



## Zero Equity 1031 Exchange: Defer Taxes When You Have No Equity

By  
William L. Exeter  
Chief Executive Officer  
Exeter 1031 Exchange Services, LLC  
Exeter Trust Company



A zero equity 1031 exchange allows a real estate investor to defer the payment of capital gain and depreciation recapture taxes when he or she sells an investment property that has no remaining equity in the property. This occurs when 100% of the proceeds from the sale of a relinquished property are required to pay off the debts and closing costs thereby resulting in zero proceeds – or cash equity – left for the investor. In other words, the sale price was not enough to cover the payoff of the outstanding loan balance and payment of the related closing expenses. The investor is left with no equity, or even negative equity, from the sale transaction.

A taxable gain can still exist even when there is no equity left from the sale of investment property. It will depend upon the adjusted cost basis in the property being sold. The investor is still able to structure and complete a 1031 exchange to defer the payment of taxes when a property has no equity or negative equity. An experienced and knowledgeable qualified intermediary, such as Exeter 1031 Exchange Services, LLC (Exeter1031™), can help the investor structure a tax-deferred exchange, often referred to as a [zero equity 1031 exchange](#), when the sale of a relinquished property has no equity.

Selling an investment property with very little or no equity feels like the end of a bad chapter. The market dropped, the real estate lost value, the debt outpaced the value of the investment property, and there is no cash left when the closing statement is finalized. Many investors assume that no cash means no taxable gain and therefore no tax consequences. That assumption can be a costly mistake.

The reality is that a sale of real estate with zero equity can still trigger a large taxable gain. This is often called phantom income—a tax liability that appears even though no cash arrives at closing. Without a careful plan, investors can walk away from a foreclosure, deed-in-lieu of foreclosure, or a distressed fire sale only to face a tax bill they never saw coming.

This article explains how a zero equity 1031 exchange works, why phantom income occurs, and what solutions exist for acquiring replacement property when you have no cash equity to bring to the table. You will also learn why the experience and expertise of your [qualified intermediary](#), often referred to as accommodator or facilitator, matters more in these exchange transactions than a regular forward 1031 exchange.

### What is a Zero Equity 1031 Exchange?

A zero equity 1031 exchange is a tax-deferred exchange structured for the sale of real estate that has little, no, or even negative equity. Exeter 1031 Exchange Services, LLC coined the phrase to describe this strategy, which few qualified intermediaries, attorneys, or tax advisors actively understand or recommend.

The strategy applies most often during economic downturns. When property values fall below the debt amount owed to lenders, investors find themselves "underwater" and begin weighing options such as a foreclosure sale (i.e., trustee sale), short sale, deed-in-lieu of foreclosure sale, judicial foreclosure, other distressed property sale,



or even bankruptcy protection. A zero equity 1031 exchange offers another path. It allows the investor to defer the recognition of taxable gain and therefore the payment of capital gain taxes and depreciation recapture taxes by acquiring replacement property, even when there is zero equity in the relinquished property.

The mechanics resemble any other 1031 exchange, but with a few nuances especially if the transaction is a foreclosure sale or tax sale through an auction. The purchase and sale agreement or sale contract is assigned to the qualified intermediary or QI. This means the qualified intermediary steps into the shoes of the seller. The QI then drafts the exchange agreements and documents. The key difference is simple but significant: at the closing of the relinquished property, there is no equity or cash to send to the qualified intermediary. The exchange proceeds with zero dollars in the exchange account.

### **Why Does a Sale with No Equity Still Create a Taxable Gain?**

This is the part that surprises most real estate investors. The absence of equity does not mean the absence of taxable gain. A short sale is still a sale for tax purposes, and it triggers any gain or profit that exists in the property. A foreclosure through a trustee's sale is a forced sale, and it may also cause that gain or profit to be recognized (and realized). Similarly, a deed in lieu of a foreclosure sale is also treated as a sale for tax purposes.

The confusion comes from mixing up two different numbers: equity and gain. Equity measures what is left after the debt and expenses are paid. Taxable gain measures the difference between your adjusted cost basis and the sales price. These figures move independently, which is why a property can have zero equity and a substantial gain at the same time.

### **How a Low Cost Basis Creates Phantom Income**

Taxable gain is calculated using your sale price, closing costs and adjusted cost basis, not from the cash or equity that you receive at closing. The adjusted cost basis is computed by taking your original purchase price, adding costs for capital improvement made to the property, and then subtracting depreciation taken on the property over the years that you have owned the real estate.

Over the years of ownership of the property, your adjusted cost basis and your equity will change. The changes are generally caused by:

- **Capital improvements.** Making capital improvements to the real estate will increase the cost basis in the property.
- **Depreciation deductions taken.** Every year you depreciate the property by writing off part of your adjusted cost basis, thus your cost basis is reduced each year by the amount of depreciation taken for that year. Those deductions create a future depreciation recapture liability.
- **Cash-out refinancing.** Pulling equity out through refinancing does not lower your basis, but it does increase your debt. When the property sells, that debt is paid off with the sale proceeds—yet the original gain remains taxable.

### **Phantom Income Case Study**

Consider the case study Exeter 1031 Exchange Services, LLC uses to illustrate this. An investor buys real estate for \$1,000,000, using a \$200,000 cash down payment and a \$800,000 loan. The property grows in value to \$3,000,000. The investor has pulled equity out by refinancing the real property over the years and now owes \$2,700,000. The property drops in value to \$2,100,000 during a recession—about \$600,000 less than the debt owed to the bank.

The investor (and the property) is in financial distress and must sell the property, but the property is worth less than the outstanding loan balance. The investor is forced to pursue a short sale and ask the lender to accept less



than the full payoff amount. Yet a taxable gain of approximately \$1,100,000 still sits in the property, because it was purchased for \$1,000,000 and is still worth around \$2,100,000. The investor pulled that gain out through refinancing over the years without paying tax on it. Selling now triggers the capital gain, plus likely depreciation recapture. That is phantom income—a real tax liability with no cash to pay it.

### **How Debt Payoff and Closing Costs Consume Your Proceeds**

At the closing table, the sale proceeds are applied in a predictable order. The lender is paid off first, then closing expenses such as real estate agent commissions, title insurance premiums, settlement agent fees, and so on are paid. In a zero equity scenario, these obligations absorb every dollar of the sale price—and may still fall short.

The investor receives nothing. But the IRS still calculates gain based on the sale price, less closing costs, less the adjusted basis in the property, not the cash that changes hands. The result is a tax bill with no proceeds available to cover it. A 1031 exchange is one of the few tools that can defer that tax liability, even when equity has been wiped out.

### **Why Are Zero Equity 1031 Exchanges Uniquely Complex?**

A standard 1031 exchange uses the net cash proceeds from the sale of the relinquished property, in the past referred to as the down leg, as the down payment on the replacement property, historically referred to as the up-leg property. A zero equity 1031 exchange has no such cash. This single fact creates the central challenge of the entire transaction.

To defer 100% of the tax consequences, an investor generally must acquire replacement property of equal or greater value and reinvest all net proceeds derived from the sale. Reinvesting net proceeds is easy when those proceeds are zero. The hard part is acquiring a replacement property of equal or greater value with no cash to use as a down payment. Most lenders require 20% to 25% down on investment property, so the investor must find another way to fund the acquisition.

### **Zero Equity Exchange Deadlines**

These no equity exchange transactions also carry [strict deadlines](#) just like every 1031 exchange:

- 45 calendar days after the closing of the sale of the relinquished property to identify one or more replacement properties.
- 180 calendar days after the closing of the sale of the relinquished property (or the due date of your federal tax return, including extensions) to acquire one or more replacement properties.

The exchange will fail if you miss either deadline. A failed exchange means the deferred gain becomes immediately taxable. Because the stakes are so high and the structure so unusual, these transactions demand careful coordination among the investor, the broker, the lender, the tax advisor, and the 1031 qualified intermediary.

### **Why Does Your Choice of Qualified Intermediary Matter So Much?**

The qualified intermediary is central to every 1031 exchange. The qualified intermediary prepares the exchange agreements and related documents, coordinates with your legal, tax, financial advisors, works with your escrow officer or closing agent, and receives, holds, and [safeguards](#) your exchange funds. In a zero equity exchange transaction, the demands on that intermediary are even greater.

### **Not All Qualified Intermediaries Handle Zero Equity Exchanges**

Few qualified intermediaries even think about or understand a zero equity 1031 exchange, let alone recommend one. These transactions require specialized documentation, creative problem-solving, and close coordination with



lenders and brokers. A qualified intermediary that processes only routine exchanges may not have the technical depth to structure one correctly.

Investors need more than a transaction processor. They need a consultative partner with the knowledge, experience, and expertise to navigate a complex, technical exchange. Exeter 1031 Exchange Services, LLC delivers consultative services to individual, corporate, and institutional investors and works directly with their professional advisors to structure compliant exchanges.

### **What to Look for in a Qualified Intermediary**

The qualified intermediary industry has no licensing body or regulatory authority providing independent oversight or audits. Except for a very few qualified intermediaries, QIs are not licensed, regulated, or audited, and they have no regulatory required minimum insurance or equity capital reserve requirements. Given the amount of 1031 money these firms hold, that gap should concern every investor.

When evaluating a qualified intermediary, ask these direct questions:

- **Are you licensed, regulated or audited by any government agency?** Exeter Trust Company is licensed, regulated, and audited by the Wyoming Division of Banking, making Exeter 1031 Exchange Services, LLC, as a best practices firm, one of the few qualified intermediaries with any form of regulatory oversight.
- **Are you examined or audited by any independent outside audit firm?** Exeter Trust Company is subject to annual examinations by the Wyoming Division of Banking, annual examinations of its financial statements by a CPA firm, and annual examinations of its policies and procedures by a certified public accounting firm to ensure that it is operating in a safe and sound manner.
- **How do you hold client funds?** Exeter 1031 Exchange Services, LLC deposits, holds and safeguards client funds in separate, segregated, dual-signature, restricted [qualified trust accounts](#) with Exeter Trust Company. In the LandAmerica 1031 Exchange Services bankruptcy case, the court ruled that client funds held in the company's corporate name were corporate funds and not client funds and were subject to general creditor claims—a risk that qualified trust accounts prevent.
- **What insurance and capital reserves do you carry?** As of this publishing, The Exeter Group of Companies maintains a \$10.0 million fidelity bond, \$10.0 million in errors and omissions insurance, \$15.0 million in cyber and wire fraud insurance, and more than \$8.0 million in equity capital reserves. [Click here](#) to obtain our most recent amounts of insurance, bonding and equity capital.
- **What internal controls protect my funds?** At Exeter, four separate team members (two from Exeter 1031 Exchange Services, LLC and two from Exeter Trust Company), acting together, combined with the client's written authorization, are required to process any disbursement of exchange funds.

In a transaction with no margin for error, regulatory oversight, independent audits and exams, and strong internal controls are not luxuries. They are protections you cannot afford to skip.

### **How Can You Buy Replacement Property When You Have No Cash Equity?**

The challenge is real: acquiring one or more replacement properties without a cash down payment from the sale of your relinquished property is not easy. Several approaches can make it possible with the right combination of creativity, flexibility, expertise and experience. Each works best in specific circumstances, and all require expert guidance.



### Financing and leverage strategies

Because there is no cash received from the sale to fund the acquisition, the investor must come up with the down payment elsewhere and replace the debt that was paid off. Common options include:

- **Bringing outside cash to the closing.** An investor with capital from another source can use it as the down payment on the replacement property while taking on new debt to match or exceed the relinquished property's debt. This is often the most direct route for investors with liquidity outside the exchange.
- **Refinancing or borrowing against another asset.** Investors who own other property can borrow against it to generate the cash needed for the replacement property down payment. This option fits investors with significant equity elsewhere in their portfolio.
- **Highly leveraged replacement property.** Acquiring a property with a high loan-to-value ratio reduces the amount of cash required at closing, helping the investor satisfy the equal-or-greater-value requirement with less out-of-pocket capital. One common solution here is the use of zero coupon Delaware Statutory Trusts (DSTs) that often have 85% to 90% loan to value ratios.

### Creative Acquisition Structures for No-Cash Equity Situations

Traditional financing often falls short when there is no equity in the sale property, but creative structures can bridge the gap. The following out-side-the-box strategies require a sophisticated, experienced real estate broker, mortgage broker or lender, legal and tax advisors, working alongside a knowledgeable and experienced qualified intermediary:

- **Seller carryback financing.** The seller of the replacement property agrees to accept a [seller carry back note](#) for part of the purchase price, reducing or eliminating the cash needed at closing.
- **Delaware Statutory Trusts (DSTs).** The exchangor can acquire a beneficial interest in one or more Delaware Statutory Trusts (DSTs). DSTs qualify as real estate for 1031 exchange purposes. And, some of the Delaware Statutory Trusts (DSTs) have high leverage in the 85% to 90% range that can address the no equity problem.
- **Co-investor arrangements.** A co-investor contributes the cash down payment while the exchange entity takes on the debt, often through a tenant-in-common structure, often referred to as a TIC structure, with a tenant-in-common agreement or TIC agreement.
- **Specialized replacement options.** Some investment vehicles are structured with built-in leverage that can help match the exact debt replacement requirements of a zero-equity exchange.

None of these solutions work for every investor. As Exeter 1031 Exchange Services, LLC notes, a creative acquisition package will not fit everyone—but it can give an investor real options to consider when there is no equity in the relinquished property. With the right team, you may be able to get out from under a problem property, defer your taxes, and move into replacement property that leaves you in a stronger position than before.

### Taking the right steps with the right partner

A sale with no equity does not have to mean a surprise tax bill. Phantom income is a genuine risk, but a zero equity 1031 exchange gives investors a way to defer depreciation recapture and capital gain taxes even without equity. The strategy demands precise documentation, creative financing, and strict attention to the 45-day and 180-day deadlines.



Before you proceed with a short sale, foreclosure sale, trustee's sale, tax sale, sheriff's sale, deed-in-lieu of foreclosure, auction sale or any other distressed-property decision, consult your legal, tax and financial advisors to understand the taxable gain you may be facing. Then choose a qualified intermediary with the experience, expertise, regulatory oversight, and financial strength to structure the exchange correctly.

Exeter 1031 Exchange Services, LLC works with individual, corporate, and institutional clients in all 50 states, providing creative solutions for complex 1031 exchange challenges. To explore whether a zero equity 1031 exchange fits your situation, contact the Exeter1031™ [specialists](#) for a consultation.

## **Frequently Asked Questions (FAQs)**

### **What is phantom income in a 1031 exchange?**

Phantom income is a taxable gain that exists even though the investor receives no cash at closing. It occurs when sale proceeds are consumed by debt payoff and closing costs, yet a taxable gain remains because the property's adjusted cost basis is low—often from years of depreciation deductions and prior cash-out refinancing activity.

### **Can you do a 1031 exchange with no equity?**

Yes. A zero equity 1031 exchange allows an investor to defer capital gain and depreciation recapture taxes on the sale of real property with little, no, or negative equity. At the relinquished property closing, no cash is disbursed to the 1031 qualified intermediary, but the exchange can still be structured to acquire replacement property.

### **How do you buy replacement property without a down payment from the sale?**

Investors typically source the down payment outside the exchange—by bringing in outside cash, refinancing another asset, using seller carryback financing, consider buying beneficial interests in Delaware Statutory Trusts (DSTs), partnering through a tenant-in-common arrangement, or acquiring highly leveraged replacement property. Each approach requires an experienced broker and qualified intermediary.

### **What are the risks of a Zero Equity 1031 Exchange?**

The main risks are missing the 45-day ID period or the 180-day acquisition deadline, which would cause the exchange to fail and make the deferred gain immediately taxable. There is also the challenge of securing financing with no cash from the sale of the relinquished property. These transactions are complex and not suited to every investor.

### **Who should consider a Zero Equity 1031 Exchange?**

This strategy suits real estate investors facing a short sale, foreclosure action, trustees' or sheriff sale, tax sale, deed-in-lieu of foreclosure sale, or sale of an underwater property that still has a taxable gain due to a low cost basis. It is most viable for investors with access to outside capital or other assets, and who work with advisors experienced in distressed-property or work out exchanges.

### **Why does the choice of qualified intermediary matter for these exchanges?**

Zero equity exchanges require specialized documentation and close coordination with lenders and brokers, which many qualified intermediaries are not equipped to handle. Choosing a regulated, audited intermediary with strong internal controls—such as Exeter 1031 Exchange Services, LLC—protects both your funds and the integrity of the transaction.