An Overview of 1031 Exchange Rules

Much has been written about the intricacies of IRC §1031 Exchanges. We have many blogs on a variety of 1031 Exchange topics, ranging from highly technical aspects to general overviews. In this blog, we will be bridging the gap between the very basic and highly nuanced aspects of 1031 Like-Kind Exchanges.

Understanding the Basics of 1031 Exchanges

Savvy real estate investors often look for strategies to minimize or defer associated taxes while continuing to build their real estate portfolios, and their wealth. One of the most powerful tools available real estate investors is the 1031 Exchange, also referred to as a "like-kind exchange." This long-standing provision of the tax code is not a loophole; it has been retained in the tax code to encourage real estate investments. It allows investors to defer associated taxes on the sale of a business or investment property, provided certain conditions are met and the proceeds are reinvested into "like-kind" property. Here, we'll explore the fundamental rules and requirements that govern 1031 Exchanges.

What is a 1031 Exchange?

A 1031 Exchange is a carefully structured transaction that allows for the deferral of capital gains (and other related) taxes when one or multiple investment property(ies) is sold and one or more "like-kind" properties is purchased within a statutorily prescribed time frame. The term "like-kind" refers to the nature or character of the property, not its quality or grade. Essentially, this means that virtually all real estate held for business or investment purposes can be exchanged for other real estate held for business or investment purposes without immediate tax consequences.

Qualifying Properties in a 1031 Exchange

To qualify for a 1031 Exchange, both the Relinquished Property(ies) (i.e. the one being sold) and the Replacement Property(ies) (the one being purchased) must be held for investment or used in a trade or business. Properties held for personal use, such as a primary residence or a vacation home not used for income generation, do not qualify. Examples of like-kind properties include:

- An apartment building can be exchanged for a commercial office space
- A piece of raw land can be exchanged for a rental home
- A retail center can be exchanged for an industrial warehouse

It is important to note that 1031 Exchanges only apply to transactions involving real property. Pursuant to the Tax Cuts and Jobs Act of 2017, non-real estate assets such as machinery, vehicles, collectibles, or artwork no longer qualify for 1031 Exchanges.

Timing Rules: The 45-Day and 180-Day Limits

Timing is critical in a 1031 Exchange. Once the Relinquished Property is sold, the Exchanger has 45 calendar days within which to identify a list of potential Replacement Properties. This identification must be in writing, signed by the Exchanger, and delivered to a Qualified Intermediary (QI) or another party involved in the exchange.

After the sale of the Relinquished Property, the Exchanger must acquire one or more of the identified Replacement Properties within 180 calendar days, or by the due date of their tax return (including extensions) for the year in which the original property was sold, whichever is earlier. These timeframes run concurrently, meaning the entire exchange must be completed within 180 days, not 45 days plus 135. Some advisors say that the deadlines are 45 days to identify plus an additional 135 days to acquire. This can be confusing, especially if the Exchanger submits their identification early. It is also important to remember that if the deadlines fall on a holiday or weekend, the dates are not extended to the next business day.

Qualified Intermediary Requirement

A 1031 Exchange cannot be done independently by the Exchanger. Instead, a Qualified Intermediary (QI), also known as an exchange accommodator, must facilitate the transaction. This is because the 1031 Exchange rules prohibit the Exchanger from having even constructive receipt of the exchange funds during the exchange. The QI holds the proceeds from the sale of the Relinquished Property and disburses them to acquire the Replacement Property on behalf of the Exchanger. If the Exchanger takes control of the sale proceeds at any point, even temporarily, the transaction is disqualified, triggering a taxable event. The QI also prepares important legal documents that convert what would otherwise be considered a sale followed by a purchase into a 1031 Exchange. These documents include the exchange agreement, assignments, and other related documents.

Like-Kind Requirement

As mentioned, the Replacement Property(ies) must be of "like-kind" to the Relinquished Property. In the context of real estate, the term is interpreted broadly. For example, an Exchanger can exchange a single-family rental home for an office building or raw land for a shopping center. However, properties located within the United States must be exchanged for other properties within the United States to qualify under current regulations. Similarly, an Exchanger whose investment property is located outside of the United States would be required to replace their property with more property located outside of the United States. What is critical is that the properties that are part of the exchange must be held for use in a trade or business or for investment. So, a physician can own the building where their medical practice is located, a mechanic can own the garage where they service cars, and a landscaper can own the lot where they park their equipment.

Identification Rules

As mentioned previously, the Exchanger must identify their potential Replacement Property(ies) within 45 days after the sale of their Relinquished Property. But there are limits on how many properties the Exchanger may identify. The Exchanger must be able to satisfy any one of the following three rules:

- **Three Property Rule:** The Exchanger may identify up to three properties, without regard to the value of those properties. The Exchanger can specify that they wish to acquire one, two, or all three properties. -OR-
- **200% Rule:** If, for any reason, the Exchanger cannot satisfy the first rule, this rule requires says that the investor may identify more than three properties, provided that the total value of all identified properties (calculated as of the date of identification) must not exceed 200% of the value of the Relinquished Property(ies) that are part of the exchange. For example, if the Exchanger sold one property for $500,000, and they are identifying four or more properties, the total value of all identified properties must not be more than $1M. -OR-
- **95% Rule:** If the Exchanger has violated the first two rules, by identifying more than three properties, the total value of which exceeds double the value of what they sold, they must acquire 95% of the identified value (calculated as of the date of identification). To illustrate, if the Exchanger sold one property for $100,000, then identified seven properties whose value totals $1M, they must acquire at least $950,000 worth of those properties.

Exchanging Equal or Up in Value

To fully defer the capital gains and other related taxes, they must acquire Replacement Property(ies) of equal or greater value than the Relinquished Property(ies). Additionally, the Exchanger must reinvest all the net proceeds from the sale into the new property. Any cash or debt relief received that is not reinvested – referred to as "boot" – will be subject to taxation. Some advisors state that the investor must exchange equal or up in fair market value, equal or up in equity, and equal or up in debt. However, if the Exchanger focuses on the fair market value and equity components, and exchanges equal or up in value and equity, the debt component balances automatically. For example, if the Exchanger sold a $500,000 property that had $100,000 in debt and acquires a Replacement Property for $600,000 for all cash, their exchange has successfully deferred all of the applicable taxes.

Same Taxpayer Rule

Another critical factor in the 1031 Exchange process is the fact that the Exchanger who sells the Relinquished Property must be the same as the Exchanger who acquires the Replacement Property(ies). This rule applies to entities as well, such as partnerships or corporations. If the vested title of the Relinquished Property does not match the vested title of the Replacement Property, it may disqualify the transaction from 1031 treatment. For example, if Exchanger A sells the Relinquished Property, and then attempts to acquire the Replacement Property with A's brother, that will not work. There are a couple of narrow exceptions to this rule.

- **Spouses in a Community Property State:** Spouse A can sell the Relinquished Property in their individual name and acquire the Replacement Property with their spouse on title.
- **Disregarded Entities:** Exchanger can sell the Relinquished Property in their individual name and acquire the Replacement Property through a disregarded entity such as a single-member limited liability company, Illinois Land Trust, or revocable/living trust.

Common Uses of 1031 Exchanges

1031 Exchanges are widely used among real estate investors for a variety of reasons, including:

- **Portfolio Diversification:** Exchange one large property for multiple smaller properties; exchange from one asset class into another asset class.
- **Consolidation:** Exchanging out of several smaller properties into one larger property.
- **Upgrade or Relocate:** Exchanging an underperforming asset for one with greater income potential, often in another market.
- **Estate Planning:** Restructuring the investment portfolio based on inheritance needs, so that properties can pass to heirs with a stepped-up basis as of the date of death. This often includes aspects of one or more of the previous factors as well.

1031 Exchanges offer a powerful opportunity for real estate investors to grow, reposition, consolidate, or diversify their portfolios while deferring capital gains (and other) taxes. However, the rules governing these transactions are complex and rigid, and even seemingly minor missteps can result in unexpected tax liabilities. It is essential that investors considering 1031 Exchanges work with experienced tax advisors, real estate professionals, and Qualified Intermediaries for guidance compliant with these rigid rules, to maximize the benefits of a 1031 Exchange. By understanding the basic rules and timelines, investors can use exchanges to strategically reposition assets and enhance long-term wealth creation and preservation.