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Executing the 1031 Exchange

The opportunity for savings makes the effort worth it if your property or transaction qualifies

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Thinking about swapping your ski chalet in Aspen for an ocean-front mansion on Miami Beach? If you've used your vacation home as an investment property, and collected rental income, you might be able to take advantage of a popular tax break that allows you to defer payment of any capital-gains taxes due on the sale or perhaps avoid them entirely.

Like-kind exchanges, also known as 1031 exchanges for the section of the Internal Revenue Code they fall under, allow taxpayers to exchange real property used for business or investment purposes for like-kind property without paying taxes on the proceeds. Instead, those gains are rolled over until the taxpayer ultimately cashes out by selling the property. Under the tax code, any type of real estate used for business or investment is considered like kind, so vacant farmland can be replaced with industrial property in a 1031 exchange. However, under IRS rules, a home used solely for personal use, whether as a primary residence or vacation home, wouldn't qualify for like-kind exchange treatment.

Although like-kind exchanges are a popular tax strategy for large institutional investors that buy and sell commercial real estate such as office buildings, individual investors often take advantage of the break as well, whether they own small apartment buildings, single-family rentals or vacation homes used for business purposes. In fact, according to data firm CoStar Group, the share of transactions worth $1 million or less has increased to 32% in 2021 from 18% in 2017.

Miltiadis Kastanis, a senior director of luxury sales for Douglas Elliman Real Estate in Miami, said more of his clients are seeking 1031 exchanges now than in past years due to the run-up in housing prices. "Markets around the country are so robust that people are taking advantage of the great values of their properties and rolling those gains into properties in other markets," he said. "The opportunity to defer capital gains is the main driving force of doing a 1031 exchange."

Mr. Kastanis said he's currently working with a buyer from Rhode Island who is planning to sell a vacation home in The Hamptons and exchange it for one in Miami Beach. The buyer plans to use the new home as rental-producing property, and, subject to the IRS rules capping the amount of time he can personally use the dwelling, for personal use as well.

To successfully complete a 1031 exchange, investors must comply with strict time limits. First, the taxpayer must identify one or more replacement properties within 45 days of the date of the sale. Then, the replacement property must be acquired within 180 days of the sale. Miss these deadlines, and you'll lose the tax benefits of Section 1031.

But finding and closing on replacement property within the required time frames can be a challenge in today's market, where inventory is, in many markets, at historic lows. Mr. Kastanis said that he often looks for off-market opportunities due to the scarcity of inventory in Miami.

Still, savvy investors are conducting deals and deferring taxes, in some cases for decades. Louis Appignani, 88, a retired entrepreneur from Miami, purchased his first office building in 1993 for $2.5 million. He sold it in 2015 for $14.5 million, a $12 million gain, but he paid no taxes because he acquired an 80-acre working ranch in Jackson Hole, Wyo. for $14.5 million in a 1031 exchange. Mr. Appignani planned to hold on to that land, but he received an unsolicited of-

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fer for it in 2020 and ultimately sold the land for $25 million. He used that money in another 1031 exchange to purchase five parcels of land in Asheville, N.C.

"My $2.5 million investment was parlayed into $25 million, and I didn't pay any tax on it," he said. "Rather than pay the government, I delayed it and reinvested it."

Under the current tax code, taxpayers who complete successive 1031 exchanges without paying capital-gains taxes who then die may avoid taxes altogether since their heirs will inherit that property with a stepped-up basis equal to the value of the property at the time of death. That makes 1031 exchanges a great estate-planning tool.

Here are some things to consider if you're thinking about a like-kind exchange.

Be aware that the rules may change. The American Families Plan proposed by President Biden calls for limiting the deferral of capital gains in a 1031 exchange to a maximum of $500,000 for single taxpayers or $1 million for married couples filing a joint return. Although these provisions are pending and subject to change, realize that 1031 exchanges might be curbed in the future.

Use a qualified intermediary. To avoid triggering a taxable event, always use a so-called qualified intermediary, such as a lawyer, accountant or title company, to facilitate a 1031 exchange. That intermediary will hold the sales proceeds from the relinquished property and use them to acquire the replacement property, preventing the taxpayer from coming into contact with the proceeds of the transaction, which is prohibited. Marilyn Wright, a broker with Premier Sotheby's International Realty in Asheville, N.C., always requires her clients to use a qualified intermediary when doing a 1031 exchange. "It's imperative to make sure it's done properly," she said. "Most real-estate agents are not proficient in handling the paperwork involved, and I know I don't want to be responsible for messing up the transaction. Even the agents I know who regularly do 1031 exchanges have a company handle it for them."

Bone up on Delaware Statutory Trusts. To avoid challenges complying with the strict time periods required by the Internal Revenue Code, Steve Moskowitz, a tax attorney in San Francisco, recommends naming a Delaware Statutory Trust, a separate legal entity similar to a real-estate investment trust, as one of the replacement properties. That way, since the IRS ruled in 2004 that certain DST shares are treated as replacement property in a 1031 exchange, if the seller cannot find or close on a suitable replacement property in time, they can move ahead with the purchase of DST shares to complete the exchange. "Because of the strict time guidelines, a lot of people fall into a trap," he said. "They think they're going to do a 1031 but they miss the deadline and get stuck paying the taxes." By naming a DST as replacement property, however, taxpayers can avoid that risk.