WHAT IS 1031 EXCHANGE?

HORSHAM Luxury KELLERWILLIAMS REAL ESTATE

LETSGETMOVING WITHAMY

INTRODUCTION

At LetsGetMovingWithAmy, we believe that knowledge empowers smart real estate decisions. Buying or selling an investment property isn't just about timing the market—it's about understanding the strategies that help you protect and grow your wealth.

One of the most powerful, yet often overlooked, tools for doing that is the 1031 Exchange.

We created this guide to help you understand how a 1031 Exchange works, why it's important, and how it can benefit you as a homeowner or investor. Whether you're upgrading your portfolio, diversifying your assets, or planning your next move, knowing how to defer taxes and keep more of your equity working for you can make a huge difference in your long-term success.

Our goal is to make real estate simple, transparent, and rewarding—so you can move confidently toward your next opportunity.

WHAT EXACTLY IS A 1031 EXCHANGE?

At its core: When you sell property held for business or investment purposes, under Section 1031 you can defer recognizing (and paying tax on) the gain from that sale if you reinvest the proceeds into another eligible property of "like kind."

In other words, instead of paying capital gains tax right away, you roll the gain into the next property and postpone the tax until you eventually sell without doing another exchange (or convert it into cash).

Why use a 1031 exchange?

Here are the main reasons real-estate investors and business owners use them:

- Tax-deferral: You preserve more of your sale proceeds to reinvest, instead of paying tax immediately.
- Portfolio building / upgrading: You can trade up (or sideways) into different properties—perhaps higher quality, higher value, more advantageous location—while deferring tax.
- Wealth-accumulation strategy: Since taxes are deferred, your capital remains working for you. Over time this can enhance returns.
- Estate planning benefits: In many cases, if the property is held until death, heirs receive a "stepped-up basis," which can eliminate the deferred gain.

WHAT KINDS OF PROPERTY QUALIFY (AND WHAT DON'T)?

Qualifying property

To use a 1031 exchange, both the property you're selling (the "relinquished property") and the property you're acquiring (the "replacement property") must meet certain criteria. Among them:

- They must be held for investment or for productive use in a trade or business, not for personal use. They must be "like-kind" to each other—that is, of the same nature, character or class. The term is fairly broad when it comes to real estate.
- Both properties must be located in the United States (in general)—real property outside the U.S. does not qualify as "like-kind" with U.S. real property.

Properties that do not qualify

- Your primary residence (used mainly for personal use) ordinarily doesn't qualify, unless it's converted into qualifying investment property and meets the holding-requirements.
- Property held primarily for sale (inventory, flip properties) is excluded.
- After changes in tax law in 2018 (via the Tax Cuts and Jobs Act), only real property qualifies for Section 1031 treatment — personal property (such as equipment, vehicles, art) generally no longer qualifies.
- You cannot treat property located in the U.S. as like-kind to property located abroad.

THE PROCESS

How does a 1031 exchange actually work?

Here's a step-by-step overview of a typical (deferred) 1031 exchange:

1. Decide to sell your investment or business property (the relinquished property).
2. Engage a "qualified intermediary" (QI) before you close the sale. The QI will hold the sale proceeds (so you don't receive them directly) and will facilitate the acquisition of the replacement property.
3. Sell the relinquished property. The proceeds are sent to the QI.
4. Identify your replacement property (or properties) within the required identification period (see section 5 below).
5. Close on the purchase of the replacement property within the allowed timeframe (see section 5). The QI transfers the funds and you acquire the new property.
6. Report the exchange on your tax return using IRS Form 8824.

Key reminders:

- You must reinvest all of the equity (or as much as feasible) to maximize deferral of the gain. If you don't reinvest everything, the portion not reinvested may trigger a tax event ("boot").
- The replacement property should be of equal or greater value (and you should assume equal or greater debt) if you want full deferral. Otherwise you may owe tax on the difference.
- Timing is critical — missing deadlines can disqualify the exchange and cause immediate tax consequences.

IMPORTANT DEADLINES & RULES

Here are some of the most critical rules and timelines to remember:

- 45-day identification period: You have 45 calendar days from the date you transfer the relinquished property to identify in writing the replacement property (or properties) you intend to acquire.
- 180-day exchange period: You must complete the acquisition of the replacement property within 180 calendar days of the transfer of the relinquished property — or by the due date of your tax return (with extensions) for the year in which the relinquished property was transferred, whichever comes first.
- The identification and acquisition periods run concurrently. That means if you use all 45 days to identify, you may have less than 135 days remaining to close.
- Qualified intermediary requirement: You cannot receive the proceeds of the sale directly (otherwise you are treated as having constructively received the funds, which may disqualify the exchange). Using a QI is standard practice.
- "Like-kind" rules: While the "like-kind" standard is broad for real estate, remember that properties must be held for investment/trade/business and must not be disqualified property.
- Related-party rule: If you exchange property with a related party, there are special rules and holding-period requirements (generally the related party must hold the property for at least two years) to avoid disqualification.

TYPES OF 1031 EXCHANGES

There are a few different structures you might encounter:

- Deferred (or "traditional") exchange: You sell first, then identify and purchase your replacement property within the deadlines described above. This is the most common type.
- Simultaneous exchange: The sale of relinquished property and purchase of replacement property happen at the same time. Less common because of logistical complexity.
- Reverse exchange: You acquire the replacement property first, hold it temporarily (often via an accommodation titleholder), and then sell the relinquished property afterward. The same 45- and 180-day rules apply.
- Improvement (or build-to-suit) exchange: You use the proceeds to improve or build into the replacement property within the timeframe of the exchange rules.

IMPORTANT CAVEATS & BEST PRACTICES

- Plan ahead — You must engage a qualified intermediary before you close the sale of the relinquished property. If you wait until after you receive sale proceeds, the exchange may fail.
- Documentation is key — the identification of the replacement property, the contract terms, the QI agreement, the closing records — all must clearly reflect the exchange.
- Work with professionals — Real-estate attorney, tax advisor, exchange intermediary — these roles are essential to avoid costly missteps.
- Avoid mixing personal-use and investment use — If friendly property (vacation homes, second homes) start to have personal use, the IRS may challenge qualification.
- Stay aware of the debt/leverage side — If your replacement property has less debt than the property you sold, the difference may trigger tax (as boot).
- State and local tax issues — Some states treat exchanges differently, or have other rules. Make sure you analyze state-level taxation.
- Holding period consideration — While there's no fixed IRS minimum "hold time" for the replacement property in federal law, the pattern of use (investment/business) matters; converting too soon to personal use may create risk.
- Exit strategy matters — Since you're only deferring tax, consider how and when you plan to eventually sell or otherwise exit the investment.

SUMMARY

A 1031 exchange is a smart, strategic tool for real-estate investors and business property owners to defer capital gains tax and preserve investment capital as you move from one property to another. It’s not a free “tax-escape” — it has strict rules around property eligibility, timelines, and procedures — but when done correctly, it can significantly enhance your ability to grow your portfolio and keep more capital working for you.

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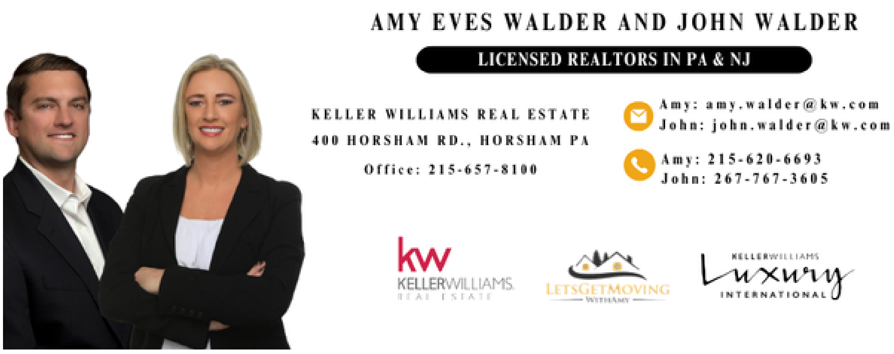

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