Understanding 1031 Exchanges

A 1031 exchange, or like-kind exchange (LKE), allows you to defer various forms of taxes—including capital gains, depreciation recapture, and state tax in most states. You can be eligible for a 1031 Exchange when you sell real estate that meets these requirements.

Like-Kind Requirement

Generally, all real estate is like-kind to other types or kinds of real estate. For example, an apartment building could be exchanged for a retail center.

Use of a Qualified Intermediary

An unrelated third party or Qualified Intermediary (QI) may be used to facilitate the 1031 exchange transaction. A taxpayer cannot utilize their realtor, lawyer, accountant or a related party, or agent as a QI. Additionally, several states require that QIs be compliant with regulatory requirements regarding insurance, bonding, and the manner in which exchange funds are held, state licensing, etc.

Time Limits & Indentification Requirement

A taxpayer is required to acquire or identify the target replacement property within 45 days after the transfer of the relinquished property. A written document that recognizably identifies the replacement property must be signed by the taxpayer and received by the Qualified Intermediary on or before the 45th day. Properties acquired within the 45-day designation period are deemed to be identified.

A taxpayer has 180 days (or the due date for filing of taxes for the year the property was sold) to acquire the replacement property. For example, if the relinquished property is sold in December, the due date for the filing the tax return for that year would be less than 180 days. In such case, it would be necessary for the taxpayer to file for a tax-filing extension in order to utilize the full 180 days.

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Exchange Requirement

It is not enough for properties to be sold and purchased within the timelines. An actual exchange must take place in which one property is exchanged for another of like-kind. Use of a Qualified Intermediary can ensure the sale and purchase become an exchange. More than one property may be sold or acquired through a 1031 exchange.

Holding Period Requirement

There is no holding period that is specifically defined in Section 1031 or the regulations. It is largely a matter of the taxpayer's intent when the property was acquired. For example, the intent can generally be determined by such factors as actual rental, proof of attempted rental, etc. However, if a replacement property is acquired then immediately sold or fixed up and sold, that might indicate the property was acquired for resale and is therefore dealer property or inventory and cannot qualify for an exchange under Section 1031.

Qualified Use Requirement

Assets to be exchanged must have been held for productive use in a trade or business or held for investment.

No constructive or actual receipt of exchange funds

It is a violation if the taxpayer (or an agent for the taxpayer) receives exchange funds or the taxpayer is directly or indirectly able to control the exchange funds during the exchange period. Use of a Qualified Intermediary can prevent any improper receipt of funds for exchange purposes.

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