Introduction to 1031 Exchanges

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About the Author:
Richard E. Goble is a Shareholder with Kerkering Barberio & Co., P.A. in Sarasota, FL. His areas of practice include Forensic Accounting and Litigation Support and Individual and Business Tax Consulting. He specializes in Real Estate Support Services and is recognized for his knowledge in the area of 1031 Exchanges. Mr. Goble joined Kerkering Barberio in 1978 and was admitted as a Shareholder in 1979.

A 1031 Exchange is an excellent tax deferral strategy. Anyone involved with real estate investments should know about tax-deferred exchanges, including realtors, lawyers, accountants, financial planners, tax advisors, escrow and closing agents, and lenders. Taxpayers should never have to pay income taxes on the sale of property if they intend to reinvest the proceeds in similar or like-kind property. *It is even possible to accomplish a 1031 Exchange in a foreclosure situation where there is significant gain.*

What is a 1031 exchange?
A 1031 Exchange is also sometimes referred to as a like-kind exchange. A like-kind exchange is the sale of property used in a trade or business, or one that is held as an investment, in exchange for property that is used in a trade or business or one held for investment.

How do they work?
The most common 1031 exchange is related to real estate, although it does not have to be. Typically, when someone sells a parcel of real estate, they'll deposit funds with an independent third party known as a qualified intermediary. From there, they have 45 days to identify a replacement property, the like-kind property, and 180 days to close on the purchase of that replacement property.

One of the best attributes of 1031 exchanges is they provide buyers the ability to defer all income tax on the sale of property if they buy a new property of equal or greater value. For instance, if someone buys a piece of property in Southwest Florida for $100,000 and sells it for $1 million, they would be facing a $900,000 capital gain. If they did a 1031 exchange and purchased another like-kind property for $1 million, they would pay no capital gains taxes on their sale.

It's important to note that this is not a permanent avoidance; it's simply a deferral of the tax. If you take my example of the replacement property, the basis for taxation would be $100,000. And the only way that gain ever goes away is if the asset is included in an estate when someone dies, or if the property is given away as part of a charitable donation.

Who benefits primarily from a 1031 exchange?
Benefits can be derived by any entity that invests in real estate: partnerships, corporations and trusts, though we find most exchanges are executed by individuals.

Are there any disadvantages to 1031 exchanges?
The major disadvantage is that you don't get the step up in depreciation to the value of the replacement property. Let's again go back to our $1 million exchange example. Though the property was purchased for $1 million, you'd still have $100,000 as the basis for depreciation.

If you did not choose to do a 1031 exchange, you'd have bought a replacement property for $1 million and you'd have $1 million as the basis, and you would then have 10 times the depreciation each year. This can shelter the income that would otherwise be produced by the property. There are also additional costs associated with doing a 1031 exchange, which aren't present when you do a straight purchase or sale such as the cost of the intermediary.

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