

Trading Up Without Paying Up: Using 1031 Exchanges to Preserve Wealth for Families with Special Needs

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I. Introduction

Section 1031 of the Internal Revenue Code allows taxpayers to defer the recognition of gain when real property held for investment or productive use in a trade or business is exchanged for like-kind property of equal or greater value.¹ This powerful nonrecognition provision is rooted in the principle of continuity of investment: if the taxpayer has not cashed out but has merely changed the form of the investment, there should be no taxable event.²

Although Section 1031 is most often associated with sophisticated real estate investors or large-scale commercial transactions, its value in the estate planning context—particularly in planning for families with special needs—has received less attention. Families with disabled beneficiaries often hold appreciated real estate as a core investment. A sale of such property can trigger substantial capital gains tax and, if not carefully managed, disrupt eligibility for means-tested public benefits such as Medicaid and Supplemental Security Income (SSI).³ Through Section 1031 exchanges, families can defer tax liability and better align assets with long-term planning objectives.

II. Statutory and Regulatory Framework

The statutory foundation of like-kind exchanges is found in IRC Section 1031(a)(1), which provides that no gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment, if such real property is exchanged solely for real property of like kind to be held either for productive use in a trade or business or for investment.⁴ This broad nonrecognition rule has long been justified by the continuity-of-investment rationale: the taxpayer who exchanges one qualifying property for another has not liquidated wealth, but has merely shifted its form.⁵

The Tax Cuts and Jobs Act of 2017 (TCJA) amended Section 1031 to narrow its scope exclusively to real property held for investment or for use in a trade of business.⁶ Prior to the TCJA personal property exchanges were also eligible including artwork, collectibles, and equipment. The elimination of personal property from Section 1031 narrowed the tool's utility but left intact its central role in real estate planning.

¹ IRC §1031(a)(1)

² See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 103.1 (explaining policy rationale).

³ 42 U.S.C. §1382b (SSI resource rules).

⁴ IRC §1031(a)(1).

⁵ See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 103.1.

⁶ Pub. L. No. 115-97, §13303 (2017) (TCJA).

Treasury Regulations provide essential detail. Treas. Reg. Section 1.1031(a)-1(b) defines like-kind property broadly to include most U.S. real property, regardless of grade or quality. For example, an apartment building may be exchanged for raw land, or farmland may be exchanged for a warehouse. Treas. Reg. Section 1.1031(k)-1 governs deferred exchanges, establishing the familiar 45-day identification period and 180-day exchange period.⁷ IRC Section 1031(h) prohibits the exchange of U.S. property for foreign property. Additionally, related-party rules under Section 1031(f) impose a two-year holding period to prevent taxpayers from circumventing recognition through family-controlled entities. These strict deadlines are non-negotiable and must be closely monitored by advisors.

Together these statutory and regulatory rules outline the use of like-kind exchanges. On its face Section 1031 is simple; however, the technical requirements can be rigid and failure to comply with timing or qualification rules results in full gain recognition.⁸ Failing to meet the technical requirements has significant implications for families engaging in special needs planning. Specifically, missing deadlines or improper structuring could result in both unexpected tax liability and adverse effects on public benefits.

III. Judicial Development of Exchanges

Although Section 1031 has existed in the tax code for nearly a hundred years, the current version has been shaped significantly by judicial interpretation. In the seminal case of *Starker v. United States* the Ninth Circuit held that a taxpayer could execute a deferred, non-simultaneous exchange and still qualify for nonrecognition treatment.⁹ Prior to *Starker*, the IRS insisted that like-kind exchanges be simultaneous. The decision opened the door to the use of qualified intermediaries and the widespread adoption of deferred exchange structures. Congress responded by amending the Code to impose the strict 45-day identification and 180-day exchange deadlines that govern deferred exchanges today.¹⁰

Later cases helped to define the parameters of Section 1031. In *Magneson v. Commissioner*, the Ninth Circuit ruled that a simultaneous transfer to a partnership was acceptable only if the taxpayer promptly transferred replacement property into the partnership and his transaction did not lose its “investment character.”¹¹ By contrast, in *Bolker v. Commissioner* the Court ruled that a taxpayer may exchange property even if it is the taxpayer’s intent to sell it shortly thereafter if held for productive use or investment.¹² These cases illustrate that not the holding period, but rather personal predisposition of the taxpayer is crucial to qualification.

Exchange litigation also has seen widespread use of the step transaction doctrine. The Tenth Circuit in *True v. United States* collapsed three steps into one, making the transaction a taxable event, and cautioned that transactions with lack of economic substance undertaken principally to avoid taxes may be disregarded.¹³ The holding underscores the importance of structuring exchanges with genuine business purposes.

Practical variants of the exchange transaction, such as multi-party and related-party transactions have also been recognized by courts. In *Alderson v. Commissioner*, the Ninth Circuit had allowed

⁷ Treas. Reg. §1.1031(k)-1(b), (c).

⁸ See Mertens, Law of Federal Income Taxation §44:28 (strict application of deadlines).

⁹ *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979).

¹⁰ IRC §1031(a)(3); Treas. Reg. §1.1031(k)-1(b), (c).

¹¹ *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985).

¹² *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985).

¹³ *True v. United States*, 190 F.3d 1165 (10th Cir. 1999).

an exchange where a taxpayer exchanged property with another person through a third-party intermediary — an anticipation of today's qualified intermediaries.¹⁴ Together, *True* and *Alderson* illustrate that Section 1031 remains heavily fact-dependent, requiring advisors to pay close attention to both form and substance.

IV. Mechanics of a 1031 Exchange

The successful execution of a like-kind exchange requires adherence to two core components: the relinquished property and the replacement property. Both must be held for investment or productive use in a trade or business.¹⁵ Property held primarily for resale, such as inventory, does not qualify for Section 1031 treatment.¹⁶

The concept of 'like-kind' is defined broadly for real property. Treas. Reg. Section 1.1031(a)-1(b) provides that differences in grade or quality do not matter so long as the properties are both real property held for investment or business use. Thus, an apartment building may be exchanged for farmland, or an office building may be exchanged for a warehouse. However, U.S. real property is not like-kind to foreign real property under IRC Section 1031(h).¹⁷

Timing rules are particularly important. Under IRC Section 1031(a)(3) and Treas. Reg. Section 1.1031(k)-1(b), the taxpayer must identify potential replacement property within 45 days of transferring the relinquished property. Identification must be in writing and unambiguously describe the property. The taxpayer then has 180 days from the transfer—or until the due date of their tax return, if earlier—to acquire the replacement property.¹⁸ Failure to comply with either the 45-day or 180-day deadlines results in immediate recognition of built-in-gain.

The use of a qualified intermediary (QI) is essential in deferred exchanges. The QI holds proceeds from the sale of the relinquished property, ensuring that the taxpayer does not have actual or constructive receipt of the funds.¹⁹ Revenue Procedure 2000-37 created a safe harbor for 'reverse exchanges,' where the replacement property is acquired before the relinquished property is sold.²⁰

This guidance was later refined by Revenue Procedure 2004-51, which curtailed certain abusive arrangements but preserved the general utility of reverse exchanges.

Specialized structures such as improvement or 'build-to-suit' exchanges are also permitted, allowing taxpayers to use exchange proceeds to construct improvements on replacement property. However, even these transactions must satisfy the identification and 180-day requirements. This can be tough given actual construction schedules.

The operation of the mechanical rules creates both opportunities and pitfalls. In the case of families engaged in special needs planning, the strictness of these deadlines means careful involvement of advisors is essential to creating an undesired outcome.

¹⁴ *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963).

¹⁵ IRC §1031(a)(1).

¹⁶ Treas. Reg. §1.1031(a)-1(a)(2).

¹⁷ IRC §1031(h).

¹⁸ IRC §1031(a)(3); Treas. Reg. §1.1031(k)-1(b), (c).

¹⁹ Treas. Reg. §1.1031(k)-1(g)(4).

²⁰ Rev. Proc. 2000-37, 2000-2 C.B. 308; modified by Rev. Proc. 2004-51, 2004-2 C.B. 294.

V. Intersection with Special Needs Planning

Families with beneficiaries who have special needs face unique planning challenges when managing appreciated real estate. Liquidating property through a sale can create significant capital gains tax liability while also generating cash that may jeopardize eligibility for means-tested programs such as Medicaid and Supplemental Security Income (SSI).²¹ For example, SSI imposes a strict \$2,000 limit on countable resources.²² A lump-sum cash distribution resulting from the sale of appreciated property could easily disqualify a beneficiary.

Section 1031 exchanges provide a means of deferring tax liability while preserving real estate wealth in a form that may be more manageable within the context of long-term planning. Families can exchange highly appreciated, actively managed properties—such as duplexes or small rental units—for triple-net-leased commercial properties or other investment real estate that generates stable income and requires minimal oversight. This repositioning can make it easier to combine real property interests with a supplemental needs trust (SNT).

The interaction between Section 1031 and SNTs requires careful attention. An SNT may serve as the owner of replacement property, provided that the trust meets statutory requirements and is drafted to preserve Medicaid and SSI eligibility.²³ Boot, or non-like-kind property received in an exchange, must be avoided or directed away from the disabled beneficiary, as cash distributions could be deemed countable resources.²⁴ Advisors must also consider state-level rules governing trusts and benefits, which may impose additional constraints.

The ability to defer tax on appreciated real estate while aligning the resulting assets with trust planning objectives can preserve capital for years. Combined with the basis step-up at death under IRC Section 1014, exchanges can allow families to defer gain during life and ultimately eliminate it at death, maximizing the value available for the care of a disabled beneficiary.²⁵

Section 1031 and special needs planning intersect around two key issues, tax deferral and benefits preservation. By aligning the real estate sales alongside trust structures advisors can assist families in preserving financial security and continued public benefit availability for those with special needs.

VI. Hypotheticals

Hypothetical 1: Converting Active Rental Real Estate into Passive Income Property

Husband and wife purchased a duplex 30 years ago for \$100,000. Today it is worth \$1.2 million and generates some rental income but requires substantial ongoing management. Their adult daughter is disabled and relies on SSI and Medicaid for her daily needs. If husband and wife sell the duplex outright, they would realize approximately \$1.1 million in gain, triggering hundreds of thousands of dollars in capital gains tax. Instead, they structure a Section 1031 exchange into a triple-net-leased commercial property. The exchange defers recognition of gain, preserves the full \$1.2 million of value, and produces stable income with minimal management. Because the

²¹ See IRC §61(a)(3) (gross income includes gains from property sales).

²² 42 U.S.C. §1382b (SSI resource rules).

²³ See 42 U.S.C. §1396p(d)(4)(A) (statutory basis for special needs trusts).

²⁴ IRC §1031(b) (boot rule).

²⁵ IRC §1014 (basis step-up at death).

replacement property is easier to administer, husband and wife can later contribute it to a supplemental needs trust, ensuring long-term financial support for their daughter.

Hypothetical 2: Using an Exchange to Fund a Future Supplemental Needs Trust

Husband and wife own raw land with very low basis and have held the property for over twenty years. Their estate plan includes funding a third-party supplemental needs trust for the benefit of their daughter upon their deaths. However, husband and wife are concerned that the land is unproductive and difficult to manage. As such, they execute a Section 1031 exchange into a multi-family residential property. The exchange defers gain, while the new asset generates predictable rental income. Upon their deaths, the property receives a step-up in basis under IRC Section 1014, eliminating the deferred gain. The property then funds the supplemental needs trust, providing income to their disabled child without jeopardizing public benefits.

Hypothetical 3: Failed Exchange and Public Benefits Consequences

A family attempts to complete a Section 1031 exchange but fails to identify replacement property within the 45-day period. As a result, the qualified intermediary returns \$900,000 in cash proceeds. Under IRC Section 1031(b), the entire gain is recognized. Worse still, the family deposits part of the proceeds into a bank account titled in the name of their disabled child. The deposit exceeds the \$2,000 SSI resource limit resulting in immediate disqualification from Medicaid and SSI.²⁶ This scenario illustrates the dual risks of technical noncompliance with Section 1031 and the collateral consequences to the taxpayer's public benefits.

These hypotheticals illustrate the inflexibility of Section 1031 exchanges. When done correctly, they can protect wealth, change the form of assets and be consistent with special needs trust planning. But missing statutory deadlines or misusing the money could result in severe tax and benefit risks.

VII. Planning Pitfalls and Ethical Considerations

Despite the benefits, advisors must take care to avoid frequently occurring mistakes and maintain adherence with ethical rules. There is little room for error in practice with respect to statutory language that imposes inflexible rules on family planning since private letter rulings cannot be obtained to hold open the statute and regulations.

One of the most common is pitfalls is among related parties. IRC Section 1031(f) creates a two-year holding period requirement where property is exchanged between related parties (a term that has been read broadly to cover family members and entities with common ownership).²⁷ Transactions designed to move basis or avoid gain recognition among family members are heavily scrutinized by the IRS. Advisors will need to consider whether related party rules would be triggered where you are dealing with parents, children or family trusts.

²⁶ 42 U.S.C. §1382b (SSI resource rules).

²⁷ IRC §1031(f).

The step transaction doctrine also presents significant risk. Courts have consistently applied this doctrine to re-cast multi-step transactions that are without economic reality.²⁸ For example, a 'drop-and-swap' strategy, in which a partnership distributes property to a partner shortly before an exchange, may be recast as a taxable sale. Advisors should ensure that transactions have an independent business purpose.

Ethical implications go beyond those related to complying with tax laws. Attorneys of families with special needs dependents need to be aware of fiduciary obligations, conflicts of interest and the greater-than-normal susceptibility of disabled clients.²⁹ The Model Rules of Professional Conduct require attorneys to maintain loyalty, competence, and diligence, while avoiding actions that could harm a client's eligibility for essential public benefits.³⁰

Moreover, advisors must be able to effectively discuss complex transaction structures with their clients, who are sometimes not financially sophisticated and often have very little tax knowledge. It is ethically incumbent upon us to explain, simply and clearly, the hazards associated with blowing time limits, structuring improperly or on the wrong end of boot. Investment professionals take this idea into account when financial suitability standards and fiduciary duties are balanced with considerations of client welfare and investment objectives.

Simply put, when it comes to 1031 exchanges in the special needs context not only is a high degree of technical mastery necessary, but also an appreciation for the ethical and fiduciary duties owed vulnerable clients. Advisors must combine stringent compliance with transparent communication and a client-centric focus.

VIII. Legislative and Policy Outlook

Section 1031 has been a frequent target of policy and legislative discussions. Many policymakers see like-kind exchanges as a deferral vehicle that disproportionately favors high-net-worth individuals and real estate holders. Efforts to repeal or restrict Section 1031 have appeared in Treasury's Greenbook over the years during both the Obama and Biden administrations.³¹ Their specific proposals have tended to limit the amount of gain that would be eligible for deferral to \$500,000 per taxpayer per year.

Nevertheless, in the past Congress has maintained Section 1031 appreciating its value in increasing transactional liquidity and fostering economic growth. The Tax Cuts and Jobs Act of 2017 limited Section 1031 to real property but did not repeal it.³² The ongoing existence of Section 1031 illustrates the tension between revenue concerns and macroeconomic stimulus.

For advisors dealing with families who have special needs considerations, awareness of legislative risk is critical. Although Section 1031 remains available, the repeated inclusion of limitation proposals in Treasury's Greenbook signals that it is a perennial target. Families who are considering exchanges as part of long-term planning should be advised that the availability of deferral is not guaranteed indefinitely.

²⁸ See *True v. United States*, 190 F.3d 1165 (10th Cir. 1999).

²⁹ See Restatement (Third) of the Law Governing Lawyers §16 (duty of loyalty and care).

³⁰ ABA Model Rules of Professional Conduct, Rules 1.1, 1.4, 1.7.

³¹ U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals (the "Greenbook").

³² Pub. L. No. 115-97, §13303 (2017) (TCJA).

Looking ahead, advisors should be vigilant about legislation going forward. Even without a repeal statutory changes could vary identity timing, the types of permitted property or the importance of related-party rules. These sorts of changes could potentially interfere with families' abilities to efficiently reallocate assets for the purpose of special needs planning.

IX. The “One Big Beautiful Bill” Act and Section 1031 Exchanges

The OBBBA, signed into law in July 2025, was Congress's most significant tax legislation since the TCJA in 2017. Though the sweeping bill covered numerous topics including individual income tax rates, retirement savings changes, and corporate international taxation, many advisors focused in on whether Section 1031 would see a major change or be eliminated.

Earlier versions of the OBBBA would have restricted like-kind exchanges, in line with Treasury Greenbook estimates to cap deferral at \$500,000 per year for each taxpayer. But those recommendations did not make it through the Legislature. In its final form, OBBBA left Section 1031 intact. Like-kind exchanges remain available for real property, subject to the post-TCJA limitation that excludes personal property.

The lesson from OBBBA is twofold. First, Section 1031 continues to provide reliable deferral opportunities for real estate investors and families engaging in special needs planning. Second, frequent return to the issue of repealing or curtailing it in legislative bargaining points to its fragility.

All put together, OBBBA reiterated the persistence of Section 1031 yet affirmed it remains a perennial target for policy change. Families who are applying the planning strategy of using Section 1031 in their special needs plans should continue to monitor the evolving legislature that may limit this deferral tactic.

X. Qualified Opportunity Zones and Comparison to Section 1031

Qualified Opportunity Zones (QOZs) were created by the TCJA to encourage investment in economically distressed communities.³³ Codified at IRC Section 1400Z-1 and 1400Z-2, the program incentivizes taxpayers to reinvest capital gains into Qualified Opportunity Funds (QOFs), which in turn invest in designated zones certified by the Treasury Department.

Under the statute, taxpayers may elect to defer recognition of eligible capital gains if those gains are invested in a QOF within 180 days of the sale or exchange that generated them.³⁴ Under the OBBBA, the deferred gain must be recognized no later than five years after the initial investment or upon disposition of the QOF investment, whichever occurs earlier. Qualified Opportunity Zones also offer partial basis adjustments historically 10% for five-year holdings.³⁵ Finally, if the QOF investment is held for at least ten years then all of the post-investment appreciation is excluded from gross income.³⁶

Both QOZs with Section 1031 exchanges allow taxpayers to defer capital gains but their mechanics differ substantially. Section 1031 requires reinvestment in like-kind real property and offers potentially indefinite deferral, with the possibility of permanent elimination of gain at death through

³³ IRC §§1400Z-1, 1400Z-2; Pub. L. No. 115-97, §13823 (2017) (TCJA).

³⁴ IRC §1400Z-2(a)(1).

³⁵ IRC §1400Z-2(b)(2)(B).

³⁶ IRC §1400Z-2(c); Treas. Reg. §1.1400Z2(a)-1 through -3; IRS Notice 2018-48, 2018-28 I.R.B. 9; IRS Notice 2020-39, 2020-26 I.R.B. 984.

the basis step-up under IRC Section 1014. By contrast, QOZs apply to a broader range of gains and provides for a basis step-up after five years and elimination of post-investment appreciation after ten years.

From a planning perspective, Section 1031 is often more compatible with special needs strategies, particularly where families hold real estate intended for eventual transfer into a supplemental needs trust. QOZ investments require hyper-technical compliance requirements that may be inappropriate for a trustee. However, in instances in which liquidity from a sale cannot be reinvested into like-kind property exchange QOZs may provide another tax-efficient alternative.

XI. Section 1035 Exchanges of Insurance and Annuities

While Section 1031 governs exchanges of real property, Section 1035 provides a parallel deferral mechanism for insurance and annuity contracts. IRC Section 1035(a) allows nonrecognition of gain on certain exchanges of life insurance policies, endowment contracts, and annuities, provided that the insured remains the same and the exchange does not involve cash or other non-qualifying property.³⁷ Like Section 1031, Section 1035 reflects the principle of continuity of investment: taxpayers who simply exchange one qualifying contract for another should not face immediate taxation.

In *Conway v. Commissioner*, the First Circuit upheld nonrecognition treatment for an exchange of life insurance contracts, reinforcing the continuity rationale.³⁸ More recently, the IRS has addressed modern variations such as annuity-to-annuity exchanges (Rev. Rul. 2003-76) and partial annuity exchanges (Rev. Rul. 2007-24).³⁹ With these rulings, it is clear that Section 1035 protects a high degree of flexibility, but it also must follow strict statutory rules.

Parallels to Section 1031 are striking. Both provisions require continuity of investment, and both impose limitations on qualifying property. Just as boot in a Section 1031 exchange triggers gain, receipt of cash or other property in a Section 1035 transaction causes recognition.⁴⁰ Similarly, Section 1035 disallows cross-exchanges as does Section 1031 (for different reasons). For example, swapping an annuity for a life insurance policy. This is similar, although different, to Section 1031 which disallows exchanges of U.S. property for foreign property.

Section 1035 exchanges can provide a useful tool for special needs planning. Life insurance and annuities are often used to fund supplemental needs trusts or provide stable income streams for individuals with disabilities. Through the benefit of not having to figure out income tax at the time of an exchange, families can rework contract terms and long-term planning objectives to match better. One example would be for a family exchanging their old life insurance policy into a contemporary contract with superior long-term care riders, thereby increasing the amount available to support a child who has become disabled.

XII. Conclusion

The 1031 exchange is one of the most potent and least used tools in special needs and estate planning. Through the deferral of gain and maintaining families' ability to horizontally diversify into higher-yield property, Section 1031 helps families preserve capital for the long term, make

³⁷ IRC §1035(a); Treas. Reg. §1.1035-1.

³⁸ *Conway v. Commissioner*, 111 F.2d 611 (1st Cir. 1940).

³⁹ Rev. Rul. 2003-76, 2003-1 C.B. 355; Rev. Rul. 2007-24, 2007-1 C.B. 1282.

⁴⁰ IRC §1035(d)(1).

investments in supplemental needs trusts, and maintain public benefits eligibility. Paired with deathbed basis step-up to the extent allowed by law, Section 1031 provides families a way to eliminate most, if not all, built-in-gain.

For advisors to families with special needs Section 1031 exchanges can provide a cornerstone strategy in wealth preservation, but it must be integrated carefully in trust and ethical planning while considering eligibility benefits. With an understanding of not only the technical needs, but also the larger policy background, advisors can assist families in providing stability, security and peace of mind for family members at their most vulnerable.