Estate Planning with the 1031 Exchange: Defending Your Legacy from Extreme Taxation

Students of classic literature (as well as fans of the television series *Breaking Bad*) may well be familiar with the tale of *Ozymandias*, “King of Kings.” Percy Bysshe Shelley’s 1817 sonnet foretells the inevitability of even the mightiest empire eventually crumbling away to nothing, ravaged by the erosion and decay of time and nature.

While relating the story of Ozymandias to the topic of estate planning may seem a bit dramatic on its face, if the subject is *your* empire, or shall we say your *legacy*, it will surely be of no less importance to you and your family than the lessons of history. After all, you have spent a lifetime creating that legacy, you do not want such work to be withered away by the ravages of taxation—particularly if it can be avoided.

The 1031 “like-kind” exchange has long been a staple of the real estate world, utilized by savvy investors to maximize after-tax gains. In recent years, however, it has taken on a new use.

The 1031 has become a shrewd estate planning tool.

Estate Tax Law: From Chaos to Clarity

When the Bush-era tax cuts of 2001 (EGTRA) were enacted, they came with a complex and ever-changing schedule of estate tax law. The peak of the craziness came in 2010, when the estate tax was eliminated altogether—but with a catch. In exchange for the elimination of estate tax, inheritors effectively lost the use of the step-up provision for cost basis. In essence, the estate tax was traded for capital gains taxes as inheritors were no longer able to reset the cost basis of assets received.

Yet another odd twist in this saga was that the elimination was for just one year, after which the entire EGTRA was “sunset” and tax law reverted to the 2000 status.

Eventually, lawmakers mercifully negotiated a compromise on the “death” tax, and created stability in the law for planners and investors alike.

Even better, for a significant majority of high net worth families, the best of both worlds was granted: The exemption amounts were raised to a level that effectively eliminated the estate tax (in 2017 $5.49 million individual and $10.98 million for married couples utilizing the portability of spousal exemption), and the step-up in cost basis for heirs was retained.

Without the need to create family trusts to take full advantage of the sizable marital exemption, in recent years the focus of estate planning has turned to maximizing the benefit of the step-up in cost basis that heirs receive.

Enter the 1031

The 1031 exchange allows you to roll your gains from a qualifying real estate sale into a new “like-kind” property on a tax-deferred basis. What’s more, this exchange may be utilized over and over until eventually your heirs inherit not only the property, but the stepped-up cost basis that might wipe out a significant capital gains tax liability that has been deferred for decades.

To illustrate, let’s examine an (extremely) simplified scenario. An investor buys a property for $250,000 (which we will use as the cost basis), and ten years later using a 1031 exchange sells the property for $500,000. The investor then buys a new property for the same $500,000 price. Under the 1031

exchange, the $250,000 capital gain liability is deferred to the new property which was bought for $500,000 (but now carries a cost basis of just $250,000). In addition, while we did not consider income for simplicity's sake, it should be noted that any tax liability for depreciation expense subject to recapture is also deferred.

Suppose our investor continued to use the 1031 exchange throughout his life, and the final property had an estimated value of $2,000,000. The property continued to carry the cost basis of $250,000, meaning that if it was sold just before death, $1,750,000 in long-term capital gains would be generated. Under current tax law, the bill would amount to around $350,000 (again for simplicity's sake we are ignoring investment income, depreciation expenses, and recapture, as well as 3.8% investment income tax for the Affordable Care Act).

However, if the 1031 is also used as an estate planning tool, the accrued capital gains liabilities are eliminated due to the step-up in cost basis heirs receive.

So if the property is instead held until death, the inheritor would receive a cost basis equal to the estimated market value of the property. The inheritor could turn around and sell it for $2,000,000 and the capital gains tax would be $0, eliminating capital gains (and recapture) taxes over the entire cycle of multiple property holdings.

If the investor's estate does not exceed the $5.49 (or $10.98 million) threshold, no federal taxes will be due. Our investor has effectively transferred his holdings to heirs, tax-free.

To the extent that the estate *does* exceed the exemption threshold, a valuation discount may be applied to the real estate, because it is considered an illiquid asset. In some cases the discount may be enough to bring the estate value back below the exemption threshold (meaning no federal estate taxes are due). In cases where the threshold has been exceeded, the discount will, however, lower the total liability.

Maximizing Your Legacy

The story of Ozymandias is told eons after his empire's demise, when "nothing beside remains." While the poem teaches us that nothing will withstand the centuries, surely we would like our legacy to outlast the 270 days required to file and pay federal estate taxes. Utilizing the tax advantages of real estate investing and the 1031 exchange can help maximize the amount passed on to your heirs.

It should be said that as great as a tool as the 1031 is, one should give careful consideration and consult with their tax and investment professionals before diving into the water. In particular, use of the exchange to defer recapture taxes may affect the amount of depreciation allowed on a new investment. With a skilled and experienced navigator, however, the 1031 exchange can significantly increase the impact of your legacy.