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A 1031 Exchange is good for both the client and broker

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What is an Exchange

A 1031 Exchange allows owners of business or investment property to defer the recognition of the capital gains tax normally due upon the sale of the property so long as they use the proceeds to buy another business or investment property of equal or greater value. Although most people think about exchanges only in conjunction with commercial or industrial property, there is a huge need for exchanges when dealing with residential properties as well. There are structures that allow exchangers to purchase vacation homes, retirement homes, and under some very special circumstances, the ability to combine an exchange with a primary residence.

Misconceptions About Exchanging

The most common question upon hearing about Exchanges for the first time is "If this is so beneficial then why isn't everyone doing it?" The simple answer: a lot of misconceptions and a lack of planning. Some of the major misconceptions are as follows:

Misconception 1. If you want to complete an Exchange, you have to find someone who you can "swap" property with. While this is originally how Exchanges were structured, Exchangers are now free to sell their property to anyone they wish, and to buy from anyone they wish. Although there are a few issues regarding sales and purchases between related parties, most Exchanges are structured not unlike any other typical sale and subsequent purchase. A 1031 exchange does not obviate the need for a realtor. Quite to the contrary, in most cases an Exchanger has an even greater need for a realtor due to the time constraints placed on Exchangers.

Misconception 2. An entity wishing to Exchange property has to buy the exact same type of property they are selling. One of the greatest myths of 1031 Exchanges involves the requirement that the exchanged properties be "like kind". Many people wrongly assume that like kind means the same type of property (i.e. – apartment building exchanged for an apartment building). However, as long as the property to be sold, and the property to be purchased are held for the productive use in a trade or business, or for investment purposes, Exchangers are free to purchase whatever type of property they want. As long as it is considered real property in the state in which the property is located, the interest can most likely be Exchanged. In addition to traditional interests in real property, Exchanges of development rights, air-rights, timber rights, and mineral rights are not uncommon.

Misconception 3. Exchangers have to complete the Exchange in one simultaneous transaction. By virtue of a favorable ruling to the taxpayer in the now famous case of Starker v. United States in 1979, Exchangers have the ability to complete an Exchange on a delayed basis so long as they purchase replacement property within 180 days of selling their first relinquished property. Other structures, including reverse Exchanges and improvement Exchanges, afford the Exchanger even more flexibility.

Why is recommending an exchange a good business practice for real estate brokers?

A more concrete way in which an Exchange benefits the broker, as well as the client, is the fact that an Exchange allows an Exchanger to purchase replacement property using that portion of the proceeds that would normally be used to pay a capital gains tax. For example, a sale of a property for $500,000, with a basis of $100,000, could result in a combined state and federal capital gains tax of approximately $100,000. There are a lot of variables that can affect the exact tax consequence, but consider that when properly leveraged, the seller of this property has lost approximately $400,000 in buying power. Buying power which could be used to acquire property of considerably more value than if the tax consequences were recognized. The tax savings achieved by completing an Exchange, allows more funds to become available for the purchase of replacement property. ***The higher the value of the replacement property, the greater the commission realized by the real estate broker.***

Additionally, in a tight market there are many potential sellers who refuse to sell because they do not want to pay the capital gains tax associated with the sale. An Exchange is the tailor made solution for these potential clients. A scenario that normally excites a potential seller is where their property, which is located in a hot market area, can be Exchanged for property in a developing market, without a capital gains tax liability. This allows a client to take advantage of a strong market, and not have to worry about overpaying for a replacement property in the same market. Or when a client is informed that they can Exchange out of a management intensive property into a more passive investment such as a tenant in common share in a triple net leased property. ***Informing clients of the benefits of Exchanging helps create your own inventory.***

You may also wish to consider the client who draws out the process of purchasing a replacement property. All the benefits associated with an Exchange do come with a few restrictions, some of which actually benefit the real estate broker. Identification rules make it easy for Exchangers to choose multiple properties that they might purchase, but the fact is, once their 45 day identification period is up, the Exchanger's choices on that list are set in stone. The way in which these rules benefit the broker is that the client must make up their mind within the time restrictions given. The client has all the time in the world before the sale of the relinquished property takes place, and 45 days from that date to identify potential replacement property. ***Once the 45 days are up, the broker's job is done, and the client must buy at least one of the properties which it identified or face a tax consequence. You now have the most motivated client you could ask for.***

In conclusion, it is important to remember that a client's advisors are sometimes in the best position to see solutions that the client is unaware of, or just too close to the transaction to realize. It is all to often the case that each professional advising a client thinks one of the other professionals took the time to discuss an important issue. In order to properly advise a client, a real estate broker should have a basic working knowledge of Tax Deferred Exchanges, and be able to recommend at least one attorney and one accountant who can properly advise the client, and the services of a reputable Qualified Intermediary. Remember, your client will always be grateful to you for making them aware of the benefits of an Exchange. The danger lies in not exploring the possibilities.

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