1031 EXCHANGE

PAY ZERO TAXES UNTIL YOU DIE.

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As you likely remember, the Section 1031 exchange allows you to sell a piece of appreciated real estate and defer all the taxes as long as you invest the entire proceeds in like-kind property.

And then consider this: a cost segregation study allows you to separate qualifying real estate into separate components with shorter depreciable lives that speed up deductions and in many cases create immediate write-offs.

Can you (a) defer a large gain via Section 1031 and (b) immediately create a large write-off on the new asset with a cost segregation study?

You can, but you have to make sure you don't miss this one important step.

1031 Exchange Overview

The Section 1031 exchange allows you to sell appreciated real estate and defer all taxable gains when you fully reinvest the sales proceeds into new qualifying real estate.

Example 1. You purchased a rental property five years ago for $200,000. The property has appreciated tremendously in the past five years and is now worth $500,000.

You depreciated the rental by $30,000, so its adjusted basis is now $170,000. If you sell for $500,000, you'll have a taxable gain of $330,000.

But you don't sell outright. Instead, you utilize a 1031 exchange to make the sale and roll the sales proceeds (and the taxable gain) into the purchase of an eight-unit apartment building that costs $1,000,000.

Key point. Many savvy investors continue using 1031 exchanges until death, when their relatives inherit the asset with a stepped-up basis. And then, because of that stepped-up basis, those relatives can likely sell that asset federal-income-tax-free.

1031Cost Segregation Overview

Residential real estate is depreciated over a life of 27.5 years, and commercial real estate is depreciated over a life of 39 years.

Example 2. You purchase a small apartment building for $1,000,000. A qualified appraisal shows that 80 percent is building, and 20 percent is land.

This makes your depreciable basis $800,000. (You cannot depreciate land.)

You write off the $800,000 basis over 27.5 years, giving you annual write-offs of $29,091.

An applied cost segregation study breaks that $800,000 building into components such as appliances, flooring, lighting systems, and land improvements. The components have lives of 20 years or less, qualifying them for faster depreciation and bonus depreciation as well.

For 2022, bonus depreciation is 100 percent, but it drops to 80 percent for 2023.

Key point. Cost segregation studies use the depreciation rules in effect when you place the property in service, not when you do the study. But you realize the tax benefits in the year of the study.

Example 3. Let's say that of the $800,000 apartment building basis, 25 percent ($200,000) goes to shorter-life assets and $600,000 to the 27.5-year depreciable life category. Because you placed this building in service in 2022, you can use bonus depreciation to immediately deduct $200,000 for the short-lived assets.

This would result in a first-year write-off of $221,818 ($200,000 + $21,818 = wow!) and a $21,818 write-off for Year 2 through Year 27.5.

Calculating Basis in a 1031 Exchange

When you complete a 1031 exchange, the basis in your new asset is calculated by reducing its value by the deferred gain. That new basis amount can be accounted for in two different ways, described below.

Method 1: Track two assets. With this method, the remaining basis of the old asset continues on its original timeline and the new “additional” basis of the new asset starts on a new schedule.

Method 2: Track one asset. Here, you make the IRS regulation 1.168(i)-6(i)(2) election.[8] This election allows you to treat the sum of the exchanged basis and the new/excess basis as one asset, both put into service at the same time.

Example 5. Your old asset’s remaining basis of $170,000 would be combined with your new/excess basis of $500,000 ($400,000 for building and $100,000 for land). You depreciate the $570,000 building basis ($170,000 + $400,000) over 27.5 years.

In the example above, you lose out because you are depreciating everything over 27.5 years.

Cost Segregation Can Change the Game

If you will use cost segregation on the newly acquired Section 1031 asset, you may want to make the 1.168(i)-6(c)(5)(iv) election because that applies cost segregation to the entire basis.[9]

Example 6. Under the track-one-asset method, your depreciable basis is $570,000. If the cost segregation study shows that 25 percent of the basis is bonus depreciation or Section 179 qualifying property, you write off:

- $142,500 immediately,
- $15,545 immediately, and
- $15,545 in subsequent years.

Example 7. Under the track-two-assets method, you apply the cost study to the additional investment's portion of the depreciable basis ($400,000, in this example). If the cost segregation study shows that 25 percent of the basis is bonus depreciation or Section 179 qualifying property, you write off:

- $100,000 immediately in bonus depreciation or Section 179 expensing;
- $10,909 immediately in 27.5-year depreciation;
- $7,555 immediately in depreciation of the old $170,000 basis;
- $10,909 each year for 26.5 years; and
- $7,555 each year for 20.5 years.

Here, you can see that with cost segregation, the track-one-asset method is the winner—assuming you will keep the property in your real estate portfolio until death.

But we have to point out: there is more to consider that could change the result. For example, how long will you keep the property? With a short holding period, recapture on bonus depreciation and Section 179 expensing comes into play and could impact your selection of method.

Takeaways

Combining a Section 1031 exchange with a cost segregation study can produce great results.

Continuous use of the Section 1031 exchange enables you to continue upgrading your real estate portfolio without incurring any federal taxes on the upgrades. And you can keep doing this until you die.

When you upgrade your real estate using the Section 1031 exchange, you have the opportunity to use a cost segregation study to create large deductions in the year of exchange.

If you are going to use cost segregation on an asset acquired via a 1031 exchange, you need to consider the IRS Reg.