

1031 Exchange if Selling at a Loss

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From a Declaration of Principals jointly adopted by a committee of the American Bar Association and a committee of publishers and associations.



CAN I DO A 1031 EXCHANGE IF I SELL AT A LOSS?

The answer is a simple YES! Because of the economy and cash flow concerns, some investment property owners are thinking of selling their property at a loss and not doing a 1031 exchange. It is important that as owners and investors we know the tax consequences of such a sale and the options available. In every case we need to know what the current adjusted basis is for a property. We look at selling at a loss in different ways. First, if we sell for less than what we paid, plus improvements, it seems like a loss to us. However, Uncle Sam looks at the "adjusted basis" of the property before declaring a loss.

If the "adjusted basis" is less than what the property is sold for, then we have a "total gain". Only if the adjusted "tax basis" is more than what we sell the property for does Uncle Sam consider we have a true loss. Most often the lower "adjusted basis" is the result of depreciation we have taken or could have taken. As mentioned, it is important that we know the "adjusted basis" of our property before we make any decisions. As the term implies, over time you adjust the basis in a property. When you purchase a property you have a starting basis which is figured by taking the purchase cost of the property and adding purchase expenses. As you add depreciable improvements, you adjust your basis up. If you own an improved property, you take a depreciation deduction every year, which lowers your basis. All of these adjustments, up for improvements and down for depreciation, give you your "adjusted basis". By subtracting this "adjusted basis" from the selling price we hope to receive, we have the projected "total gain". The "total gain" will be taxed at different rates. The profit will be taxed at the capital gain rate (15%) if you have owned the investment more than a year. The "recaptured depreciation" is taxed at a flat rate of 25%. The amount of taxes due from "1250 recaptured depreciation" can be significant.

Let's illustrate with a simple example. We bought a beach rental for \$500,000 years ago. We have not done any depreciable improvements, though we have had lots of trips to Home Depot for operating expenses over the years. We have taken \$100,000 in depreciation. Our adjusted basis is \$400,000. During the boom years we saw our property value rise to \$800,000 and sometime wished we had sold. Now we have an offer for \$450,000. That seems like a loss, but our adjusted basis is \$400,000. We have a gain of \$50,000. This gain comes from the depreciation taken and will be taxed at 25%. Since the property is in NC, NC wants to be paid, too, and will apply the state income tax rate to the \$50,000 gain as well.

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So while we feel that we are selling the property at a loss, Uncle Sam and Aunt NC says, "No, you owe us tax money on the 'total gain' if you sell." However, if you do a 1031 exchange, all the total gain, including the tax on recaptured depreciation, will be deferred.

If we exchange a property with a true loss, then the loss amount is added to the basis of the replacement property. A simple example would be if we had a vacation area lot that cost us \$200,000 that we sold for \$100,000 and exchanged for a \$100,000 lot close to our home. We would have a \$100,000 loss in the eyes of the IRS and would add our loss to the new basis of our replacement property. Because of the exchange, the new lot would have a starting basis of \$200,000, even though we only paid \$100,000 for the lot.

Of course, there are/may be other factors which will impact your tax situation, such as suspended losses on the property which may offset some of your gain, so be sure to consult with your tax advisor. Knowing your adjusted basis is an important step to determine if you truly have a loss and whether a 1031 exchange would be beneficial or not.

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