

NJ N2K Hour: 1031 Exchanges

Requirements and
Underwriting Practices

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What is a 1031 Exchange?

- A 1031 exchange is a swap of one investment property for another that allows capital gains taxes to be deferred.
- The name is derived from Section 1031 of the U.S. Internal Revenue Code.
- This provision allows an individual or entity to avoid paying capital gains taxes when an investment property is sold and to reinvest the proceeds from the sale within certain time limits in a property or properties of like kind and equal or greater value.
- The taxpayer who owns the relinquished property must also be the same taxpayer who takes ownership of the replacement property.

What is a 1031 Exchange? (cont.)

- 1031 exchanges are frequently utilized on commercial transactions.
- In the context of a commercial transaction, a title company can act as a Qualified Intermediary in a 1031 exchange in conjunction with its ability to serve as an escrow officer throughout the transaction.
- The title company can serve as an escrow officer on behalf of the taxpayer as he or she disposes of an initial property and identifies prospective properties that meet the requirements of a 1031 exchange to defer capital gains tax on realized gains.
- If the title company does not act as the qualified intermediary, then the title company will not deal directly with the buyer or seller but instead will deal solely with the Qualified Intermediary facilitating the exchange.
- The title company's central role in a 1031 exchange is that the agents on either side of the deal have access to all pertinent information and that the exchange can legally take place.

26 U.S. Code § 1031

- Section 1031 on its face appears to permit only a direct exchange of properties between two taxpayers.
- However, following the 1979 decision in *Starker v. U.S. taxpayers*, deferred exchanges were permitted in which the taxpayer sold the Relinquished Property to a buyer and acquired Replacement Property from a seller using the Realized Proceeds.
- Deferred exchanges are often called “Starker” exchanges.
- The Internal Revenue Service challenged deferred exchange, but the Tax Court allowed them.
- Therefore, in 1991, the Internal Revenue Service (IRS) adopted Regulations permitting them and governing their structure.

What is Replacement Property?

- Two types of properties that can be exchanged are real property and investment properties.
- Real property includes buildings and land, both commercial and residential.
- Investment property applies to properties held for generating income, such as rental properties.
- Personal property or intangible property cannot be used as part of a 1031 exchange.
- Personal property includes your primary residence, personal use vacation homes, and other personal belongings.
- Intangible property includes Inventory or stock in trade, stocks, bonds, or notes, other securities or debt, partnership interests, and certificates of trust.

Like-Kind Requirement

- For property to be eligible for a 1031 Exchange, the relinquished and replacement properties must be “Like-Kind” to each other.
- The term “Like-Kind” refers to the nature or character of the property, which ignores any differences of grade or quality.
- For example, residential, commercial, vacant land, mixed-use, and single-family rentals are all considered to be Like-Kind to one another.
- Both properties must be held for use in a trade or business or for investment.
- Property used primarily for personal use, like a primary residence or a second home or vacation home, does not qualify for like-kind exchange treatment.
- Real property that is improved with a residential rental house is like-kind to vacant land.

Eligibility Requirements

- However, real property within the United States is not like-kind to property outside of the United States.
- Furthermore, improvements that are conveyed without land are not of like-kind to land.
- To proceed with a 1031 exchange, you must first buy replacement property for equal or greater than sold for and reinvest all proceeds.
- Identify replacement property within 45 days of close of sale.
- Purchase replacement property within 180 days of close of sale.
- Must sell and buy property that is considered “like-kind” to each other.

Eligibility Requirements (cont.)

- The identification must be in writing, signed by you and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary.
- Notice to your attorney, real estate agent, accountant or similar persons acting as your agent is not sufficient.
- Replacement properties must be clearly described in the written identification.
- Regarding real estate, this must include a legal description, street address or distinguishable name.
- The IRS also has strict guidelines for the maximum number and value of properties that can be identified.

Completing the 1031 Exchange

- The replacement property received must be substantially the same as property identified within the 45-day limit.
- The proceeds from the sale must be held by a Qualified Intermediary (QI), a third-party that ensures the exchange complies with IRS regulations.
- The new property must be equal or greater value to the old value to avoid paying “Boot” (proceeds that are not re-invested which become taxable).
- If the new property is less than the sale of the old property, a 1031 Exchange can still be valid, but the Exchanger may have to pay taxes on the unused capital gains.
- You cannot receive any cash or other non-like-kind property during the exchange.
- Capital gains taxes are deferred, but they are not eliminated.
- Taxes will be owed on the gain when you sell the replacement property without conducting another exchange.

Reverse 1031 Exchange

- A reverse 1031 exchange is an IRS-sanctioned strategy where an investor acquires a new "replacement" property before selling their current "relinquished" property, allowing for tax deferral in a tight market.
- A reverse 1031 exchange offers more flexibility because a taxpayer may be faced with losing the opportunity to acquire their ideal replacement property when dealing with a traditional 1031 exchange.
- The investor might not have found a buyer for their relinquished property, or that property may not even be listed for sale yet.
- Even if the relinquished property is already under contract, the closing date may not be before the investor would purchase the replacement property.
- In a reverse 1031 exchange, an entity known as an Exchange Accommodation Titleholder (EAT) steps in to take title to the property while the taxpayer finds a buyer for their relinquished property.

Reverse 1031 Exchange (cont.)

- Once the EAT steps in, a taxpayer has up to 180 days to sell the relinquished property and finish the exchange for the replacement property that the EAT is holding.
- The taxpayer doesn't fully acquire the replacement property before the sale of the relinquished property, so the 1031 exchange can be done in the proper sequence.
- The Qualified Intermediary (QI) doesn't provide funds for the purchase.
- The funds instead come from a loan from the taxpayer to the QI or through a bank loan.
- The loan is then paid off once the relinquished property is sold and the money becomes available.
- During the period where the replacement property is held by the QI, the property is leased to the taxpayer, which allows the investor to sublease the property to tenants and collect and retain the rent.

Reverse 1031 Exchange (cont.)

- The taxpayer is responsible for expenses associated with the property as part of the lease.
- Once the transaction concludes, the QI simply makes it fee, and all the profits and costs of the new property are retained by the investor.
- The costs associated with a reverse 1031 exchange may vary depending on the type of property or value of the property.
- Other factors may include how long the EAT will be on title and the type of financing that is being utilized.
- The QI also holds the title to the new property temporarily, but the costs associated with the buildings, maintenance, and more are passed on to the end buyer.
- Lastly, the QI also charges a fee to act as the Exchange Accommodation Titleholder (EAT).

Mortgages

- A mortgage or deed of trust on the Relinquished Property can be paid off with exchange proceeds.
- The portion of the proceeds used to pay the mortgage or deed of trust are deemed Realized Proceeds and are always included in the Exchange Value, so the mortgage must either be replaced with a new mortgage or cash in purchasing of the Replacement Property.
- If the Taxpayer borrowed funds to purchase the Relinquished Property, the loan cannot be repaid out of exchange funds unless the loan was secured by a mortgage or deed of trust on the Relinquished Property.
- The Taxpayer also cannot take back a note in partial payment of the purchase price of the Relinquished Property without recognizing gain because a note is treated as other property, not Replacement Property.

Role of the Qualified Intermediary

- A Qualified Intermediary (QI) is a neutral third party in a 1031 exchange that facilitates the sale of the relinquished property and the purchase of the replacement property.
- The QI holds the proceeds from the sale to ensure they are not received by the taxpayer, preserving the tax-deferred status of the exchange under IRS guidelines.
- The QI is not required for a pure exchange where there are only two parties to the exchange, the Taxpayer and the Buyer.
- However, in a three or four-party exchange, a QI is required which includes the Taxpayer, the Buyer of the old property and the Seller of the replacement property.
- In a deferred like-kind exchange, it is the QI's obligation to withhold and not the obligation of the real estate escrow person (REEP).
- The QI must remit the withholding, and the accompanying withholding forms, unless the seller or transferor qualifies for an exemption.

QI Requirements

- Foreign financial institutions and foreign branches of U.S. financial institutions can enter into an agreement with the IRS to be a qualified intermediary.
- Any individual who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period preceding the date of the transfer of the Relinquished Property by the Exchanger is treated as an agent of the Exchanger and is specifically disqualified from being a Qualified Intermediary.
- A QI is required to provide the U.S. withholding agent with identifying information regarding U.S. persons subject to Form 1099 information reporting unless the QI assumes the primary obligation to do Form 1099 reporting and backup withholding.
- If a QI does not assume Form 1099 reporting and backup withholding responsibility, you must report on Form 1099 and, if applicable, backup withhold as if you were making the payment directly to the U.S. persons.

QI Requirements (cont.)

- Per 26 CFR § 1.1031.(k)-1(g)(6), the Exchanger is prohibited from having actual or constructive receipt of the proceeds from the sale of the Relinquished Property (Exchange Funds), or the ability to pledge, borrow or otherwise obtain the benefits of the Exchange Funds during the exchange or those proceeds will be taxable as boot.
- The QI therefore holds the proceeds from the sale of the relinquished property in a secure escrow account.
- The QI will typically prepare all necessary exchange documents during the 1031 exchange process.
- Some of these documents may include an Exchange Agreement, Assignments of Purchase and Sale Agreements, Notices of Assignment to the respective buyer and seller, and a Replacement Property Identification Notice, which will need to be completed for the exchange.

Benefits of Using a QI

- Without a QI, the transaction would not meet the necessary requirements and can potentially disqualify the exchange and trigger the immediate payment of capital gains taxes.
- The QI typically coordinates details with the closing agent to ensure the transaction is documented as a 1031 exchange and not a taxable sale and will provide written instructions to the closing agent.
- The closing statements will be reviewed by your Exchange Officer in advance of the closing.
- The QI holds exchange funds in a segregated, interest-bearing exchange account until the replacement property is acquired.
- The QI remains neutral throughout the 1031 exchange process, helping to ensure the integrity of the transaction.

Benefits of Using a QI (cont.)

- Numerous safeguards are in place to protect your funds during the Exchange Period.
- The QI will also keep you aware of the important timelines and provide timely reminders before the closing date.
- Ideally, you should contact the 1031 exchange company one to two weeks prior to the scheduled closing of the relinquished property.
- This time period will allow your Exchange Officer to prepare and forward the exchange documents to you with sufficient time to review and execute them.
- It also enables your Exchange Team to provide the closing agent ample notice that the transaction is part of a 1031 exchange.
- Please note that once title of the relinquished property is conveyed to the buyer and funds disbursed for the closing, it is too late to initiate the exchange, and the sale will be considered a taxable event.

Disadvantages of a 1031 Exchange

- 1031 exchange disadvantages include strict IRS deadlines (45-day identification, 180-day closing), high complexity, and transaction costs.
- A 1031 exchange only defers taxes (does not eliminate them) and requires reinvesting in similar "like-kind" property, limiting liquidity.
- These requirements can lead to overpaying or buying subpar properties due to time pressure.
- Depreciation recapture and capital gains taxes must be paid when the property is eventually sold without a new 1031 exchange.
- If the new property is of lesser value or debt is reduced, the difference (boot) is immediately taxable.

Disadvantages of a 1031 Exchange (cont.)

- Exchanging properties continually can tie up funds in real estate, making it hard for an investor to access liquid capital if required.
- While real estate can be a profitable investment, it's not as liquid as some other assets.
- Like all real estate transactions, 1031 exchanges are not immune to market downturns.
- If the value of the replacement property drops significantly, it can negatively impact an investor's portfolio.
- Lastly, each state varies in terms of using a 1031 exchange and may have certain rules which can complicate the 1031 exchange further.



Escrow Requirements

Key Documents

- Some of the documents below are typical for a 1031 Exchange:
- **A Purchase Agreement with 1031 Cooperation Clause allows the contract to be assigned to a qualified intermediary.**
- **An Exchange Agreement between the investor and the qualified intermediary outlining how the exchange will be structured.**
- **The Assignment of Contract which transfers the seller's interest in the purchase agreement to the qualified intermediary.**
- **The Notice of Assignment which provides written notice to the buyer that the contract has been assigned as part of a 1031 exchange.**
- **Replacement Property Identification Notice with the property description and investor's signature.**
- **Lastly, the title commitment which is prepared by the title company as part of the standard closing process.**

Role of the Title Company

- Even when not acting as the QI, a title company may assist in coordinating transaction documentation, handling escrow, and working with the QI and taxpayer to help ensure that the logistics of the exchange align with IRS rules.
- However, the taxpayer remains ultimately responsible for compliance with Section 1031 and related Treasury regulations.
- When dealing with a 1031 exchange, sale proceeds must be directed to a qualified intermediary (QI) to avoid constructive receipt.
- The title company helps implement these instructions but is not responsible for tax compliance.

Title Searches and Settlement

- A title company also conducts searches to verify facts such as ownership and any attached tax liens on the property which can help resolve some potential legal problems that could potentially delay or even prevent the sale.
- When necessary, the title company may issue a policy to protect the buyer or lender from future claims.
- Title companies can also manage transaction documents such as deeds and escrow instructions for settlement.
- While they do not handle IRS filings, their documentation supports the legal validity of the real estate transfer.

Benefits of Using a Title Company

- Unlike a qualified intermediary (QI), the title company facilitates closing, performs title searches, holds escrowed funds (not exchange funds), and issues title insurance.
- Although title companies are not legally required for a 1031 exchange, it is highly unusual and risky not to use one, as the title company will ensure clean title and proper closing procedures.
- The title company works closely with your qualified intermediary to ensure the transaction is structured correctly.
- The closing process will typically involve a series of documents, including:

**Settlement Statement (ALTA or Closing Disclosure); Deed;
Exchange Instructions; and Assignment of Sale Contract.**

Post-Closing

- Once the closing has occurred and the deed has been recorded, the title insurance policy will be issued by the title company to protect the new ownership interest.
- The Final Exchange Accounting Statement is then prepared by the qualified intermediary showing the flow of funds for the exchange.
- Once the exchange is completed, the investor must report the transaction when filing their tax return.
- The required documentation is IRS Form 8824 – Like-Kind Exchanges.
- This form reports the relinquished property, the replacement property, and the deferred capital gain.

Asset Preservation, Inc. (API)

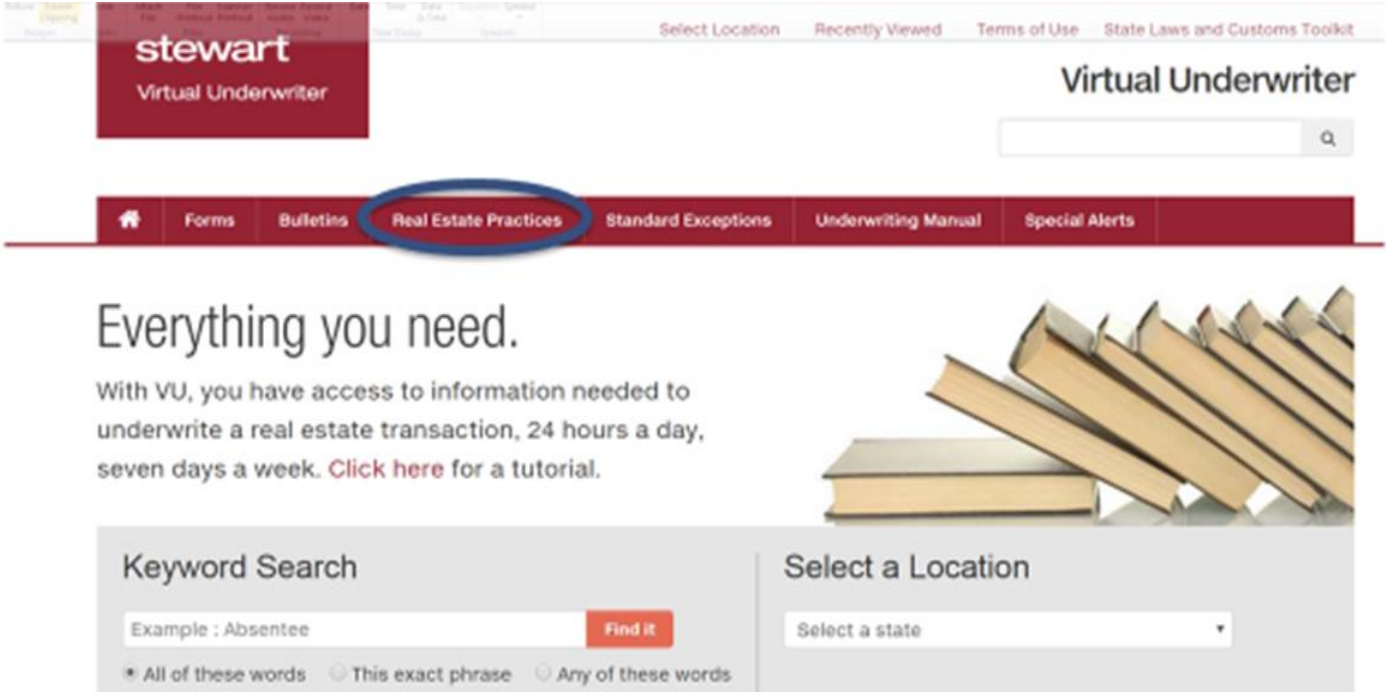
- Each title company typically uses their own 1031 exchange company.
- Asset Preservation, Inc., a Stewart subsidiary, is a 1031 Qualified Intermediary, and is also a recognized national leader in 1031 exchange companies, having successfully completed over 200,000 IRC Section 1031 exchanges.
- Please be sure to visit their website below for more information.

<https://apiexchange.com/>

Conclusion and Wrap-Up

- A traditional 1031 exchange is a swap of one investment property for another that allows capital gains taxes to be deferred.
- The name is derived from Section 1031 of the U.S. Internal Revenue Code.
- A reverse 1031 exchange is an IRS-sanctioned strategy and offers more flexibility where an investor can acquire a new "replacement" property before selling their current "relinquished" property, allowing for tax deferral in a tight market.
- Even when not acting as the QI, a title company may assist in coordinating transaction documentation, handling escrow, and working with the QI and taxpayer to help ensure that the logistics of the exchange align with IRS rules.
- Although title companies are not legally required for a 1031 exchange, it is highly unusual and risky not to use one, as the title company will ensure clean title and proper closing procedures.

www.VUwriter.com



The screenshot shows the Stewart Virtual Underwriter website. At the top left is the Stewart logo with the text "Virtual Underwriter". To the right, there are navigation links: "Select Location", "Recently Viewed", "Terms of Use", and "State Laws and Customs Toolkit". Below this is a search bar with a magnifying glass icon. A dark red navigation bar contains several menu items: "Forms", "Bulletins", "Real Estate Practices" (which is circled in blue), "Standard Exceptions", "Underwriting Manual", and "Special Alerts". Below the navigation bar, the main content area features the heading "Everything you need." followed by the text: "With VU, you have access to information needed to underwrite a real estate transaction, 24 hours a day, seven days a week. [Click here](#) for a tutorial." To the right of this text is an image of several books stacked together. At the bottom of the page, there are two search boxes. The left one is titled "Keyword Search" and contains the text "Example : Absentee" and a "Find it" button. Below it are three radio button options: "All of these words" (selected), "This exact phrase", and "Any of these words". The right one is titled "Select a Location" and contains a dropdown menu with the text "Select a state".

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June N2K HOUR

The Current State of Tax Sale Foreclosure Law in New Jersey

Tuesday

June 16th

11:00AM