TOP 25 FAQs - 1031 Exchange Explained

1. Can some of the members of an LLC do their own exchange or cash out at the time of the sale of the property?

The IRS Code does not allow members/partners to do his or her own exchange, only the entity can do so. Given enough preplanning, there is a technique referred to as a "drop & swap" whereby certain members/partners can drop their interest from the entity and enter the exchange individually and not at a member/partner.

2. When doing an exchange, is it sufficient to get tax deferral if the gain is rolled over?

No, to fully shelter the gain, the sale price of the relinquished property, net of closing costs must be reinvested. Another way to look at this is that the net amount going into the exchange account must be reinvested and there must be equal or greater mortgage debt on the new property compared to what was paid off upon closing of the old property.

3. The Qualified A person acting to facilitate an exchange under section 1031 and the regulations. This person may not be the taxpayer or a disqualified person. Section 1.1031(k)-1(g)(4)(iii) requires that, for an intermediary to be a qualified intermediary, the intermediary must enter into a written "exchange" agreement with the taxpayer and, as required by the exchange agreement, acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer.Intermediary wants how much just to hold my money?!

Under the regulations there are quite a few options to deal with holding the money from the sale. Some do not require putting the money with the QI although that is generally the easiest and most convenient. The real reason a taxpayer must use a QI is, through the paperwork provided, use of a QI converts the transaction of the sale of a property and the later purchase of a new property to an exchange of the one for the other.

4. Does it jeopardize my exchange if the other party to the sale or purchase contracts chooses not to sign receipt of the notice of assignment?

No, there is no requirement under the regulations that the counterparty needs to sign receipt of the notice of assignment. Rather the only requirement is that the other party needs to receive the notice of the assignment. Receipt for it may be a common courtesy but it does not harm the exchange if the party prefers not to sign for that notice.

5. Can I pay my replacement property loan application and related fees out of my exchange account?

No, an exchange is a like kind exchange of real estate for other real estate. Incidental costs such as paying loan related fees do not constitute the direct payment for like kind real estate.

6. Can I pay my attorney fees out of the exchange account?

To pay such fees out of an exchange account, the fee needs to meet two pronged criteria. First, the fee must relate only to legal services pertaining to the sale and/or purchase. The second one is that the type of payment must be one that is typically found on a closing statement in the locale where the property transaction takes place.

7. Are there any special rules regarding notice of assignment when there are others selling with me or buying with me?

Yes, the Regulations require that all parties to the contract must receive notice of the assignment by the taxpayer of his/her interest. So should there be other parties selling or buying with the taxpayer, those parties must get the notice as well as the party on the opposite side.

8. Under the safe harbor, is the Qualified A person acting to facilitate an exchange under section 1031 and the regulations. This person may not be the taxpayer or a disqualified person. Section 1.1031(k)-1(g)(4)(iii) requires that, for an intermediary to be a qualified intermediary, the intermediary must enter into a written "exchange" agreement with the taxpayer and, as required by the exchange agreement, acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer.Intermediary the one to whom I must give the 45-day notice of identification to?

No, the Regulations provide that any party to the exchange can be the necessary recipient of the notice. So, for example if the contract with the seller of the new property contains a reference in the contract stating that this is the replacement property for the buyer's exchange, that would be sufficient.

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9. If I am involved in a related-party transaction, is it cured if both parties hold onto the property for at least two years?

No, this is a misconception. The two-year curative provision only applies if the related parties are exchanging directly with one another. This is seldom the case. In a situation where the taxpayer sells the relinquished property to a third party and acquires and holds replacement property for an excess of two years from the related party, that is not sufficient to meet the rule.

10. Is the exchange invalidated under the related-party rules if I sell the relinquished property to a related party?

No, the purpose of adding the related party rules to the Tax Code was to prevent taxpayers from manipulating the tax result by buying replacement property from a related party such as a subsidiary company. That so called tax abuse is not applicable when a party is selling the relinquished property to a related party.

11. Can I buy my replacement property from my relative such as my son-in-law or cousin?

Yes, the related party rules to not necessarily include all relatives. Rather they disallow persons that are descendants or one another. Lineal descendants such as Parent, child, grandparents, siblings are considered related for this purpose, not so for in laws, aunts, uncles, cousins, etc.

12. How do I report a sale of relinquished property in year prior, but exchange proceeds are paid to me in the next tax year?

The default is that the payment of the tax is treated as an installment and payable in the year in which the funds were able to be paid out. Should a particular taxpayer wish to pay it in the first year to take advantage of tax losses in that year or for other reasons that can be done by a special election.

13. In a reverse exchange, since the Accommodator will be in title, does that mean it collects the rent from the property tenants?

No, the Reverse Exchange Rev. Proc. is very taxpayer friendly and relations between the Accommodator and taxpayer do not have to be arm's length. Typically, the Accommodator will In the context of reverse exchange administration a Master Lease between the Exchange Accommodation Titleholder as Lessor and the taxpayer as Lessee, is often used in order for taxpayer to be able to sublease the property to the actual property tenants. This removes the need for the Exchange Accommodation Titleholder from having any interaction with the property tenants. If also puts responsibility on the taxpayer to pay for utilities, taxes and insurance.Master Lease the property to the taxpayer enabling the taxpayer to manage the property, collect the rent and pay for expenses.

14. In connection with my exchange, my bank is willing to lend me 80% LTV. Does that work for me for my exchange?

No, this is a common problem. Since for exchange purposes a taxpayer must roll over all the net cash, the amount of the loan should be for the remainder of the purchase price.

15. Can I do an exchange of a franchise where I own the land and the business?

No, effective with the current changes to the Tax Code made beginning with the year 2018, only real estate can be the subject of an exchange. As a result, personal property such as a business or franchise cannot be the subject of exchanges.

16. Can I refinance the relinquished property prior to the exchange or the replacement property after the exchange?

While there is nothing in the Regulations on this question, for technical reasons it is considered bad practice to refinance in anticipation of entering an exchange. By doing so, it changes the amounts on cash and debt that would need to be applied to the replacement property acquisition and it is tantamount to "gaming the system". Refinancing after an exchange to pull some equity out does not have these issues and is considered proper.

17. Can I, as seller, or my attorney, hold the earnest money prior to the closing of the RQ Property?

Yes, that does not cause any issues since the exchange rules do not come into play until the time the relinquished property is transferred. At that time neither the taxpayer nor his/her agent should be holding onto exchange funds.

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18. Does the Qualified A person acting to facilitate an exchange under section 1031 and the regulations. This person may not be the taxpayer or a disqualified person. Section 1.1031(k)-1(g)(4)(iii) requires that, for an intermediary to be a qualified intermediary, the intermediary must enter into a written "exchange" agreement with the taxpayer and, as required by the exchange agreement, acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer.Intermediary have to be referenced on the Settlement Statement or sign it?

The primary purpose of a Settlement Statement on a commercial transaction is to let the buyer and seller see how the amount they must pay, or the amount received was calculated. As a legal matter it is not required by any exchange rules. However, in different jurisdictions settlement agents have the practice of refereeing the Qualified Intermediary and/or having it sign the Settlement Statement.

19. Can a 1031 exchange be done where I am the seller or buyer under articles of agreement for deed?

Yes, but there are some challenges. If a taxpayer is selling on an installment basis, to the extent that most of the purchase price is payable beyond the 180-day exchange period, the taxpayer can only get deferral if he/she advances the amount into the replacement property even though it may not be received for a period of years. A buyer can but under an installment contract and the balance that is carried by the seller is treated like any other debt, such as a new loan by a bank lender.

20. Can an exchange be done where all or part of the sale price involves owner financing?

Yes, same answer as above. The seller would have to advance the sum being financed into the replacement property. Later receipt of that principal sum from the buyer would be tax deferred. A charge paid by a borrower to a lender for the opportunity to borrow funds via a loan or the funds earned by an account owner/beneficiary on the amount held on deposit.Interest paid during that period would be taxable.

21. Can credit card bills or other costs be paid out at a closing upon the sale of relinquished property?

Some costs that pertain closely to the sale of the property such as commissions, title insurance fees, closing fees, recording fees, transfer taxes, etc. can come out of the proceeds before the net amount is sent to the Qualified A person acting to facilitate an exchange under section 1031 and the regulations. This person may not be the taxpayer or a disqualified person. Section 1.1031(k)-1(g)(4)(iii) requires that, for an intermediary to be a qualified intermediary, the intermediary must enter into a written "exchange" agreement with the taxpayer and, as required by the exchange agreement, acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer. Intermediary.

22. In a reverse exchange, how is it determined whether to park the replacement property or the relinquished property?

As a rule of thumb, it is generally easier to park the replacement property. However, when the taxpayer has financing set up for the replacement property that the lender will not allow to be in the name of the Accommodator, this cannot be done. There may be other reasons as well such as known environmental issues on the replacement property.

23. For a reverse exchange, are a double set of real estate transfer taxes applicable when there is an extra conveyance of title?

The IRS issued a ruling years ago that said for purpose of the Accommodator's role in holing and transferring reverse exchange property, it could be considered the agent of the taxpayer and as a result extra transfer taxes did not need to be paid. There are a few states that still require payment regardless of the IRS ruling.

24. If I am doing a reverse exchange, do I still need a conventional forward exchange?

Yes, many people think if they are doing a reverse exchange, that is an alternative in lieu of the reverse exchange. That is not correct. The only thing a reverse exchange does is to allow the taxpayer to effectively control the replacement property when the corresponding relinquished property cannot be sold first. A forward exchange is still necessary to exchange the old property for the new property.

25. For a reverse exchange, do I have to get those funds being lent to the Accommodator prior to closing?

The IRS rules allow the taxpayer to lend the necessary funds to the Accommodator, but just like a bank lending funds, those funds are typically provided directly to the settlement agent and do not need to come to and through the Accommodator.