

1031 EXCHANGES: A CASE STUDY

Finding an intermediary that is qualified to facilitate a 1031 transaction is essential to a successful 1031 transaction.

Scott Spinner

As a nationwide provider of real estate transactional services, our clients at Sutton Alliance turn to us for sound judgments and informed real estate decisions.

One recent transaction involved a seller (the exchanger) who wanted to sell a piece of property and purchase another in exchange, and to take advantage of the tax benefits afforded under Internal Revenue Code (IRC) Section 1031. When he contacted the company, he was directed to a customer representative in our 1031 Exchange Services division. He asked if we would be able to prepare the necessary documentation for a tax-deferred transaction and to act as the qualified intermediary, also called "QI" or "exchange accommodator."

In my role as general counsel, I oversee the daily operations of Sutton Alliance's legal and escrow departments. When this file reached my desk, I noticed that this individual was also someone I had previously represented as an attorney when he purchased a commercial office building. In addition, 2 years ago I assisted him as a real estate broker, when I negotiated for him with a buyer's broker the listing price on another property he was selling.

The IRC provides that a reciprocal trade or actual exchange must take place in each 1031 transaction. The IRS takes the position that if you touch the money, you are required to pay the tax. According to this position, you must relinquish control of the money, and to do so, you must use a qualified intermediary to transfer the money from the sold property into the purchased property.

The intermediary helps preserve the fiction of an exchange and solves the problem of actual receipt or constructive receipt of the sale proceeds.

The exchanger must assign to a qualified intermediary their interest as seller in the relinquished property. The code also provides that the intermediary must be an independent party to the transaction. Therefore, if an exchange accommodator, or qualified intermediary, is a related party to the exchanger, that individual is

disqualified to act as the intermediary. Safe harbor under Section 1031 is only provided when using a qualified intermediary.

A disqualified party is a person or entity (corporation, limited liability company, partnership) who or which is related to the exchanger. A person is a related party if he or she is a relative — brother, sister, father, mother, wife, child, etc. An entity is related to the exchanger if the same persons own 10 percent in value of the outstanding stock of the corporation or more than 10 percent of the capital interest or the profit interests in the partnership. In addition, a person would be disqualified if within 2 years preceding transfer of the relinquished property, he or she were the exchanger's employee, attorney, accountant, real estate broker or agent, or investment bank or broker.

It is important to note, however, that not everyone with whom you have had a recent business relationship is prohibited from acting as the QI. Under the following conditions you remain within the safe harbor protection: (1) if the person or entity acting as the intermediary only provides the exchanger with the following services: routine financial, trust, title insurance or escrow services; or, (2) if the person acting on behalf of the exchange accommodator serves the exchanger solely with respect to exchange property, then he may be a qualified intermediary.

Therefore the QI may be an attorney or an accountant, but only where he does not currently represent the exchanger in such a professional capacity, or had done so within 2 years preceding the proposed 1031 exchange.

Accordingly, having represented this individual in the past as his attorney and real estate broker, my company is now disqualified to act as the qualified intermediary for the current transaction.

However, I am not precluded from giving legal advice and counsel to my client regarding how to structure this deal in order to take advantage of the benefits afforded under Section 1031 of the IRC.

My client and a group of investors pur-

chased this property 3 years ago and took title as a limited liability company. He told me that the partners could never agree on how to manage the property, so 3 months ago the member investors voted unanimously to dissolve the LLC. Each member took an individual interest in the property as a tenant-in-common.

Unfortunately, now I was forced to advise my client once again that he would not be able to take advantage of the benefits afforded under the code.

Under IRC Section 1031, "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment purposes." Where you dissolve an entity and make each former member a tenant-in-common, unless done with proper planning a year or more in advance of the contemplated sale, the IRS takes the position that each of the individual owners is now holding the property for resale purposes only, and not for productive use or trade. This scenario, which is disfavored by the IRS, is commonly referred to as a "drop and swap."

Choosing an intermediary is the most important step in developing a defeasance exchange. A professional QI is typically a member of the Federation of Exchange Accommodators, and is bonded. Most title companies have separate entities that will serve as qualified intermediaries. Sutton 1031 Exchange Services, a division of Sutton Alliance, maintains both Errors and Omissions coverage and fidelity bonds, and is a member of the Federation of Exchange Accommodators.

While there are certain persons who may not act as your qualified intermediary or certain situations that may not qualify you for the benefits under 1031, you can benefit from experts before you decide to complete an agreement to sell a property that may be part of an exchange transaction.

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