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Wealth Planning Update

Managing real estate capital gains with like-kind exchanges (Section 1031)

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Key takeaways:

- Capital gains taxes may be deferred with proper planning and the use of like-kind exchanges.
- Identifying the right replacement property and determining how best to manage it going forward is one of the crucial steps to helping ensure the success of a like-kind exchange.

What this may mean for you:

- Due to the level of complexity involved in properly implementing a like-kind exchange, it is important to consult with a knowledgeable advisor.

Deferring taxes through a like-kind exchange

In many cases, if you are planning to sell real estate and purchase new real estate, the tax gain can be deferred by following certain procedures in the Internal Revenue Code (IRC). An investor can exchange one real estate investment for another (or several) and can postpone paying taxes on the unrealized gain in the relinquished property if the proceeds are reinvested in 'like-kind' property. This type of like-kind exchange, or 1031 exchange named after the IRC Section allows real estate investors to reinvest the proceeds from a sale on a pre-tax basis.

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Basic requirements[1]

There are several basic requirements for completing a like-kind exchange.

- The property must be held for investment or used in a trade or business. Inventory and personal use property are not eligible.
- The relinquished and acquired properties must be of like kind. Like-kind property is property of the same nature, character, or class. Prior to 2018, a wide range of property from real estate to tangible personal property qualified for tax deferral through a like-kind exchange. However, the Tax Cuts and Jobs Act of 2017 eliminated this treatment for all property except real estate. Personal property is no longer eligible for 1031 exchanges. This includes any type of security investment, including real estate investment trusts (REITs). However, most types of directly-held real estate qualify as like-kind property, so farmland can be exchanged for an apartment building or a vacant lot can be exchanged for a strip mall.
- Unless you are directly exchanging one piece of real estate for another without a price differential, a qualified intermediary is used to hold the proceeds received from the sold property and apply them to acquire the new property.
- The replacement properties must be identified within 45 days of the sale of the relinquished property. You may identify up to three replacement properties, irrespective of the value of the properties, or you may identify as many properties as you like provided that the total value of the properties does not exceed 200% of the fair market value of the relinquished property. A separate rule allows you to identify more properties than would be allowed by these two restrictions as long as you acquire at least 95% of the value of the identified properties by the required date.
- The acquisition of the new property must be completed by the earlier of 180 days from the sale of the relinquished property or the due date of the acquirer's Federal income tax return. Filing an income tax extension extends this deadline, causing the 180 day rule to control.
- To qualify for full tax deferral, the value of the acquired property must equal or exceed the value of the relinquished property, including debt. If the acquired property is worth less than the relinquished property, then only a partial deferral may be available.

Reverse 1031 exchanges, where the new property is acquired before the existing property is sold, are also allowed. While the basics of completing a reverse exchange are relatively straightforward, the implementation can be complicated so it is important to consult with your professional tax advisors and identify an experienced qualified intermediary to make sure that the tax deferral will be respected by the IRS.

Planning with like-kind exchange

To the extent that a like-kind exchange allows for the deferral of gain recognition, the basis (original cost less depreciation taken for tax purposes) of the relinquished property carries over to the acquired property. Depreciation begins in the year of acquisition, but based on the carried over basis of the original property.

Over the course of a lifetime and through a series of like-kind exchanges, you can exchange properties many times while potentially deferring taxes. In fact, current law allows for taxes on capital gains to potentially be eliminated by holding exchanged real estate until you pass away. This means that - if you are holding a replacement property when you die and your heirs inherit it - the step-up in basis to fair market value for the property (versus the property's initial purchase price) allows the property to then be sold by your heirs without capital gains tax being a factor. It should be noted though that some current tax proposals call for the elimination of this step up in basis. If such a proposal were to become law, then the ability to eliminate the gain would be lost. Like-kind exchanges can be done

with family members or other related parties. However, there are rules to prevent related parties from swapping low-basis assets for high-basis assets in order to reduce income taxes. Generally, both parties must hold the exchanged properties for two-years for the deferral to work, but there are exceptions to these rules that are worth discussing with an advisor.

The 1031 exchange rules also provide flexibility for investors that want to make a smaller investment in a multiple-owner scenario. Tenancy-in-common (TIC) interests are undivided, fractional interests in real estate, which still qualify for the deferral of capital gains taxes. A Delaware Statutory Trust (DST) is a legal entity constructed under Delaware law to comply with the 1031 exchange requirements. The DST owns real estate and investors can purchase ownership interests in the DST. Both types of real estate ownership take the management out of the investors' hands while potentially providing access to professionally managed, institutional-grade real estate. These types of ownership also have drawbacks and therefore may not be good options for many investors. For instance, investors generally do not have control over how the property is managed or when it is sold and the interests typically are not very liquid.

So, just complete a 1031 exchange and all is well, right? Not so fast…

Buying and selling assets in today's market presents its own set of challenges. The pandemic and its resulting economic impact created significant disruption in the real estate markets, but the recovery is well underway. In fact several sectors of the real estate markets have surpassed pre-pandemic rent, occupancy, and pricing levels. Available inventory and transaction volume have also picked up quite a bit in 2021, which is critical to identifying and closing on a replacement property within the required timeframe.

Additionally, when factoring in the costs of selling the original property and the costs of acquiring the replacement property, an investor may need to buy an asset with significantly higher yield than the one they sold in order to replace the cash flow they received from the sold property. Fortunately, there are strategies to accomplish this, including:

- Acquiring a different asset class with higher yields (e.g. retail vs. multi-family).
- Acquiring assets in a location or market where higher yields are normal (tertiary markets vs. core markets).
- Acquiring assets of a different 'class' (e.g., Class A Office vs Class B Office).
- Finding an asset or assets to buy at below market price (off-market or distressed).

Each of these strategies comes with its own challenges. Successfully identifying and managing real estate assets to potentially enhance their cash flow (higher yields) and creating appreciation requires both general and specific real estate experience, such as local market knowledge, property management capabilities, and asset management. Managing real estate from a distance can lead to challenges, complications, and/or missed opportunities that can make the difference between a successful investment and problematic one. Evolving state and local health guidelines adds another layer of complexity to managing properties while trying to preserve cash flow during the pandemic.

Passive vs. active investments

Many investors like the idea of finding a passive property investment to complete the 1031 exchange so they can just pick up the check in the mailbox each month. Oftentimes these exchanged properties consist of a single building with a single tenant who has a lease that requires minimal involvement from the landlord and 'Single-Tenant, Net

Leased' (STNL) investments. A high quality, well located building with a strong credit tenant on a long-term lease can provide years of predictable and passive income to an investor.

Unfortunately, these types of properties can also be problematic for several reasons. Demand remains strong for these type of properties due to perceptions about ease of ownership and stability of the investment. This drives prices up (and yields down), and quality properties with reasonable yields may be hard to find. Furthermore, with a single tenant any interruption in the rent leaves a property generating no income and creates the potential for significant capital being needed to secure a new tenant for the building.

Alternatives to STNL investments include multi-tenant properties, either commercial or residential, which may diversify risk by offering an owner multiple income streams and varying lease expirations. Commercial properties typically provide higher yields, but, again, replacing a tenant may require additional cash reserves to facilitate. However, perhaps the biggest challenge to the passive investor is the fact that multi-tenant properties can be management intensive.

The future of like-kind exchanges

The tax benefits provided by 1031 exchanges have long been under scrutiny and in consideration for elimination by Congress. As discussed earlier, the scope of 1031 exchanges was greatly reduced with the 2017 Tax Cut and Jobs Act. President Biden initially proposed limiting this provision to taxpayers making under $400,000 a year[2], but this proposed change has not appeared in the most recent tax plan. With real estate markets gaining momentum and some degree of uncertainty around the future of the 1031 exchange, now is the time to re-evaluate your real estate portfolio and discuss with your advisors what, if any, changes should be considered.

A word about Opportunity Zone Funds

One additional strategy for deferring capital gains is a Qualified Opportunity Zone Fund. The 2017 Tax Cuts and Jobs Act established the Qualified Opportunity Zone program to provide a tax incentive for private, long-term investment in economically distressed communities. The Opportunity Zone program allows for gain deferral on the sale of any appreciated assets where there is a reinvestment of the gain into an Opportunity Zone Fund. There is no requirement to invest in like-kind property to defer the gain. To defer a capital gain, a taxpayer has 180 days from the date of the sale or exchange of the appreciated property to invest the realized capital gain dollars into a Qualified Opportunity Zone Fund. The fund then invests in Qualified Opportunity Zone Property. However, there are fairly complex requirements and structures that taxpayers must follow in order to maximize the potential tax benefits.

Unlike a 1031 exchange, the long-term capital gain realized on the sale of personal property or real assets is only deferred until December 31, 2026. There are additional potential benefits that can 1) eliminate the gain on the appreciation of the Opportunity Zone Fund and 2) reduce the deferred gain by 10% if you invest by December 31, 2021 and hold for five years (15% if the Opportunity Zone Fund investment was made prior to December 31, 2019 and held for seven years) and 2). However, realizing these benefits is very much dependent on meeting specific criteria around the dates of the original qualifying events and the holding period of the Fund. For more information on Opportunity Zone Funds, see our accompanying Wealth Planning Update.

Next steps

Contact your advisor to learn more about the planning and asset management services to assist you in the full life cycle of owning investment real estate. Comprehensive analysis, planning, and execution is available to help you achieve your short, medium, and long-term investment goals if you are considering a 1031 exchange.

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[1] Internal Revenue Service, “Instructions for Form 8824 (2020), https://www.irs.gov/instructions/i8824#idm139888469375040

[2] American's for Tax Fairness "Summary of Biden-Sanders Unity Task Force Tax Policy Recommendation," July 9, 2020