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TAX

Working Out a 1031 Exchange of Real Estate

You can still avoid current capital gains tax when you exchange one real estate property for another, or as a result of an exchange involving multiple parties, as long as certain requirements are met.

Ken Berry • Oct. 18, 2022

The massive Tax Cuts and Jobs Act (TCJA) cracked down on like-kind exchanges of property under Section 1031 of the tax code. Essentially, the TCJA eliminates the tax

deferral break for such exceptions, beginning in 2018. Key exception: The crackdown doesn't apply to swaps of real estate.

Accordingly, you can still avoid current capital gains tax when you exchange one real estate property for another, or as a result of an exchange involving multiple parties, as long as certain requirements are met. But the tax-favored treatment isn't automatic. In particular, be aware of the following four rules:

1. The properties must be "like-kind." But this isn't as restrictive as you might think because the IRS takes a liberal view. For instance, you can give up an apartment building in return for a warehouse or even raw land.
2. A 1031 exchange only works for investment or business properties. In other words, none of the properties involved in the exchange can be a personal residence like your home.
3. The deal may not be entirely tax-deferred. To the extent you receive "boot" in the exchange, you owe current tax on the amount, equal to the lesser of the realized gain of the property received in exchange or the fair market value (FMV) of the boot. Typically, boot is cash, but it might also be a reduction in a mortgage.
4. Finally, there are two key deadlines to meet to qualify for tax deferral under Section 1031.

- You must identify or actually receive the replacement property within 45 days of transferring legal ownership of the relinquished property.

- You must receive title to the replacement property within the earlier of 180 days or your tax return due date, plus extensions, for the tax year of the transfer.

The 180-day period begins to run on the date legal ownership of the relinquished property is transferred. If that period straddles two tax years—say, 2022 and 2023—it might be shortened by the tax return due date. For instance, if you transfer ownership on December 15, 2022, you only have until the tax return due date to obtain the title. But a tax filing extension can trigger the 180-day limit

To fully understand the tax benefits of a 1031 exchange, let's look at a hypothetical:

Example: You acquired a business building 15 years ago for $500,000 that's now worth $1.5 million. If you sell the building this year, you would have a $1 million long-term capital gain. Assuming for simplicity that the entire amount is subject to the 20% capital gain rate plus the 3.8% net investment income tax (NIIT), you would owe $238,000 in taxes on the sale. However, if you swap the property under Section

1031 exchange without receiving any boot, your tax bill is zero! (A boot is non-like-kind property that may also be involved in some exchanges.)

Usually, it's difficult to find a single owner who owns property you want that also wants to acquire property you own in a swap. For that reason, most like-kind exchanges involve multiple parties. Depending on your situation, you may also enlist the services of a "qualified intermediary" to help facilitate an exchange.

This is not a do-it-yourself proposition. Obtain professional assistance to complete the transaction.

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