When Should a Person or Company Consider a 1031 Exchange?

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A 1031 Exchange is a process authorized under Section 1031 of the Internal Revenue Code that allows for a seller of property to avoid the payment of capital gains tax which would otherwise be due upon the sale.

There are many factors that must be considered to determine if an exchange will work for any seller, however, the two primary questions to answer are:

1) Will there be capital gains tax due upon selling the property and

2) Do I want to purchase a replacement property?

If the answer is yes to both of these questions, then a 1031 Exchange is an excellent tax deferral tool.

The purpose of doing a 1031 Exchange is to defer payment of tax upon selling business or investment real estate. The tax deferral occurs when the seller "rolls" their investment into a replacement property by utilizing the 1031 exchange process. Since the seller doesn't cash out their investment, they are able to avoid recognition of taxes.

Anyone considering an exchange should answer question one by calculating the amount of tax that will occur upon a sale of the property**. If selling the property will result in a gain, then that gain is likely taxable and a 1031 Exchange should be considered to defer payment of that tax.**

The calculation of gain is done by subtracting the basis in the property from the sale price of the property. Every property has a basis. The basis in a property is primarily defined as the amount paid for the property (this includes amounts paid for improvements) less any depreciation. For example, if a property is purchased for $300,000 and has depreciated $50,000 the basis in that property is $250,000. If the property then sells for $400,000 there is $150,000 in gain. This gain is likely taxable. The federal tax will be at the taxpayer's capital gains rate on the amount of gain attributable to appreciation, at the depreciation recapture rate for the amount of depreciation and 3.8% on any amount of gain taxable as net investment income, if applicable. State level taxes on capital gains may also apply.

Then comes question number two. The key part to a 1031 Exchange is the exchange component. In order to defer the tax under Section 1031, the seller must "roll" over their investment into other business or investment real estate**. If the seller is interested in continuing to own real estate then a 1031 Exchange is an excellent tax deferral tool.**

A 1031 Exchange Qualified Intermediary is necessary to complete the process of a 1031 Exchange and can provide further information on how exchanges work.