ABOUT SECTION 1031 EXCHANGES

Source: Federation of Exchange Accommodators | www.1031.org

The opportunity to protect hard earned equity in the sale of an investment has been available to consumers since 1921. However, complexities and details of the tax code prevented only the most knowledgeable from using this option. In 1990 the Omnibus Budget Act clarified the process an opened this option to a broader set of consumers.

Section 1031 Exchanges, which have become more popular since the mid-90s, allow investors to defer the tax on capital gains until some point in the future.

Section 1031 of the Internal Revenue Code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business, or for investment. A tax-deferred exchange is a method by which a property owner trades one or more relinquished properties for one or more replacement properties of “like-kind”, while deferring the payment of federal income taxes and some state taxes on the transaction.

The theory behind Section 1031 is that when a property owner has reinvested the sale proceeds into another property, the economic gain has not been realized in a way that generates funds to pay any tax. In other words, the taxpayer’s investment is still the same, only the form has changed (e.g. vacant land exchanged for apartment building). Therefore, it would be unfair to force the taxpayer to pay tax on a “paper” gain.

The like-kind exchange under Section 1031 is tax-deferred, not tax-free. When the replacement property is ultimately sold (not as part of another exchange), the original deferred gain, plus any additional gain realized since the purchase of the replacement property, is subject to tax.

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