by **Patrick Harrigan**

1031 Exchanges: Withstanding the Test of Time

The ability to complete a 1031 exchange began in 1921 and is just a few years shy of 100 years old. Exchanges have withstood the test of time and will continue to be a useful tool for sellers of commercial and investment real estate.

On Wednesday, December 20, 2017, Congress passed tax reform bill H.R.1, also known as the Tax Cuts and Jobs Act, and President Trump signed the bill on Friday, December 22, 2017. In that legislation, Congress preserved the ability to complete a tax-deferred exchange of real estate.

Tax-deferred exchanges are often called 1031 exchanges since Section 1031 of the Internal Revenue Code tax code allows for such an exchange. 1031 exchanges are also known as like-kind exchanges or Starker exchanges, named after a landmark Supreme Court case that opened the door for the process of a typical deferred exchange used today.

A 1031 exchange, in its simplest form, is a person or business entity selling real estate and purchasing other real estate. As long as the proper procedures are followed, the Internal Revenue Service will recognize the transaction, not as a sale and purchase, but as an exchange of a relinquished property for a replacement property. This recognition as an exchange allows the seller to defer the payment of taxes that would otherwise be due upon the sale. Those taxes include capital gains tax, depreciation recapture tax, net investment income tax and state taxes.

Exchanges apply to like-kind property that is held for use in a trade or business or for investment purposes. The like-kind requirement in the exchange rules is actually quite flexible. Any property that is commercial or investment property can be exchanged for any other property that fits that definition. This means that land can be exchanged for retail property, or multifamily property can be exchanged for a warehouse, for example. For the most part, any real estate can be exchanged for any other real estate as long as the property is not the personal use property of the exchanger, such as a home or cabin, nor property that is held primarily for resale. Improvements to property not yet constructed also do not qualify.

The principal reason for the tax deferral in an exchange is that the exchanger “rolled” his or her investment from the relinquished property into the replacement property and didn’t cash out or pocket the proceeds from the sale of the relinquished property. The Treasury Department’s regulations set out a safe harbor process to allow an

exchanger to complete an exchange and avoid the taxable receipt of proceeds from the relinquished property sale.

The process

The majority of exchanges completed today are deferred exchanges where the exchanger sells the relinquished property to a buyer and acquires the replacement property at a later point in time. This process is often referred to as a forward 1031 exchange and requires the use of a qualified intermediary. The qualified intermediary is an independent third-party exchange company that is hired by the exchanger to facilitate the exchange and hold the proceeds between the relinquished property sale and the replacement property purchase. It is possible to complete an exchange in the reverse order, however, that process is more complex than a forward exchange.

The procedure for a forward-deferred 1031 exchange involves a few steps. The exchange must be set up at or before closing on the relinquished property sale. The exchange company will hold the proceeds from the sale to avoid receipt of those proceeds by the exchanger. Once the relinquished property sale closes, the exchanger has 45 days to identify the replacement property by providing the exchange company with a written description of the replacement property. Then, the exchanger must close on the replacement property within 180 days of the relinquished property closing or less if the due date of the exchanger's tax return falls within the 180 days, unless the exchanger files a tax return extension.

Real estate agent involvement

The role of the real estate agent is not significantly altered when the client is completing an exchange.

Relinquished property

The listing agreement will not be affected when a seller plans to complete an exchange, however, this is the point when a real estate agent can be the most valuable to the seller client. Reminding the client to consider the tax consequences of the sale early in the sale process allows the client to consult his or her tax professional. The client should look into what taxes will be due upon the sale, possible replacement properties and timing requirements. The client can then determine if an exchange will benefit them and work within their investment plans.

For the most part, the offer to purchase agreement will not be altered by the seller's exchange. Exchange professionals usually suggest placing some language in the offer referencing the seller's exchange simply to make the buyer aware of the exchange and that an intermediary will be involved on the seller's side of the transaction. This language can also comfort the buyer by stating that the seller's exchange will not cause the buyer any additional cost or liability.

There are some requirements at the closing of the

relinquished property sale when setting up an exchange. The exchange company will work with the title company to coordinate signing the exchange paperwork and deliver the proceeds to the exchange account. The closing statement will be drafted to reflect the seller's exchange showing the involvement of the exchange company and delivery of proceeds to that exchange company. The deed will reflect the names of the seller and buyer as it would with any transaction.

Replacement property

The exchange is completed when the exchanger acquires a replacement property. The offer to purchase on the replacement property may include some language to notify the seller that the buyer is completing an exchange and that the exchange will not cause additional cost or liability to the seller.

As with the relinquished property, the closing of the replacement property will include some documents for the exchanger to sign, and the exchange should be reflected on the closing statement. The deed will not be affected and will be from the seller to the buyer as usual.

Once the exchange is complete, the exchanger will report on his or her tax return that any gain, which would have been taxable, was "rolled" into the replacement property and is thereby tax deferred.

During the legislative process, the National Association of REALTORS®, state REALTOR® associations, numerous commercial real estate associations and the Federation of Exchange Accommodators all fought to retain the ability to complete 1031 exchanges. By retaining the ability to complete an exchange, recent tax reform legislation has allowed the commercial and investment real estate sector to continue to contribute to economic growth.

Patrick Harrigan is President/COO of Gain 1031 Exchange Company LLC, which acts as a qualified intermediary of like-kind (Starker) exchanges. Patrick has focused his career on exchanges for over 10 years and has 15 years of experience with commercial and investment real estate transactions. He is a member of both the Wisconsin and Minnesota state bars. Patrick is also a member of the Federation of Exchange Accommodators (FEA) and achieved the Certified Exchange Specialist designation through the FEA in 2010, reflecting the highest standard in exchange knowledge and professionalism.For more, visit www.gain1031exchangecompany.com or call 262-402-8072.