
Chapter 6. Tax Implications of Voluntary Property Exchanges

Introduction

This chapter deals with voluntary exchanges and should not be confused with the discussion in chapter 7 on postponing the recognition of gain or loss when property is involuntarily converted and qualified replacement property is acquired. See Internal Revenue Service (IRS) Publication 544, *Sales and Other Dispositions of Assets*, for more details.

For various reasons, forest owners may wish to voluntarily exchange some or all of their timber and/or forest land for other property. For example, exchanges can be used to consolidate or diversify your forest and other investments, to obtain greater cash flow, and to eliminate or reduce management problems. In many cases, voluntary exchanges are made to postpone the payment of income tax on the difference between the exchange value of the property given up and the owner's basis in the property.

Section 1031 of the Internal Revenue Code (IRC) provides that gain or loss is not recognized when property held for productive use in a trade or business, or for investment, is exchanged solely for like-kind property which also is to be held for productive use in a trade or business, or for investment. The rules for like-kind exchanges do not apply to stocks, bonds, notes or other securities, or to partnership interests. They also do not apply to property held for sale to customers in the ordinary course of a trade or business, discussed in chapter 5; thus, some timber properties will not qualify. Furthermore, property acquired solely for exchange purposes is not considered held for productive use in a trade or business or for investment. These considerations bring into question transactions involving the exchange of standing timber only for other real property when the intent is to postpone tax on the disposal of the standing timber. An additional consideration is whether timber disposed of which is to be harvested by the party receiving it qualifies as real property under applicable State law.

Exchanges under IRC section 1031 sometimes are referred to as tax-deferred or nontaxable exchanges. Postponement of gain or loss is achieved by carrying over to the property received in the exchange the basis of the property transferred. The holding period of the property given up likewise is transferred to the property received. The realized gain is deferred until the property acquired in the exchange is disposed of in a subsequent taxable transaction. Thus, the gain is only potentially taxable.

The tax may be avoided altogether if the replacement property is still held by the taxpayer at his or her death, when its basis is stepped-up to its date-of-death value (see chapter 4, "Original and Adjusted Basis").

If, however, you receive money or nonqualifying property in the exchange, your gain is recognized to the extent of the sum of money and/or the fair market value (FMV) of the other property received, and is taxable. Cash and nonqualifying property received in an exchange often is referred to as *boot* (Example 6.1).

Example 6.1.—*Exchange With Boot.*

In 2012, to more closely consolidate your timber holdings, you exchanged a 40-acre tract (both land and timber) with an FMV of \$50,000 for 30 acres of timber property with an FMV of \$40,000, plus \$10,000 in cash. Your adjusted basis in the 40-acre tract was \$25,000. Although the realized gain is \$25,000 (the difference between the total consideration of \$50,000 received and the \$25,000 adjusted basis), the gain is recognized only to the extent of the cash received. Therefore, you pay tax only on \$10,000 of gain (you must, however, report the entire transaction on your 2012 income tax return). Your basis in the 30-acre property you received is \$25,000.

Nonrecognition Mandatory for Qualified Transactions

Satisfaction of the like-kind exchange provisions results in mandatory application of nonrecognition treatment. Nonrecognition in such cases is not elective. Thus, you may not benefit from an exchange that results in a loss.

Properties Eligible for Like-Kind Exchange Treatment

To qualify for nonrecognition of gain, it is not necessary that investment property be exchanged for other investment property, or that property used in a business be exchanged for other property used in a business. The property received in exchange must only be of a like-kind to that given. Like-kind refers to the nature or character of property, not its grade or quality. Thus, an exchange of an item of property within one of the three classes used in defining like-kind property for another item within the same class will qualify as like-kind. These three classes are (1) depreciable tangible personal property, such as equipment; (2) other personal property,

including intangible personal property, nondepreciable personal property, and personal property held for investment; and (3) real property.

Exchange of Real Property for Real Property

The exchange of virtually any parcel of real property for another parcel of real property should qualify as like-kind as long as the interests in the property given up (the “relinquished property”) and the property received (the “replacement property”) are of a similar character or nature. The most common form of ownership interest is *fee simple*. A *fee simple* interest is not limited to a certain period of time. A leasehold interest is not of the same character or nature as a fee simple interest because a leasehold interest is limited to a designated time period. A lease with 30 years or more remaining is an exception to this rule, however. It is considered of like-kind to a fee simple interest.

The Meaning of Investment and Trade or Business

As noted previously, at the time of the exchange both the relinquished property and the replacement property must be held either for productive use in a trade or business, or for investment. Thus, property held for use in a trade or business may be exchanged for investment property, and vice versa. No precise definition exists for what constitutes a trade or business, or an investment, as discussed in chapter 3. The key factor in both cases, however, is intention to make a profit.

Change in Use

The relinquished property may originally have been acquired for another purpose. Likewise, the use of the replacement property may be changed to a nonqualifying use at some time after the exchange. Such a change in use of the replacement property, however, may indicate an intent not to hold it for a qualified use at the time of the transaction. The burden is on the taxpayer to prove that both the relinquished property and the replacement property were held for productive use in a trade or business, or as an investment.

Time Considerations

If an exchange of like-kind properties is not simultaneous, the exchange must be completed (that is, the replacement property must be received) by the earlier of two dates: (1) the 180th day after the transfer of the relinquished property or (2) the due date (including extensions) for the transferor’s Federal income tax return for the tax year in which the exchange took place.

Furthermore, in a nonsimultaneous exchange, the replacement property to be received by the transferor must be formally identified—or actually received without being identified—on or before the day that is 45 days after the date on which the transfer of the relinquished property occurred.

Multiparty Exchanges

If you want to (or will only) exchange your property for another particular property, but the person who wants your property does not own the like-kind property that you wish to acquire, you still can enter into a nontaxable exchange if the other person acquires the property you want and you then exchange your property for that property (Example 6.2).

Example 6.2.—*A Multiparty Exchange.*

You own 100 acres of farmland, with a low basis, for investment. You do not want to sell the farmland because a sale would result in your having to pay a large capital gain tax. You are, however, willing to exchange the farmland for a 200-acre tract of forest land that is on the market. Your neighbor wants your farm acreage, but does not own the forest land, and although the owner of the forest acreage wants to sell, he does not want your farmland. To consummate a transaction acceptable to all parties concerned, your neighbor purchases the forest property for cash from its owner. You then transfer your farmland to your neighbor in exchange for the forest acreage. The exchange is nontaxable to you if the time limits described previously are met.

Assumption of Liabilities

Liabilities assumed in an exchange are treated as cash equivalents (boot). The taxpayer who assumes the liability or gets property subject to a liability is the one who owns the boot. If each party assumes a liability of the other (or acquires property subject to a liability), only the net liability constitutes boot given or received (Example 6.3).

Example 6.3.—*Liability as Boot.*

Your forest property held as an investment has an adjusted basis of \$30,000, an FMV of \$100,000, and a mortgage of \$60,000. You exchange it for other investment real estate, which is worth \$80,000 and has a \$40,000 mortgage. You also receive \$5,000 in cash. Your realized gain is \$75,000 because you received a total consideration of \$105,000: property worth \$40,000 (\$80,000 value, minus \$40,000 mortgage), plus the \$60,000 mortgage on the property you transfer, plus \$5,000 cash, minus your adjusted basis of \$30,000. The recognized (currently taxable) gain, however, is limited to the boot of \$25,000, computed as follows:

Mortgage on property you give up	\$ 60,000
Less mortgage on property you receive	–40,000
Net reduction of your indebtedness	20,000
Plus cash you receive	+ 5,000
Maximum gain to be recognized	\$ 25,000

Exchanges Between Related Parties

If you exchange like-kind property with a related taxpayer, and within 2 years of the date of the last transfer that was part of the exchange, either you or the other party disposes of the property received in the exchange, then any gain or loss not recognized in the exchange is recognized on the date of the later transaction. Related taxpayers are brothers and sisters (whole and half blood), spouses, parents and grandparents, and lineal descendants. In-laws are not related taxpayers. Disqualifying dispositions include indirect transfers, such as to a corporation controlled by a related person. Exceptions are made for transfers at death and as a result of certain involuntary conversions, and for non-tax avoidance transactions.

Basis After a Nontaxable Exchange

The basis of property received in a like-kind exchange where no part of the gain is recognized (no *boot* is received) is the adjusted basis of the property transferred. When two or more properties are acquired in exchange for one, the basis of the exchanged property must be allocated between the properties received in proportion to their respective FMVs on the date of the exchange. If money is received as part of the exchange and some gain is recognized, the basis in the replacement property is decreased by the amount of money received and increased by the gain recognized. If money is paid, the basis is increased by the amount paid. If non-like-kind property other than cash is received, and some gain is recognized, the basis must be allocated (according to the respective FMVs) to all the replacement properties. If noncash *boot* is given as part of the exchange, and gain or loss is recognized on transfer of the *boot*, the basis of the like-kind replacement property is the total basis of all the relinquished properties, increased by any recognized gains on the *boot* or decreased by any recognized loss on the *boot*.

Application to Timber Properties

As noted previously, to qualify for nonrecognition of gain, property given and received in an exchange must only be of like-kind (of the same nature or character), not necessarily of like grade or quality. Timberland and unsevered timber—also called standing timber or stumpage—are real property. The right to cut and remove standing timber under the provisions of

a timber deed or cutting contract is classified as “other personal property” in most States. Among the States, however, some variation exists regarding the classification of timber contracts. Because State, not Federal, law determines the legal classification of items of property, it is necessary to consult legal counsel for such determinations.

An exchange of forest land containing primarily premerchantable and young-growth timber for timber property containing mostly merchantable timber will qualify as like-kind (see the summary of Revenue Ruling (Rev. Rul.) 72-515, appendix A). An exchange of timberland, with retention of the timber rights, for land and timber also will qualify (see the summary of Rev. Rul. 76-253, appendix A), as will an exchange of bare land with no timber on it for land and timber (see the summary of Rev. Rul. 78-163, appendix A).

In general, an exchange of timberland for other real property—such as farmland, commercial real estate, or rental property—also will qualify as like-kind. The exchange of standing timber only for land and timber is an unsettled question, however. The IRS has not issued a formal position on this question as of September 30, 2012.

As discussed previously, property that is stock in trade or is property held primarily for sale to customers in the ordinary course of a trade or business does not qualify for like-kind exchange treatment. Thus, timber that is considered to be held primarily for sale (see chapter 5, “Determining the Type of Gain or Loss”) would not qualify if exchanged separately from the land. Such timber would qualify if it was exchanged together with the accompanying land, however, unless the transferor held timberland primarily for sale to customers in the ordinary course of his or her trade or business. In such cases, the timber is classified as an unharvested crop exchanged with the land.

Reporting of Like-Kind Exchanges

Like-kind exchanges must be reported on your tax return for the year the exchange is made. Exchanges of investment property (capital assets) are reported on IRS Form 1040, Schedule D. Exchanges of property held for use in a trade or business are reported on IRS Form 4797. IRS Form 8824: Like-Kind Exchanges, also is filed to support the entries on Form 1040, Schedule D, or Form 4797. If the exchange is between related parties, Form 8824 must be filed for each of the 2 years following the year of the exchange.

