

BUSINESS

SECURITY OPTIONS FOR 1031 EXCHANGE FUNDS

In structuring a deferred exchange, taxpayers must be aware of the actual receipt of the sale proceeds.

Derrick Tharpe

A §1031 tax-deferred transaction is defined by the exchange of property for other like kind property. However, if a taxpayer receives the proceeds from the sale of the relinquished property prior to acquiring the replacement property, the transaction will constitute a sale and not qualify as a tax-deferred exchange. IRC §1031.

To assist the taxpayer in avoiding actual or constructive receipt of the proceeds from the sale of the property, the 1991 Treasury Regulations provided newly defined "Safe Harbors" for the conduct of §1031 exchanges. Through the establishment of these safe harbors, the regulations provided taxpayers with mechanisms, which, if followed, would preclude a determination by the IRS that the taxpayer is in actual or constructive receipt of money, boot or the other proceeds from the exchange.

The Safe Harbors provided by the Treasury Regulations are Security or Guarantee Arrangements; Qualified Escrow; Qualified Intermediaries; and Growth Factors & Interest. Reg. §1.1031(k)-1(g).

The most significant Safe Harbor created by the 1991 Regulations is that for Qualified Intermediaries. Reg. §1.1031(k)-1(g)(4). A Qualified Intermediary (QI) is an independent third party who is designated by the taxpayer to receive the proceeds from the sale of the taxpayer's relinquished property, and thereafter, continues to hold the proceeds throughout the entire term of the exchange. As a result of this direct conveyance of funds to the QI, the taxpayer is able to avoid constructive receipt of the proceeds from the relinquished property sale. At present most tax-deferred exchanges are currently conducted using a QI.

Recently, there have been several high profile examples of qualified intermediaries who have lost or failed to adequately secure the funds entrusted to them by taxpayers seeking to do 1031 exchanges. One notable example occurred in the first months of 2007, in which a qualified intermediary failed to release millions of dollars in exchange proceeds for numerous real estate transactions in which taxpayers were acquiring replacement

exchange and, more importantly, may have lost a significant portion of the proceeds from the sale of their relinquished property.

The primary areas of concern for the taxpayer and their advisor are the misuse or loss of exchange funds by the intermediary, as well as the possibility that the QI may become bankrupt during the exchange period.

However, if appropriately applied, the safe harbors outlined above may also provide mechanisms by which the taxpayer can secure the funds while they are being held by the qualified intermediary.

One device that may be used to secure the obligation of an intermediary in a 1031 exchange is the use of another Safe Harbor, Qualified Escrow Accounts and Qualified Trusts. Reg. §1.1031(k)-1(g)(3)(i).

Typically, under this safe harbor the third party's obligation to acquire and transfer the replacement property to the taxpayer may be secured by cash (or a cash equivalent) if the cash is held in a Qualified Escrow Account or a Qualified Trust. As with all 1031 exchanges, in order to qualify under this safe harbor, the qualified escrow or qualified trust must specifically limit the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of the relinquished property sale proceeds prior to the expiration of the exchange period. Reg. §1.1031(k)-1(g)(6).

In those transactions where the qualified intermediary is used to affect an exchange, the taxpayer or their advisor may require that the QI secure the exchange proceeds through a Qualified Escrow Account or Qualified Trust. Having the qualified escrow account or qualified trust should provide the taxpayer adequate security against concerns about a dishonest intermediary by securing the obligation, through a trust or escrow agreement, to acquire replacement property and transfer it to the taxpayer.

While the Qualified Escrow Account or Qualified Trust may protect the taxpayer against a dishonest QI, it may not be sufficient by itself to protect the taxpayer's interest from a QI who is facing bankruptcy.

There have been a number of cases in which a QI has faced bankruptcy

trustee will try to treat the exchange proceeds held by the QI as a part of the QI's bankruptcy estate. Therefore, those exchanges funds could potentially be considered as an asset of the QI, which would then be subject to restrictions on transfer imposed by the bankruptcy proceedings. Also, the funds could be unavailable to acquire and transfer replacement property on behalf of the taxpayer. See *In re San Diego Realty Exchange, Inc.*, 132 B.R. 424 (Bankr. S.D. Cal. 1991).

In that case it may be necessary for the taxpayer not only to have a Qualified Escrow or Trust, but also have a perfected security interest in the qualified escrow or trust. Reg. §1.1031(k)-1(g)(3). Currently, under the safe harbors provided by 1031 Regulations the taxpayer is able to perfect a security interest in funds held in the qualified escrow account or qualified trust.

However, if the funds are not held in qualified escrow or trust the security interest would result in constructive receipt of the funds by the taxpayer and disallow exchange treatment under 1031.

The Regulations have provided mechanisms for the accomplishment of a 1031 exchange and there is no need to make them unduly cumbersome by piling on multiple safe harbors when the risks you are trying to protect against can likely be avoided by making a informed choice in selecting a reputable and secure qualified intermediary.

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McSHANE CONSTRUCTION



3381 Greenbriar Parkway
Atlanta, Georgia

Park View
COVENTRY STATION

Project Description

A new 166-unit affordable senior housing community

Construction and Design Team

McShane Construction Corporation
Martin Riley Associates Architects P.C.

Developer

The Shelter Group

McSHANE
CONSTRUCTION
CORPORATION