

Understanding Like-Kind Property and IRS Requirements for a 1031 Exchange

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A 1031 Exchange is a valuable tool for real estate investors to defer capital gains tax when investment property is sold, provided the proceeds are reinvested in replacement property.

According to the IRS, like-kind exchanges, when you exchange real property used for business or held as an investment solely for other business or investment property that is the same type or “like-kind,” have long been permitted under the Internal Revenue Code. Generally, if you make a like-kind exchange, you are not required to recognize a gain or loss under Internal Revenue Code Section 1031. If, as part of the exchange, you also receive other property or money (not like-kind), you must recognize a gain to the extent of the other property and money received. You can’t recognize a loss.

Under the Tax Cuts and Jobs Act, Section 1031 now applies only to exchanges of real property and not to exchanges of personal or intangible property. An exchange of real property held primarily for sale still does not qualify as a like-kind exchange. A transition rule in the new law provides that Section 1031 applies to a qualifying exchange of personal or intangible property if the taxpayer disposed of the exchanged property on or before December 31, 2017, or received replacement property on or before that date.

Thus, effective January 1, 2018, exchanges of machinery, equipment, vehicles, artwork, collectibles, patents, and other intellectual property and intangible business assets generally do not qualify for non-recognition of gain or loss as like-kind exchanges. However, certain exchanges of mutual ditch, reservoir, or irrigation stock are still eligible for non-recognition of gain or loss as like-kind exchanges.

Properties are of like-kind if they’re of the same nature or character, even if they differ in grade or quality. Real properties generally are of like-kind, regardless of whether they’re improved or unimproved. For example, an apartment building would generally be like-kind to another apartment building. However, real property in the United States is not like-kind to real property outside the United States.

The rules of the exchange in order to qualify for the capital gains deferral are as follows:

First, the definitions: the property that is sold in a 1031 Exchange is referred to as the “relinquished property,” and the property that is subsequently purchased is referred to as the “replacement property.” There may be one or multiple relinquished/replacement properties. Any real property can be exchanged for other real property within the same state or other state(s). Property outside of the United States, however, is not considered like-kind.

In order to avoid paying any taxes on the sale of the relinquished property, the replacement property must be of equal or greater value than the net sale price of the relinquished property. Also, if all of the proceeds from the sale of the relinquished

property are not reinvested in the replacement property, and some of the cash is taken out, this is known as “boot.” Boot is taxable up to the amount of total realized gain on the sale.

A key point to watch for is utilizing less debt to purchase the replacement property. For example, the relinquished property is sold for \$2,000,000 with debt in the amount of \$1,000,000, and the replacement property is purchased for \$2,000,000 using \$500,000 of debt. Even though the replacement property’s value is equal to (or more than) the replacement property, the \$500,000 difference in debt would be taxable. This can be offset, however, if more cash is put into the replacement property purchase.

The timing of identifying and purchasing the replacement property is very important. The possible replacement property(ies) must be identified within 45 calendar days of the sale date of the relinquished property. Up to three properties, of any value, can be identified, but only one (or two or three) must be purchased within the time frame below. Keep in mind that all of the net proceeds must be reinvested, or there will be taxable boot. More than three replacement properties can be identified, but their value cannot exceed 200% of the value of the relinquished property. Otherwise, 95% of what was identified will need to be purchased.

The replacement property must be purchased within 180 calendar days of the sale of the relinquished property. The actual rule, however, states that the closing on the replacement property must be completed on the earlier of 180 days or the next due date to file an income tax return, including extensions. So, if the relinquished property is sold between October 17 and December 31, the replacement property must be purchased on or before April 15 if the seller’s tax return is filed accordingly or an extension request is made in order for the full 180 days to complete the transaction to be allowed. The tax return and name appearing on the replacement property must be the same as those on the relinquished property. If the property is owned using a wholly-owned limited liability company, known as a single-member LLC, the LLC is treated as the taxpayer.

Below is the 1031 Exchange Process.

- **Determine whether the property should be the subject of a 1031 Exchange.**

Not every property is a good candidate for a 1031 Exchange. For example, if there is significant passive activity losses whereby those losses will be greater than or equal to the gain on the sale of the property, it may not be a good fit for a 1031 Exchange. In addition, the taxpayer¹ should run the numbers on the tax savings and consider that rates may be different compared to what they may be down the road. The seller should discuss the tax consequences with an accountant or tax attorney to determine whether a 1031 Exchange is appropriate.

- **Contact a Qualified Intermediary.**

Assuming that a 1031 Exchange is appropriate, the taxpayer should contact a qualified intermediary. A qualified intermediary is a person (or entity) who is not the taxpayer (or a disqualified person). The qualified intermediary enters into a written agreement with the taxpayer (the exchange agreement) under which the qualified intermediary:

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Acquires the relinquished property from the taxpayer

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Transfers the relinquished property to the buyer

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Acquires the replacement property from the seller

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Transfers the replacement property to the taxpayer

The exchange agreement must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain benefits of money or other property held by the qualified intermediary.

- **The property to be relinquished should be listed for sale.**

The property would be listed whether or not there is going to be a 1031 Exchange, and there is no different procedure for a 1031 Exchange (other than including a 1031 disclosure in the sales contract), so there will be no elaboration regarding listing real property for sale at this time.

- **Look for replacement property(ies).**

At this point, the taxpayer should start looking for replacement properties. Possible replacement property(ies) must be identified within 45 calendar days of the sale date of the relinquished property. One easy way for a 1031 Exchange to fail is by not identifying potential replacement properties in time.

- **The sale of the relinquished property.**

The sale is very similar to a typical real estate sale, except the qualified intermediary will hold the sales proceeds in a special account. The taxpayer cannot have access to the proceeds from the sale of the relinquished property. From this account, the proceeds will be distributed to purchase replacement property or properties.

- **Identify the replacement property.**

The replacement property or properties must be identified within 45 days of selling the relinquished property. The property(ies) must be identified to the qualified intermediary.

- **Purchase the replacement property(ies).**

Working with and through the qualified intermediary, the replacement property or properties must be purchased within 180 days of selling the relinquished property (or the next due date to file an income tax return, including extensions). The funds for this purchase must be sourced from the qualified intermediary's account. The taxpayer may bring additional cash if needed to close the transaction.

¹The person/entity selling the relinquished property and buying the replacement property will be referred to as the taxpayer.