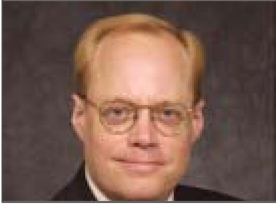
Forbes



Robert W. Wood
THE TAX LAWYER

TAXES 1/08/2015

The 1031 Exchange That Ate New York City

Even if you know no other section of the tax code, you probably know about Section 1031. It allows tax-free swaps of one business or investment asset for another. 1031 is bandied about by investors, realtors, title companies, and the public. Some use it as a verb, like Fed Exing something. You say, "Let's 1031 that building for another."

What makes it extraordinary is that in the tax law, most swaps are taxable just like sales, even if money doesn't change hands. But 1031 is a big exception. In effect, you are allowed to change the *form* of your investment without cashing out or recognizing gain. Like your 401(k), your investment continues to grow tax-deferred. Even better, there's no limit to the number of times you can exchange.

Most people exchange real estate. But it isn't just for mom and pop. Want proof? An investment group has just bought the Winston-Salem, N.C., headquarters of financial-services giant BB&T Corp. in an enormous exchange deal that was specifically pegged to this IRS rule. BB&T occupies the 20-story office tower under a 23-year lease. An investment group will sell stakes in the building to investors wanting to participate in 1031 deals.

IRS rules allow syndicating 1031 exchange interests in the BB&T building to investors. Of course, 1031 has been used in big deals before. Take Hilton's sale of the Waldorf-Astoria to Anbang Insurance Group Co. for $1.95 billion. Hilton said the 'sale' would actually be a 1031 with the untaxed cash going into other hotels.

Although "Like-kind" is part of 1031 lingo, the rules are surprisingly broad. You can exchange an apartment building for raw land, or a ranch for a strip mall. Those sound pretty different, and they are. But they are all 'like-kind."

And delayed exchanges are OK too. In fact, virtually all exchanges are done this way. Classically, an exchange is a simple swap of one property for another between two people. But the odds of finding someone with the exact property you want, who wants the exact property you have, are slim.

For that reason, the vast majority of exchanges are delayed, three party, or "Starker" exchanges (named for the first tax case that allowed them). In a delayed exchange, you need a middleman who holds the cash after you "sell" your property. The middleman, usually a qualified intermediary, then buys the replacement property for you using the escrowed cash. Subject to time limits below, this three-party exchange is treated as a swap.

Once the sale of your property closes, the intermediary receives the cash. Within 45 days, you must specify the property you want to acquire in writing to the intermediary. You can designate three

properties so long as you eventually close on one of them. Alternatively, you can designate more properties if you come within certain valuation tests.

Once you designate, you must close on the new property within 180 days of the sale of the old. Start counting when the sale of your property closes. The 45 days and 180 days run concurrently. Designate replacement property within 45 days, and you have 135 days left to close on the replacement property.

If have cash left over, the intermediary pays it to you at the end of the 180 days. That cash is called "boot" and is taxed, generally as a capital gain. You must consider mortgage loans or other debt on the property you relinquish, and any debt on the replacement property you acquire. If you don't receive cash back but your liability goes down, that too will be treated as income just like cash.

1031 is for investment and business property, not personal. Too bad, that means you can't swap your primary residence for another. Well, not unless you first convert your residence to investment property....

For alerts to future tax articles, follow me on Forbes. You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.