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Avoiding the Pitfalls of 1031 Exchanges

Undoubtedly one of the best methods of deferring capital gains taxes is through the use of Section 1031 of the Internal Revenue Code, 26 U.S.C. § 1031, commonly known as the 1031 Exchange. However, as popularity of the 1031 Exchange increases so do concerns. In today's market, a basic understanding of 1031 Exchanges is invaluable and thorough due diligence is key.

Basics of the 1031 Exchange

A 1031 Exchange is a transaction joining together the sale of old property and the purchase of new property in order to defer capital gains. Although 1031 Exchanges can be used for a variety of assets, they are traditionally used in real estate. Exchangers who sell appreciated property and reinvest the proceeds in a new property avoid gain recognition. To realize such benefits and to classify as a valid 1031 Exchange, the exchanger must strictly adhere to several rules. First, the property sold and the property received in exchange must be held for investment or for use in a trade or business. Second, the properties must be of "like kind," meaning the nature of the properties must be identical. Third, the properties cannot be specifically excluded from tax free exchange treatment, as designated by the Internal Revenue Code. The taxpayer that sells the old property must be the same taxpayer that purchases the new property and, in order to defer all the gain, the properties purchased must be equal or greater in value to the properties sold.

The predominant rule for the 1031 Exchange is that all proceeds from the sale of old property must be held by a Qualified Intermediary and must be reinvested in new property. Cash kept from the sale of property is often referred to as "boot" and is taxable. "Boot" is anything that is exchanged that is not "like kind" property. For instance, mortgages are a form of boot. When the mortgage on old property is less than that of the new property, taxes might be paid on the difference. Under certain circumstances, mortgage boot may be offset with additional cash.

1031 Exchanges can be achieved in several ways, but today, the most common exchange is the delayed exchange. To avoid having to find someone to simultaneously swap properties with, the delayed exchange allows you to sell your property first and then buy replacement property at a later date. The exchanging party must identify the property to be received within 45 days and the property must be received within 180 days or before the due date of the exchanger's tax return. Security devices, such as cash or cash equivalents held by a qualified intermediary, can be used to secure the delayed transfer.

An Unregulated Market

Qualified Intermediaries are authorized under Section 1.1031 of the Department of the Treasury Regulations and are responsible for receiving, holding and safeguarding 1031 Exchange funds until the exchanger is ready to purchase a replacement property. Intermediaries also prepare required documents and help ensure compliance with regulations. However, they are not licensed, regulated, audited or otherwise monitored by any regulatory body, which can present numerous problems, as evident by the recent rise in intermediary failures.

The unregulated intermediary market has recently received attention following The 1031 Tax Group, LLC's filing for Chapter 11 Bankruptcy in May 2007. The 1031 Tax Group was a consolidated group of five qualified intermediary companies doing business throughout the United States. The 1031 Tax Group's bankruptcy filing has left hundreds of exchange customers with open accounts and vulnerable to being unable to complete the second half of their real estate exchange, and potentially losing their exchange funds altogether, which are still subject to capital gains tax. In the months prior to the 1031 Tax Group's bankruptcy filing, Southwest Exchange, a large Qualified Intermediary based in Nevada, improperly invested approximately $95 million of exchange funds, leaving exchange customers in a similar position.
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These events have prompted growing concerns over which intermediaries can be trusted. However, despite the recent rise in qualified intermediary fraud and failure, there are numerous ways to help protect your assets.

Avoiding the Pitfalls

Avoiding the pitfalls of 1031 Exchanges lies in learning the basics and conducting thorough due diligence into the intermediary. When conducting due diligence, it is important to keep in mind the following:

1. Choose an intermediary that utilizes segregated accounts. Keeping your funds in a segregated account may provide you with some security in the event that your intermediary files for bankruptcy.

2. The intermediary with the lowest fee is not always your best option. Often intermediaries lower fees while increasing retention of interest earned on your account. Be sure that you are receiving market rate interest on your funds. Be wary of representations from a Qualified Intermediary that you will receive "all the interest" on your funds; nearly every Qualified Intermediary makes a portion of their money on aggregating exchange funds for multiple customers and then receiving above market rate interest on the aggregate funds on deposit held by the Qualified Intermediary.

3. Different exchanges present different issues. Understand the packages intermediaries provide and diligently discuss and review your needs.

4. Make sure your intermediary has necessary and appropriate levels of bonding and insurance coverage as well as equity capitalization in order to account for losses.

5. Finally, conduct a background and reference check. Look for intermediaries with long term track records, experience, and professional recommendations without professional licensure issues or criminal convictions.

6. Require multiple signatures on the account to transfer the funds. However, be sure that required signatures are for trust individuals who are not exchange customer—signatory authority by the exchange customer likely would constitute constructive receipt of the sale proceeds by the customer which would destroy the tax-deferred exchange.

While the steps above cannot guarantee a successful 1031 Exchange, they can help you make the best possible choice when evaluating qualified intermediaries.

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