The Consequences of Losing Like-Kind Exchanges Under New Tax Reform

by Ben Kaup

In our rural area nearly all farmers, ranchers, and small business owners are knowledgeable on the benefits of utilizing the like-kind exchange (Section 1031 in the tax code) when it comes to running their business. It allows for the deferral of gain when you replace an asset (many times an asset that is fully depreciated or has appreciated in value) with a new asset. This deferral of gain is then calculated into the basis of the replacement asset and no taxes are levied on the taxpayer. Like-kind exchanges are beneficial when replacing equipment, but they are an invaluable tax deferral tool when it comes to selling appreciated land and real estate.

The conversation around the new tax reform is that like-kind exchanges may be eliminated since they cost the government billions in tax revenue every year. Congress' joint committee on taxation estimated in 2014 that the repeal of section 1031 could increase government revenue by up to $40 billion over 10 years, which is no small chunk of change. The repeal of Section 1031 is not as devastating as it may appear on the surface because another topic of tax reform is to increase the Section 179 limit to $2 million per year. If the removal of like-kind exchanges is coupled with an increase in Section 179 expense, tax deferred exchanges on equipment will not be a huge issue. For example, assume a rancher exchanges a fully depreciated piece of equipment worth $50,000 for a new piece worth $150,000. Under current tax law the taxpayer could defer the gain, $50,000 in this case, and take Section 179 expense on the difference of $100,000. Under the proposed changes the taxpayer would need to recognize the $50,000 gain on the sale and then could take Section 179 expense on the full $150,000 of new equipment. In this scenario, it comes out as a wash.

Where the loss of the like-kind exchange tax provision would have the largest negative impact is on exchanges involving appreciated land and real estate assets. Under current law, a taxpayer can sell their farmland and reinvest in new real estate without paying a dime of tax. The proposed regulations would hinder the taxpayer's ability to "roll over" sale proceeds into new property because capital gains tax would be imposed upon every sale of appreciated property. For example, assume a farmer plans to sell appreciated land with a basis of 100,000 and a sale price of $500,000. The farmer then plans on purchasing land with a value of $1,000,000. Under current law the farmer recognizes $0 gain and their basis in the new land is $600,000 ($1,000,000 less the deferred gain of $400,000.) An advantage of deferring the capital gains via a like-kind exchange is that upon the owner's death the basis is "stepped-up" to fair market value. This allows many landowners to never recognize gain on like kind exchanged property if they own it on their death. Under proposed changes the taxpayer would be required to pay capital gains tax on the $400,000 capital gain from the sale of the old property (likely at a 15% rate) and would get basis of $1,000,000 in the new land.

In summary, losing the like-kind exchange provision while getting an additional amount of Section 179 expense wouldn't cause much harm in equipment transactions, but could be very painful for the taxpayer when it comes to selling real estate. At Kaup's Financial Advisors we will be monitoring the changes that could be coming with federal tax reform. As always, we will keep our clients informed and up-to-date so you have the tools at your disposal to manage your taxes as efficiently as possible. As 2017 comes to an end our team at Kaup's would love to meet with you to ensure we are finishing the year with proper tax planning. Give us a call today!

Thanks,

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