



If you own U.S. real estate and live outside the United States, you may have heard about something called a 1031 like-kind exchange. It sounds like a straightforward way to avoid a large tax bill when you sell a property. But for foreign nationals, it is more complicated than it first appears.

Here is what this article covers:

- what a 1031 exchange is,
- why foreign nationals are legally permitted to use one,
- why the tax benefit may be smaller than expected,
- how your home country's tax rules can work against you, and
- why currency exchange rates add another layer of complexity.

The bottom line — a 1031 exchange may or may not work in your favor, and that depends heavily on where you pay taxes beyond the United States.

What Is a 1031 Like-Kind Exchange?

When you sell U.S. real estate at a profit, you normally owe tax on any gain. Under Internal Revenue Code Section 1031, however, you may be able to defer that tax. The way it works: you sell one property and replace it with another qualifying property. If the replacement property is of equal or greater value, the entire taxable gain on the sale can be deferred. You do not pay U.S. tax on that profit now. You pay it later, when you eventually sell the replacement property. There are specific rules that must be met to qualify. The details of those requirements are beyond the scope of this article, but a qualified tax advisor can walk you through them.

Can Foreign Nationals Use a 1031 Exchange?

Yes. Nothing in the U.S. tax code bars a foreign national from using a 1031 exchange simply because they are taxed as a nonresident in the United States. As long as they meet the same requirements that apply to any taxpayer, the deferral is available to them.

For U.S. tax residents, this is often a straightforward benefit. They generally report the sale only in the United States. Deferring the tax means deferring it in the only country that taxes the transaction. That can be a significant financial advantage.

For foreign nationals, the picture is different.

Why the Benefit May Be Limited for Nonresidents

Many countries tax their residents on income earned anywhere in the world under a worldwide income system. If your home country uses this approach, selling U.S. real estate may trigger a tax obligation, even if the United States has deferred the assessment of tax.



The reason a 1031 exchange can create a problem instead of solving one for foreign nationals is because when you use a 1031 exchange, you defer U.S. tax on the gain. But your home country likely will not recognize or match that deferral. Your home country may tax the full gain in the year you sold the original property. You defer U.S. tax, but you still pay home country tax right away with no corresponding credit for U.S. tax paid. This is how tax treaties and foreign tax credit rules generally work to avoid double taxation.

Later, when you sell the replacement property and U.S. tax needs to be paid on the original gain plus any gain on the replacement property itself. But by that point, your home country may have already taxed the original gain years earlier. You could face tax in both countries on overlapping amounts, with limited ability to take credit for one against the other.

The Tax Credit Problem, Explained Simply

Think of it this way. Without a 1031 exchange: you sell, you pay U.S. tax, you use that as a credit in your home country, and your total tax is managed across two systems, basically all in the same tax year.

With a 1031 exchange: you sell, you pay zero U.S. tax that year, your home country taxes the full gain with no credit available, and then years later when the replacement property in the 1031 exchange is sold the U.S. collects its deferred tax. Your home country would only be taxing the sale of the replacement property. Remember, the profit on the sale of the original property was already taxed in the year it was sold.

U.S. income tax rates are often lower than tax rates in other countries. Because of that, deferring U.S. tax may not save you as much as you might expect. In some cases, the combination of home country tax (paid now) and deferred U.S. tax (paid later) could exceed what you would have paid if you had simply paid U.S. tax at the time of sale and taken the credit to avoid double taxation.

Currency Exchange Rates Add Another Layer

There is one more factor that foreign nationals must consider. When your home country calculates your taxable gain, it will likely do so in its own currency not in U.S. dollars. The exchange rate between the U.S. dollar and your home currency will almost certainly be different on the date you sell the property than it was on the date you bought it.

That difference can be significant. The gain your home country sees — measured in its own currency — could be meaningfully larger or smaller than the gain reported in the United States. This is not a matter of anyone making an error. It is simply how currency translation works. But it means the numbers that matter to the U.S. tax system and the numbers that matter to your home country may tell two very different stories about the same transaction.



Key Takeaways

- A 1031 like-kind exchange lets a U.S. seller of real estate defer but not eliminate tax on a gain, by replacing the sold property with a qualifying property of equal or greater value.
- Foreign nationals are not disqualified from using a 1031 exchange simply because they are nonresident taxpayers in the United States.
- Many countries tax their residents on worldwide income. A 1031 exchange may defer U.S. tax but will likely not defer home country tax on the same sale.
- When no U.S. tax is paid in the year of sale, there may be no U.S. tax credit available to reduce the home country tax bill — which could increase the total tax paid.
- When the U.S. deferred tax eventually comes due, the home country may have already taxed the same gain. This can result in a higher combined tax burden than simply paying U.S. tax at the time of sale.
- Currency exchange rate differences between the time of purchase and the time of sale can create meaningful discrepancies between what the U.S. reports as a gain and what the home country reports as a gain.

Conclusion

A 1031 like-kind exchange is a legitimate and potentially valuable tool. For U.S. tax residents, it can provide a real and straightforward benefit. For foreign nationals, it requires careful analysis that goes well beyond the U.S. tax rules alone.

Before deciding whether to pursue a 1031 exchange, a foreign national selling U.S. real estate should work with a tax advisor who understands both U.S. tax law and the tax rules of their home country. The question is not simply whether the exchange qualifies under U.S. law. The question is whether, taking everything into account, the exchange actually reduces your total tax burden or increases it.

Author's Note

This article is for informational purposes only and does not constitute legal or tax advice.

Cross border transactions present unique complexities and involve a different fact pattern. Each is unique. Small changes in a fact pattern can have very different tax results. Your intended goals, property values, ownership structures, gain calculations, timing, risk tolerance, and other items all affect the strategy that is right for you.

Consulting with tax professionals who regularly handle property transactions the involve nonresidents (individual or entity) helps ensure you understand your specific obligations and in exploring available options so you maximize your profits and minimize tax and compliance costs.

I am happy to advise you on the options available in your unique situation.



About the author

David A Cumberland, CPA CGMA has presented at the local, state, and national level as well as authored articles intended for both the taxpayer and tax professional. He is vice chair for the FICPA International tax committee and founder of Cumberland CPA & Co. which serves clients worldwide. He has published in the FICPA's Florida CPA Today magazine and produces client-based tax articles in English and Spanish to educate both current and prospective clients. He primarily practices in the area of inbound international tax work covering both individual and business tax preparation and consulting. Fluent in Spanish, his emphasis is working with international clients or clients with international considerations. David brings unique value and perspective to advising clients as a CPA as he has more than two decades of operational management experience in business. Having retired as lead shareholder of the International Tax Team of one of the largest independent certified public accounting firms in Southwest Florida, his focus now is continuing to serve clients he is passionate about in a boutique setting.

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