

Partial 1031 Exchanges – Cashing Out a Portion of the Sale Proceeds

It is a fundamental principle that Exchangers should exchange equal or up in value to fully defer the relevant taxes in a 1031 Exchange. To put it another way, an Exchanger needs to reinvest the net equity and incur equal or greater debt, if any, compared to what was paid off at closing. What happens when an Exchanger wishes to cash out a portion of their proceeds instead? This blog will explore the implications of retaining some cash and not reinvesting that portion of the exchange proceeds, and a potential alternative.

1031 Exchange Basics

A key requirement for Exchangers is that they must adhere to the 45-day identification and 180-day exchange timelines. Second, all property must fit the qualified use requirements of IRC §1031, in that property must be “held for productive use in a trade or business or for investment”. Third, as per above, to fully defer all of the applicable taxes, the Exchanger must exchange into Replacement Property(ies) equal or greater in value to the Relinquished Property and utilize all of the equity from the disposition of the Relinquished Property, which is sometimes referenced as ‘trade equal or up in value and equal or up in equity’.

While full deferral requires meeting these reinvestment rules, it is possible to replace debt paid off with fresh cash brought into the replacement property acquisition. However, it is not possible to replace net cash from the sale with excess debt on the purchase.

Exchanging Down

Sometimes, however, an Exchanger may determine that they wish to withhold a portion of the exchange proceeds to pay down other debts, pursue other business opportunities, or to be used for other personal reasons. For example, we have seen Exchangers keep money out of the exchange so that they can buy a new car, a vacation, or for their children’s college education. Alternatively, some Exchangers have difficulty finding property(ies) that meet their investment criteria, coming up short on their reinvestments. Perhaps they were seeking to diversify from the sale of one large property into several smaller ones, and they either couldn’t find enough appropriate properties or one of them fell through.

Additionally, some Exchangers dispose of Relinquished Property that had some debt and choose to acquire Replacement Property with no debt. These Exchangers may be reinvesting all of the exchange proceeds (i.e. equity), but they are not exchanging up in value.

Finally, some Exchangers have been misadvised that they must only reinvest the capital gains only, and that they can withdraw their initial investment at the time of the sale. As discussed above, this is simply not true.

In any of these scenarios, these Exchangers have found themselves in the position where they are not fully reinvesting the exchange value or the exchange funds. The amount that is not being reinvested is commonly referred to as “boot”.

Effects of Exchanging Down

Regardless of the reason, Exchangers who exchange down in value or equity face a likely taxable event at the end of the year. It is a ‘likely taxable’ event because they may have passive activity losses or other offsets that can be applied to the funds that are not reinvested. This is a good reason why a savvy Exchanger will include their tax and legal advisors in the planning and execution of their 1031 Exchange.

Exchangers who have boot in their exchange may be subject to capital gains, depreciation recapture, state, and net investment income taxes on the boot. Capital gains, state, and net investment income (NIIT) taxes vary based on the Exchanger’s federal income tax bracket and state of residency, while depreciation recapture is 25%, regardless of the Exchanger’s tax bracket.

Let’s look at a couple of possible scenarios to further illustrate Exchanging Down in Value:

Scenario 1

Exchanger disposes of a multi-family property for \$1 million, on which they have \$200,000 in appreciation (i.e. capital gains), and they have taken \$100,000 in depreciation during the time they owned the property. This Exchanger now acquires a Replacement Property for \$800,000, leaving \$300,000 exposed to taxation. The first \$100,000 will be treated as depreciation recapture and taxed at 25%. The remaining \$200,000 will be treated as capital gains, taxed at 20% for this particular individual. Adding the NIIT and a five percent state tax, the net taxable event for this Exchanger will be \$82,600, due when they file their tax return for the year of the sale.

Scenario 2

Exchanger disposes of raw land for \$1 million, which they had acquired for \$700,000, resulting in \$300,000 in capital gains. Exchanger has determined that they would like to retain \$100,000 of the proceeds at the closing table to invest in non-real estate investments. That \$100,000 will not be part of the 1031 Exchange, it is considered boot and subject to capital gains, state and NIIT taxes.

Possible Solutions

If our first Exchanger was unable to identify suitable property(ies) and they were not interested in a Delaware Statutory Trust (DST) or other passive real estate investments, there isn't much that can be done to mitigate the taxable impact of their transaction.

Our second Exchanger has a clear alternative strategy. Rather than withdrawing the \$100,000 at the sale of the Relinquished Property, this Exchanger could reinvest the entire amount into a Replacement Property and thereafter refinance the property to withdraw the \$100,000. For most Exchangers, as long as the refinancing the Replacement Property is not part of an integrated plan with the purchase of the property, it should be a non-taxable event, allowing the second Exchanger to meet the goals of diversifying their investments while still executing a full 1031 Exchange. However, for partnerships, "debt-financed distributions" can be taxable, so it is essential to consider the specific tax implications before pursuing this strategy

As mentioned previously, Exchangers are encouraged to consult with their tax and legal advisors before and during the 1031 Exchange process, a Qualified Intermediary does not have access to the Exchanger's full tax situation and, in any event, cannot provide tax or legal advice.