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Information and Risk Management Ideas for Real Estate Professionals

Understanding Starker Exchanges

Investment vehicle offers win-win opportunities for agents, investors

In this world nothing can be said to be certain, except death and taxes," Benjamin Franklin wrote in a 1789 letter. More than two centuries have gone by since then, and you still can't argue with Franklin. Although, judging from the billion-dollar anti-aging industry, lots of Americans are trying their best to avoid at least one inevitability. As for taxes? You can't escape them—but there are strategies out there to mitigate the damages.

On the real estate front, the Internal Revenue Service (IRS) has a provision that allows individuals to essentially roll over the profits from one real estate investment into a new one. Officially known as a Internal Revenue Code (IRC) Section 1031 exchange, it's often called a Starker exchange after a 1979 decision by the U.S. Ninth Circuit Court of Appeals that paved the way for broader interpretation and use of the IRS rules.

So what is an IRC Section 1031 exchange? "A tax-deferred exchange gives people the opportunity to defer capital gains taxes owed upon the sale of investment or income property by exchanging the property for other like-kind property," explains Rochelle Stone, President and CEO of Starker Services. "Exchanges can range from a simultaneous exchange of two properties to complex, multi-party transactions involving construction and/or reverse exchanges." The most commonly used method is a delayed exchange, in which a replacement property is identified and purchased after the old property is sold.

There are three key elements anyone considering an exchange needs to know:

- Time requirements
- Qualified intermediary requirements
- Notification requirements

The time requirements refer to how long a person has from the time they closes on an old property to the time they identify a like-kind property and then proceeds to close on the sale. Under IRC Section 1031, the clock starts running from the date the old property is sold. An investor then has 45 days to designate in writing the property they wish to purchase, and a total of 180 days (from the date of sale of the old property) to close on the new property.

The qualified intermediary requirements address who is eligible to prepare exchange documentation, hold the proceeds from the sale of the old property in escrow, and serve as a middleman facilitating the rollover of funds and the purchase of the new property. It's similar to how people manage tax-deferred retirement income: they must use a bank, mutual fund or other third party to roll it over directly

from one investment vehicle into another. When executing an IRC 1031 exchange, an intermediary can be any neutral third party—from attorneys (other than one's own) to companies, like Starker Services, that specialize in providing intermediary services.

The notification requirements refer to the need for a seller preparing to do an exchange to notify the buyer of the old property that there is an exchange. Similarly, the seller must be notified when the buyer of the new property is doing a Starker exchange. The main reason is that the "rollover" means that the qualified intermediary has constructive receipt or control over the proceeds in order to make the sale tax-deferred rather than taxable. While notification doesn't have any tangible impact on the other party to the transaction, the requirement is in the regulatory language and must be followed.

Stone offers some sample language real estate agents can incorporate into a real estate contract or include as an addendum. When selling property, she suggests using language such as, "It is the intent of the seller to perform an IRC Section 1031 tax-deferred

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exchange by trading the property herein with [qualified intermediary]. Buyer agrees to execute an assignment agreement at the request of seller at no additional cost or liability to buyer."

When buying property, Stone offers the following sample language: "It is the intent of the buyer to perform an IRC Section 1031 tax-deferred exchange by trading the property herein with [qualified intermediary]. Seller agrees to execute an assignment agreement at the request of buyer at no additional cost or liability to seller."

Creating Loyal Clients

As property prices have skyrocketed in recent years, everyone from casual investors to real estate moguls have sought strategies to avoid paying capital gains taxes on properties they may have bought a while ago and held onto for investment purposes. "IRC 1031 is a fair tax code," says Rochelle Stone. "Whether you're Donald Trump or an average person on the street, you get the same advantages and can defer the tax bill, if its millions or just \$10,000."

Agents and brokers, as real estate professionals, have a responsibility to know something about Starker exchanges

and to inform their clients about these tax-deferred products. Agents who offer solutions are generally seen as professional and knowledgeable—just the impression you want to keep current clients and attract new ones. What you don't want is to have clients learn about these investment vehicles after it's too late and they've just paid huge tax bills. In such cases, the clients are likely to come back and say, "You should have known."

Beyond the issue of mitigating risk, real estate agents and brokers who understand and can steer their clients to IRC Section 1031 exchanges can reap real rewards. "A client who has just saved thousands of dollars in taxes now has 15 to 30 percent more to invest in another property," points out Stone. "They're motivated to purchase new property, and they're very likely to use your services in that process." All of which translates into additional commissions.

The bottom line is that IRS Section 1031 exchanges are win-win situations for real estate professionals and their clients. Everyone wants to save money and make money, and Starker exchanges offer a way to do just that.

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Risk Management Reporter is published by Victor O. Schinnerer & Co.

¹ "Home Building is Fast Becoming an Industry of Giants," by Steve Brown. *newjersey.com*, February 6, 2006. On the Web at www.newjersey.com.