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State tax law considerations in Section 1031 exchanges – by Sandy Klein

May 24, 2022 - Front Section (https://nyrej.com/section/ROP)

A Section 1031 exchange of like-kind real estate (1031 exchange) allows the seller to defer the recognition of capital gain taxes and depreciation recapture for federal income tax purposes. However, the taxpayer's ability to defer tax at the state level depends on the state in which the real estate is located. While most states follow the federal rules and allow 1031 Exchanges, the Commonwealth of Pennsylvania does not recognize 1031 exchanges. Several states have "claw-back" provisions if the original relinquished property was sold in one state and the replacement property acquired in a different state is later sold. Lastly, taxpayers need to be mindful of state income tax withholding requirements in states where the seller is a non-resident.

Pennsylvania income tax law does not contain a provision comparable to Internal Revenue Code Section 1031. Exchanges of property that result in a gain are generally taxable. There is, however, an exception provided for taxpayer's whose method of accounting permits the deferral of gain from a like-kind exchange. Generally, this exception is only available to taxpayers that consistently use generally accepted accounting principles (GAAP). Thus, cash basis individuals will be taxable on any gain realized from an exchange of property.

In certain states, if replacement property is later sold in a taxable sale, the original state the property was exchanged out of will want to "claw-back" the gain and collect tax. The following states currently have claw-back provisions in place:

- California;
- Oregon;
- Montana; and
- Massachusetts.

California, for example, requires taxpayers who exchange real property located in California for like-kind property located outside of California, under Section 1031, to file an annual information return, Form 3840, California like-kind exchanges, with the Franchise Tax Board. Form 3840 must be filed for the taxable year of the exchange and for each subsequent taxable year, generally until the California source deferred gain is recognized in a taxable transaction. Non-residents of these states are only required to recognize the portion of the gain on the ultimate taxable sale of the property that occurred on the original sale of the property. Any gain that accrued between the date of the original sale and the date of the ultimate sale resulting in recognition of the gain for Federal income tax purposes is taxable to the state in which the replacement property is located.

Assume, for example that Ann, a non-resident of California, sold property located in California in 2022 with a basis of $100 and realized a gain of $1,000 that was deferred for Federal and California income tax purposes as a result of successfully completing a 1031 exchange for property located in Florida. Ann must complete California Form 3840 for 2022 and file it with the California Franchise Tax Board.

Assume further that Ann continues to hold the Florida replacement property during 2023 and 2024 and then sells the Florida replacement property in 2025 for a gain of $1,500 (sales price of $1,600 less basis of $100). Ann must continue to file California Form 3840 for 2023 and 2024 regardless of whether she is otherwise required to file a California income tax return. In 2025, when the property is ultimately sold in a fully taxable transaction, Ann will report gain of $1,500 for Federal income tax purposes and a gain of $1,000 for California income tax purposes.

Many states have income tax withholding requirements applicable to non-residents that may require withholding on the gain from the sale of real estate involved in a 1031 exchange. A number of these state have exemptions for taxpayers selling their property in a 1031 exchange. For example, if a New York non-resident relinquishes property located in New York as part of a 1031 exchange, the person is subject to a withholding tax of 10.90% in 2022. New York state does, however, provide an exemption from withholding. A non-resident desiring exemption should complete IT-2663 and indicate that the property sold is part of a 1031 exchange.

Although the gain on many 1031 exchanges will be totally tax deferred, there are instances where a portion of the gain may be taxable and, therefore, subject to withholding. Examples include a transaction that results in depreciation recapture or a transaction in which the taxpayer receives boot. In those cases where only a portion of the gain is recognized, withholding may be required on the portion of the gain that is recognized.

Unless you are a resident of a state that does not have an income tax and your 1031 exchange involves only property located within that state, the state income tax consequences of the transaction must be considered to avoid unintended consequences.

Sandy Klein, CPA, is a partner at Shanholt Glassman Klein Kramer & Co., New York, N.Y.