

HOW 1031 EXCHANGES WORK

EXCHANGE BASICS



IRC Section 1031 Background

An exchange of property, like a sale, generally results in the current recognition of gain or loss. Section 1031(a) provides an exception to this general rule. Under Section 1031(a)(1), no gain or loss is on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.

The Tax Cuts and Jobs Act of 2017 modified Section 1031(a)(2) to specifically exclude the exchange of any real property held primarily for sale.

Section 1031(a)(3) was added by Section 77 of the Tax Reform Act of 1984. Section 1031(a)(3) provides that any property received by the taxpayer in a deferred exchange is treated as property which is not like-kind property if (A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the relinquished property in the exchange, or (B) such property is received after the earlier of (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (ii) the due date (including extensions) of the taxpayer's tax return for the taxable year in which the transfer of the relinquished property occurs.

Business Use vs. Held for Investment

Section 1031 does not define either the term "productive use in a trade or business" or "for investment". The Treasury Regulations provide that otherwise unproductive property held by a "non-dealer" for future trade or business use or for future appreciation constitutes property held for investment. The relevant qualified use is the use of each property in the Taxpayer's hands. The use of property in the hands of the purchaser of relinquished property or the seller of replacement property is irrelevant.

Qualifying property must be used in a trade or business in which the Taxpayer is engaged. The test is applied at the time of the exchange without regard to the Taxpayer's motive prior to the exchange.

The language of Section 1031(a) states that an exchange of like-kind property will qualify provided the property received is "to be held for" productive use or investment. This reflects the continuity of ownership concept underlying nontaxable exchanges. (Reg. 1.1002-1(c)). How long the replacement property must be held by

the Taxpayer is undefined. Depending on the facts and circumstances, the Internal Revenue Service may construe subsequent dispositions taxable or nontaxable, as evidence that the property was not acquired "to be held" so that the initial exchange would be taxable.

Like-Kind Property

Like-kind refers to the nature or character of the property, not to its grade or quality. The fact that the real estate is improved or unimproved is immaterial. The non-recognition rules of Section 1031 concern the dichotomy between real property and personal property rather than real estate which has dissimilar locations, characteristics, or profit-producing uses.

Improved real estate may be exchanged for unimproved real estate, and urban real estate may be exchanged for rural real estate. A leasehold interest of at least 30 years duration (including optional renewal periods) is like-kind to a fee interest.

Reciprocal Transfer of Property

The essence of an exchange is a reciprocal transfer of properties as distinguished from a sale for cash followed by a reinvestment into replacement property. The Internal Revenue Service originally took the position that the reciprocal transfer of property must be simultaneous. Under this view, a transfer of like-kind property today for property to be received in the future would not constitute an exchange.

In *Starker v. U.S.* 1975-1 USTC 8443 (D. Oregon 1975), the Ninth Circuit Court rejected this position. The Tax Reform Act of 1984 attempted to provide more certainty in the area of delayed exchanges by implementing the 45-day Identification Period and the 180-day Exchange Period.

45-Day Identification Period

A limited number of properties must be designated as the property to be received in the exchange within 45 days from the date Taxpayer surrenders control of the relinquished property.

The requirement in Code §1031(a)(3)(A) that the exchange property be identified within 45 days after the date on which Taxpayer transfers the property relinquished in the exchange is an arbitrary cut-off date which presumably must be strictly complied with.

180-Day Exchange Period

Replacement property must actually be received within 180 days of the date Taxpayer surrenders control of the relinquished property or the date (including extensions) his tax return is due for the year in which the relinquished property is surrendered, whichever comes first.

Thus, for exchanges beginning on or after October 17 (assuming a calendar year Taxpayer and a non-leap year) the filing deadline of the income tax return due April 15 of the following year will have to be extended in order to avoid shortening the 180 day period allowed for completing the exchange.

Sample Assets that Can Be Exchanged

Any real property held for productive use in a trade or business, or held for investment, may be exchanged for like-kind real property

that will also be held for productive use in a trade or business, or held for investment.

Examples include, but are not limited to the following:

Real Estate

All real estate is like-kind to any other real estate, regardless of its grade or quality

Leaseholds

Existing leaseholds with 30 or more years to run, including extensions

Real property held primarily for sale is excluded from 1031 treatment.

Domestic property may be exchanged for other domestic property of like-kind, and foreign property may be exchanged for other foreign property of like-kind. However, domestic property may not be exchanged for foreign property, even if it is of like-kind.