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Exchanges Made Easy – Two Simple Steps for Agents

Real estate agents are faced with a myriad of issues during the course of a sale transaction. Moreover, clients expect their agents to have all of the answers and to have them quickly. One of the most common sources of confusion is IRC§1031 exchanges. Specifically, what is required from a client's perspective and an agent's perspective? Although a client's qualified intermediary ("QI") will guide them through the rules and regulations governing exchanges, real estate agents can play a key role, even before the exchange commences, by knowing what steps to take at the outset of the transaction.

First, at the initial stages of a transaction, real estate agents can assist their clients by alerting them to the tax saving benefits of a §1031 exchange. Since any property – other than a seller's primary residence – potentially qualifies for a tax-deferred exchange, agents should advise clients of this fact and encourage them to consult with their tax advisor and/or a qualified intermediary ("QI") well before closing, to determine whether they will benefit from exchanging.

Second, at the contract negotiation stage, agents can protect clients who intend to exchange by including a "cooperation clause" in the contract. This provision discloses the client's intent to exchange and expresses the other party's agreement to cooperate with the exchange. This provision also notifies the other party that the contract will be assigned to a QI for the purpose of effectuating an exchange.

An assignment of the contract is crucial to an exchange because it satisfies the Treasury Regulation requirement of a transfer between the exchanger and the QI. Without an assignment to the QI, the exchanger will be treated as if they transferred the property directly to the purchaser with no QI and the exchange will fail. And, in order for the assignment to be held valid, the other party to the transaction must receive written notice of the assignment. In that regard, §1.1031(k)-1(g)(4)(v) of the Treasury Regulations provides that a QI is treated as entering into an agreement if the rights of a party to the agreement are assigned to the QI and all parties to that agreement are notified in writing of the assignment on or before the transfer of the property.

The IRS reiterated the "notice" requirement in Technical Advice Memorandum 200130001, wherein the taxpayers had to pay the tax on their gain from the sale of two properties simply because no notice of the assignment to their QI was ever given to the purchasers of their relinquished properties. The result seems harsh; nonetheless, compliance is relatively simple.

Therefore, obtaining the other party's advance agreement to cooperate ensures that they will not create delays in the transaction and/or refuse to acknowledge the required assignment.

This "cooperation clause" can be in the form of either a direct provision in the purchase and sale agreement or an addendum thereto. While the client's QI can provide the appropriate language for this purpose, real estate agents need to know to ask for it.

In today's difficult market, the inclusion of a cooperation clause in the purchase and sale agreement also provides an additional benefit. REO properties or properties sold in a short sale require lender approval. However, lender approval will be significantly delayed and/or withheld if the lender is not apprised at the outset of a transaction that it will be an exchange and the contract will need be assigned to a QI. Being apprised at the outset of a short sale transaction or when the terms of the sale of the REO property are negotiated, allows for an exchange to be considered by the lender as part of its more difficult underwriting process. On the other hand, if a cooperation clause is not included in the purchase and sale agreement, the lender can (and many do) refuse to allow the assignment to a QI, resulting in delay or worse- a cancelled transaction.

In short, certain measures taken by the real estate agent before the QI enters the picture will not only impress the client, but may help avoid the expense of a pitfall in the transaction.

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