

# 1031 Exchange

## What is a 1031 Exchange?

The Federal 1031 laws allow Taxpayers or Exchangers to sell a Real Property (Real Estate) Investment and acquire “like-kind” Real Property deferring both Federal and State Taxes. “Like-kind” Real Property is when the Relinquished Property (has been) and Replacement Property (will be) “held for productive use in the investor’s trade or business or for investment.”

‘**For investment**’ means the Relinquished Property cannot be the Exchanger’s ‘Personal Residence’ nor can the Exchanger intend to acquire the Replacement Property as a Personal Residence. There are numerous advantages to participating in a 1031 Exchange, some of which have been set forth below:

- Deferment of Federal Tax (short term and long term) & State Tax.
- Replacement Property(ies) can facilitate a new Depreciation Schedule for the Replacement Property.
- Capital preservation and growth of long-term wealth all while deferring both State and Federal Tax.
- Using an appreciated asset to acquire new asset(s) with potential appreciation and possible greater cash flow.
- Consolidation and Restructuring of Real Estate Assets.
- Diversification of Real Estate Asset types, such as replacing a Single Family Home, Condominium or Apartment (labor intensive) to Triple Net Lease (mailbox money).
- The Taxpayer can be any Individual or Entity (Trust, Limited Liability Company, Corporation, etc.).
- Replacement Property(ies) can be located anywhere in the U.S., yielding the possibility of Geographic Diversification.

## What is ‘Profit’ for Tax Purposes?

Understanding how the IRS calculates ‘Profit’ is essential because the amount of taxable income may be greater than originally thought. Profit is not simply the Relinquished Property’s ‘Original Acquisition Price’ less the ‘Net Sales Price’, depreciation must be considered.

‘Profit’ is the difference between the ‘Cost Basis’ of the Property and the ‘Net Sales Price’. Generally, the ‘Cost Basis’ of the Relinquished Property is the ‘Original Acquisition Price’ plus the cost of ‘Improvements’ less ‘Depreciation’. Be mindful, if the Relinquished Property has been held by the Taxpayer for a significant amount of time or if the depreciation has been accelerated, then ‘Cost Basis’ could be extremely low. The ‘Net Sales Price’ is the ‘Gross Sales’ Price less selling expenses.

**PROFIT** = Net Sale Price – Cost Basis

**NET SALES PRICE** = Property Sales Price – Selling Expenses

**COST BASIS** = Property Acquisition Price + Improvement – Depreciation

Taxpayers often confuse ‘Cash Flow’ and ‘Profit’. For example, if the Taxpayer previously had a ‘cash out’ refinance on the Relinquished Property, then at the time of sale the Cash Proceeds (from the sale of the Relinquished Property) are relatively modest. In this example, the ‘Cash Flow’ or ‘Proceeds’ at the time of sale can be relatively low while the ‘Profit’ could be substantially more.

## Replacement Property Requirements

Generally, to defer both Federal and State Taxes, the following should be considered when acquiring the Replacement Property(ies):

- Reinvestment of the Proceeds/Equity from the Sale in the Replacement Property.
- Secure a loan concurrently with the acquisition of the Replacement Property(ies) in an amount equal to or greater than the loan on the Relinquished Property.
- If the Taxpayer acquires more than one Replacement Property both the Equity Investment and Debt Replacement on the Replacement Property(ies) are cumulative.

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