The 1031 Exchange Deferred Your Gain. Cost Segregation Accelerates Your Deductions. Most Investors Never Stack Both.

By Timothy C. Franklin · August 13, 2026 · 7 min read

An investor calls. They just closed a 1031 exchange. Sold a building they had owned for twelve years. Deferred $600,000 in capital gains. They are excited, and they should be.

Then someone mentions cost segregation on the replacement property. The response is immediate.

"I already did a 1031. That took care of my taxes."

We hear a version of that every week. And every time, it costs the person saying it real money. Not because the 1031 was wrong. Because what they believe about it is.

What the 1031 Actually Does

A 1031 exchange allows you to defer capital gains tax when you sell one investment property and reinvest the proceeds into another. The gain does not disappear. It defers. The tax obligation rolls forward into the replacement property, to be settled when that property is eventually sold without another exchange.

That is a powerful tool. It preserves capital that would otherwise go to the IRS. It lets you trade up in value without writing a large check in the year of the sale.

But here is the precise boundary of what the 1031 does. It handles the property you sold. The relinquished property. The one that is gone.

The replacement property — the one you just bought — is a new asset. It has its own basis. Its own depreciation schedule. Its own tax strategy. And the 1031 touches none of that.

What Cost Segregation Actually Does

A cost segregation study is an engineering-based analysis of the property you own right now. It identifies components of the building that qualify for shorter depreciation schedules: 5-year, 7-year, and 15-year property, rather than the standard 39-year schedule for commercial real estate.

On a $3 million commercial building, a study typically identifies 20 to 40 percent of the building's value in components that can be accelerated. Under the One Big Beautiful Bill Act's restored 100% bonus depreciation, those reclassified components may be deducted entirely in year one.

Cost segregation operates on the property you are currently holding. The replacement property. The one the 1031 delivered you into.

The 1031 handled the exit. Cost segregation handles the entry. They are not competing strategies. They operate at different moments, on different properties, using different sections of the tax code.

> *The 1031 handled the exit. Cost segregation handles the entry. Most investors only do one.*

Two Strategies. Two Different Properties. No Conflict.

Most investors who say 'I did a 1031, so I don't qualify' are imagining a conflict that does not exist. They believe the 1031 used up some depreciation allowance. Or that accelerated depreciation on the new property will undo what the 1031 accomplished. Neither is true.

The 1031 exchange applies to the property you sold. Defers capital gains and depreciation recapture on the relinquished property. Governed by IRC Section 1031. The transaction is complete the day you close on the replacement property.

Cost segregation applies to the property you bought. Accelerates depreciation on the replacement property you now own. Governed by IRC Section 168 and Section 179. Can be ordered any time you own the property.

These strategies are not in the same lane. They do not interfere with each other. An investor who does both is not double-dipping. They are using two separate provisions of the tax code at two separate moments in the same transaction.

What Your Basis Looks Like After an Exchange

When you complete a 1031 exchange, the IRS does not give you a fresh basis at the purchase price of the replacement property. It assigns two separate pieces of basis to that new asset. Each piece has its own depreciation rules. Each responds differently to a cost segregation study. Understanding the difference is what determines how much of the acceleration you actually get.

The Carryover Basis

The carryover basis is the adjusted basis from the relinquished property, transferred into the replacement. Adjusted basis is not what you sold the property for. It is not the fair market value. It is what you originally paid, minus the depreciation you claimed during the hold period.

Example: You bought a building for $500,000. Over the years you claimed $100,000 in depreciation. Your adjusted basis at the time of the exchange is $400,000. The property appreciated and you sell it for $900,000. The $400,000 adjusted basis carries into the replacement property. Not the $900,000 sale price.

By default, the carryover basis continues depreciating on the same schedule as the old property. Same method. Same class life. Whatever years remained on the old asset's depreciation clock, those years continue on that same clock. The clock does not reset.

There is an election that changes this. Under Treasury Regulation 1.168(i)-6, you can treat the carryover basis as if the replacement property were newly acquired. That election restarts depreciation on the carryover portion using the replacement property's class life and method. When a cost segregation study is then performed, components of the carryover basis can be reclassified into shorter-lived property and may qualify for bonus depreciation. Without the election, cost segregation on the carryover portion is limited to whatever remained on the old schedule. The election is what unlocks the acceleration.

The Excess Basis

The excess basis is the new capital you invested in the replacement property above the equity you brought from the exchange. In the example above, you exchanged $900,000 in proceeds into a $1.5 million replacement property. You put in $600,000 in new cash. That $600,000 is your excess basis. It has no prior depreciation history. It is fresh capital in a new asset.

The excess basis is straightforward. Any components reclassified by a cost segregation study into 5-year, 7-year, or 15-year property qualify for bonus depreciation at current rates. Under the One Big Beautiful Bill Act's restored 100% rate, those short-life components of the excess basis can be fully deducted in year one. No election required.

How the two pieces add up: $400,000 carryover basis plus $600,000 excess basis equals $1,000,000 in total depreciable basis. The replacement property cost $1.5 million. The $500,000 difference is the deferred gain the 1031 protected. That is the trade: $500,000 in fresh basis given up to keep that gain off your return for now. In most cases, still the right call.

A properly structured cost segregation study accounts for both pieces separately. The excess basis components go toward immediate deductions. The carryover basis components go toward accelerated depreciation when the 1.168(i)-6 election is in place. Most investors understand that they have basis to depreciate. Most do not know that the two pieces have different rules, and that the election is what determines how much of the acceleration they actually get.

The 1031 did not eliminate your depreciable basis. It restructured it. There is still real property value to depreciate, and a cost segregation study determines how fast you can take it.

The Real Play: Chain Them Together

The investors who build real wealth over time are not using one of these strategies. They are using both, repeatedly, in sequence.

You acquire a property. You order a cost segregation study. You accelerate the depreciation, generate a meaningful deduction in year one, and put that tax savings back to work. You hold the property. You depreciate it on the accelerated schedule.

Eventually you sell. You execute a 1031 exchange. The gain defers. The proceeds roll into a larger replacement property.

You order a cost segregation study on the replacement property.

The cycle starts again. Each exchange preserves capital that compounds into the next property. Each study generates deductions on the new asset that fund the next move. The two strategies are not parallel. They are sequential. Each one sets up the next.

THE COMPOUNDING EFFECT

A 1031 exchange on a property that has never had a cost segregation study is a missed opportunity. The exchange deferred the gain. But the property that was sold was likely under-depreciated for years. Those deductions cannot be recovered. They simply did not happen. The investor who does cost segregation first, then exchanges, gets both benefits on every cycle.

You Can Still Go Back

One of the most common situations we encounter is an investor who completed a 1031 exchange one, two, or three years ago and never ordered a cost segregation study on the replacement property. They assumed it was too late. Or that the 1031 had already handled it.

It is not too late.

The IRS allows a cost segregation study to be performed retroactively using a change in accounting method, filed on Form 3115. If you acquired the replacement property within the last three years, you can order a study today and capture all the accelerated depreciation you would have taken from the beginning. The catch-up deduction applies in the year the Form 3115 is filed.

Three years of missed depreciation on a $2 million property can be substantial. The timing window is real. It closes.

What to Do Now

If you have completed a 1031 exchange in the last three years and no one has walked you through a cost segregation analysis on the replacement property, that conversation needs to happen.

Not because something is wrong with your tax return. Because something is missing from it.

The 1031 was the right move. Now the question is what you do with the property you just acquired. How fast can you depreciate it. How much of that basis can be accelerated. What the deduction looks like in year one versus year ten.

Those are questions a cost segregation study answers. The analysis is specific to your property and your basis. The numbers are either there or they are not. We will tell you which, before any study begins.

The 1031 handled the exit. The study handles the entry. Both need to happen. Most investors only do one.

IRS OFFICIAL REFERENCE

IRS Publication 946: How to Depreciate Property (IRS.gov)

Official IRS guidance on depreciation methods, bonus depreciation, and property classification under MACRS.

See What Your Replacement Property Qualifies For.

Run a free cost segregation estimate in 60 seconds. Enter your property details and get your estimated first-year deduction — no contact info required to see the numbers.

triplestarstrategy.com/free-analysis