When Should a Person or Company Consider a 1031 Exchange?

By Patrick Harrigan, JD, Certified Exchange Specialist®
President and COO
Gain 1031 Exchange Company, LLC
www.gain1031exchangecompany.com

A 1031 exchange is a process authorized under Section 1031 of the tax code that allows for a seller of property to avoid the payment of capital gains tax which would otherwise be due upon selling the property.

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

Anyone considering an exchange should answer question one by calculating the amount of capital gain that will occur upon selling the property. The calculation of gain is done by subtracting the adjusted basis of the property from the amount realized upon selling the property. If that calculation results in a gain, then that gain is likely taxable and a 1031 exchange should be considered to defer payment of that tax. The basis in a property is loosely defined as the amount paid for the property (less any allowed depreciation). The amount realized is the amount of the sale price. For example, if a property is purchased for $300,000 and sold for $400,000, then there is $100,000 in gain. This gain is likely taxable.

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, commercial 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.