Abstract: A Section 1031 exchange (also known as a like-kind exchange) allows commercial or investment real estate owners to avoid capital gains tax when selling the property by swapping qualifying properties. This article notes that recent legislation has cracked down on Sec. 1031 exchanges, but currently it's still possible to use this technique for qualified real estate transactions. A sidebar explains multiple-party transactions.

Deferring a tax hit with a Sec. 1031 exchange

Do you own commercial or investment real estate that has substantially increased in value? If you sell the property, you may be hit with a huge capital gain tax liability. Possible solution: Consider a Section 1031 exchange (also known as a like-kind exchange) in which you swap qualifying properties while paying zero or little current tax.

Recent legislation has narrowed the availability of Sec. 1031 exchanges, but you can still use this technique for qualified real estate transactions. However, keep in mind that a repeal or modification of the rules has been discussed. So, if you're interested in an exchange, you may want to act soon.

What's the deal?

Under Sec. 1031 of the Internal Revenue Code, you can defer tax on the exchange of like-kind real estate properties if specific requirements are met. Previously, this tax break was available for various types of property, such as trade-ins of business vehicles. But as of 2018, the Tax Cuts and Jobs Act strictly limits the Sec. 1031 rules to real estate transactions.

Note that the properties — both the one you relinquish and the one you receive — must be business or investment properties. You can't avoid current tax if you swap personal residences, but you may be able to exchange a vacation home that is treated as a rental property. (There may be other complications, so consult with your tax advisor.)

Normally, a sale of appreciated real estate would result in capital gains tax. For individual property owners, the maximum tax rate is 20% if the property has been owned for longer than one year. Otherwise, the gain for individuals is taxed at ordinary income tax rates currently topping out at 37%.

If you meet the requirements under Sec. 1031, there's no current tax due on the exchange — except to the extent that you receive "boot" as part of the deal. Boot includes cash needed to "even things out" or other concessions of value (such as a reduction of mortgage debt). In some cases, cash may be combined with a valued benefit.

If you receive boot, you owe current tax on the amount equal to the lesser of:

- The realized gain, i.e., the difference between the adjusted basis of the property being given up and the fair market value of what's received in exchange (including any boot), or
- The fair market value of the boot.

On the other hand, if you're the one paying boot, you won't realize any taxable gain.

What are the requirements?

For these purposes, "like-kind" refers to the property's nature or character. The prevailing tax regulations provide a liberal interpretation of what constitutes like-kind properties. For instance, you can exchange improved real estate for raw land, a strip mall for an apartment building or a marina for a golf course. It doesn't have to be the exact same type of property (for example, a warehouse for a warehouse).

Timing is everything. The following two deadlines must be met for a like-kind exchange to qualify for tax-free treatment:

1. You must identify (or actually receive) the replacement property no later than 45 days after transferring legal ownership of the relinquished property, and

2. The title for the replacement property must be transferred to you 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 of the transfer of legal ownership of the relinquished property. If that period straddles two tax years, it might be shortened by the tax return due date. So, if you give up title to the property in November or December this year, the due date for 2022 returns (April 18, 2023) would arrive before 180 days are up. Keep this in mind as the end of the year approaches.

Also, in the real world, it's unlikely that you'll own property that another person wants to acquire while he or she also owns property that you desire. These one-for-one exchanges are rare. The vast majority of Sec. 1031 real estate exchanges involve multiple parties. (See the sidebar, "Multiple-party exchanges.")

Who can help?

Unless you're an expert in the field, a Sec. 1031 exchange is not a do-it-yourself proposition. Enlist the services of professionals, including your CPA, who can provide the assistance you need.

Sidebar: Multiple-party exchanges

Depending on your situation, you might use a "qualified intermediary" to cement a Section 1031 exchange. Essentially, the qualified intermediary is a third party that helps facilitate the deal. The parties create an agreement whereby the qualified intermediary:

- Acquires the relinquished property from the taxpayer,
- Transfers the relinquished property to the buyer,
- Acquires the replacement property from the seller, and
- Transfers the replacement property to the taxpayer.

Note that the agreement must limit the taxpayer's rights to receive, pledge, borrow or otherwise obtain benefits of cash or other property held by the intermediary. In addition, specific IRS reporting requirements must be met. Typically, the intermediary charges a fee based on the value of the properties.