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## What Property Qualifies for a 1031 Exchange?

There are three requirements for a valid §1031 like-kind exchange. First, of course, there must be an exchange. Two parties swapping property satisfies this. However, more commonly it is satisfied through the use of a Qualified Intermediary. Second, both the relinquished property and the replacement property must be like-kind to each other. With regard to real estate, the definition of like-kind is very broad. While there are exceptions, you could almost say all real estate is like kind to all other real estate.

The third requirement tends to be more difficult to understand. Both the property given up in an exchange and the property received must be held for a qualifying use. A qualifying use can be either an “investment property” or “property held for the productive use in a trade or business”.

To constitute “investment property” a person should plan to hold the property for a considerable period of time. For example, if you purchase ten acres of vacant land on the fringe of development hoping the metropolitan area will continue to grow, this constitutes “investment property”. Your intent when you acquire the land is to hold it for a considerable period of time and let the value increase due to market appreciation not due to improvements you plan to make to the property. Examples of “property being held for the productive use in a trade or business” would be rental property or a property owned and occupied by a taxpayers business.

If property is held primarily for sale, it will not qualify for a 1031 exchange. Property held primarily for sale is inventory and any gain (profit) is taxable as ordinary income. Examples of inventory would be homes built by a builder or lots sold by a developer who bought vacant land, subdivided it, constructed roads and utilities and sold the sub lots. It would also include those properties commonly referred to as “fix and flips”. This is because the intent was to buy the property, fix it up and sell it for a higher price. The property is inventory just like a shirt sold to a consumer by a department store.

To determine if property should be considered “held for sale” courts have considered many factors. These include: why the taxpayer purchased the property; whether improvements were made to the property; the normal business of the taxpayer; and whether the taxpayer took steps which would usually indicate an intent to sell (such as advertise or list the property for sale).

If property is held for personal use, it will not qualify for a 1031 exchange. This includes primary residences and second homes. Primary residences are covered by §121 of the Internal Revenue Code (providing an exclusion of up to $500,000.00 of gain if someone has lived in the home for at least two of the last five years). Second homes are also considered personal use property and do not qualify for 1031 treatment. A property would generally be considered to be a second home if the personal use (including use by relatives) is more than 14 days per year.

WWW.1031INFINITY.COM
480-788-8456
1530 E. Williamsfield Rd., Suite 201
Gilbert, AZ 85285

Section 1031 provides an investor with a tremendous opportunity to build wealth by deferring the payment of capital gains taxes. However, it cannot be used to defer taxes owed from the sale of inventory or personal use property.

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