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Financial issues in a 1031 Exchange and what to do

March 25, 2013 - New York City

The goal of a 1031 exchange is to defer the capital gain taxes that would otherwise be due when a taxpayer sells a property at a profit. The taxpayer can either defer all of the taxes, or can choose instead to pay tax on a portion of their capital gain and defer paying taxes on the balance.

While the formula for obtaining either result is relatively simple, the financial aspects of a 1031 exchange seem to be a source of great confusion. With that in mind, the following points are offered to provide some clarity:

1. Full Tax Deferral. To fully defer taxes in a 1031 exchange, the taxpayer must acquire replacement property that is the same or greater value as their relinquished property (less certain closing costs), and spend all of the net proceeds from their sale. If the taxpayer does so, most often they will also acquire the replacement property with the same or greater amount of mortgage debt as was owed on their relinquished property.

2. Partial Exchange. If the taxpayer chooses to acquire a less expensive replacement property, one of two things will happen:

i. They will not spend the full amount of their sales proceeds, resulting in taxpayer receiving cash at the end of the exchange; or

ii. The mortgage debt on the replacement property will be less than the mortgage debt on the relinquished property, leading to "mortgage relief."

The cash or the mortgage relief received by the taxpayer is referred to as "boot" and in most cases will be subject to taxation. Doing a partial exchange and receiving boot is permissible under the exchange regulations, but given the tax implications, it is essential that the taxpayer plan for this result. This is especially true with mortgage boot, since there is no cash available from the transaction to pay the taxes that may be due, meaning the taxpayer will have to pay the federal and local governments out of their pocket.

3. Debt to Equity Ratio Doesn't Matter. A common misconception is that the replacement property must be leveraged at same level as the relinquished property, i.e. if the loan to value ratio on the relinquished property was 65%, the replacement property must also have a loan to value ratio of 65%. This is untrue; the loan to value ratio does not matter, provided the first rule in this article is followed. Indeed, many taxpayers take full advantage of the taxes deferred in the 1031 exchange and leverage the sales proceeds at higher levels to acquire more expensive properties, which they hope will provide better cash flow and greater appreciation.

4. But Too Much Debt Can Be Bad. If the amount of the mortgage debt the taxpayer uses to acquire the replacement property results in the taxpayer not being able to spend the full sales proceeds from their relinquished property, the taxpayer will wind up receiving cash boot at the end of the exchange, and may have an unintended tax bill as a result.

5. Less Debt is Fine. A taxpayer may decide to reduce the amount of debt used to acquire the

replacement property by using additional cash. The mortgage debt that was paid off on the relinquished property is replaced with money from other sources. While a taxpayer cannot use mortgage debt to replace the cash equity that must be spent in a 1031 exchange, they can use additional cash to replace the mortgage debt.

6. Reinvest the Cost Basis. Many taxpayers believe that in a 1031 exchange they can pull out their cost basis tax free, and only reinvest their capital gain. Unfortunately, it doesn't work that way. While the cost basis is deducted from the sales price in determining the capital gain in a taxable transaction, in a 1031 exchange the cost basis is essentially transferred from the relinquished property to the replacement property. Any funds that are retained by the taxpayer are viewed as being part of the profit rather than the basis, and thus are subject to taxation.

Given the potential pitfalls, taxpayers should review their specific tax situations with their advisors before selling a property. Nevertheless, with careful planning, a 1031 exchange is a great vehicle for a taxpayer to achieve the financial and investment objectives.

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