

Tax Free Exchange of Real Estate

By [Gina L. Gwozdz, CPA](#)

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You can defer capital gains taxes, ordinary income taxes and depreciation recapture taxes when you exchange real estate that you are holding in your trade or business or for investment. This is known as a Section 1031 exchange. You can exchange properties as many times as you like effectively creating almost unlimited tax deferral.

You must exchange your property for "like-kind" property. Like kind is defined by how the property is used, not the character of the property. When you exchange your property, you transfer your tax basis and accumulated depreciation from your original property to your new property. By transferring your basis and accumulated depreciation you are deferring the gain, until you ultimately sell your property.

You will have to pay taxes immediately (instead of deferring them) if you receive any money (or "boot"). This is why you should purchase a replacement property that costs more than what you're selling your existing property for and obtain a larger mortgage than what your current mortgage is. The goal is not to take out any cash, and to effectively accomplish this it is usually best to work with a qualified intermediary. This intermediary can arrange the paperwork, hold the sales proceeds, compute the proration of your operating expenses (which would be considered boot if paid through the exchange) such that you know how much additional cash you need to put into the transaction to make sure all taxes are deferred.

Properly depreciating your property after the exchange can be somewhat complex, so it is best to have your tax professional help you with this. The basis in your new property that you transferred over from your existing property continues to be depreciated on your old depreciation schedule, using the old life. The increase in basis, due to your new property, is depreciated as a separate asset.

When you eventually sell your replacement property, you'll have to recapture some of your depreciation. You have to recapture some of the depreciation you took, because the property that you sold has actually appreciated in value even though on your tax return you indicated (through the use of depreciation) that it was depreciating.

Gina L. Gwozdz is a CPA who has chosen to specialize in taxes. Visit her website at <http://GLGcpa.com> to view more Tax Tip Articles.