What is a 1031 Exchange?

A **1031 exchange, otherwise known as a tax deferred exchange is** a simple strategy and method for selling one property, that's qualified, and then proceeding with an acquisition of another property (also qualified) within a specific time frame. The logistics and process of selling a property and then buying another property are practically identical to any standardized sale and buying situation, a ***"1031 exchange"*** is unique because the entire transaction is treated as an *exchange* and not just as a simple sale. It is this difference between "*exchanging*" and not simply buying and selling which, in the end, allows the taxpayer(s) to qualify for a deferred gain treatment.

So to say it in simple terms, sales are taxable with the IRS and 1031 exchanges are not!

Why 1031 Exchange?

Any Real Estate property owner or investor of Real Estate, should consider an exchange when he/she expects to acquire a replacement "like kind" * property subsequent to the sale of his existing investment property. Anything otherwise would necessitate the payment of a capital gain tax, which is currently 15%, but may go to 20% in future years. Also include the federal and state tax rates of your given state when doing a 1031 exchange. The main reason for a 1031 is that the IRS depreciates capital real estate investments at a 3% per year rate as long as you hold the investment, until it is fully depreciated. When you sell the capital asset, the IRS wants to tax you on the depreciated portion as an income tax, and that would be at the marginal tax rate. Example, if you hold an investment for 15 years, the IRS depreciates it 45%. It then wants you to pay the taxes on that 45% depreciation. If combined state and federal taxes are 35% at the marginal rate, that's about 15% of the cost of the property (one third of 45%). If your property is fully depreciated, it becomes the whole 35% marginal tax rate. Another way to make it easy to understand is when purchasing a replacement property (without the benefit of a ***1031 exchange***) your buying power is reduced to the point, that it only represents 70-80% of what it did previously (before the exchange and payment of taxes). Below is a look at the basic concept, which can apply to all 1031 exchanges. From the sale of a relinquished real estate property, we should understand this concept so that we can completely defer the realized capital gain taxes. The two major rules to follow are:

1. **The total purchase price of the replacement "like kind" property must be equal to, or greater than the total net sales price of the relinquished, real estate, property.**
2. **All the equity received from the sale, of the relinquished real estate property, must be used to acquire the replacement, "like kind" property.**

The extent that either of these rules (above) are violated will determine the tax liability accrued to the person executing the Exchange. In any case which the replacement property purchase price is less, there will be a tax responsibility incurred. To the extent that not all equity is moved from the relinquished to the replacement property, there will be tax. This is not to say that the **(1031) exchange** will not qualify for these reasons. Keep in mind, partial exchanges do in fact, qualify for a partial tax-deferral treatment. This simply means that the amount, of the difference (if any), will be taxed as a boot or "non-like-kind" real estate property.

"Like Kind Property" basically means **real property for **real property**. It does not mean sell a lot or land and buy a lot or land. You can buy any type of real estate. Consider duplexes, triplexes, fourplexes for example.*