TAX

Voices Building wealth for clients through 1031 tax-deferred exchanges

By Randy Kaston John Starling July 05, 2022, 7:52 p.m. EDT3 Min Read

When addressing the significant tax obligations clients may incur from the sale of real property, the 1031 tax-deferred exchange is an effective strategy by which to defer capital gains and build net worth.

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For the last 100 years, 1031 exchanges have helped ensure the continuity of investment, with benefits that span across the entire economy. Despite stringent guidelines and restrictions on tax-deferred exchanges, investment and business property owners can benefit greatly from utilizing this type of transaction. A 1031 tax-deferred exchange allows a person who owns real estate for investment or business purposes to sell their property and purchase “like-kind” property to defer paying their capital gains tax. The replacement property must be identified by the property owner, now known as the exchanger, within 45 days and the new property must also be settled within 180 days of the date of settlement of the relinquished property.

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It’s important to consider all the facts before beginning the 1031 exchange process, including the amount of the tax obligation the exchanger is facing and the current market conditions, as well as addressing any lending issues you may encounter.

Two key aspects of 1031 exchanges to consider are:

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Qualified intermediary
The assistance of a qualified intermediary, or QI, is required under the Internal Revenue Code to facilitate an exchange, as the intermediary becomes the entity you exchange with to complete a tax-deferred exchange. The only exception to this requirement is if you are swapping property with someone that has property you are buying. It is best to use an intermediary that is a member of the Federation of Exchange Accommodators, the national trade organization for qualified intermediaries, as it has strict standards that its members must adhere to and its members provide a deep working knowledge of the exchange procedures and experience that can help make the process easier.

The QI has many responsibilities, including:

- Drafting the exchange agreement and assignment documents
- Accepting and notifying all parties of contracts associated with the exchange
- Providing instructions to the settlement agent — the professional who facilitates the transfer of real property in a purchase and sale
- Creating a qualified escrow account for the proceeds from the sale, which eventually funds the settlement of the replacement property
- Receiving the 45-day identification notice for the replacement property and handling the direct deeding issues
- Preparing a comprehensive accounting of the funds placed in escrow as well as copies of all exchanges and closing documents
- Replacement property criteria

‘Like-kind’
To qualify for a 1031 tax-deferred exchange, the exchanger needs to find a property considered “like-kind.” The term doesn’t refer to the grade or quality of a property but rather to the property’s nature or character. It simply means that real property must be exchanged for real property — and all real property is “like-kind.” For example, if you own a single-family rental property and wish to purchase a farm as a replacement, that falls under the definition of “like-kind.” Exchanging a lot or condominium meant for investment or business purposes for an office building also meets those guidelines. The like-kind designation basically means investment for investment property.

Examples of real property interests that can be exchanged for another type of real estate include: - commercial properties; multifamily rentals; vacant lots; single-family rentals; vacation rentals like those properties offered through Airbnb or VRBO; farmland and ranch land; improvements on property not already owned; oil, gas and other mineral interests; water rights; cell tower, billboard and fiber optic cable easements; conservation easements; and Delaware statutory trusts (DSTs).

Examples of non-like-kind exchanges would be investment property for a primary residence, or a second home or a replacement property purchased specifically for a quick resale and not for long-term investment. These types of exchanges are not eligible for a tax-deferred exchange.

The replacement property must be of equal or greater value than the relinquished property, and all cash equity from the sale must be reinvested in order to have no tax on the sale of the relinquished property. If the exchanger buys a property of lesser value, the difference of the two property values is subject to capital gains tax and unrecaptured depreciation tax.

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