Changes to 1031 exchanges under the new “Tax Cuts and Jobs Act of 2017” - by Brendan Greene

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On December 22, 2017, President Trump signed the revised tax reform bill, formerly presented as and called the Tax Cuts and Jobs Act, into law. The new law has many of our clients asking how it could affect their ability to do 1031 Exchanges. The good news is that the new law still allows for deferring of capital gains taxes by using Internal Revenue Code §1031, with only a single change to scope.

Previously, §1031 allowed for the exchange of both real estate and personal property when doing a 1031 tax-deferred exchange. For example, if you were selling property with a car wash situated on the lot, and you also wanted to sell the car wash equipment and defer the capital gains on both the real estate and the equipment, you were able to do so if you rolled over the net proceeds from the sales of both the real estate and the equipment and purchased like kind real estate and personal property.

The change that comes with the new tax law is that IRC §1031 no longer includes the ability to exchange personal property, but instead is now limited to real estate. However, if you had previously started a personal property exchange in 2017 and either closed on the sale of relinquished property or acquired replacement property prior to December 31, 2017, then you can complete your personal property exchange in 2018.

If you’re not already familiar with this process, a 1031 tax-deferred exchange is a method allowed by Internal Revenue Code (IRC) §1031, whereby an owner of certain investment or business property may defer paying capital gains taxes on the sale of such property if the owner acquires “like kind” property within a certain period of time.

All real estate held for investment or business purposes may be considered “like kind” to any other real estate held for investment or business purposes. For example, raw land can be exchanged for an apartment building. The Exchanger must be able to demonstrate that both the property being sold (the “relinquished property”) and the property being bought (the “replacement property”) is held for business or investment purposes. Note that stocks, bonds, partnership or LLC interests, personal residences or inventory do not qualify as like kind property.

Investors may have a variety of motives for exchanging their property. Such motives include: Deferring paying capital gains taxes; exchanging several smaller hard to manage properties for one larger easier to manage property; exchanging a partial interest in one property to a full interest in another; exchanging to a property an investor may use in his own practice (i.e. a doctor could sell a rental property and buy an office building he may use for his practice); exchanging raw land for rental property to generate cash flow; exchanging depreciated property to higher value property that can be depreciated; or even exchanging a rental property in Boston for a rental property in Florida, which may be allowed to later serve as a retirement home.

The Exchanger assigns his interest in the Purchase and Sale Agreement for his or her relinquished property to a Qualified Intermediary ("QI"). The QI receives the net sale proceeds so that the Exchanger does not have actual or constructive receipt of the funds. The QI holds the net sale proceeds until they are needed for the close of the replacement property. The Exchanger has 45 days beginning the day after the sale of the relinquished property to identify replacement property, and will do so by giving written notice to the QI. The Exchanger then has 180 days to close on any identified replacement properties. The 180-day clock begins the same day as the 45-day clock: the day after the sale of the relinquished property. During this 180-day period, the sale proceeds are held in a federally insured account with local Banks and are held in the name of Greater Boston Exchange Company, LLC.

In order for an Exchanger to defer all capital gains taxes, there are two general guidelines that must be followed. First, the taxpayer must roll over the entire net proceeds into the replacement property. Second, the purchase price of the replacement property must be equal to or greater than the relinquished property.

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