gains, 2012				
	% of Firms		% of Deferred Gains	
Industry	Partnerships	C Corporations	Partnerships	C Corporations
Agriculture	37.4	23.0	2.7	0.7
Oil, Gas, Mining	1.9	2.1	4.3	13.4
Construction	5.2	22.6	0.2	0.3
Vehicles and Transportation	2.9	10.7	33.7	69.7
Retail/Wholesale	6.0	16.9	1.5	1.3
Banks and Finance	0.6	2.4	0.7	8.2
Real Estate	34.8	2.6	51.4	1.6
Services and Other	11.2	19.8	5.5	4.6
Total	100	100	100	100
Amounts	10,551	17,249	$15.6 B	$33.5 B

Source: IRS Statistics of Income, Corporation and Partnership Files, 2012. Tabulations by the authors. Bottom row shows numbers of returns. Dollar amounts are in $ billions. See Appendix Tables for details.

The figures in Table 1 are based on the industry of the partnership, however, and so do not show the actual types of property being exchanged.[8] In order to get a better picture of the types of property being exchanged, we examined the like-kind exchange transactions reported on e-filed partnership returns for 2009, the latest year these detailed data were available. The transactions were categorized using the descriptions provided by partnerships on Form 8824 for reporting like-kind exchanges. The analysis showed that 76 percent of the deferred gains were real estate (See the following table.). This is a significantly higher percentage than was found using only the industry of the firms with deferred gains. The largest percentages of transactions, however, were for farm equipment (33%), cars and trucks (30%) and real estate (18%).

Table 2: Type of Like-kind Transactions by Partnerships, 2009		
	Deferred gain	
Type of Property	Amount ($1million)	Percent distribution
Real estate	972.3	76.2%
Miscellaneous	91.9	7.2%
Aircraft	56.7	4.4%
Farm equipment	49.6	3.9%
Construction equipment	40.0	3.1%
Electronics	32.9	2.6%
Commercial trucks	11.2	0.9%
Oil and gas	9.1	0.7%
Appliances	5.3	0.4%
Cars and small trucks	5.1	0.4%
Leisure vehicles	1.6	0.1%
Total	1275.6	100.0%

Source: Tabulations from 2009 E-filed Partnership Returns

Individual taxpayers also report deferred capital gains from like-kind exchanges of business or investment property. In most cases, this would be property related to a sole proprietorship (Schedule C) or a farm (Schedule F). In 2011, the most recent year for which transactions details are available, taxpayers reported $3.3 billion in deferred gains. Business real estate accounted for 31.5 percent and rental real estate for another 27.0 percent. Together with exchanges of farmland and other land, real estate accounted for almost 80 percent of the amount of deferred gains. Deferred gains in 2011 were down dramatically from the $21.2 billion of deferred gains in 2007.

[8] The Appendix provides further historical trends and detailed information on like kind exchanges.

Nearly half of the 2007 amount was deferred gain on residential rental properties and most of the rest was business real estate and land. In total, real estate accounted for over 90 percent of the amount of gains deferred by individuals in 2007. In both years, the largest number of transactions involved trade-ins for replacement vehicles of trucks and other vehicles used for business or farm purposes.

Table 3. Deferred Capital Gains of Individuals in Like-kind Transactions, 2011

Type of Property	Transactions	Amount	Percent
Rental real estate	4,639	922	27.9
Business real estate	2,909	1,040	31.5
Other land	3,061	280	8.5
Business personal property	60,716	665	20.2
Vehicles	123,038	-239	-7.2
Farm equipment	12,452	-48	-1.5
Farmland	1,759	410	12.4
Collectibles	75	169	5.1
Other assets	4,654	102	3.1
Total, all types	213,305	3,301	100.0

Source: IRS Statistics of Income, Sales of Capital Assets Study, 2011. Tabulations by the authors.

4. Conclusions

This paper documents trends in the use of like-kind exchanges to defer capital gains realizations for each of individuals, corporations, and non-corporate entities. These exchanges have grown over the years and peaked over $100 billion in 2006, before the onset of the Great Recession. Deferrals by corporations now to account for the lion share of these transactions. Much of the latter, however, involve deferrals from exchanges of motor vehicles.

Until recent budget proposals[9], very little attention has been paid to exploring the trend in like kind exchanges and the factors that shape them. How much of the observed trend can be explained by the evolving tax planning technology, tax depreciation allowances, or changes in capital gains tax rates are yet to be examined and the subject of future research,

The deferral of capital gains tax allowed by the like-kind exchange rules is not currently considered a tax expenditure in the Federal Budget. While measures of economic income generally include capital gains each year as they accrue, the Federal Budget accepts the current system of not taxing capital gains until they are “realized” as part of the baseline tax system against which tax expenditures are measured. In contrast, like-kind exchanges are considered to be a tax expenditure by the Joint Committee on Taxation (JCT). Like the Federal Budget, the JCT accepts the realization-based system for capital gains in its baseline tax and therefore does not consider deferral of tax on capital gains to be a tax expenditure. However, the JCT considers like-kind exchanges to be a tax expenditure because such exchanges allow deferral of tax beyond the year of exchange. Both the JCT and the Federal Budget include the preferential rates for long-term capital gains in their lists of tax expenditures.

[9] See U.S. Department of the Treasury (2015). The Joint Committee on Taxation (2014) estimated that the tax expenditure for like-kind exchanges is $5.7 billion for corporations and $3.0 billion for individuals and non-corporate entities for fiscal year 2014. These estimates do not include any allowance for behavioral changes if the provision were repealed.

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Data Appendix

The following tables show key variables related to like-kind exchanges of C corporations and partnerships for 2007, 2010 and 2012. Data for C corporations excludes mutual funds (RICS) and real estate investment trusts (REITS). These periods reflect the peak period of like-kind exchanges, lower levels during the recession and the economic recovery as of 2012. Similar data compiled by the IRS Statistics of Income for additional years back to 1995 can be found at www.irs/taxstats.

Like-Kind Exchanges and Deferred Gains of C Corporations (in millions), 2007, 2010 and 2012

Industry / Primary Business Activity	Number of Firms	FMV Like-kind received	Total FMV received	Basis on property given up	Realized gains	Ordinary income recognized	Total recognized gains	Deferred gains	F1120 capital gains	% of Deferred Gains
2007										
Agriculture	2,529	303	337	212	126	0	35	91	92	0.4
Mining	128	222	223	46	178	1	2	176	290	0.7
Oil & Gas	264	2,897	3,135	1,239	2,182	409	581	1,598	7,741	6.2
Construction	4,265	593	623	425	228	1	33	195	860	0.8
Manufacturing	2,106	2,182	2,325	1,051	1,274	21	146	1,128	6,394	4.4
Vehicles	1,110	20,752	20,810	8,605	13,489	47	130	13,374	331	51.8
Transportation	24	236	259	36	944	174	207	741	177	2.9
Communication	214	709	751	231	543	4	73	481	3,499	1.9
Wholesale-Retail	2,867	1,337	1,404	705	718	16	80	638	5,916	2.5
Banks & Finance	190	4,484	5,650	2,017	3,782	106	139	3,659	14,029	14.2
Insurance	462	304	305	182	123	0	2	122	3,649	0.5
Real Estate	1,185	4,957	5,116	1,832	3,350	16	153	3,197	1,153	12.4
Services & Misc.	2,334	755	815	412	467	21	65	402	902	1.6
All	17,678	39,729	41,754	16,994	27,404	815	1,645	25,801	45,033	100.0
2010										
Agriculture	2,280	362	366	266	100	0	4	96	84	0.3
Mining	168	136	138	47	93	0	1	91	128	0.3
Oil & Gas	101	3,728	4,224	1,209	3,023	98	494	2,530	7,348	8.6
Construction	1,997	212	216	144	72	3	3	69	67	0.2
Manufacturing	1,223	579	604	356	278	8	26	252	565	0.9
Vehicles	853	28,690	28,697	9,196	24,405	972	975	23,411	164	79.9
Transportation	28	206	208	83	179	2	6	172	39	0.6
Communication	102	40	62	22	86	24	24	62	209	0.2
Wholesale-Retail	2,006	769	813	415	436	15	52	384	1,464	1.3
Banks & Finance	144	2,166	3,231	1,366	1,939	50	50	1,889	1,108	6.4
Insurance	572	32	79	48	67	0	0	67	1,815	0.2
Real Estate	695	423	438	277	235	0	15	218	47	0.7
Services & Misc.	2,527	221	244	187	57	1	4	54	422	0.2
All	12,697	37,565	39,319	13,616	30,970	1,174	1,654	29,295	13,461	100.0
2012										
Agriculture	3,966	783	784	535	250	0	1	248	1	0.8
Mining	117	269	356	302	317	8	44	265	52	0.9
Oil & Gas	241	9,115	10,202	4,834	5,360	129	1,119	4,228	1,247	14.4
Construction	3,906	384	395	290	105	9	1	95	10	0.3
Manufacturing	1,312	866	879	547	348	8	14	325	23	1.1
Vehicles	1,794	30,056	30,056	5,660	25,702	2,397	2	23,302	2,400	79.5
Transportation	49	115	119	47	87	0	3	83	3	0.3
Communication	78	2,284	2,301	1,227	1,215	39	64	1,112	103	3.8
Wholesale-Retail	2,917	709	752	356	491	13	36	443	49	1.5
Banks & Finance	161	2,829	4,026	1,491	2,685	92	0	2,593	93	8.8
Insurance	248	284	298	123	175	3	11	161	14	0.5
Real Estate	442	1,083	1,105	705	575	5	17	553	22	1.9
Services & Misc.	2,019	408	432	288	144	3	20	120	23	0.4
All	17,249	49,183	51,703	16,405	37,452	2,707	1,332	33,528	4,039	114.4

Source: IRS Statistics of Income, Corporate Income Tax Returns Files, 2007, 2010 and 2012. Note: Categories of deferred gains are based on the industry or primary business activity of the firm. Vehicles includes firms that manufacture, sell, lease or rent cars, trucks and other road vehicles. Data on asset types is not available because many businesses state "Available upon request" on their capital gains forms. Dollar amounts are in millions of dollars.

Like-Kind Exchanges and Deferred Gains of Partnerships (in millions), 2007, 2010 and 2012										
2007										
Industry / Primary Business Activity	Number of Firms	FMV Like-kind received	Total FMV received	Basis on property given up	Realized gains	Ordinary income recognized	Total recognized gains	Deferred gains	F1065 capital gains	% of Deferred Gains
Agriculture	4,733	936	940	359	581	0	4	577	39	1.6
Mining	133	15	15	15	0	0	0	0	0	0.0
Oil & Gas	55	943	951	615	314	8	8	306	43	0.9
Construction	1,513	93	359	246	113	0	98	15	11	0.0
Manufacturing	224	33	33	27	7	0	0	7	5	0.0
Vehicles	1,259	985	988	397	846	2	4	842	46	2.4
Transportation	136	136	136	122	14	0	0	14	0	0.0
Communication	134	1,319	1,334	307	1,242	3	13	1,229	3	3.5
Wholesale-Retail	502	618	700	332	368	6	75	293	33	0.8
Banks & Finance	412	978	984	647	518	0	6	512	507	1.4
Real Estate	7,626	65,298	69,147	34,013	35,192	35	3,798	31,394	1,696	88.2
Services & Misc.	906	840	844	561	396	2	5	391	722	1.1
All	17,634	72,195	76,431	37,641	39,592	56	4,012	35,580	3,104	100.0
2010										
Agriculture	5,062	1,389	1,420	825	595	1	28	567	93	9.3
Mining	28	35	35	15	20	0	0	20	165	0.3
Oil & Gas	150	349	796	199	649	10	409	240	424	3.9
Construction	659	37	37	49	-12	0	0	-12	0	-0.2
Manufacturing	402	48	53	38	16	0	2	13	1	0.2
Vehicles	626	5,589	6,129	3,303	2,848	53	547	2,301	-1	37.6
Transportation	525	306	306	228	78	0	0	78	-1	1.3
Communication	24	354	429	174	255	34	74	181	0	2.9
Wholesale-Retail	648	178	181	91	99	2	4	95	4	1.6
Banks & Finance	152	176	179	93	86	0	2	83	228	1.4
Real Estate	2,948	9,595	10,351	7,536	2,969	1	458	2,511	561	41.0
Services & Misc.	2,047	195	226	147	79	2	31	48	8	0.8
All	13,272	18,253	20,142	12,697	7,682	104	1,556	6,126	1,482	100.0
2012										
Agriculture	3,951	1,540	1,574	1,118	457	3	34	423	42	2.7
Mining	71	199	199	76	122	0	0	122	0	0.8
Oil & Gas	128	286	317	111	576	15	27	549	5	3.5
Construction	549	84	84	56	28	0	0	28	0	0.2
Manufacturing	90	18	18	16	7	2	2	5	51	0.0
Vehicles & Transp.	302	3,117	3,564	1,763	5,737	4	447	5,290	12	33.7
Communication	9	2,494	2,852	1,686	1,166	358	358	809	0	5.2
Wholesale-Retail	629	240	252	121	252	1	13	239	2	1.5
Banks & Finance	68	272	272	162	110	0	0	110	136	0.7
Real Estate	3,675	17,377	20,418	10,267	10,379	20	2,320	8,059	389	51.4
Services & Misc.	1,077	251	262	208	56	0	8	47	142	0.3
All	10,551	25,878	29,812	15,584	18,889	403	3,209	15,680	779	100.0

Source: IRS Statistics of Income Partnership Returns Files, 2007, 2010 and 2012. Note: Categories of deferred gains are based on the industry or primary business activity of the firm. Vehicles includes firms that manufacture, sell, lease or rent cars, trucks and other road vehicles. Data on asset types is not available because many businesses state "Available upon request" on their capital gains forms. Dollar amounts are in millions of dollars.