



# 1031 Exchanges

## The Need to Know



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## Introduction

The Internal Revenue Code contains a provision called Section 1031 that allows investors to defer tax liabilities on the sale of investment properties by reinvesting the proceeds from such a sale into a “like-kind” property. This provision was created to encourage investment and economic growth while preserving an investor’s capital base. There are plenty of rules and regulations associated with Section 1031, and it is important to understand them to decide whether a 1031 exchange (a “1031”) is right for you and your investment needs. Below, we have compiled a comprehensive breakdown of the 1031 exchange process, including tax implications, tax-planning techniques, real-world applications, and state-specific laws.

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## What is a 1031 Exchange?

Generally, the sale of real estate requires investors to recognize ordinary income, capital gain, depreciation recapture, and/or Medical Surcharge income tax liabilities. A 1031 exchange permits the deferral of tax liabilities when investors sell a property and reinvest the proceeds into another qualifying property of equal or greater value.

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## Benefits of a 1031

**Deferral of Capital Gains Tax** – although not eliminated, an investor can defer taxes indefinitely by reinvesting the proceeds from the sale of real property into “like-kind” properties.

**Estate Planning** – Benjamin Franklin famously stated that the only things certain in life are death and taxes. However, Section 1031 of the IRC argues otherwise. By continuously exchanging properties under 1031 rules, investors can defer capital gains and depreciation recapture taxes indefinitely. If the final replacement property is held until death, the investor’s heirs will inherit the properties at a stepped-up basis, effectively eliminating deferred taxes on capital gains and depreciation recapture taxes.

**Wealth Accumulation** – as an investor continues to engage in 1031 transactions, he will notice a compounding effect of deferring taxes over multiple exchanges and keep more money in his pocket allowing for increased investment.

# Eligible Exchanges

Not all types of property are eligible for a 1031. The relinquished property must have been held for rental or investment purposes or used in your trade or business and can only be exchanged for other real property that will be held for rental or investment purposes or used in your trade and business. Additionally, 1031 exchanges involve the sale of a relinquished property and subsequent reinvestment into a “like-kind” replacement property, meaning both the relinquished property and the replacement property must be of the same nature or character. However, they do not need to be of the same use or quality. For example, you can relinquish a Class A multifamily property and replace it with a Class B industrial property.

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## Eligible Property Types Include:

- Single-family residential properties
- Multi-family residential properties
- Commercial office buildings
- Retail shopping centers or strip malls
- Industrial warehouses
- Vacant, undeveloped, or raw land
- Farm, ranch, or timber land
- Oil and gas interests
- Mineral rights
- Water rights
- Air rights
- Tenant-in-common (TIC) investment properties (fractional interests)
- Delaware Statutory Trust (DST) investment properties (fractional interests)

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## Acceptable “Like-Kind” Exchanges:

- Single-family rental → Multifamily apartment building
- Commercial office building → Industrial warehouse
- Vacant land → Retail shopping center
- Farms or ranches → Hotels or motels
- Oil, gas, minerals, water, or air rights → Other investment real estate
- Delaware Statutory Trust (DST) interests → Other investment properties
- Tenant-in-Common (TIC) interests → Apartment complexes, office buildings, etc.

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Although considered property, personal residences, inventory, stocks, bonds, and partnership interests do not qualify under Section 1031.

**See below for an expanded list of excluded property:**

#### Personal Use Assets

- ▶ Primary residences
- ▶ Second homes
- ▶ Vacation homes (personal use)
- ▶ See section on second homes and vacation properties

#### Property Held for Sale

- ▶ Property held for development and then subsequent sale
- ▶ Property acquired for conversion, then sale (e.g., condo conversion)
- ▶ Property acquired to fix-up or rehab and sell (flip)

#### Securities

- ▶ Cash
- ▶ Stocks
- ▶ Bonds
- ▶ Mutual funds
- ▶ Real Estate Investment Trusts (REITs) (except via an UPREIT)

#### Interests in an Entity

- ▶ Partnership interests in a general or limited partnership
- ▶ Membership interests in a limited liability company (unless it is a disregarded entity such as a single-member LLC)
- ▶ Shares of stock owned in a "C" or "S" corporation

# The Exchange Process

- 1 ..... Identify a Qualified Intermediary
- 2 ..... Sell the Relinquished Property
- 3 ..... Identify the Replacement Property
- 4 ..... Acquire the Replacement Property
- 5 ..... Ensure Compliance with IRS Guidelines to Qualify for Tax Deferral

## 1 - Identify a qualified intermediary

Qualified intermediaries (“QI”) play a critical role in 1031 transactions. They are responsible for holding the proceeds from the sale of the relinquished property and facilitating the acquisition of the replacement property without the investor taking constructive receipt of funds. **The investor cannot, under any circumstance, take receipt of funds without otherwise triggering a taxable event.**

Therefore, the necessary first step for any 1031 is to identify a qualified intermediary who will:

- Hold sale proceeds from the relinquished property
- Prepare necessary exchange documentation
- Ensure IRS Compliance with time timelines (45-day identification rule and 180-day completion rule)
- Coordinate with title companies, escrow agents, and accountants
- Disburse funds for acquisition of replacement property
- Properties held in Title Holding Trusts/Land Trusts (beneficial interests)
- Vacation rentals (see section on vacation properties)

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## 2 - Sell the relinquished property

An Investor must sell the relinquished property and transfer the proceeds to the QI.

## 3 - Identify the replacement property

Within 45 calendar days of selling the relinquished property, the investor must identify up to three replacement properties. Please note that since the timeline is 45 calendar days, if the deadline falls on a Saturday, Sunday, or legal holiday, the deadline is not extended to the next business day.

There are specific requirements for identifying the replacement property. They must be clearly identified to your QI using at least one of the following:

1. Street address
2. Legal description
3. Assessor's parcel number

The investor is only allowed to identify **up to three replacement properties** unless he uses the 200% of Fair Market Value (FMV) Identification Rule or the 95% Identification Exception.

### 200% of FMV Identification Rule

This rule allows the investor to identify more than three potential replacements if the combined FMV of the identified properties does not exceed 200% of the gross sale price of the relinquished property.

### 95% Identification Exception

This rule allows the investor to identify more than both the three-property identification rule and the 200% of FMV identification rule. Under the 95% identification rule, an investor can identify as many properties as desired so long that he acquires 95% of the FMV identified.

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## 4 - Acquire the replacement property

The exchange must be completed within 180 calendar days of the sale of the relinquished property. By the 180th calendar day following the original sale, the investor must take legal title to all replacement properties to be acquired, no later than the earlier of:

1. Midnight of the 180th calendar day following the closing of the original sale of the relinquished property.
2. The due date to file your federal income tax return for the income tax year in which the relinquished property was sold, including any extensions of time to file.

## 5 - Ensure compliance with IRS guidelines

Once the replacement property is acquired, the investor must ensure ongoing compliance with the IRS regulations to maintain the tax-deferred status of the transaction. **The investor must:**

### Ensure that the proper use of the replacement property is compliant

The investor must maintain documentation of how the property is used.

Acceptable forms of documentation include:

- ▶ Lease Agreements
- ▶ Utility and Expense Records
- ▶ Depreciation Reports
- ▶ Business Entity Ownership

### Report the exchange on IRS Form 8824

### Avoid prohibited transactions that may trigger early taxation

- ▶ Reselling the property too soon – although holding the property for less than a year will not automatically disqualify the property for a 1031, flipping the property within a year raises IRS scrutiny as it will be more difficult to prove the intention to hold the property for investment purposes.
- ▶ Taking cash or other boot – if any funds are not reinvested they will be taxed immediately (see relevant section)
- ▶ Changing property use without documentation
- ▶ Using exchange funds for personal expenses

### Ensure title and taxpayer entity consistency

- ▶ If a property was owned by an LLC or corporation, the replacement must also be under that same entity
- ▶ A single-member disregarded LLC is treated the same as the individual taxpayer
- ▶ Changes in ownership structure after the exchange could trigger a taxable event

### Consider state-specific compliance requirements

- ▶ Some states impose additional 1031 reporting requirements, i.e Clawback Rule (see relevant section)
- ▶ Form 3840 – required annually for out-of-state replacements

### Plan for estate and tax implications

- ▶ If investor holds the property until death, heirs will inherit it with a stepped-up basis effectively eliminating all deferred capital gains taxes.
- ▶ Other considerations? Potential regulation, risks?

## Types of Exchanges

There are various types of exchanges worth touching on. As discussed below, all exchanges barring the simultaneous exchange must be completed within 180 calendar days.

**Simultaneous Exchange** – the investor sells the relinquished property and acquires the replacement at the same time. It can be quite challenging to execute given the precision of timing required.

**Delayed Exchange** – this is most common type of 1031. It involves the initial sale of the relinquished property followed by the acquisition of the replacement property. A QI will hold the sale proceeds to ensure compliance with the IRS rules.

**Reverse Exchange** – the replacement property is acquired before the relinquished property is sold. Investors engaging in reverse exchanges must use an Exchange Accommodation Titleholder (EAT) to hold the property during the process.

**Construction (Improvement) Exchange** – this type of exchange allows investors to use exchange funds to improve the replacement property. The total value of the new property (including improvements) must meet or exceed the value of the relinquished property.

## Other Forms of Tax Deferral and Exclusion Strategies

In addition to the 1031 Exchange, there are other tax deferral and tax exclusion strategies involving real property.

### 1033 Exchange

Under Section 1033 of the Internal Revenue Code, real or personal property subject to involuntary conversion, either from Eminent Domain proceeding or destruction from a natural disaster, can be exchanged on a tax-deferred basis for “like-kind” real or personal property similar or related to the relinquished property.

### 121 Exclusion

This provides the ability to sell your primary residence and to exclude up to \$250,000 in capital gains (\$500,000 for married couples). The investor must have owned and lived in the property for at least 24 of the preceding 60 months.

### 453 Installment Sale (Seller Carry-Back Note)

Section 453 of the IRC allows an investor to sell real property and provide the buyer with seller financing by carrying back an installment note. The seller will be able to defer the recognition and payment of his capital gain income tax liability until he receives principal payments. However, depreciation recapture and income tax liabilities cannot be deferred under Section 453 and are due and payable in the year in which he sells the relinquished properties.

**721 Exchange (upREIT or 1031/721)**

Also known as an upREIT or 1031/721 Exchange, Section 721 of the IRC allows investors to exchange investment real estate for units in a Real Estate Investment Trust.

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## Taxable Boot in 1031 Exchanges

“Boot” refers to any form of compensation an investor receives that is not included in the “like-kind” exchange. Boot is taxable and not eligible for deferral under Section 1031. There are various types of boot to be aware of. Most common is Cash Boot. This is cash received by an investor as part of an exchange. For instance, if an investor receives \$1,000,000 in proceeds from the sale of the relinquished property, and acquires a replacement property for \$950,000, the \$50,000 of cash pocketed is considered boot and is taxable. Forms of taxable boot include:

**Cash Boot** – discussed above

- ▶ How to avoid it: ensure that the value of the replacement property matches or exceeds the value of the relinquished property.

**Debt Relief Boot** – if the replacement property is financed with debt, the new mortgage must match or exceed the mortgage of the relinquished property, otherwise the difference is considered taxable boot. Unless offset by additional cash, the new mortgage should not be less than the old mortgage.

- ▶ How to avoid it: match the financing to the required exchange value either by bringing more cash to the table or taking out a larger mortgage.

**Non-Like-Kind Property** – any personal property received as part of the exchange is considered taxable boot

- ▶ How to avoid it: only exchange real assets.

**Loan Acquisition Costs Boot** – any loan fees, points, or costs related to securing financing on the replacement property are not exchangeable under 1031 rules and is taxable.

- ▶ How to avoid it: pay loan acquisition fees out-of-pocket rather than using exchange funds

**Seller Financing Boot** – Also known as installment sale boot, if a seller carries back financing for the buyer of the relinquished property, the (promissory note) is considered

taxable boot. For example, if an investor sells a property for \$800,000 and provides \$200,000 of financing to the buyer in lieu of a full cash payment, that money is not considered “like-kind” property and is taxable boot.

- ▶ How to avoid it: structure the sale such that all proceeds flow directly through a QI and avoid taking seller-financed payments

**Prepaid Rent Boot** – occurs when an investor receives prepaid rent from tenants as part of a 1031 exchange. Rent is considered ordinary income rather than part of the real estate transaction and cannot be deferred under 1031 exchange rules.

- ▶ How to avoid it: there are a few options to avoid prepaid rent boot
  - ▶ Adjust the purchase price of the replacement property down by the same amount as the prepaid rent and let the seller keep the prepaid rent. This allows the buyer to avoid the taxable event.
  - ▶ Allocate the prepaid rent to the seller so that it remains their responsibility at closing. The buyer will be able to avoid reporting the prepaid rent as ordinary income.
  - ▶ To reduce taxable income, investors can offset the prepaid rent with deductible expenses such as management fees, maintenance, or depreciation.

**Excess Exchange Boot** – exchange funds such as attorney fees, accounting fees, or unrelated closing costs are considered non-transactional costs and are taxable

- ▶ How to avoid it: only use 1031 exchange funds for qualifying real estate transaction expenses like title fees, escrow, real estate commissions, etc.

**Earnest Money Boot** – if earnest money is paid for a replacement property before the exchange is set up, and that money is later reimbursed by exchange funds, it is considered boot.

- ▶ How to avoid it: have a QI pay the earnest money to ensure it remains within the exchange structure. Alternatively, have the seller reduce the replacement property price by the earnest money amount and do not get reimbursed for the earnest money deposit so that the total exchange value remains the same.

# Depreciation Recapture & 1031 Exchanges

To understand the tax implications of selling investment property through a 1031 exchange, it's important to first understand depreciation. Depreciation is a tax deduction that allows property owners to recover the cost of improvements made to a property over a set period of time—27.5 years for residential rental properties and 39 years for commercial properties. This reflects the natural wear and tear, aging, and obsolescence of the building over time.

Depreciation applies only to the building or improvements, not the land, which is not depreciable. Each year, investors can reduce their taxable income by deducting a portion of the property's depreciable value.

Most often, depreciation is calculated using the straight-line method, which spreads deductions evenly across the property's useful life. However, in some cases, owners may use accelerated depreciation or bonus depreciation, which front-load a greater portion of the deductions into the early years of ownership.

When the property is eventually sold, any depreciation claimed is subject to depreciation recapture tax. If the investor used accelerated or bonus depreciation and claimed more than they would have under the straight-line method, the difference is referred to as additional depreciation—and it may be taxed at a higher rate upon sale.

## Depreciation Recapture

Upon the sale of an investment property, the IRS will recapture the tax benefit that investors received over the life of the investment. The sum of the depreciation taken throughout the investment is taxed as ordinary income up to a 25% tax rate (additional depreciation does not have a tax rate cap).

In the context of a 1031 exchange, depreciation is only recaptured if the replacement property has a depreciable component of lesser value. It is crucial to understand that depreciation recapture can trigger a tax liability in a 1031 exchange even if investors replace their properties with assets of equal or greater value. Thus, to more effectively defer taxes using a 1031 exchange, investors should ensure that not only is the gross value of the replacement property of equal or greater value than the replacement, but also that the depreciable value of the replacement property is of equal or greater value than that of the relinquished property.

# State-Specific Considerations & Interstate Exchanges

Most states follow federal Section 1031 exchange rules, but some impose state-level regulations.

**Clawback Provisions** – certain states track deferred gains from a relinquished property and claim those taxes if the replacement property is later sold in a taxable transaction in another state. This means that even if an investor moves his investment to another state, the original state may still claim capital gains tax on the initial transaction.

## States with Clawback Provisions:

Oregon	Montana
California	Massachusetts

**How it Works** – some states will track the deferred capital gains tax from a 1031 and enforce tax on gains even if the investor moves or reinvests in another state. When the investor sells the replacement property in a taxable sale, the original state will enforce the capital gains tax on the deferred gain from the first exchange.

**Double Taxation Risk** – When an investor exchanges into a new state that has a state capital gains tax, they may owe capital gains in both the original and new states when the replacement property is later sold in a taxable transaction

If one engages in continuous 1031's until death, then he will avoid the clawback and double taxation risks as his heirs will inherit the properties with a stepped-up basis. However, states like the four mentioned above will track deferred gains, so if an investor eventually decides to sell an asset in a taxable transaction (regardless of the state), he will be responsible for the state-capital gains from the original sale in the original state.

It is always best to consult a tax professional and QI as they are best equipped to provide personalized strategies that minimize tax liabilities and ensure compliance with the IRS regulations, helping navigate state-specific tax laws effectively.

## States Without State Capital Gains Tax:

Alaska	Florida	Nevada
New Hampshire	South Dakota	Tennessee
Texas	Wyoming	

*Note: While these states do not tax capital gains, federal capital gains tax obligations still apply.*

# Key Timelines, Terms, Provisions, Rules, and Regulations in 1031 Exchanges

## Key Timelines

- ▶ **45-Day Identification Rule** – Investors must identify up to three potential replacement properties within 45 days of selling the relinquished property.
- ▶ **180-Day Exchange Completion Rule** – The entire 1031 exchange process must be completed within 180 days from the sale of the relinquished property.
- ▶ **Tax Filing Deadline Exception** – If the tax filing deadline arrives before the 180-day period, the exchange must be completed by the tax return due date (unless an extension is filed).

## Key Terms & Definitions

- ▶ **1031 Exchange** – A tax-deferred transaction that allows investors to reinvest proceeds from a sold investment property into a like-kind property.
- ▶ **Relinquished Property** – The original investment property that the investor sells in the exchange.
- ▶ **Replacement Property** – The new property acquired through the 1031 exchange.
- ▶ **Qualified Intermediary (QI)** – A third-party facilitator that holds the proceeds from the sale and ensures compliance with 1031 rules.
- ▶ **Like-Kind Property** – Any investment or business-use real estate, provided it is of the same nature or character, regardless of quality.
- ▶ **Boot** – Any cash, debt relief, or non-like-kind property received in an exchange that is subject to taxation.

## Provisions & Rules

- ▶ **Same Taxpayer Rule** – The same taxpayer (individual/entity) must own both the relinquished and replacement properties.
- ▶ **Equal or Greater Value Rule** – To fully defer taxes, the replacement property must be of equal or greater value, and all exchange proceeds must be reinvested.
- ▶ **Boot Taxation** – Any portion of proceeds not reinvested or used for non-qualifying expenses is taxable.
- ▶ **Three-Property Replacement Rule** – An investor can generally only identify three potential replacement properties for a 1031 exchange.
- ▶ **200% FMV Rule** – If identifying more than three replacement properties, the total value cannot exceed 200% of the relinquished property's sale price.
- ▶ **95% Identification Exception** – If identifying more than three replacement properties, the investor must acquire at least 95% of the total identified value.

## State-Specific Tax Considerations

- ▶ **Clawback Provisions** – Some states track deferred capital gains and impose tax on capital gains on the original relinquished property sale when the replacement property is sold in another state.
- ▶ **Double Taxation Risk** – If an investor exchanges into a state with capital gains tax, both the original and new states may impose tax on a future taxable sale.

## Tax Strategies & Compliance

- ▶ **Continuous 1031 Exchanges** – By repeatedly reinvesting through 1031 exchanges, investors can defer capital gains taxes indefinitely.
- ▶ **Step-Up in Basis at Death** – If the investor holds the property until death, its value is brought up to fair market value.
- ▶ **IRS Form 8824 Filing Requirement** – Investors must report all 1031 exchanges to the IRS using Form 8824 during tax filings.
- ▶ **Annual Clawback Reporting (California - Form FTB 3840)** – California requires annual reporting of out-of-state replacement properties to track deferred gains.

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