

Legal Considerations & Challenges for 1031 Exchanges

Prior to entering into a like-kind exchange under Section 1031 of the Internal Revenue Code of 1986, as amended ("Section 1031"), the taxpayer/proposed exchanger should consider the economic and legal aspects of the exchange transaction. First, Section 1031 is a tax-deferral provision; it is not a tax avoidance provision. In other words, the adjusted tax basis of the property being sold, or the relinquished property, carries over to the purchased property, or replacement property. There are certain adjustments to the tax basis, which are to be made, but, in general, the gain inherent in the relinquished property carries over to the replacement property. Second, Section 1031 is not an all or nothing provision. A taxpayer/exchanger can defer all, part or none of the gain inherent in the relinquished property. The amount of gain to be "recognized" for tax purposes depends upon the amount of "boot" received in the transaction. In order to defer all of the gain, a common benchmark, which taxpayers should use, is that the taxpayer must purchase replacement property of equal or



MRE/THI PHOTO

Paul J. Linstroth

greater value than the relinquished property and all of the equity from the relinquished property must be invested in the replacement property. A common misnomer is that some taxpayers believe that they only need to buy

replacement property equal to the equity in the relinquished property. A taxpayer who follows this path is in for a surprise. They may have conducted an exchange transaction and not deferred any of the gain from the sale of the relinquished property. Third, and probably the most important, the taxpayer must consider the economic consequences associated with acquiring the replacement property. Some taxpayers become enamored with the thought that they can defer taxes and acquire replacement property, which they would not otherwise acquire due to the economic uncertainties of that property. In short, as with any other real estate transaction, the taxpayer must conduct its due diligence on any potential replacement property.

With respect to drafting the documents related to an exchange transaction, it must be determined whether the transaction the taxpayer is contemplating is, among others, a forward exchange, reverse exchange, improvement exchange or tenant in common transaction. The taxpayer/exchanger should consider inserting in the purchase and sale agreement for both the

relinquished and replacement properties a "cooperation clause." Such a clause generally provides that the other party to the transaction will cooperate with the taxpayer/exchanger, at no expense to the other party, in conducting a like-kind exchange should the taxpayer/exchanger elect to do so. If such a provision is not in the purchase documents, it is by no means fatal to the transaction. Rather, it is merely a useful tool to make certain that there are no glitches should the taxpayer wish to undertake a like-kind exchange. In a forward exchange, the most often utilized structure involves the use of a qualified intermediary. The qualified intermediary generally will have a set of form documents, which would include an exchange agreement, an assignment of the relinquished and replacement property purchase agreements, and a form upon which the taxpayer/exchanger would designate its potential replacement properties. In a reverse exchange transaction, typically you will see a qualified exchange accommodation agreement, a lease and

QI? from page 11

exchange may be the very most important aspect of your exchange. At the closing of your sale going into an exchange the Q.I. is assigned into the purchase agreement. They are effectively given the "bundle of rights" to the property, which includes the right to sell the property. The closing statement says the Q.I. is the seller. The proceeds of the sale have to go to the Q.I. Technically it is the Q.I.'s money! At this point it is a little late to start being concerned about who you have selected to be your Q.I.

Your choice of Q.I. should be one of the first things you do when planning an exchange. They not only hold the funds as required by 1031 law, but if they are a full service firm they will be available and want to guide you through the exchange from beginning to end to assure a defensible exchange. If they can't or won't do that you probably have made a poor choice.

In your first interview with a prospective Q.I. here are questions that should be among those you ask:

- How long have you been in business?
- What experience do you have?
- How many exchanges do you facilitate annually?
- Can you facilitate exchanges of every kind and everywhere?
- Do you have a large support staff of

specialists in every aspect of exchanging?

- Are you and your staff Certified Exchange Specialists(r)?
- Are you and your staff readily available by phone when I need you?
- Do you pool my funds with others or do you offer individual accounts?
- What security arrangements do you maintain for my funds?

And probably the most important question . . .

- Do you have a FIDELITY BOND?

There have been only a handful of Q.I. defaults across the Nation. I am not aware that any were covered by Fidelity Bond. One in Wisconsin was the owner of a title insurance company who also operated a Q.I. service. He embezzled exchangor funds. The bond underwriter for his title company refused to pay for exchangor losses because they said it was not the same business.

The amount of the bond may be of less importance than knowing the Q.I.'s background. If you are at the point of seeking compensation from the bond underwriter you have probably made a poor choice of Q.I. at the beginning.

By: Wendell W. Maltby, CES(r), is Midwest Regional Manager for Starker Services, Inc.

Legal from page 7

a note. Throughout the period of the reverse exchange, the "exchange accommodation titleholder" will have title to either the relinquished or replacement property. In an improvement exchange (i.e., where improvements will be made to the replacement property as part of the exchange), the taxpayer and the qualified intermediary should enter into an agreement which states that the exchange proceeds from the sale of the relinquished property will be used to make improvements to the replacement property during the period of time which the qualified intermediary holds the replacement property. Finally, in a tenant in common transaction, you will generally have the basic forward exchange documents, noted above, but there will also be a single member limited liability company which will be formed to hold the undivided interest in the real estate that the taxpayer/exchanger is acquiring in the exchange transaction. This single member limited liability company is disregarded for tax purposes and the taxpayer is viewed as acquiring a direct interest

in the replacement property even though title is vested in an entity. In addition, there are various agreements between the tenants in common who own the property which set forth their rights and obligations with respect to the ownership of the property and their rights and responsibilities with regard to the approval of leases, the partition of the property, the allocation of income and expense and so forth.

Finally, in conducting an exchange transaction the taxpayer/exchanger should carefully select a qualified intermediary. At a minimum, the qualified intermediary will be holding the taxpayer's exchange proceeds, and, in the case of a reverse exchange or improvement exchange, hold property in which the taxpayer has an interest. Therefore, make certain that you understand the financial wherewithal and credibility of the qualified intermediary that you may be dealing with in the transaction. Furthermore, each qualified intermediary, or an exchange accommodation titleholder in the case of a reverse exchange, will charge a fee for their

Legal to next page