

1031 Exchange: Ten Reasons Why

There are many reasons supporting the property owner’s decision to enter into a 1031 exchange. Not all of them revolve around the goal of deferring capital gains taxes. To understand and assist those wondering whether a 1031 exchange is for them, let’s look at what a 1031 exchange does.

1031 Exchange Benefits

Enforced by the Internal Revenue Service (IRS) Code Section 1.1031, a 1031 exchange allows the U.S. citizen and non-resident alien individuals, estate, trust and corporation to sell real property held for productive use in business or investment and replace with real property of equal or greater value. A 1031 exchange defers three potential taxes that are triggered upon sales – federal and state capital gains and recaptured depreciation. However, 1031 tax deferrals vary depending on state regulations. In some states, there may be a county tax while some states do not have a state capital gains tax.

If the asset is held for less than one year, the tax rate reflects the ordinary income tax. If the asset is held for one year and a day, then the long-term capital gain rate applies. Total the taxes together and they can exceed forty (40) percent of the capital gain. For example,

Original Purchase Price	\$400,000
Plus Improvements	0
Less Depreciation Taken	50,000
Adjusted Basis	350,000
Sales Price	750,000
Less Adjusted Basis	350,000
Less Selling Expenses	60,000
Realized Gain	290,000
Taxes:	
Recaptured Depreciation	12,500
Federal Capital Gain (15%)	36,000
Indiana State Capital Gain (3.4%)	9,860
Tax Due:	\$58,360

A 1031 exchange defers the tax due allowing an indefinite, interest free loan to be used towards the purchase of replacement property. When the replacement property is sold the taxes are due on the appreciation and depreciation of the replacement property along with those deferred from the relinquished or old property. Another exchange can be initiated to continue the tax deferral. There is no restriction on the number of exchanges. Ultimately, a tax will be due unless the property is given to a charity or to heirs upon death. If the intent is to replace the property and there is no loss to offset the gain, then most likely, your CPA will agree that a 1031 exchange is a beneficial strategy.

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Ten Reasons 'Why'

There are ten major reasons when a 1031 exchange makes sense given the intent is to replace with equal or greater value:

1. Number one reason to a 1031 exchange is to **defer the capital gain.**
2. **Appreciation.** The property may have appreciated in value that it only makes sense to capture the value and replace with another asset to allow it to appreciate.
3. **Depreciation.** The property may have been held for twenty or more years. There are few years left to take additional depreciation. A 1031 exchange allows the Exchangor to replace with another property that resets the depreciation schedule allowing for additional depreciation to be taken.
4. **Cash flow.** Rather than holding on to land that typically does not provide a cash flow. A 1031 exchange into a residential, commercial property or tenants in common allows for a cash flow.
5. **Consolidation.** Instead of holding multiple properties, consolidate into one. Reduce the labor intensity of managing multiple properties and focus on one
6. **Diversification.** If one property is held, then by selling the ranch or farm, replace with multiple properties.
7. **Relocation of investment.** If the Exchangor moves and wants to be close to the investment property either for limited personal use or to manage.
8. **Build on land already owned.** Either the Exchangor owns land or a building that can be improved with the exchange proceeds and debt

retired. This is often the case in commercial real estate where the Exchangor owns multiple properties, one of them being land.

9. **Makes economic sense to sell.** The current property is within the path of progress. An offer has been tendered, it makes sense to sell and relocate.

10. **Estate planning.** With the assistance of an estate planning attorney or professional, in preparation for the next line of owners or if the current ownership wants to part company, a 1031 exchange is a viable strategy.

Eligible Property

Internal Revenue Code Section 1031 applies to real property held in the production of income or for investment. Real property is broad and includes real estate, gas and oil interests, timberland, conservation easements and thirty year leasehold interests.

Property held in the U.S. must be replaced with property held in the U.S. Foreign property can be replaced with property held in any foreign country.

When the intent is to hold the property for investment or in a business, then the facts of how long the property is held, the amount of personal use, was the property in a rental pool and itemized on Schedule E of the Exchangor's 1040 federal tax return support the intent. Revenue Procedure 2008-16 requires that a vacation property or dwelling unit to be held for two years with no more than 14 overnights or ten percent of rental overnights of personal use per year. The replacement property must be held for two years and have no more than fourteen overnights or ten percent of rental overnights per year to be eligible for 1031 consideration.

There is no other hold time defined in the 1031 code. The intent and facts support whether the property is eligible.

There are many issues that should be addressed before initiating a 1031 exchange. Is the tax return that is selling, the same as the tax return acquiring? This applies to husband/wife, partnerships and companies and their subsidiaries. Will the debt be replaced or is an installment loan possible? Planning and gathering input from the Exchangor's Qualified Intermediary and accountant are critical to affecting the optimum 1031 exchange strategy. A Certified Exchange Specialist® at Atlas 1031 can provide a roadmap including action steps and milestones to ensure a successful 1031 transaction.

About the Author

Andy Gustafson, Certified Exchange Specialist®, serves as a managing member of Atlas 1031 Exchange, LLC, a worldwide accommodator of Internal Revenue Code Section 1031. To date, he has accommodated over 1,400 simple and complex, real and personal property exchanges. He can be reached at office number 800.227.1031 or info@atlas.com



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