

## What is a 1031 Exchange?

In the summer of 1990, the I.R.S. finally came out with the long awaited rules on Deferred Exchanges. Section 1.1031 of the Internal Revenue Code laid out in detail the procedure for turning a sale and purchase type transaction into an exchange.

These new rules allowed owners of certain types of like kind Real and Personal property to sell their property and buy other like kind property without paying the Capital Gains Tax.

The like kind provision for Real property is quite broad, and includes Land, Rental, and Business property. Any of which, can be exchanged for the other. The like kind provision for Personal property is more restrictive.

This type of property must be in productive use in a business (depreciable property), and can only be exchanged for the same type of property.

As an example a business aircraft for a business aircraft (a fixed wing airplane for a helicopter will work), or a commercial truck for a commercial truck, etc.

The rule also required that the "Exchanger" use a safe harbor to hold the proceeds while the exchange was in progress, and spelled out what those safe harbors were.

The only practical safe harbor for most "Exchangers" is a "Qualified Intermediary."

# What qualifies for a 1031 Exchange?

## **QUALIFIED PROPERTIES**

The classification of properties exchanged determines if the property qualifies for Section 1031 treatment.

### ***A. The IRS's 4 classifications of Real Estate:***

1. Property held for personal use. (Personal Property)
2. Property held primarily for sale. (Dealer Property)
3. Property held for productive use in a trade or business. (Business Property)
4. Property held for investment. (Investment Property)

The last two qualify for Section 1031 tax deferral, the first two do not. Both the property received and the property sold must be of "Like Kind". It is your use of the property that determines its classification. What the other party does with the property does not affect your tax status.

### ***B. Like-Kind Property***

1. Like-kind refers to your use of the property and not to its grade or quality.
2. "1031" property may be mixed as to type and still be like-kind. As an example, you may exchange land for a duplex, or a commercial building for a retail store, etc.
3. Property held outside the USA and its territories does not qualify for exchange with property held within the USA.

### ***C. Partnership Interests***

Your interest in a partnership cannot be traded for an interest in another partnership.

Exception: The partnership as an entity can exchange real estate it owns for other like-kind real estate.

### ***D. Transfer Between Spouses***

There are no income tax consequences in entering into financial transactions between spouses. In addition, most transfers incident to a divorce are tax free. However, transactions with a former spouse are normally subject to tax unless they qualify for nonrecognition under the provisions of Section 1031.

### ***E. Sale / Lease Back As An Exchange***

A lessee's interest in a lease with a term of 30 years or longer in real property is considered like-kind to other real property. In addition, property which is subject to a lease can be, even if the lease is for a term of 30 years or longer, the subject of a tax free exchange. However the receipt of prepaid lease payments in an exchange for a 30-year or longer lease is taxed as ordinary income and will not qualify for tax-free exchange treatment.

#### ***F. Business Assets***

The personal property assets of one business can be exchanged for like-kind assets of another business and will be held as a like-kind exchange under Section 1031. The real property is treated the same as any other exchange. The like-kind requirements for personal property are much more stringent than for real property (e.g., a truck cannot be exchanged for a car, nor can a barge be exchanged for a cargo ship).

#### ***G. Vacation Homes & Properties***

This type of property does not qualify if it is used solely for personal use.

It may qualify if rented, and must pass a use test each year.

Robert E. Latshaw, Jr., *CCIM*  
*Certified Commercial Investment Member*  
*Of the National Association of Realtors*

502 Baltimore Avenue, Suite 200, Baltimore, Maryland 21204-4502  
Direct Dial 410-296-3400, Fax 410-296-3400  
E-mail [reljr@latshaw.net](mailto:reljr@latshaw.net)