Swap Smart

A Real Estate Agent's Guide to 1031 Exchanges

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Publication 2427
November 4, 2024

A 1031 exchange, named after Section 1031 of the Internal Revenue Code, is a powerful tax-deferment strategy used by real estate investors when selling investment property. It allows an investor to defer paying capital gains taxes on the sale of certain types of investment property by reinvesting the proceeds into a similar property. That is why a 1031 exchange is commonly referred to as a "like-kind" exchange. The primary purpose of a 1031 exchange is to encourage investment, stimulate economic activity, and foster liquidity in the real estate market.

Real estate agents play a vital role in helping clients navigate the complexities of 1031 exchanges. Here are several ways they can support their clients throughout this process.

Key Takeaways

- "Like-kind" refers to the nature or character of the property, not its type.
- Educate clients on the benefits of 1031 exchanges, including potential tax advantages and investment opportunities.
- Assist clients in identifying suitable replacement properties considering values, rental income, and market trends.
- Connect clients with reputable qualified intermediaries who ensure IRS compliance and refer them to experienced tax advisors and attorneys for handling complex tax and legal aspects.
- Ensure contracts allow for necessary adjustments and cooperation.

Know the Basics

What Types of Properties are Eligible?

To qualify for a 1031 exchange, the property being sold (referred to as the relinquished property) and the property being purchased or "exchanged" (referred to as the replacement property) must be held for investment, business, or productive use in a trade or business. Personal residences and properties for personal use, such as vacation homes or hunting ranches, do not qualify. Property held for inventory, such as property bought to fix and sell, or just to sell in the future, is not eligible for a 1031 exchange. Also note that property within the United States cannot be exchanged with property outside the country. Interestingly, though, a foreign property can be exchanged for another foreign property.

Here are some common types of investment or trade/business properties that qualify for a 1031 exchange:

- Residential rental properties, including apartment buildings, duplexes, and single-family homes used for rental purposes.
- Commercial properties such as office buildings, shopping centers, and retail stores.
- Industrial properties such as warehouses and manufacturing facilities.
- Raw land that is unimproved and that can be used for investment purposes.
- Ranches, which are generally large tracts of land used for agricultural purposes.

What are the Requirements for a Like-Kind Exchange?

The concept of like-kind in a 1031 exchange is often misunderstood to mean that the properties being exchanged must be identical or similar in type. However, this is not the case. Rather, like-kind refers to the nature or character of the property, rather than its specific type or form.

In simpler terms, the IRS does not require that the properties being exchanged be the same in terms of their physical attributes, such as size, shape, or location. Instead, what matters is the underlying nature or purpose of the properties involved in the exchange.

For example, in a 1031 exchange, a commercial office building could be exchanged for a retail shopping center, or vacant land could be exchanged for a rental apartment complex. Despite being distinct types of properties, they are considered like-kind because they are all held for investment, business, or productive use in a trade or business.

The historical significance of the term like-kind was more relevant prior to 2018 when several types of personal and intangible property, in addition to real estate, could be exchanged. Since 2018, only real estate is eligible for a 1031 exchange.

The broad interpretation of like-kind for real estate properties allows for flexibility in structuring 1031 exchanges and enables investors to diversify their real estate portfolios without being limited to specific property types. It also aligns with the underlying purpose of the 1031 exchange, which is to stimulate investment and promote liquidity in the real estate market by deferring taxes on property transactions.

How Does the Property's Value Figure In?

To avoid taxes, the value of the replacement property must be greater than or equal to the value of the relinquished property. If the replacement property is less than the value of the relinquished property, there may be taxes due on the excess value, also known as "boot."

Educate Clients

Many property owners may not be familiar with the benefits of a 1031 exchange. Real estate agents who represent investor clients can educate their clients about the potential tax advantages and investment opportunities associated with 1031 exchanges. By raising awareness, agents can help clients make informed decisions about whether a 1031 exchange aligns with their goals.

Refer Clients to a Qualified Intermediary . . .

To facilitate a 1031 exchange, investors typically engage a qualified intermediary (QI) who acts as a third-party facilitator to ensure compliance with IRS regulations. The QI holds the proceeds from the sale of the relinquished property and disburses them to acquire the replacement property. The seller cannot hold the proceeds from the relinquished property, or the seller will realize taxable gain.

Agents can provide valuable guidance by connecting clients with reputable QIs who can navigate the complexities of the exchange process. Make sure to research before recommending a QI. Check references. There is no state or federal agency that regulates or oversees QIs. While there are many good and reputable QIs, there are also stories of bad actors who have absconded with money that was entrusted to them.

. . . and to Qualified Tax/Legal Consultants

1031 exchanges involve complex tax and legal implications that require specialized expertise. Real estate agents cannot give legal or tax advice and should recommend their clients work closely with tax advisors, attorneys, and other professionals to ensure compliance with IRS regulations and optimize the tax benefits of the exchange. Again, having a list of good tax professionals to recommend to clients who do not already have their own will help the transaction go more smoothly and keep the real estate agent from being put in a position of being asked for advice outside of their expertise.

Identify Replacement Properties

One of the key requirements of a 1031 exchange is the identification and acquisition of replacement properties within specific timelines. Real estate agents can assist clients in identifying suitable replacement properties that meet their investment criteria and like-kind exchange requirements. This may involve evaluating property values, rental income potential, location dynamics, and market trends. Agents can provide valuable insights and guidance to help clients make informed decisions when selecting replacement properties for their 1031 exchanges.

Track Key IRS Deadlines

The IRS imposes strict timelines on 1031 exchanges, and keeping track of their deadlines is of the utmost importance.

The investor must identify potential replacement properties within 45 days of the sale of the relinquished property and complete the exchange by acquiring the replacement property within 180 days. These days are counted in calendar days, and there is no extension if the last day lands on a holiday or weekend.

Act as Coordinator

Agents can coordinate with the title company, tax or law firm, and the QI on the relinquished property closing. They can help ensure that net proceeds go directly to the QI, not the seller. Agents who are involved in the replacement property transaction can assist in coordination between all parties in the transaction as well.

Negotiate Contracts for Replacement Properties

Once suitable replacement properties have been identified, real estate agents can negotiate favorable terms and manage the transaction process on behalf of their clients.

Although the IRS does not require a reference to a 1031 exchange be present in the contracts for the relinquished or replacement properties, it is important to have two provisions in the contracts to avoid potential issues with the other parties to the contracts.

The first provision is for the seller of the relinquished property and the buyer of the replacement property to have the ability to assign the contracts to the QI. This can be achieved by simply adding "or Assigns" to the listed seller or buyer as applicable in the contracts. A term allowing assignment by the relevant party to a QI can also be added to the contracts under Special Provisions.

The second provision is to notify the other party of the intent to perform a 1031 exchange and getting agreement from the other party to cooperate as needed in that process. A provision holding the other party harmless from any costs or liabilities resulting from the exchange (a hold harmless provision) is also often included. If attorneys are involved in the process, they will provide the necessary language. In addition, many commercial contracts have 1031 exchange language in the boilerplate of the form. Many QIs can provide clients with the necessary language as well if they are involved at the front end of the process.

Remember, real estate agents can add business terms only to Special Provisions. Noting the intention of one party to perform a 1031 exchange and having the other party agree to cooperate is considered business terms. Drafting a hold harmless provision, however, might be considered the practice of law. Real estate agents should check with their broker about inserting language regarding a 1031 exchange. Some brokers have standard language they want their agents to use.

Finally, Empower Clients

By understanding how 1031 exchanges work, educating clients, and negotiating and facilitating transactions, agents can empower their clients to better achieve their investment goals.

Keep in mind that a 1031 exchange transaction is a specific type of real estate transaction, and, under TREC Rule 535.2(i)(5), the first three times a sales agent performs a new type of real estate brokerage activity, that agent must receive coaching and assistance from an experienced license holder competent in that particular kind of transaction. So, agents should talk to their broker before adding 1031 exchanges to the services they provide to clients.

RESEARCH FELLOW

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