Even Internal Revenue Code Section 1031 Exchanges Have Tax Traps

By Robert W. Wood

Virtually every Californian knows something about Internal Revenue Code Section 1031. Even if you know no other tax code section by number or description, you likely know about Section 1031. It's the ubiquitous provision that expressly permits swaps of one business or investment asset for another without tax.

This tax code section is bandied about by lawyers, realtors, title companies, investors and the public. Some people even make it a verb, a la FedEx, as in: "Let's 1031 that building for another." In California, the traditional land of escalating real estate prices and dabblers in property, most people exchange real estate.

Whatever you are exchanging, one need not receive cash to have income subject to tax. In fact, most swaps are taxable as sales. Yet if you come within Section 1031, you'll either have no or limited tax due at the time of the exchange.

In effect, you are allowed to change the form of your investment without cashing out or recognizing a capital gain. Your investment continues to grow tax-deferred. Moreover, there is no limit to the number of times you can close Section 1031 exchanges.

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You can roll over the gain from one piece of investment real estate to another again and again. Although you may have a profit each time, Section 1031 allows you to avoid tax until you actually sell for cash. The idea is to keep your investment growing on a tax-deferred basis. When you eventually sell for cash, you'll pay one long-term capital gain tax (currently 15 percent).

Although you can make a simple swap of one property for another between two people, the odds are slim that you'll find someone with the exact property you want who wants the exact property you have. For that reason, the vast majority of exchanges are delayed, three party, or Starker exchanges (named for the first tax case that allowed them). You need a middleman to hold the cash after you "sell" your property, and to "buy" the replacement property for you. This three party exchange is treated as a swap.

There are two key timing rules. Once the sale of your property occurs, the intermediary will receive the cash. You can't receive the cash or it will void the Section 1031 treatment. Within 45 days of the sale of your property, you must designate replacement property in writing to the intermediary, specifying the property you want to acquire.

You must also actually close on the new property within 180 days of the sale of the old. Note these two time periods run concurrently. You start counting when the sale of your property closes. If you designate replacement property exactly 45 days later, you'll have 135 days left to close on the replacement property.

Another key rule is the qualified escrow account. Your money must remain there until you close the other leg of your exchange. The rules are not too complicated, and there's a whole industry of exchange accommodators out there. Nevertheless, use some care and deal with reputable professionals.

A recent Tax Court case, Ralph E. Crandall Jr. and Dene E. Dulin T.C., Summ. Op. 2011-14, illustrates the mess these deals can become if you're not careful. Ralph Crandall and Dene Dulin owned investment property in Arizona and wanted to own investment property in California. Intending a tax-free exchange, they sold the Arizona property, directing the money into an escrow account with Capital Title. They closed on the California property and reported it as a tax-free swap but the Internal Revenue Service cried foul.

Why? None of the escrow agreements even mentioned a like-kind exchange under Section 1031 or expressly limited their right to get the money. That disqualified the exchange even though they actually did use the money to swap for new property.

To be qualified, an escrow agreement must expressly limit the taxpayer's rights to receive, pledge, borrow or otherwise obtain the cash or its equivalent held in the account. The Capital Title escrow account wasn't qualified. That meant even though this couple reinvested their sales proceeds, they had to pay tax first.

Other common glitches involve debt on the old or new property, so be careful. One of the main ways people get into trouble with these transactions is failing to consider loans.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

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