Practical considerations in representing a 1031 exchange Seller or Buyer.

A 1031 Exchange, or more formally known as a like-kind exchange or a tax-deferred exchange, is a tax strategy employed in the United States which allows real estate investors to sell one property and purchase another without immediately incurring or subjecting themselves to capital gains taxes. This process is provided for under Section 1031 of the Internal Revenue Code, hence the "1031 exchange" namesake. The goal of a 1031 exchange is to promote investment and economic growth by allowing investors to defer incurring a tax on their proceeds at sale by reinvesting their capital.

As you can imagine, the tax implications of a 1031 exchange are complicated. I always advise clients to speak with their CPA or tax professional prior to undergoing the exchange since I am not qualified to give tax advice. Frankly, I don't even file my own taxes! I have a trusted CPA that I use to assist in the process, and I always recommend the same to clients. Therefore, I'm going cover some of the main requirements of a 1031 exchange. Then, a few purchase agreement provisions to be aware of while representing a 1031 exchange seller/buyer.

This list is not all encompassing, and I recommend speaking with a 1031 QI and a CPA, but generally, to undertake a 1031 exchange, the following must be met:

1- The properties must be "like-kind". Generally, you're going to be exchanging real property for real property. Asset class is not a distinction, so you can sell residential and buy commercial or vice versa. Also, the property must be for a qualified use, meaning it must be held for investment or business use. It cannot be for personal use such as a primary residence. Be careful here when clients want to 1031 into a "vacation home" that the property meets the definition of a qualified use.
2- The proceeds from the sale of the relinquished property must be held by a Qualified Intermediary (QI) or sometimes called an "accommodator". The QI is a third party who holds the funds and is tasked with complying with IRS regulations to ensure the transaction is in compliance. Some attorneys will try to be a QI and represent their client. That is not advised. We always require the client to hire an independent QI. An experienced QI is an essential member of the deal team (CPA/Lawyer/QI) to advise on the process and the transaction.
3- Nomination and purchasing timeline must be met. A client has 45 days from the sale of the property to identify or "nominate" replacement properties to their qualified intermediary (QI). Further, the client has 180 days to finalize the acquisition of the replacement property. That 180 days to close begins at the sale of the relinquished property and does not toll until the end of the 45-day nomination period. So, approximately 6 weeks to nominate replacement properties and 6 months to close.
4- The seller cannot directly receive the proceeds. The proceeds of the sale of the relinquished property will go to the QI, to be held on behalf of the Seller, at closing. If the Client "touches the money", then the 1031 exchange is void and the proceeds will be subject to tax. The QI has a fiduciary duty to the client to hold the funds on their behalf.

5- Reinvestment- To fully realize the entire deferment of all capital gains taxes, Client must reinvest all of the net proceeds of the relinquished property into the replacement property. If Client nets 1,000,000.00 from the relinquished property, Client must re-invest the entire 1,000,000.00 of proceeds. If Client only reinvests 500k, the remaining $500k not reinvested will be subject to capital gains tax.

So long as those general principles are met, Client will be eligible for a deferment of their capital gains. Let's see an example.

Seller Sally has owned a 10-unit multi-family apartment building for many years. As her tax benefits in the apartment building have been minimized, she believes it is time to sell. Sally is going to sell the Property for 1,000,000.00 to Buyer Bill. Sally has heard about 1031 exchanges and is interested in retaining your firm to assist in the process. Sally has an interest in purchasing a strip mall near her house in an up-and-coming area which she believes will flourish and appreciate over time. Sally comes to your office and is looking for some help in navigating this situation.

The above scenario is extremely common in the Commercial Real Estate space. Many times, we will see a client who has owned a profitable property for a long period of time and has depreciated their basis down to near zero. Now, they're ready to sell and they're looking for a new property to buy which can provide better or similar cashflow and tax advantages. In an effort to keep this article focused, we'll skip all items dealing with the business side of the transaction, such as, is this a good deal, what is the return on capital in these replacement properties compared to relinquished, will purchase be cash or financed and differences in strategy, etc. Let's just assume the math is good, the numbers work, and Sally is paying cash.

Let's start talking with the purchase agreement for the sale of the relinquished property. By law, Seller does not necessarily have the right to 1031 exchange by default.

To protect our client (seller Sally), we always include language in a purchase agreement that seller shall have the right to 1031 exchange their proceeds of the sale and buyer will agree to comply with any reasonable requirements needed by Seller's QI. Personally, I like to inform Buyer's upfront that Seller will be performing a 1031 exchange and the best way to do that is include the right to 1031 exchange in the agreement. Language we use is something like, "Seller and Buyer agree that Seller shall have the right to participate in a 1031 exchange with the proceeds of this sale." In our fact pattern above, this allows Sally to exchange into a replacement property.

On the flip side of the transaction, if you're representing buyer, you'll want to have language ensuring that buyer will not be responsible for any 1031 associated fees or requirements. Usually, the language states that buyer will cooperate with Seller's 1031 exchange but won't be required to assist or incur any obligations.

For the fact pattern above, inserting 1031 exchange language accomplishes two purposes. First, it notifies Buyer that Seller will be attempting a 1031 exchange, so Buyer won't be surprised or caught off-guard. It also implicitly implies that Seller won't be able to grant extensions on

closing since Seller will have their own timeline on their own purchase to navigate, so Buyer needs to be serious about closing in the time allotted in the purchase agreement. Second, it gives Buyer some peace of mind that they won't be involved in the 1031 and will not bear any responsibility. Some buyers, especially those without counsel, believe the 1031 will affect them. This type of language makes it clear it will not.

Okay, so let's assume Sally has an executed purchase agreement for her MFH apartment building with 1031 allowance provision included. Now, she is on the hunt for a replacement property. This is the more difficult situation to navigate as seller has to balance their selling obligations on the relinquished property with their buying obligations on the replacement property. Two provisions that I think are important to discuss on the buying side are below.

First, and the most obvious issue when it comes to navigating this tightrope of selling one property to fund a purchase property, is the hand-money deposit on the purchase property. Specifically, your client is almost assuredly going to be required to place a hand-money deposit and that will usually be a significant amount. In deals in the 1–5-million-dollar price point, it is common to have anywhere between 25k to 100k hand money deposits. That is a sizeable amount of money to lose if the hand money went non-refundable and buyer cannot close.

When attempting to negotiate for a replacement property, we try to incorporate as many escape provisions as possible. Since Sally is only able to purchase the replacement property so long as her own property sells, she will want as many escape contingencies as possible.

The most common way to protect Sally is to request an extended due diligence period with refundable hand money. It is standard, especially in commercial real estate, to have a period of time for due diligence with a refundable hand money, say thirty (30) days. Within that time period, buyer can back out of the deal for any reason and have their money refunded.

For our purposes, if you can negotiate this due diligence period to be extended to say sixty days, that gives Sally more time to ensure her apartment building will sell prior to her deposit becoming nonrefundable. While this is the easiest way to protect Sally, it is also the most obvious and buyer counsel will push back for good reason.

Another escape provision is the 1031 exchange contingency buried deep in the purchase agreement which will say like:

"Buyer shall be released from responsibility under this Agreement if Buyer's 1031 relinquished property is not sold or transferred prior to date xx/xx/xxx. In the event of the failure of said property to sell, Buyer is released from this Agreement and Buyer's hand money deposit is returned".

Sometimes, counsel will not catch this contingency and assume the hand money deposit is non-refundable after the diligence period. This is not correct. A careful examination of the 1031 contingency and provision is required. In our scenario, if Sally's apartment building does not sell, Sally could use this provision to escape the purchase property agreement and have her hand money deposit refunded.

A final provision that may seem relatively common is the specific performance provision. While the concept of specific performance is in many purchase agreements, it can have more relevance and complexity in a 1031 exchange.

Let's assume in the above fact pattern that Sally put the strip mall property under contract and the seller informs Sally they will not be able to close. Sally wishes to file for specific performance to enforce the agreement.

As you can guess, the timeline of 180 days to close becomes crucial now. In theory, the specific performance suit would be successful, but as we all know, in practical terms, very few litigation cases are going to be resolved in 180 days or less, which makes specific performance lose its usefulness.

As a result, buyers are including language in their specific performance clause saying the following:

"In the event of Seller's breach of the agreement and/or failure to effectuate the closing of the Property, Seller will be responsible for damages, including but not limited to consequential damages, which may arise from Buyer's failure to comply with Buyer's 1031 exchange…"

Basically, if seller breaches the agreement and closing does not occur within the 180 days, seller could be responsible for buyer's tax penalties, including buyer's potential capital gains.

In our example, Sally files suit for specific performance. The case takes approximately 10 months to resolve and she is awarded the Property. Sally incurred a capital gain of $1,000,000.00. Now, seller will be required to compensate buyer for the tax.

Whether this would be enforceable is a good question. That being said, personally, if I'm representing a seller, I would be very careful before I allow my client to sign an agreement and subject themselves to that liability. In many exchanges, the realization of capital gains tax could be upwards of 6 or 7 figures of liability.

While 1031 exchanges provide great benefits to real estate investors, they can also provide great consequences to those who fail to protect their clients.

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