FEDERATION of EXCHANGE ACCOMMODATORS
The Voice of the 1031 Industry

1255 SW Prairie Trail Parkway
Ankeny, IA 50023
Phone: (515) 244-6515
Fax: (515) 334-1174
www.1031.org

Understanding the Impact of Depreciation on Like-Kind Exchanges

Like-kind exchanges under IRC §1031 support investment in commercial and residential real estate and encourage preservation of family-owned farms, ranches, and forestland. Like-kind exchanges provide deferral, not elimination, of tax. By preserving cash flow, section 1031 encourages taxpayers to divest properties that are under-utilized, inefficient, or that simply do not meet current needs, with replacement properties that will permit businesses to grow and thrive.

Depreciation and Timing Benefits

When a depreciable asset is exchanged under IRC §1031, the gain from investment profit (capital gain) and the gain from depreciation taken (depreciation recapture) is not recognized, but rather is rolled into the like-kind replacement property. When the replacement property is later sold, tax is paid on the total gain (capital gain plus depreciation recapture) on the investment.

Depreciation of the replacement property is only allowable for any remaining tax basis (that was carried over from the relinquished property) and for value representing additional capital investment in the new property. The total depreciation expense allowed over the life of an asset involved in an exchange is no greater than the depreciation expense of an asset not involved in an exchange.

Example: Taxpayer owned a small apartment building ("Alpha Apartments") for 12 years, which was purchased for $900,000. Taxpayer took annual depreciation deductions which reduced the tax basis to $507,273. Taxpayer sold Alpha Apartments as part of a §1031 like-kind exchange for $1,850,000. Section 1031 permitted Taxpayer to preserve capital and reinvest the full value of the relinquished property into a replacement apartment building ("Beta Apartments") purchased for $1,850,000, without cash flow having been eroded by $339,205 in taxes. However, rather than taking the full cost basis of $1,850,000, the tax basis of Beta Apartments, is reduced by the amount of unrecognized gain from Alpha Apartments, resulting in reduced depreciation deductions. Taxpayer's allowable depreciation deductions are reduced by $34,545 per year, which results in incrementally higher annual income taxes. (Full detail is on page 2.)

Essentially, §1031 provides nothing more than a cash flow timing benefit that is important to growing businesses. Section 1031 benefits the taxpayer by permitting immediate reinvestment of the entire amount of sale proceeds back into the business. Absent §1031, cash flow would be impaired because the taxpayer would need to reserve funds from the sale proceeds to pay capital gains and depreciation recapture taxes, and would have to increase borrowing, use other savings, or liquidate other assets to obtain additional funds necessary to purchase the replacement asset.

For every dollar of unrecognized gain rolled into the replacement property, there is an equal dollar of foregone (disallowed) depreciation. This foregone depreciation, equal to the unrecognized gain, results in lower annual depreciation deductions and incrementally higher annual income to the taxpayer, taxed at ordinary income tax rates. In exchange for the US Treasury deferring the benefit of a lump sum tax payment at the time of sale, this deferral allows reinvestment resulting in an increase in economic activity. **Recent research by EY (Ernst & Young)[1] has estimated that approximately $6 billion per year in additional tax revenue is generated due to forgone depreciation.**

[1] Economic Contribution of the Like-Kind Exchange Rules to the US Economy in 2021," EY, May 2021, https://1031buildsamerica.org/wp-content/uploads/EY-FEA-Economic-activity-supported-by-LKE-rules-May-2021-Final.pdf.

Section 1031 Preserves Capital for Taxpayer and Foregone Depreciation Delivers Additional Revenue to Treasury

TAXABLE SALE of ALPHA APARTMENTS **Owned for 12 years prior to sale**		**Tax**
Original Purchase Price	**$ 900,000**	
Annual depreciation deduction	$ 32,727	
Accumulated depreciation (12 years)	$ 392,727	
Adjusted basis	$ 507,273	
Sale Price after 12 years	$ 1,850,000	
Total Gain	$ 1,342,727	
Tax on SALE (if not exchanged)		
Capital gain @ 23.8%*	$ 950,000	$ 226,100
Gain due to depreciation @ 28.8%**	$ 392,727	$ 113,105
TOTAL TAX WHEN SOLD		**$ 339,205**
§1031 LIKE-KIND EXCHANGE of ALPHA APARTMENTS into BETA APARTMENTS **Held for 7 years after exchange**		
Beta Apts (Replacement Property) Purchase Price	**$ 1,850,000**	
Deferred gain from Alpha Apts (relinquished property)	$ 1,342,727	
Tax basis at purchase of Beta Apts ("carry-over" basis)	$ 507,273	
Annual depreciation deduction allowed after exchange	$ 32,727	
►Without §1031, annual depreciation would be	$ 67,273	
►Forgone annual depreciation deduction	$ 34,545	
Additional annual income tax @ 35%	**$ 12,091**	
Additional income tax paid over 7 years		**$ 84,636**
Beta Apts Sold after 7 years	**$ 2,400,000**	
Accumulated depreciation (from both Relinquished & Replacement apartment buildings)	$ 621,818	
Adjusted tax basis of Beta Apts at sale	$ 278,182	
Total gain at sale	**$ 2,121,818**	
Capital gain @ 23.8%*	$ 1,500,000	$ 357,000
Gain due to depreciation @ 28.8%**	$ 621,818	$ 179,084
TOTAL TAX WHEN SOLD		**$ 536,084**
COMBINED ADDITIONAL INCOME TAX + TAX ON SALE		**$ 620,720**

* Rate includes 20% capital gains rate plus 3.8% net investment income tax
** Rate includes 25% depreciation recapture rate plus 3.8% net investment income tax