NExT 1031

What qualifies as "like-kind" property?

Under IRC §1031, any real or personal property can be exchanged, provided it is held "for productive use in a trade or business" or "for investment" and is exchanged for property of "like-kind" that will also be held for one of these same purposes.

1. Qualified Use Requirement

Both the Relinquished and the Replacement Properties must be by the taxpayer either for investment purposes or for the productive use in a trade or business. The critical issue is that a taxpayer must have had the intent to hold the properties for business or investment purposes and not have held them for resale (i.e. inventory in your business).

a. Intent to Hold - Many investors and their advisors get hung up on the length of time that taxpayers have (or have not) held title to their property when trying to decide whether it would be considered qualified use property and therefore qualify for 1031 exchange treatment. The amount of time is not the real issue here. The taxpayer's intent to hold the properties for investment purposes is what really matters. Since proving intent is subjective, a taxpayer should be prepared to prove that they had the intent to hold their relinquished properties and their like-kind replacement properties for investment or use in their trade or business. One of the best ways to demonstrate intent to hold is to do just that — hold the properties sufficiently long enough so that it is easy to prove a taxpayer had the intent to hold for investment.

b. Properties Held For Investment - Properties held for investment purposes can be any property or asset that you acquire and hold for income production (rental or leasing activities) or for growth in value (capital appreciation). Properties held for investment do not need to produce income or cash flow. They merely have to be held for investment in order to qualify for 1031 exchange treatment.

c. Properties Used in Your Trade or Business – A taxpayer may acquire and use a property or asset in their trade or business and it will qualify for tax-deferred exchange treatment. For example, a taxpayer could acquire a commercial office building from which it will operate its business. Properties or assets used in your trade or business will qualify for 1031 exchange treatment.

2. Like Kind Property Requirement

There is some confusion regarding what types of property qualifies for a Section 1031 tax deferred exchange. It is not true that if you sell a condominium you must acquire a condominium. "Like-kind" does not mean "exactly the same," particularly with the exchange of real property. You can exchange out of or into any of the following asset types: single family, multi-family, commercial office, retail shopping, industrial, vacant land, oil and gas interests, mineral rights, riparian water rights, tenant-in-common investments or even a leasehold interest in real estate of 30 years or more. A single-family rental unit, for example, may be exchanged for other real property office building. In addition, all real properties in the United States is considered “like-kind” to all other domestic real property even if that property is in a different state. However, property inside the United States is not "like-kind" to property located outside of the United States.

"Like-kind" definitions on personal property are more restrictive. Essentially, personal property assets must be either “like-kind” or “like-class” to qualify. Properties are “like-class” if they are included within the same General Asset Class or Product Class. For example, a taxpayer may exchange a corporate jet for a helicopter since they are classified in the same General Asset Class.

3. Properties that do not qualify for Section 1031 treatment

Under IRC §1031, the following properties do not qualify for tax-deferred exchange treatment:

- Primary residence- But a special exemption to capital gains taxation when you sell your primary residence provided by Section 121 of the tax code. Simply, a single-owner can exclude up to $250,000 in gains while married couples can combine their exemption for a total of $500,000 capital gains exclusion (when they lived in the home 3 of the last 5 years.)
- Stock in trade or other property held primarily for sale (i.e. property held by a developer, “flipper” or other dealer) - The exclusion encompasses two aspects - A) “Stock in trade,” which is property held for sale to customers in the ordinary course of the taxpayers’ trade or business resulting in gain taxed as ordinary income and; B) “Property held primarily for sale,” which is a much more expansive category of excluded property. The word primarily is viewed as being held “principally” or “of first importance.”
- Securities or other evidences of indebtedness or interest
- Stocks, bonds, or notes
- Certificates of trust or beneficial interests- These represent a right to an interest in the stock or a corporation and are not considered real property.
- Interests in a partnership
- Choses in action – A chose in action is the right to recover or receive money or other property by judicial proceeding but is not considered property itself.
- Foreign property (real or personal) for U.S. based property
- Goodwill of one business for goodwill of another business