What is a §1031 transaction?

A: An owner of real estate used in their trade or business or held for investment is not taxed on the profit they realize from the sale of the property when they purchase **like-kind** replacement property in an Internal Revenue Code (IRC) **§1031 reinvestment plan**, also called a §1031 transaction or exchange.

Two classifications of real estate make up §1031 like-kind property in reinvestment plans:

- **investment property**, also labeled as capital assets; and
- **business-use property**, which is property held for productive use in a trade or business.

§1031 investment property includes:

- residential and commercial (passive) rental real estate requiring active management;
- investment (portfolio) real estate not requiring active management; and
- vacation homes held for profit or resale.

Business-use property is real estate used to house an owner's trade or business and includes hotel or motel operations.

However, before business-use property qualifies as like-kind property, it must be owned for at least one year before it is sold or exchanged. Business-use property is unlike investment property which has no holding period requirement before disposition.

After one year of ownership, the business-use property may be sold and replaced in a §1031 reinvestment plan by purchasing either business-use property or investment property. Similarly, investment property may be sold and replaced by either business-use property or investment property in a §1031 reinvestment plan.

Conversely, while a principal residence is a capital asset, it does not qualify as §1031 property since it is neither used in a business nor held for passive or portfolio investment purposes.

Further, properties transferred — exchanged — between related persons in a §1031 transaction must be held by both persons for a minimum of two years after acquisition.

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