1031 Exchange: What is like-kind?

Since 1921, the rules for qualifying and completing 1031 exchanges have gradually broadened and become less restrictive. Even so, there are dos and don'ts and several gray areas of which taxpayers should be aware. For the taxable gain to be deferred, specific key requirements must be satisfied.

One specific requirement is: **Properties must be “Like-Kind”: Two real estate assets of a similar nature irrespective of class or quality, that (if exchanged by the rules) can be replaced without realizing any taxable gain.**

Defining Like-Kind Requirements

There are many requirements to ensure a compliant 1031 exchange. Potential exchangers frequently pose questions on what property is considered "like-kind" to another property. Generally, any type of genuine property interest is like-kind to any other type of real property. The properties do not have to be of the same nature. For example, an exchanger could exchange a single-family home held as a rental property for a vacant parcel of land purchased as an investment. Section 1031 defines like-kind property as any property owned for investment or use in a trade or business. The relinquished property and the replacement must be of like-kind to qualify for exchange treatment.

Examples of Property that are NOT Like-Kind

In simple terms, the taxpayer must use both properties involved in exchange for trade, business, or investment purposes. So, for example, although a personal residence or a vacation home is real estate, it would not qualify for exchange treatment since it is held for personal use and not for investment. Property owned as part of a dealer's or developer's inventory also does not qualify. The rules provide that the words "like-kind" reference the nature or character of the property and not its class or quality. Under regulations, things to consider are "the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, and the duration of the interests."

Examples of Like-Kind Property

- Strip center for multi-family rental
- Vacant lot for improved property
- Improvements on property not already owned
- Oil, gas and other mineral interests
- Water rights
- Cell tower, billboard and fiber optic cable easements
- Conservation easements

The Regulations require the replacement property to be located within the United States (and some territories) and qualify as like-kind for the property sold in the United States. For example, a taxpayer cannot use proceeds from an office building in Dallas to acquire an investment property in Mexico. While a Mexican condominium investment sounds like a great retirement plan, after the extended rental period is over it's not going to pass muster with the IRS when it comes to Section 1031. Property located outside the United States is like-kind only to other property located outside of the United States.