CITY OF PHILADELPHIA
DEPARTMENT OF REVENUE

Philadelphia's Tax Treatment of IRC §1031 Exchanges for Business Income and Receipts Tax (BIRT) and Net Profits Tax (NPT)

Overview of IRC § 1031

No gain recognition

No gain or loss is recognized under IRC §1031 on the exchange of real property held for productive use in a trade, business or for investment if that property is exchanged solely for property of a like-kind which is to be held either for productive use in a trade, business or for investment. This non-recognition treatment, however, does not apply to stock in trade or to property primarily held for sale.

Like – kind property

The term "like-kind" relates to the nature and character of the properties exchanged, rather than to their grade or quality. Although properties don't have to be identical, a comparison of properties occurs. The comparison determines whether a taxpayer has acquired a new asset or merely exchanged an asset of similar nature or character. Real estate, whether improved or unimproved, as well as depreciable tangible personal property used in a trade or business, can be exchanged under §1031. The exchange of property does not have to be simultaneous but, time limits exist for the identification and receipt of replacement property.

Receipt of "Boot" & Gain Recognition

As noted above, if the exchange transaction meets all the requirements of IRC §1031, no gain or loss is recognized on the transaction. However, where the taxpayer receives cash or other property that is not like-kind ("boot") then gain, if any, to the recipient is recognized, but not in excess of the boot [Treasury Reg. § 1.1031(b)-1(a)].

Philadelphia tax treatment of IRC § 1031 transactions

The City of Philadelphia does not have an ordinance that specifically adopts IRC § 1031 treatment for the non-recognition of capital gains on the sale or exchange of like-kind property. Both the Philadelphia Code and Revenue Department regulations are silent as to this specific federal statute. To the extent that it is not required under the Philadelphia Code, the Department of Revenue will **not** recognize IRC § 1031 on like-kind exchanges.

BIRT – Gross Receipts portion of the tax

BIRT Regulation Section 324 - Sale of Capital Assets states: *(e)xcept as otherwise provided, the gains (not gross proceeds) resulting from the sale of capital assets, such as plant, machinery and equipment, furniture and fixtures, vehicles, etc., are to be included in the tax base if the property is located in Philadelphia at the time of sale. ... In computing the gains or losses from the sale of a capital asset, the cost of the asset, less allowable depreciation, is deductible from the gross proceeds of the sale.* There is no provision in the BIRT regulations that allows IRC § 1031 tax- free exchange treatment when reporting gains from the sale, exchange, or other disposition of property. Therefore, taxable gross receipts will include the net *realized* gain on the sale or exchange of the asset.

BIRT – Net Income, Method I versus Method II

Taxpayers that originally elect to report net income under Method II must use IRC § 1031 for purposes of reporting Net Income – provided IRC § 1031 is used to determine Federal taxable net income for the sale/ exchange transaction. The definition of *Net Income* under Philadelphia Code § 19-2601 for Method II is *(t)he taxable income from any business activity as returned to and ascertained by the Federal Government prior to giving effect to the exclusion for dividends received and net operating loss…* Since IRC § 1031 is a provision used to determine taxable income on a federal basis, it must be followed under BIRT Income Method II.

Taxpayers who utilize BIRT Income Method I cannot use IRC § 1031 due to BIRT Regulation 403 – Net Income Method I which states: *(t)he rules and regulations applicable to determining taxable net profits for the Net Profits tax imposed in Chapter 19-1500 of The Philadelphia Code shall be the rules and regulations applicable to determining taxable net income for Net Income Method I.*

Net Profits Tax

For purposes of calculating the Net Profits Tax (NPT), Income Tax Regulation 101(i) defines *Net Profit* as *the net gain from the conduct, operation or prosecution of a trade, business, profession, enterprise, or other activity…* *Net Gain* is defined under Income Tax Regulation 101(h) as *cash, credit, property, remuneration, or consideration that is* ***realized*** (emphasis added) *after allowance for all expired costs and expenses which are ordinary, necessary, and reasonable as measured in accordance with a cash or strict accrual accounting system.* ***Net gain shall include the disposition of assets occurring as part of the normal operations or termination of the business*** (emphasis added).

Updated 20220915