

TOP TEN EXCHANGE RED FLAGS



QUALIFIED
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SERVICES

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- 1. The Disqualified Qualified Intermediary:** To effectuate a deferred Section 1031 exchange, taxpayers must utilize the qualified intermediary safe harbor. Any person serving as a qualified intermediary for the taxpayer cannot be a disqualified party. Examples of disqualified parties include the taxpayer's attorneys, accountants, real estate agents/brokers and employees. Under the Internal Revenue Code's attribution rules, the disqualification cannot be removed by setting up a separate legal entity owned by the disqualified party or by a disqualified party's family member. Taxpayers seeking the services of a qualified intermediary company should inquire into the entity's ownership to ensure the exchange will not be disqualified as a result of its ownership.
- 2. Not Asking the Right Questions:** While most exchangers and practitioners appreciate the complexities of Section 1031, some hold the opinion that most exchanges are "plain vanilla." Rarely is this the case. By asking the right questions from the start, a seasoned qualified intermediary can uncover problems and offer alternative structures. Planning and careful consultation with the qualified intermediary, as well as tax and legal advisors, is the key to a successful exchange transaction.
- 3. Unassignable Real Estate Purchase Agreements:** While it is common practice to place exchange cooperation language in purchase agreements, a critical component of the language is often omitted. Under Section 1031, the exchanging taxpayer must have the ability to assign the agreement to the qualified intermediary. It is crucial to review agreements for the ability to assign, or to amend contractual language to state that the agreement may be assigned by the exchanging taxpayer.
- 4. Trading Down in Value:** It is a common misconception that an exchanger can defer all tax on the sale of a relinquished property by simply reinvesting gain on the sale. Generally speaking, to defer all tax on an exchange transaction, three general rules must be satisfied. First, the value of the replacement property must be greater than or equal to the value of the relinquished property. Second, all equity from the relinquished property must be reinvested into the replacement property. Third, all debt relief from the relinquished property sale must be replaced with equivalent new debt on the replacement property; or in the alternative, new cash can be substituted for debt relief. While gain on an exchange can be partially deferred, tax will result to the extent a trade down in replacement property value occurs. Exchangers are encouraged to consult with their tax advisors regarding other tax matters that may impact the ability to defer taxes in a Section 1031 exchange.
- 5. Not Utilizing the Power of Reverse Exchanges:** A reverse exchange transaction may be appropriate when a taxpayer desires to take title to a replacement property prior to conveying the relinquished property. Revenue Procedure 2000-37 provides a safe harbor for these situations. To accommodate a reverse exchange, title may be parked with an Exchange Accommodation Titleholder. A reverse exchange can afford an exchanging taxpayer with the ability to locate and acquire the most suitable property with reduced time pressures. Commonly, a taxpayer can utilize a reverse exchange to achieve significant savings on the purchase of the replacement property.

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6. **Not Documenting the Exchange:** The documentation requirements of Section 1031 are strict and the requirements for accuracy cannot be overlooked. To effectively accommodate an exchange transaction, a qualified intermediary must ensure that technical exchange document terms, notices, identifications and other requirements are handled correctly. This can only be accomplished by providing specialized services, following specific standards of practice and working closely with an exchanging taxpayer's advisors.
7. **Prohibited Related Party Transactions:** The related party rules under Section 1031 are complex and confusing. Misapplications of these rules are a common reason for failed exchange transactions. It is a common misconception that a taxpayer can purchase replacement property from a related party in a deferred exchange transaction provided the property is held for two years. This is incorrect as set forth in Revenue Ruling 2002-83, wherein it states that related party replacement property purchases are specifically prohibited. Exceptions and structuring alternatives do exist. However, careful analysis of the underlying facts and circumstances must occur.
8. **Flipper and Dealer Status:** To qualify for Section 1031 treatment, property must be held for investment or use in a trade or business. This is distinguished from properties held for sale or as inventory. Property flippers and dealers are not eligible for Section 1031 treatment. With advanced planning, it is possible to structure ownership arrangements to afford the use of Section 1031 for properties held in an investment context.
9. **Settlement Statement Problems:** Careful attention must be paid to settlement statements for properties involved in a Section 1031 exchange. Besides documenting the flow of funds and intent of the parties, it is important to avoid using exchange proceeds to pay for non-qualifying expenses such as rents and deposits, loan costs and expenses unrelated to the property. Further, the replacement property cannot be over-financed. Mishandled expenses and loan proceeds can result in an unexpected tax obligation, or an exchange that is outside the safe harbor.
10. **Partnership Issues:** Many investment property owners hold property in multi-member LLCs, most of which are considered partnerships for tax purposes. While partners may desire to sell the partnership property and exchange into separate replacement properties, this is not permitted under Section 1031. If undertaken sufficiently in advance of a disposition of partnership property, a partnership may be terminated and converted into an exchangeable tenancy-in-common interest. Further, structuring alternatives within the partnership may be utilized to allow retiring partners to exit. Advanced planning by the exchanging taxpayer is crucial.



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