1031 Exchange Rules: What You Need to Know

How savvy investors use 1031s to defer capital gains and build wealth
By
ROBERT W. WOOD

TABLE OF CONTENTS

In real estate, a 1031 exchange is a swap of one investment property for another that allows capital gains taxes to be deferred. The term, which gets its name from IRS code Section 1031, is bandied about by realtors, title companies, investors, and soccer moms. Some people even insist on making it into a verb, as in: "Let's 1031 that building for another."

IRS Section 1031 has many moving parts that real estate investors must understand before attempting its use. An exchange can only be made with like-kind properties and IRS rules limit use with vacation properties. There are also tax implications and time frames that may be problematic. Still, if you're considering a 1031—or are just curious—here is what you should know about the rules.

KEY TAKEAWAYS

- A 1031 exchange is a swap of properties that are held for business or investment purposes.
- The properties being exchanged must be considered like-kind in the eyes of the IRS for capital gains taxes to be deferred.
- If used correctly, there is no limit on how many times or how frequently you can do 1031 exchanges.
- The rules can apply to a former primary residence under very specific conditions.

What Is Section 1031?

Broadly stated, a 1031 exchange (also called a like-kind exchange or a Starker) is a swap of one investment property for another. Although most swaps are taxable as sales, if yours meets the requirements of 1031, you'll either have no tax or limited tax due at the time of the exchange.[1]

In effect, you can change the form of your investment without (as the IRS sees it) cashing out or recognizing a capital gain. That allows your investment to continue to grow tax-deferred. There's no limit on how many times or how frequently you can do a 1031. You can rollover the gain from one piece of investment real estate to another, to another, and another. Although you may have a profit on each swap, you avoid tax until you sell for cash many years later. Then, if it works out as planned, you'll pay only one tax, and that at a long-term capital gains rate (currently 15% or 20%, depending on income—and 0% for some lower income taxpayers).[2]

Most exchanges must merely be of "like-kind"—an enigmatic phrase that doesn't mean what you think it means. You can exchange an apartment building for raw land, or a ranch for a strip mall. The rules are surprisingly liberal. You can even exchange one business for another. But there are traps for the unwary.

The 1031 provision is for investment and business property, although the rules can apply to a former primary residence under certain conditions. There are also ways you can use 1031 for swapping vacation homes—more on that later—but this loophole is much narrower than it used to be.

In order to qualify for a 1031 exchange, both properties must be located in the U.S.

Special Rules for Depreciable Property

Special rules apply when a depreciable property is exchanged. It can trigger a profit known as depreciation recapture that is taxed as ordinary income.[3] In general, if you swap one building for another building you can avoid this recapture. But if you exchange improved land with a building for unimproved land without a building, the depreciation you've previously claimed on the building will be recaptured as ordinary income.

Such complications are why you need professional help when you're doing a 1031.

Changes to 1031 Rules

Before passage of the new Tax Cuts and Jobs Act (TCJA) in December of 2017, some exchanges of personal property—such as franchise licenses, aircraft, and equipment—qualified for a 1031 exchange. Now, only real property (or real estate) as defined in Section 1031 qualifies.[4]

It's worth noting the TCJA full expensing allowance for certain tangible personal property may help make up for this change to tax law.

The TCJA includes a transition rule that permitted a 1031 exchange of qualified personal property in 2018 if the original property was sold or the replacement property acquired by December 31, 2017.[1] The transition rule is specific to the taxpayer and did not permit a reverse 1031 exchange where the new property was purchased before the old property is sold.

Exchanges of corporate stock or partnership interests never did qualify—and still don't—but interests as a tenant in common (TIC) in real estate still do.

Delayed Exchanges and Timing Rules

Classically, an exchange involves a simple swap of one property for another between two people. But the odds of finding someone with the exact property you want who wants the exact property you have is slim. For that reason, the majority of exchanges are delayed, three-party, or Starker exchanges (named for the first tax case that allowed them).

In a delayed exchange, you need a qualified intermediary (middleman) who holds the cash after you "sell" your property and uses it to "buy" the replacement property for you. This three-party exchange is treated as a swap.

There are two key timing rules you must observe in a delayed exchange:

45-Day Rule

The first relates to the designation of a replacement property. Once the sale of your property occurs, the intermediary will receive the cash. You can't receive the cash, or it will spoil the 1031 treatment. Also, within 45 days of the sale of your property, you must designate the replacement property in writing to the intermediary, specifying the property you want to acquire.[5] The IRS says you can designate three properties so long as you eventually close on one of them. You can even designate more than three if they fall within certain valuation tests.[6]

180-Day Rule

The second timing rule in a delayed exchange relates to closing. You must close on the new property within 180 days of the sale of the old.[5]

The two time periods run concurrently, which means you start counting when the sale of your property closes. If you designate a replacement property exactly 45 days later, for example, you'll have just 135 days left to close on it.

Tax Implications: Cash and Debt

You may have cash left over after the intermediary acquires the replacement property. If so, the intermediary will pay it to you at the end of the 180 days. That cash—known as "boot"—will be taxed as partial sales proceeds from the sale of your property, generally as a capital gain.

One of the main ways people get into trouble with these transactions is failing to consider loans. You must consider mortgage loans or other debt on the property you relinquish, and any debt on the replacement property. If you don't receive cash back, but your liability goes down—that, too, will be treated as income to you, just like cash.

Suppose you had a mortgage of $1 million on the old property, but your mortgage on the new property you receive in exchange is only $900,000. You have $100,000 of gain that is also classified as "boot," and it will be taxed.

1031s for Vacation Homes

You might have heard tales of taxpayers who used the 1031 provision to swap one vacation home for another, perhaps even for a house where they want to retire and Section 1031 delayed any recognition of gain. Later, they moved into the new property, made it their primary residence, and eventually planned to use the $500,000 capital-gain exclusion. The exclusion allows you to sell your primary residence and, combined with your spouse, shield $500,000 in capital gain, so long as you've lived there for two years out of the past five.

In 2004, Congress tightened that loophole.[7] Yes, taxpayers can still turn vacation homes into rental properties and do 1031 exchanges. Example: You stop using your beach house, rent it out for six months or a year, and then exchange it for another property. If you get a tenant and conduct yourself in a businesslike way, you've probably converted the house to an investment property, which should make your 1031 exchange OK.

However, if you merely offer it for rent but never actually have tenants, it's probably not allowable. The facts will be key, as will the timing. The more time that elapses after you convert the property's use to rental the better. Although there is no absolute standard, anything less than six months of bona fide rental use is probably not enough. A year would be better.

Moving into a 1031 Swap Residence

If you want to use the property you swapped for as your new second or even primary home, you can't move in right away. In 2008 the IRS set forth a **safe harbor rule**, under which it said it would not challenge whether a replacement dwelling qualified as an investment property for purposes of Section 1031. To meet that safe harbor, in each of the two 12-month periods immediately after the exchange.[8]

- **You must rent the dwelling unit to another person for a fair rental for 14 days or more.**
- **Your own personal use of the dwelling unit cannot exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.**

Moreover, after successfully swapping one vacation or investment property for another, you can't immediately convert the new property to your primary home and take advantage of the $500,000 exclusion.[9]

Before the law was changed in 2004, an investor might transfer one rental property in a 1031 exchange for another rental property, rent out the new rental property for a period, move into the property for a few years and then sell it, taking advantage of exclusion of gain from the sale of a principal residence. Now, if you acquire property in a 1031 exchange and later attempt to sell that property as your principal residence, the exclusion will not apply during the five-year period beginning with the date the property was acquired in the 1031 like-kind exchange. In other words, you'll have to wait a lot longer to use the primary-residence capital-gains tax break.

The Bottom Line

A 1031 exchange can be used by savvy real estate investors as a tax-deferred strategy to build wealth. The many, complex moving parts not only require understanding the rules, but also enlisting professional help—even for seasoned investors.

ARTICLE SOURCES

Investopedia requires writers to use primary sources to support their work. These include white papers, government data, original reporting, and interviews with industry experts. We also reference original research from other reputable publishers where appropriate.

1. **Internal Revenue Service. "Like-Kind Exchanges - Real Estate Tax Tips." Accessed Mar. 12, 2021**
2. **Internal Revenue Service. "Topic No. 409 Capital Gains and Losses." Accessed Mar. 12, 2021.**
3. **Internal Revenue Service. "Instructions for Form 4797." Accessed Mar. 11, 2021.**
4. **Internal Revenue Service. "The Treasury Department and IRS Issue Final Regulations Regarding Like-Kind Exchanges of Real Property." Accessed Mar. 12, 2021.**
5. **Internal Revenue Service. "Instructions for Form 8824 (2020)." Accessed Mar. 12, 2021.**
6. **Internal Revenue Service. "1.1031(K)–1 Treatment of Deferred Exchanges." Page 103. Accessed Mar. 12, 2021. 2021.**
7. **US Congress. "Public Law 108-357, Section 840." Page 181. Accessed Mar. 12, 2021.**
8. **Internal Revenue Service. "Rev. Proc. 2008-16." Page 5. Accessed Mar. 12, 2021.**
9. **Internal Revenue Service. "Rev. Proc. 2005-14." Accessed Mar. 12, 2021.**