

# The Basics of 1031 Exchanges in 2022 and Beyond

Section 1031 of the Internal Revenue Code allows an owner of business or investment real estate to sell old property (relinquished property) and acquire new property (replacement property) without paying any taxes on the profit of the sale of the old property. The principle underlying these “tax-deferred exchanges” is that by using the exchange value in one property to buy another—instead of receiving cash for that exchange value—a property owner is simply continuing the investment in the original property. As such, the IRS won’t recognize the sale as a taxable event, provided that the owner (referred to in this article as the “taxpayer” or “exchanger”) adheres to the many rules governing exchanges.

The purpose of this article is to provide an overview of some of the most fundamental 1031 exchange rules and concepts, as well as to clarify some common misconceptions. Each concept is discussed below.

## Calculating Taxes Due Upon Sale VS 1031 Exchange

As a starting point, a taxpayer should always have a sense of his or her hypothetical tax liability before deciding whether to do an exchange. In very broad terms, the ultimate amount of tax is determined by “capital gain,” which is generally determined by subtracting the amount a taxpayer originally paid for a property from the amount which he or she sells it for. For instance, if Betty originally bought an apartment building in Omaha for \$100,000 (her “cost basis”) and sells it for \$250,000, her capital gain is \$150,000. Betty may also add the value of any “capital improvements” she made during her ownership to her cost basis, which would reduce her recognized capital gain.

Betty’s \$150,000 gain—provided it is long-term capital gain—is taxed at 15-20% depending on Betty’s income level. Betty probably also took a “depreciation” deduction over the period she owned the property, say, a total of \$20,000. Depreciation is “recaptured” via a 25% tax upon sale. Betty’s gain could also be subject to state capital gain tax and/or depreciation recapture. Lastly, if Betty is a single person earning over \$200,000 in the year of sale (or, for married couples filing jointly, earning over \$250,000 in the year of sale), Betty would also be subject to the Net Investment Income Tax (“NIIT”) at the rate of 3.8%. The income pertaining to the sale of the property in addition to her other sources of income is included in determining whether Betty was subject to the NIIT. Some may be familiar with the NIIT by one of its nicknames: “Medicare” or “Obamacare Tax”.

In this example, Betty’s (approximate) tax liability would be:

\$22,500 in federal capital gain tax (15% of \$150,000)

\$5,000 in depreciation recapture (25% of \$20,000)

\$7,500 in state capital gain tax (5% of \$150,000—actual amount varies by state)

\$5,700 in NIIT tax (\$5,700)

Total tax liability = \$40,700

Note: Mortgage debt and the amount of Betty’s net cash proceeds after mortgage debt is paid off is not what determines capital gain.

## **Taxes are Deferred, Not Eliminated with a 1031 Exchange**

If Betty decides she wants to reinvest the \$40,700 she would otherwise pay in taxes into new real estate, she can defer, rather than eliminate, her capital gain, depreciation recapture, and other tax liability. But, if and when she eventually cashes out by selling the property she bought as replacement property, she will owe the \$40,700 at that time, plus whatever additional tax liability accrued on the new property.

Exception: Upon the death of an exchanger, his or her heirs receive a “step up” in basis that does effectively eliminate the deferred taxes.

## **Role of a Qualified Intermediary**

The most common kind of 1031 exchange is a “forward” or “delayed” exchange using a Qualified Intermediary, or QI, like Accruit. Rather than require an actual swap of one property—i.e., transferring relinquished property to Party A and also receiving replacement property from the same Party A—the forward exchange process effectively allows an exchanger to sell relinquished property to a third-party buyer and within 180 days thereafter acquire replacement property from a third-party seller, hence the “delayed” terminology.

The critical parts of this structure are that: (1) the QI is assigned the exchanger’s rights in both the relinquished and replacement property contracts, which allows the taxpayer to “exchange” properties with the QI, as required by Section 1031; and (2) the QI receives the net proceeds from the sale of relinquished property and uses them as directed by the taxpayer to acquire replacement property. If a taxpayer, or a disqualified person like a relative or agent, receives the funds, even briefly, the exchange won’t be valid.

Note: If replacement property must be acquired before relinquished property is sold—an increasingly common scenario in today’s tight real estate market—a “reverse exchange,” may be a possibility.

## **1031 Exchange Timing Requirements**

Section 1031 has strict timing and identification requirements. If Betty elects to do an exchange, she must identify replacement property within 45 days after the date she closes the sale of her apartment building, and she has 180 days from the date of closing to ultimately acquire replacement property (135 days from the identification deadline).

With regard to identification, Betty may identify up to three potential replacement properties, and ultimately close on any one of them. If she wishes to identify more than three properties, she may do so provided that the combined fair market value of all identified properties does not exceed the 200% of the value of the relinquished property. In Betty’s example, the combined value of four or more identified properties could not be more than \$500,000. If a taxpayer identifies more than three replacement properties and violates this “200% rule,” he or she must close on 95% of the value of all replacement properties, which in most circumstances means all of them.

## **Like-Kind Property in a 1031 Exchange**

Relinquished property must be “like-kind” to replacement property. Despite the term “like-kind,” the two properties need not actually be of the same type or quality. In fact, all real estate is “like-kind” to all other real estate under Section 1031, provided that the exchanger has the intent to hold it for business or investment use (see below). Properties can also be exchanged across state lines. So, Betty could exchange her apartment building in Omaha for an office building in Tampa, a beachfront condo in Hawaii, or ranchland in Wyoming. Additionally, one property can be exchanged for multiple properties and vice versa.

Frequently, an exchanger wishes to acquire an interest in a multi-member LLC or other partnership that owns

real estate as replacement property. However, interests in an entity are not like-kind and thus do not qualify for exchange treatment, even if it’s a special-purpose entity that only owns real estate. An exchanger may acquire a tenancy-in-common or other fractional interest in real estate, including an interest in a Delaware Statutory Trust, but the replacement property must be real estate, or another interest that qualifies as like-kind, like a leasehold interest longer than 30 years.

## **Qualified Use and Holding Period**

As emphasized above, under Section 1031 a taxpayer must intend to hold both the relinquished and replacement properties for investment or use in a trade or business. Neither vacation homes nor primary residences qualify for 1031 exchange treatment, with some limited caveats. Holding vacant land for the appreciation in value, even if it generates no income, satisfies the rule, where, conversely, allowing a family member to “lease” property for less than fair-market-value rent may be problematic. A developer intending to “flip” property following development would not be eligible for 1031 treatment.

This holding period requirement raises the question of how long a taxpayer must hold property to qualify for 1031 treatment. The answer: it depends. While Section 1031 doesn’t specify a particular duration, time is relevant to determining intent. Two years is generally regarded as sufficient, and a shorter period of time could suffice if a taxpayer can demonstrate actual intent to hold the property at the time it was acquired. Perhaps an exchanger entered into a five-year commercial lease with a replacement property tenant shortly after acquiring the property, but because of quick appreciation in value receives an attractive cash offer after one year of ownership. Under such circumstances, the taxpayer may be excused for the relatively short holding period.

## **Same Taxpayer Requirement**

The taxpayer who owns relinquished property must be the same taxpayer that acquires replacement property. The taxpayer may be an individual or entity and may not necessarily be the party on the deed. For instance, the taxpayer may own property in a living trust, an Illinois-type land trust, or a single-member LLC (“SMLLC”), all of which are generally “disregarded entities” for tax purposes, which means the entities don’t file their own tax returns but rather their assets are reported on the underlying taxpayer’s tax returns. Essentially, although they may provide important protection of personal assets or be effective estate planning strategies, the IRS treats them for tax purposes as if they don’t exist. So, if Betty owned her apartment building in Betty’s Investments, LLC, a SMLLC and thus disregarded entity, she could acquire replacement property in the same LLC, or a different SMLLC, or in her individual name, etc.

A tax partnership, however, is not a disregarded entity, it files its own tax returns and issues a K-1 to each

partner/member and accordingly is a distinct tax entity. For example, if Betty and her sister Blanche owned the Omaha apartment building in a two-member LLC called BB Investments, LLC, the LLC—not Betty and Blanche as individuals—would be the taxpayer for exchange purposes. As such, BB Investments, LLC would have to acquire replacement property. If Betty and Blanche acquired it in their individual names, they would violate the same-taxpayer requirement and invalidate the exchange, unless they used a technique called “drop and swap.” The drop and swap technique involves converting partnership interests to interests in the underlying real estate itself before an exchange.

### **Avoiding “Boot” By Purchasing Replacement Property of Equal or Greater Value**

To fully defer taxes on all gain realized from the sale of relinquished property, an exchanger must acquire replacement property of equal or greater value to the relinquished property. This includes replacing any mortgage debt paid off at closing of the relinquished property with new mortgage debt on replacement property, or new cash. In other words, if Betty sells her apartment building for \$250,000, she would have to acquire replacement property of at least \$250,000, regardless of the amount of her net proceeds after debt payoff. If she paid off \$100,000 in mortgage debt and only realized \$150,000 in net proceeds, she would still have to acquire a \$250,000 replacement property, and offset the \$100,000 mortgage payoff with a new mortgage on her replacement property, or \$100,000 of new cash. Cash received or debt paid off that is not offset by new debt or new cash is referred to as “cash boot” or “mortgage boot,” respectively.

Note: An exchanger is permitted to cash out a portion of the value of relinquished property, but would be taxed on that amount, starting with 25% depreciation recapture tax.

### **Consult With a Knowledgeable QI**

As is apparent from the above discussion, successfully completing a 1031 exchange requires compliance with a number of rules. This article is a useful starting point to understand some of the most basic requirements, but is by no means exhaustive. We at Realogy 1031 are standing by to discuss your specific scenario and whether an exchange is advisable under your particular circumstances.