CALIFORNIA ASSOCIATION OF REALTORS®

QUICK GUIDE

Internal Revenue Code § 1031: Tax-Deferred Exchanges

What is a "1031 exchange?"
IRS Code § 1031 allows real property to be exchanged for other real property without the immediate payment of capital gains tax. In a 1031 exchange, the seller of appreciated property may "exchange" appreciated property for other real property "of like kind" to avoid paying taxes on the gain. Taxes on the increased value of the transferred ("downleg") property will be deferred up to the value of the received ("upleg") property.

What if the upleg property is purchased for less than sales price of the downleg property?
If the upleg property is purchased for less than the sales price of the downleg property, the difference in values will be immediately taxable as "boot."

What types of property are eligible for a 1031 exchange?
Section 1031 applies to the exchange of real property for any other real property. However, it does not apply to properties held for personal use. Nor does it apply to properties that are intended to be sold. Rather, both the upleg and the downleg properties in a 1031 exchange must be held for use in a trade or business, as an investment, or for production of income. If either property is used as a personal residence of the exchangor, an exchange will not be eligible for tax deferral.

After an exchange is completed, how long is it necessary to wait to convert the property to personal use?
First off, if that was the intention all along, then the property might not qualify as a 1031 exchange. However, after an exchange is completed, an exchangor may eventually convert the upleg property to personal use. It is not clear how long the upleg property must be used for business, trade, or investment purposes before conversion in order to avoid problems with tax authorities, but most tax professionals recommend a period of at least two years.

Do the purchase and sale of properties involved in a 1031 exchange have to be simultaneous?
No. A taxpayer may acquire an upleg property after disposing of a downleg property so long as:

- An upleg property is identified within 45 days of the sale of the downleg property and;
- The purchase of the upleg property closes no later than 180 calendar days after the downleg property is transferred, OR the due date (determined with regard to extension) of the tax return for the year in which the downleg was transferred away.

A taxpayer may also receive tax deferral through a "reverse exchange" in which the upleg property is purchased prior to the sale of the downleg property.

How should a Section 1031 exchange be structured?
There are numerous ways to structure an exchange, and the best method will depend on the specific circumstances at hand. An exchange should be facilitated by a person or entity with expertise in the area, known as an "exchange accommodator" or "qualified intermediary." The exchange accommodator must be an "unrelated party" with no existing relationship to the exchangor.