Acquiring Multiple Replacement Properties

An Analysis of the Benefits along with Basis and Tax Calculations

1031 Knowledge

Selling one property and acquiring several replacement properties in an Internal Revenue Code Section 1031 exchange can have significant advantages over a simple trade of one income property for another. The following discussion describes some of those advantages and certain tax rules relating to exchanges involving multiple replacement properties.

To set the stage, let's take a hypothetical case of a 1031 exchange scenario involving the acquisition of multiple replacement properties. Suppose a taxpayer in Los Angeles, California, is selling a single-family rental (SFR) that she acquired more than a decade prior. She is under contract to sell the SFR for $600,000. For the sake of simplicity, let's assume she has no debt on the property and will pay no closing costs. She has an adjusted basis in the SFR of $200,000. If she simply sells the property, rather than engage in a deferred 1031 exchange, she would incur a tax in the amount of $114,700.[1] Given the potential tax, this taxpayer desires to engage in a 1031 exchange. In the process, she decides that she would also like to diversify her real property investments, take advantage of differing market conditions and improve her cash flow. Accordingly, she decides to acquire six replacement properties in Sunbelt states, three in Arizona and three in Florida.

IDENTIFICATION OF REPLACEMENT PROPERTIES - 200% RULE

Treasury Regulations under IRC §1031 (Regulations) require that a taxpayer identify, in writing, replacement property to be acquired in a 1031 exchange within 45 days following the closing of the sale of the relinquished property. These Regulations establish three different sets of rules which may be used to identify qualified replacement property. The rule most commonly used by taxpayers is the "three property rule." Under this rule, a taxpayer can identify up to three like-kind properties as replacement property *without regard to* value. Since our taxpayer intends to acquire more than three replacement properties, the three property rule would not work. The second identification rule is the "200% rule." Under this rule, a taxpayer may identify any number of replacement properties *provided that the aggregate value of all property on the identification list does not exceed 200% of the value of the relinquished property*. In this scenario, the relinquished property is worth $600,000, so our taxpayer could identify any number of replacement properties provided that the aggregate value of identified properties does not exceed $1,200,000. Thus, if our taxpayer desires to acquire three rental properties in Phoenix, Arizona - each worth $100,000 and three rental properties in Vero Beach, Florida - each worth $100,000 she would have identified replacement property worth $600,000, well within the limit imposed by the 200% rule. Accordingly, our taxpayer might identify alternate properties as fall-back properties which would be

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BASIS CALCULATION IN REPLACEMENT PROPERTIES

Let's assume that our investor successfully acquires her six replacement properties in a 1031 exchange utilizing a qualified intermediary to hold the sales proceeds. Since she has exchanged into six replacement properties, she must apportion her original basis in the relinquished property. (Recall that her adjusted basis in the relinquished property was $200,000.) Under the Treasury Regulations, a taxpayer must generally allocate basis among multiple replacement properties ratably, in proportion to their relative respective values. Since the values of the replacement properties in this simple example are all the same, each replacement property would receive a basis equal to 1/6th of her original adjusted basis[2] -- in this case, $33,333.[3] So what has our investor achieved?

- 100% tax deferral on the sale of her relinquished property;
- Potentially increased cash flow since the six replacement properties can be rented for more total rental income than the single relinquished property;
- With six tenants, instead of one, more income is maintained when one tenant moves out.
- Diversification into two real estate markets in different states, one in the West and one in the East;
- Increased flexibility – e.g., if the taxpayer decides to sell for cash down the road, she could sell one of the rental properties to generate cash while recognizing gain on only 1/6 of her original investment.

Footnotes:

[1] Depreciation recapture at 25% on the $175,000 = $43,750; plus Federal capital gain taxes of 15% on the remaining economic gain = $33,750; plus state taxes in California at 9.3% on the $400,000 gain = $37,200. $43,750 + $33,750 + $37,200 = $114,700.

[2] 6 properties x $100,000 = $600,000

[3] $200,000 basis in relinquished property / 6 replacement properties = $33,333 basis in each of the six replacement properties

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