PacificCPE

COURSE

30502A

Nontaxable Exchanges, Capital Assets, and Related Rules

Not every asset disposition triggers a tax bill—and knowing when that's the case can make a real difference for your clients. This course covers like-kind exchanges, spousal transfers, qualified small business stock exclusions, DC Zone assets, and Qualified Opportunity Funds. It then moves into distinguishing capital from noncapital assets, understanding related-party sale rules, and handling other disposition scenarios. A practical overview for any tax professional working with clients who buy, sell, or exchange property.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize what type of exchanges are not taxable and when a gain or loss is recognized on this type of transaction.
- Recognize how to classify gains and losses as either ordinary or capital.
- Identify when to classify capital losses as either short-term or long-term.

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Chapter 1: NONTAXABLE EXCHANGES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize what type of exchanges are not taxable and when a gain or loss is recognized on this type of transaction.

Certain exchanges of property are not taxable. This means any gain from the exchange is not recognized and any loss cannot be deducted. Your gain or loss will not be recognized until you sell or otherwise dispose of the property you receive.

I. LIKE-KIND EXCHANGES

Generally, if you exchange real property you use in your business or hold for investment solely for other business or investment real property of a like-kind, you do not recognize the gain or loss from the exchange. However, if you also receive non-like-kind property or money as part of the exchange, you recognize gain to the extent of the value of the other property or money you received in the exchange. And, you do not recognize any loss. In general, your gain or loss will not be recognized until you sell or otherwise dispose of the property you receive in the exchange. See Qualifying property, later, for details on property that qualify and exceptions.

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be a like-kind exchange, the property traded and the property received must be both of the following.

- Qualifying property
- Like-kind property

These two requirements are discussed later.

Additional requirements apply to exchanges in which the property received is not received immediately upon the transfer of the property given up. See Deferred Exchange, later.

If the like-kind exchange involves the receipt of money or unlike property or the assumption of your liabilities, see Partially Nontaxable Exchanges, later.

If the like-kind exchange involves a portion of a MACRS asset and gain is not recognized in whole or in part, see the partial disposition rules in Treasury Regulations section 1.168(i)-8.

CODE SECTION 1031

Before we go any farther in explaining nontaxable exchanges, we believe reading the actual Code Section and some examples from the regulations will help with the learning process.

Sec. 1031. Exchange of Property Held for Productive Use or Investment

(a) Nonrecognition of gain or loss from exchanges solely in kind

(1) In general

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.

(2) Exception for real property held for sale

This subsection shall not apply to any exchange of real property held primarily for sale.

(3) Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property

For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if –

(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(B) such property is received after the earlier of –

(i) 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.

(b) Gain from exchanges not solely in kind

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) Loss from exchanges not solely in kind

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) Basis

If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.

(e) Application to certain partnerships –

For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in the partnership.

(f) Special rules for exchanges between related persons –

(1) In general. If

(A) a taxpayer exchanges property with a related person,

(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

(C) before the date two years after the date of the last transfer which was part of such exchange –

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer,

there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (c) occurs.

(2) Certain dispositions not taken into account

For purposes of paragraph (1)(C), there shall not be taken into account any disposition –

(A) after the earlier of the death of the taxpayer or the death of the related person,

(B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or

(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

(3) Related person For purposes of this subsection, the term “related person” means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).

(4) Treatment of certain transactions

This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

(g) Special rule where substantial diminution of risk

(1) In general

If paragraph (2) applies to any property for any period, the running of the period set forth in subsection (f)(1)(C) with respect to such property shall be suspended during such period.

(2) Property to which subsection applies

This paragraph shall apply to any property for any period during which the holder's risk of loss with respect to the property is substantially diminished by –

(A) the holding of a put with respect to such property,

(B) the holding by another person of a right to acquire such property, or

(C) a short sale or any other transaction.

(h) Special rules for foreign real property

Real property located in the United States and real property located outside the United States are not property of a like kind.

Multiple-party transactions. The like-kind exchange rules also apply to property exchanges that involve three- and four-party transactions. Any part of these multiple-party transactions can qualify as a like-kind exchange if it meets all the requirements described in this section.

Receipt of title from third party. If you receive property in a like-kind exchange and the other party who transfers the property to you does not give you the title, but a third party does, you still can treat this transaction as a like-kind exchange if it meets all the requirements.

Basis of property received. If you acquire property in a like-kind exchange, the basis of that property is the same as the basis of the property you transferred.

Example

You exchanged real estate held for investment with an adjusted basis of $225,000 for other real estate held for investment. The basis of your new property is the same as the basis of the old property ($225,000).

For the basis of property received in an exchange that is only partially nontaxable, see Partially Nontaxable Exchanges, later.

Money paid. If, in addition to giving up like-kind property, you pay money in a like-kind exchange, you still have no recognized gain or loss. The basis of the property received is the basis of the property given up, increased by the money paid.

Reporting the exchange. Report the exchange of like-kind property, even though no gain or loss is recognized, on Form 8824. The instructions for the form explain how to report the details of the exchange.

If you have any recognized gain because you received money or unlike property, report it on Form 8949, Schedule D (Form 1040), or Form 4797, as applicable. See Chapter 2 of course 30503N. You may have to report the recognized gain as ordinary income from depreciation recapture.

Exchange expenses. Exchange expenses are generally the closing costs you pay. They include such items as brokerage commissions, attorney fees, and deed preparation fees. Subtract these expenses from the consideration received to figure the amount realized on the exchange. If you receive cash or unlike property in addition to the like-kind property and realize a gain on the exchange, subtract the expenses from the cash or fair market value of the unlike property. Then, use the net amount to figure the recognized gain. See Partially Nontaxable Exchanges, later.

Exchange expenses also include the closing costs you pay on the acquisition of replacement property. In addition, some expenses and receipts that may be reflected on the closing statement (for example, property taxes, rent prorations, security deposits, and repairs) are not exchange expenses.

Qualifying Property

The nonrecognition rules for like-kind exchanges apply only to exchanges of real property held for investment or for productive use in your trade or business and not held primarily for sale.

In a like-kind exchange, both the real property you give up and the real property you receive must be held by you for investment or for productive use in your trade or business. Buildings, land, and rental property are examples of property that may qualify. The rules for like-kind exchanges do not apply to exchanges of the following property.

- Real property use for personal purposes, such as your home.
- Real property held primarily for sale.
- Any personal or intangible property that is not defined as an interest in real property in Regulations section 1.1031(a)-3(a)(5).

You might have a nontaxable exchange under other rules.

A dwelling unit (home, apartment, condominium, or similar property) may, for purposes of like-kind exchange, qualify as property held for productive use in a trade or business or for investment purposes if certain requirements are met.

An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of one property for another property except to the extent the transaction includes an exchange of like-kind real property. Whether you engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange. The exchange of noncash assets that are not real property is considered non-like-kind property received or paid. See also Multiple-Property Exchanges, later.

Like-Kind Property

To qualify for the non-recognition rules, there must be an exchange of like-kind property. Like-kind properties are properties of the same nature or character, even if they differ in grade or quality. The exchange of real estate for real estate is an exchange of like-kind property.

An exchange of city property for farm property or improved property for unimproved property is a like- kind exchange.

The exchange of real estate you own for a real estate lease that runs 30 years or longer is a like-kind exchange. However, not all exchanges of interests in real property qualify. The exchange of a life estate expected to last less than 30 years for a remainder interest is not a like-kind exchange.

An exchange of a remainder interest in real estate for a remainder interest in other real estate is a like- kind exchange if the nature or character of the two property interests is the same.

Foreign Real Property Exchanges

Real property located in the United States and real property located outside the United States are not considered like-kind property under the like-kind exchange rules. If you exchange foreign real property for property located in the United States, your gain or loss on the exchange is recognized. Foreign real property is real property not located in a state or the District of Columbia.

This foreign real property exchange rule does not apply to the replacement of condemned real property. Foreign and U.S. real property can still be considered like-kind property under the rules for replacing condemned property to postpone reporting gain on the condemnation.

Deferred Exchange