Tips For The 1031 Consumer

What real estate owners should look for before doing a 1031 Exchange.

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For several years now, tax deferred exchanges have been a major force in the real estate market. While the concept of like-kind exchanges has been a part of the tax code since 1918, it first became a practical tool within the reach of all investors when, in 1990, the U.S. Treasury Department issued the Omnibus Budget Act of 1990. In the Act, the Treasury clarified the 45-day identification period and 180-day exchange period rules and clarified the actual and constructive receipt issues by allowing the use of a Qualified Intermediary (QI) as a safe harbor.

The Federation of Exchange Accommodators (FEA), the national trade organization representing the parties directly involved in Section 1031 exchange transactions, markets the concept and teaches investors about the benefits and techniques of Section 1031 exchanges. This marketing effort was first successful on the West Coast, the FEA's home. The shorter transaction period typical in that part of the country, and possibly a higher risk tolerance, also contributed to the Section 1031 exchange's early popularity on the West Coast.

While Section 1031 exchanges did not catch on as quickly on the East Coast, the good news did eventually travel. The late 1990s saw the beginning of a real estate boom that we are still experiencing today. The appreciations in real property are enormous and continue to grow. Investors, their tax and legal counsel, lenders and realtors throughout the country have become educated in the nuances of tax-deferred exchanges as a matter of necessity. Section 1031 of the tax code provides one of the only commercially accessible safe harbors available to small and mid-level investors for earnings attributable to the ownership of investment real estate. Section 1031 exchanges are therefore a staple of real estate investment and real property transactional practice.

For those of us in the real estate transaction business, the increased recognition has ignited a profitable trend. Demand for tax benefits has spurred demand for replacement properties. And the increase in transactions consequently enticed many new entrants into the Qualified Intermediary (QI) business.

Investors, or 1031 consumers, have a wealth of options when it comes to choosing the best provider to facilitate their tax-deferred exchanges. The following are some ideas regarding what you might expect or request of your qualified intermediary:

1. Fidelity Bonds and Errors & Omissions Coverage

The QI has a fiduciary responsibility to receive, hold and safeguard Section 1031 exchange funds during a transaction. Since there are no regulatory or financial restrictions placed on a QI, a 1031 consumer will be interested in the QI's financial stability, as well as the bonds and E&O policies that the QI has in place.

2. Membership in the FEA

The FEA encourages innovation in the industry, establishes ethical standards of conduct and works toward the development of uniformity of practice and terminology within the exchange profession. Membership in the FEA indicates a QI's participation in the exchange of ideas and knowledge regarding tax-deferred exchanges.

3. Access to Title Insurance Underwriting

Timing is the key to a Section 1031 exchange transaction. The investor is faced with tight deadlines within which to sell property, identify replacement property and close on replacement property.

The ideal QI does more than dot the i's and cross the t's on the agreement and assignment documents involved in the transaction. In order to smooth the way and help investors meet deadlines, a QI will:

- Have access to title companies nationwide. Replacement properties can be located anywhere, and a QI with ties to title companies with a national focus can help clear title and arrange the closing in a quick and efficient manner. On the other hand, too-close ties to just one nationwide company can have the perverse effect of limiting underwriting flexibility.
- Be experienced at closing complex transactions. Most exchange transactions are not simple forward exchanges. A QI with ties to sophisticated title companies can help you work through the knotty title issues arising in complex transactions and ensure that title company delays do not arise and jeopardize the tax-deferred status of the transaction.

4. Interest Income on Exchange Funds

The QI market is not uniform in its treatment of interest income on exchange funds. An investor is not only entitled to negotiate with a QI to retain the interest income, but he or she should enlist the QI to negotiate with financial institutions to obtain the best rate on his or her behalf.

5. Experience

There is no question that experience is the best teacher. Familiarity with a particular type of transaction will help a QI conduct its role in the transaction in the most professional manner.

In the last 10 years, Section 1031 of the Internal Revenue Code has successfully made the journey from obscurity to common practice. There are many professionals who stand ready to give advice and help facilitate the exchange transactions. The right professionals are the ones who can and routinely do deliver the successful transactions. **SCB**

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