

Assets That Do Not Qualify for a 1031 Exchange

Taxpayers nationwide are able to acquire better performing properties or meet other investment objectives by understanding the great variety of properties that can be exchanged under Internal Revenue Code Section 1031. There are, however, some types of assets that do not qualify for non-recognition treatment, such as:

1) Stock in trade or other property held primarily for sale: The exclusion encompasses two aspects –

A) “Stock in trade,” which is property held for sale to customers in the ordinary course of the taxpayers’ trade or business resulting in gain taxed as ordinary income and;

B) “Property held primarily for sale,” which is a much more expansive category of excluded property. The word primarily is viewed as being held “principally” or “of first importance.” [*Malat v. Riddell*, 383 US 569, 5 L. Ed. 2d 154, 86 S. Ct. 244 (1966)].

Generally the IRS considers property held primarily for any disposition as falling into the category of property held primarily for sale. [*Rev Rul 75-292*, 1975-2 CB 333; *Wagnesen v. Comm.*, 74 TC 653 (1980)]. See Asset Preservation’s flyer titled “Property Held for Sale” for a more exhaustive list of factors the IRS reviews to determine if a taxpayer is holding a property primarily for sale.

2) Stocks, bonds or notes: Although stocks can be exchanged in a corporate reorganization under IRC §1036(a) and certain United States bonds under IRC §1037, none of these types of transactions qualify for tax deferral under IRC §1031.

3) Other securities of evidences of indebtedness or interest: The scope of this category is not clear because most of the court cases addressing this category are obsolete after the 1984 amendment excluding partnerships interests from §1031 deferral. Check with your tax and/or legal advisor.

4) Interests in a partnership: In 1984, the exclusion of an interest in a partnership was added to the Internal Revenue Code. [*Tax Reform Act of 1984*, Pub. L. No.98-369, 98 Stat.494: IRC §1031(a)(2)(D)]. Although a partnership or limited liability company (LLC) can perform an exchange at the entity level, the individual partnership interest or LLC member interest is excluded. However, an interest in a partnership that has made a valid election under IRC §761(a), to be excluded from the application of subchapter K, is treated as an interest in each of the assets of the partnership and not as an interest in a partnership. A thorough discussion is beyond the scope of this article and taxpayers should get guidance from their tax and/or legal advisors regarding timing and other issues involving exchanges where property has been held in a partnership or LLC.

5) Certificates of trust or beneficial interests: These represent a right to an interest in the stock or a corporation and are not considered real property.

6) Choses in action: A chose in action is a right to recover or receive money or other consideration or property, but a chose in action is not considered property in itself. Courts typically look to state law for the definition of a chose in action. [*See Miller v. United States*, 63-2 USTC & 9606, SD Ind 1963]. The chose in action exclusion is vague due to the difficulty in defining the term itself and it has rarely been used to disallow non-recognition treatment in an exchange. Some major league player contracts have been considered a chose in action and denied exchange treatment. [*Ltr Rul 8453034*; *Heltzer v. Comm.*, TC Memo 1991-404, 62 TCM 518, 537].