1031 Exchange from a Taxable State to a Tax-Free State

By Nace Cohen, CPA February 8, 2019

Want to get away? Since the election, we've been getting so many calls from investors looking for a way out of paying high taxes on the sale of investment properties in taxable states. There's a simple and wonderful solution to this: Do a 1031 tax deferred exchange into a tax-free state!

Example: Can I sell my investment property in New York, a taxable state, and 1031 exchange it for property in Florida, a tax-free state? If so, then in addition to deferring taxes to Uncle Sam, can I defer the NY state and city income taxes too? The answer is yes to both! This is significant, as the NY income tax rate can reach to 9%, plus add 4% if you live in NYC. Together with the federal income tax rate of 15-25%, you can see the value a 1031 exchange brings to the investor's table. Apply this strategy to other states that levy a personal income tax and the decision to 1031 exchange becomes a no brainer.

In the IRS code lies section 1031, termed "Like Kind" exchange. This code section allows a taxpayer to defer the gains tax on the sale of their investment property by reinvesting the sales proceeds into "like-kind" replacement property. When they follow the safe harbor rules of IRC 1031, including the hiring of a Qualified Interneidary (QI) to set up the exchange and hold the money, the tax saved is reinvested as equity into the new property, a wealth building technique.

In general, all states must follow US income tax laws, of which IRC section 1031 is one. Some states have tried to limit income taxes leaving their domain through 1031 exchange, but in most instances those efforts have failed or were limited. Georgia, Mississippi, and Pennsylvania are states that deviate from federal law and will tax you on the sale even if you're doing a 1031. Where other states have succeeded is in withholding taxes on a sale of real property by a taxpayer who does not reside in the state. However, with proper planning and filing of a simple application ahead of the sale, withholding can be avoided by simply checking the 1031 exchange box on the form. Working with a QI experienced in exchanging throughout the entire US is helpful in deciding how to perform a successful exchange form one state to another.

Where other states have also been successful is with a "clawback" rule. California holds the torch on this one. A "clawback" rule allows the state to collect tax on the sale of the old, or relinquished, property when the replacement or new property is eventually sold down the road in a traditional sale. Remember a 1031 exchange only defers the tax, it does not exclude it. California Assembly Bill 92, effective January 1, 2014, requires the taxpayer who exchanged property in CA in a 1031 exchange for a replacement property outside CA to file a return with the Franchise Tax Board each year the property is held. If you fail to file a return, even as a non-resident, or if you sell the replacement in a traditional sale later on, CA will "claw back" their state tax on the sale of the old property. One useful strategy to rid the ongoing filing requirement for the non-resident taxpayer of CA may be to claim the out of state replacement as a principal residence after a period of time. Once the time constraints are met, they could sell that property in a traditional sale and utilize the principal residence exclusion to exclude all or part of the old CA gain. Again, seek counsel when doing this.

In addition to taxes, there are many reasons why investors 1031 exchange from one state to another. Going where the climate suits your clothes, cost of living, health, nearer to family and friends, or kids leaving for college make an empty nest, are just some. 1031 exchanges are designed to allow the investor flexibility to consolidate or diversify their property holdings by removing the tax burden from the sale. If you manage your own property, being an absentee landlord to a property in your old state creates a hardship that can affect the value of the property negatively, and a 1031 exchange is the right solution to this barrier as well.

Let’s Talk About Timing

If you are one of those sitting on the fence trying to decide if the time is right to sell property located in a high tax state, you may want to rethink that clawback rule. Once the states that haven’t formalized them such as New York, New Jersey, Connecticut, Illinois, etc. figure out investors will 1031 exchange out of their state to a no tax state and lose potential tax revenue, what do you think will happen? It was just reported NY lost $3 billion in tax revenue last year due to the masses leaving the state. How fast could NY or another high tax state increase income taxes, including implementing a 1031 exchange clawback rule, in an effort to stop the bleeding?

This being a very real possibility, now would be a good time to investigate doing a 1031 exchange of your investment property from a high tax state to a no or low tax state. Any new state tax will act contrary to your investment objectives, wealth accumulation or legacy bequeathed to your beneficiaries. We see the timing right in NY, NJ, IL, MA and CA. Those are all states where you want to consider leaving due to high and increasing tax rates. By deferring the tax on the sale and repositioning those investments into a lower taxed state through a 1031 exchange, you will keep more of earnings that you were paying to that state and placing it right back to your pocket! The weather is not so bad down south either in Florida, Arizona, perhaps New Mexico or Texas. Sound like a plan? Well then, it’s time to get away!

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