

## Cost Segregation Newsletter - August 2007

August 2007 Cost Segregation and 1031 Exchanges:

1031 Exchanges (also known as a Like Kind Exchanges) are transactions under US law that specify under section 1031 of the IRS code 26USC§1031 "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." Taxpayers are allowed to defer all of the capital gains taxes resulting from the exchange of investment property, when they use a qualified intermediary, following the IRS guidelines, and using the proceeds of the exchange investment property within 180 days of their transaction. In order to obtain full benefits, the replacement property must be of equal or greater value, with an equal or greater amount of debt, unless the taxpayer adjoins cash to the deal to replace the debt instead, and all of the proceeds from the relinquished property must be used to acquire the replacement property. The taxpayer must have appointed his interest in the relinquished property to a qualified intermediary prior to the close of the sale, so that the taxpayer has lost control of the funds before he has any opportunity to obtain them. At the close of the relinquished property sale, the proceeds are sent by the closing agent to the qualified intermediary, who will hold the funds until the transaction pertaining to the replacement property is ready to close. Then the proceeds from the sale of the relinquished property are deposited by the qualified intermediary to purchase the replacement property, which is then delivered to the taxpayer. A CPA must determine whether a cost segregation study will be beneficial for a replacement property acquired in a section 1031 exchange with the carryover tax basis. Second, CPAs must consider depreciation recapture resulting from the cost segregation study if the property is later disposed of in a section 1031 exchange. The taxpayer receives a carryover tax basis for the replacement property in a 1031 exchange, rather than a fair-market-value tax basis. It is entirely feasible for taxpayers to benefit from a cost segregation study on the replacement property. The idea behind 1031 Exchanges is that the taxpayer is only exchanging one property for another property of "like-kind"; there is nothing received by the taxpayer that can be used to pay taxes with. All of the capital gain is still locked up in real estate and so no gain or loss can be claimed.