

Is a Partial Exchange a Valid 1031 Exchange?

Partial Exchange? Strategies to Achieve 100% Tax Deferral

1031 Insight August 2022

A 1031 Exchange allows a taxpayer to defer 100% of their capital gain tax liability. To do this, the exchanger must buy new Replacement Property equal to or greater than in value to the property sold and reinvest all the proceeds from the sale of their old property.

But what happens if a taxpayer desires to purchase property lower in value or takes a portion of the cash from the closing of the sale and only invests a portion of their proceeds towards a 1031 Exchange? The good news is that these transactions still qualify for tax deferral under Section 1031 of the Tax Code. They simply become “partial” 1031 Exchanges where the taxpayer has a partially tax deferred transaction rather than deferring all their taxes.

The portion of the exchange proceeds not reinvested is called “boot” and is subject to capital gains and depreciation recapture taxes. Usually, boot is in the form of cash, an installment note, debt relief or personal property and is valued to be the “fair market value” of the non-like-kind property received. It is important to understand that the receipt of boot does not disqualify the exchange; it merely introduces a taxable gain into the transaction.

Whether your 1031 goal is full or partial deferral, work with your tax and legal advisors to strategically make your 1031 work best for your situation. Here are a few scenarios to illustrate partial and full deferral strategy:

If you fit into these scenarios:

- **Taking cash at the sale of the Relinquished Property Example:** *Lila is selling her rental townhouse for \$1,000,000. At the close of escrow, she wants to receive \$100,000 to invest in the stock market and utilize his remaining funds for his 1031 Exchange. The \$100,000 is not part of the tax deferred exchange. If the seller takes any cash from the sale, that amount becomes taxable boot.*
- **Buying Down in Value Example:** *Lila is selling her rental townhouse for \$1,000,000 and plans to utilize a 1031 Exchange to defer her taxes. However, she can only locate new property with a sales price of \$800,000 that she desires to purchase. The \$200,000 not reinvested into like kind property will be taxable.*

but your goal is to defer 100% of your taxes, **consider these potential solutions:**

- Instead of taking cash from the sale of the old Relinquished Property, reinvest all the proceeds into new Replacement Property and then do a cash out refinance in a separate transaction after the closing. It is generally considered less risky to refinance the new Replacement Property (rather than the old Relinquished Property) through a separate post-closing transaction. Offset the gain on part or all of cash withheld with carryforward losses or expensing deductions for that tax year.
- If you cannot locate enough property that equals or exceeds the value of your old Relinquished Property, consider acquiring a fractional interest in additional Replacement Property, such as a beneficial interest in a Delaware Statutory Trust (DST). DSTs allow taxpayers to acquire small fractional interests in portfolios of properties such as multi-family housing, student housing, storage locker facilities, etc.

The important point is to not assume that you need to pay taxes if you cannot locate property at the right values or have a need for cash. Everyone’s tax situation is different so always seek the guidance of a tax advisor prior to beginning your transactions.

Please feel free to reach out to one of your local IPX1031 experts to discuss the possibility and feasibility of your or your client’s next 1031 Exchange.

IPX1031. A QI like no other.

At IPX1031, we pride ourselves on being the industry leader in 1031 expertise, service and security. We aim to be your complete information resource and look forward to helping you and/or your clients maximize qualifying investments through a 1031 Exchange strategy. For more information about 1031 Exchanges, our company, our complimentary 1031 Exchange webinars, or to initiate an exchange, visit our website at www.ipx1031.com or email or call today.

Scott Nathanson
EVP | Manager of Eastern Operations
scott.nathanson@ipx1031.com
www.ipx1031.com/nathanson

For more info:
www.ipx1031.com/partial-exchange/