The Story of Lucky: Section 1031 Exchanges Can Be Used In The Context of the Sale of Tangible Personal Property

Laurence E. Fundler
Greenbaum, Rowe, Smith & Davis LLP
August 2016

The provisions of Section 1031 of the Internal Revenue Code are available and commonly employed to defer capital gains tax liability when a taxpayer purchases “like-kind” real property to replace property sold. Although this scenario is quite familiar in real estate transactions, it is worth noting that the same opportunities and rules of Section 1031 that apply to the sale of real estate also can apply to the sale of tangible personal property such as coins, artwork or other collectibles.

The following “feel good” story illustrates the value of this proven but somewhat lesser known tax planning strategy, and is based on our recent experience with a client who we’ll refer to as “Lucky” for reasons that are self-evident.

Approximately fifty years ago, Lucky spent $70 on the purchase of a counterfeit replica of a rare and expensive gold coin. The coin sat in a box for many years, virtually forgotten and never seeing the light of day. Then, not too long ago, Lucky discovered that his so-called counterfeit coin was actually not a replica but was, in fact, an authentic rare and expensive coin. The coin was also in great condition.

After learning of the coin’s authenticity and value, Lucky decided to sell it and use the proceeds to diversify his coin holdings by purchasing multiple coin sets. Lucky’s accountant astutely advised him that a 28% capital gains tax rate applies to the sale of collectibles – including coins, artwork, stamps, etc. – which would take a significant bite out of the proceeds.

Lucky wanted to know his options to either eliminate or minimize the 28% capital gains tax on the sale of the coin. The good news is that Lucky was “in luck” again when we advised him that Section 1031 can be applied in the context of collectible tangible property, such as the sale of his rare coin, if the proceeds are used to purchase replacement “like-kind” coins.

The following simplified overview provides more detail on the viability and versatility of a Section 1031 exchange in connection with the sale of certain tangible property.

A Section 1031 exchange allows a person to sell one or more appreciated assets (real property or tangible personal property) and defer the payment of capital gain taxes by acquiring one or more replacement properties of “like-kind.” Section 1031 allows for the repositioning, diversification or consolidation of investments while deferring the payment of capital gains taxes to a later time.

There are specific requirements and deadlines that must be followed in order for a sale transaction to qualify for Section 1031 treatment. Importantly, the relinquished property and the like-kind replacement property must have either been held for investment or used in a trade or business. In addition, in order to defer all of the gain, the taxpayer cannot actually or constructively receive the sales proceeds. There are various ways in which a Section 1031 exchange can be structured in order to qualify for deferral treatment. Because of the many rules and restrictions involved, it is critical that one consult with a tax advisor prior to engaging in a Section 1031 exchange.

Turning back to Lucky, the proceeds on the sale of his “counterfeit-turned-authentic” gold coin were significant, and were placed directly in the hands of a qualified intermediary and then used to purchase replacement “like-kind” coins in a transaction that qualifies under Section 1031. Lucky was successful in deferring approximately $154,000 of capital gain taxes until he sells the replacement coins – unless of course he engages in a second Section 1031 exchange at that time and further defers the taxes. If Lucky holds onto the coins until he dies, his estate will receive a stepped-up basis for the coins, and all of the deferred gain will forever escape capital gains taxes.

If you own valuable tangible property or collectibles, the capital gains tax on sale can be significant. If you want to diversify or consolidate your holdings, consider a Section 1031 exchange to defer the capital gains tax until a later time, or perhaps forever.

If you would like to learn more about the information presented in this Alert, please contact the author, **Laurence Fundler**, a member of the firm’s Tax, Trusts & Estates Department.