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THE TAX LAWYER

TAXES 08/01/19

1031 Exchanges Save IRS & State Taxes, Even Leaving California

[Section 1031](#) is one of the few sections of the tax code everyone seems to know. It is even routinely used as a verb. Under 1031, if you exchange real estate for 'like-kind' real estate, gain is postponed until you sell your replacement property. Starting in 2018, swaps of Bitcoin for Ethereum, exchanges of private aircraft, paintings, or coin collections don't qualify. Only real estate qualifies, and it must be of [like-kind](#). It has to be business or investment property, not your personal residence. Still, like-kind is actually pretty widely interpreted. Improved real estate can be exchanged for unimproved real estate. And city real estate can be exchanged for a ranch or farm.

The replacement property must be identified within 45 days after the transfer of the relinquished property. Then, the closing of the replacement must occur by the earlier of: (1) 180 days after the date of the transfer of the relinquished property; or (2) the due date (including extensions) of the transferor's tax return for the tax year in which the transfer of the relinquished property occurs. Section 1031 requires relinquished property be exchanged for replacement property, but the IRS allows the use of qualified intermediaries (QIs). The QI sells the property for cash, uses the cash to purchase the replacement property, and transfers the replacement property to the taxpayer. There are tricky rules about debt, equity, and "boot." Under Section 1031, boot is any form of property *other* than like-kind property that is transferred in a Section 1031 exchange, such as cash, personal property, and the assumption of liabilities.

You generally have to recognize taxable income to the extent you receive any "boot" in a Section 1031 exchange. However, you can generally offset some types of boot received with certain types of boot paid. The general rule is that if the boot received is the assumption of a liability, it can be offset by any type of boot paid, whether cash, other property, or the assumption of a liability. Even so, if the boot received is cash or other property, then it *cannot* be offset by the assumption of a liability.



A mortgage payoff at closing is generally treated as the *assumption* of a liability — *i.e.*, a receipt of boot — even though the buyer may not be taking the property subject to the mortgage. Although the taxpayer can offset this receipt of boot, the general rule is that the offset must be in the form of a mortgage on the *replacement* property in an amount equal to or greater than the debt on the relinquished property. Any cash the taxpayer receives as a result of the exchange will also be treated as the receipt of boot.

When a taxpayer walks away from an exchange with cash due to an increase in mortgage debt, the taxpayer may have taxable boot. Some taxpayers place a mortgage on the replacement property *after* (and independent of) a Section 1031 exchange. Some commentators have suggested that as long as a later mortgage is truly independent of the exchange (in form and substance), the cash taken out should not be treated as boot.

Complications can arise where multiple states are involved. For example, issues may arise where California real estate is substituted for non-California real estate, or when taxpayers change their state of residency after an exchange. If the taxpayer is a California resident, then all of the taxpayer's income is generally taxable by California, regardless of its source. California does conform to Sections 1031, and the golden state does not require that the replacement property also be located in California. Thus, California allows for deferral of gains that are realized on like-kind exchanges and involuntary conversions.

However, if the replacement property is out-of-state, California aggressively tracks when the replacement is ultimately sold. When the replacement property is sold, California treats the gain as California source income to the extent of the original deferred gain. That is so even if you no

longer live in California and if you are selling the non-California property twenty years later. A number of other states follow this rule, but California may be the most aggressive in enforcing it.

To enforce it, California has a special reporting requirement on taxpayers who do Section 1031 exchanges and acquire out-of-state replacement property. California requires you to file an annual information return (Form 3840) every year until the deferred gain from the Section 1031 exchange is ultimately recognized. When the taxpayer ultimately sells the out-of-state property, California will treat any gain as California-source income to the extent of the gain deferred on the original exchange.

Obviously, the state where the property is located (and your then home state of residence) will *also* want to tax at least some of the gain. Some states will tax this gain only if it represents appreciation that occurred in their state. However, there may be risks of the second state being overly aggressive and trying to tax the entire gain. If the taxpayer is a California resident at that point, the sourcing rules will generally be irrelevant. In that case, the entire gain will be subject to tax in California. You might be allowed a credit for taxes paid to the other state. If you are a California *nonresident* at the time of the sale, then you may be subject to tax in both states on a nonresident basis.

Bottom line, Section 1031 allows you to swap real estate tax free, but it can be tricky. Apart from the unforgiving 45 and 180-day requirements, many 1031 exchanges are confused when it comes to debt on either or both sides of the transaction. Big dollars can hang in the balance.

This is not legal advice. For tax alerts or tax advice, email me at Wood@WoodLLP.com.