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EARLELAW Newsletter

Section 1031 Exchanges: Qualified Intermediaries' Use of Exchange Funds

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People use various types of investments to achieve their financial goals. One advantage of using real estate, *vis-a-vis* other types of investments, is the ability to defer, sometimes indefinitely, capital gains taxes.

The Internal Revenue Code (IRC) contains a provision whereby real estate investors can defer gain or loss upon the exchange of investment properties of "like-kind". IRC § 1031.

Several requirements must be met in order for a like-kind exchange of properties to qualify for capital gains tax deferral. The properties must be held for productive use in a trade or business or for professional use, IRC § 1031(a)(1), and where the exchange is deferred for a short period of time, there must be compliance with certain time limitations. IRC § 1031(a)(3), *codifying but limiting, Starker v. United States* (9th Cir. 1979) 602 F2d 1341, 1354-1355.

Three substantive requirements must be met where an exchange is "deferred", that is, where the replacement property is not acquired simultaneously with the transfer of the relinquished property. First, the taxpayer must "identify" a like-kind replacement property within 45 days after transferring the relinquished property. IRC § 1031(A)(3)(A). Second, the taxpayer must actually receive (take title to) the replacement property no later than 180 days after transferring the relinquished property or on or before the due date for the tax return for the year in which the transfer occurred (including extensions) – whichever date occurs first. IRC § 1031(a)(3)(B). Third, Treasury Regulations require that the

replacement property be "substantially the same property as identified." Regs. § 1.1031(k)-1(d). (Up to three properties can be identified, provided the aggregate market value of the properties does not exceed 200% of the value of the relinquished property. Regs. § 1.1031(k)-1(c).)

Procedural rules prohibit the taxpayer from having access to, or being able to borrow against, cash obtained from the sale of a relinquished property. Regs § 1.1031(k)-1(g)(3), (6) & (k). Proceeds from the sale of the relinquished property can be held in an escrow or trust account, as long as the escrow holder or trustee is not the taxpayer or other "disqualified person." A "disqualified person" is defined as someone who is, or who has been within the past two years, an agent of the taxpayer, a member of the taxpayer's family, or an entity related to the taxpayer. *Id.*

A "qualified intermediary" (QI), rather than an escrow or trust, can be used to comply with the procedural requirement that prohibits the taxpayer from accessing exchange funds on which capital gains taxes are intended to be deferred. A qualified intermediary, of course, may not be a disqualified person.

Many IRC § 1031 exchanges are accomplished with the assistance of QIs. This is how the process works: The taxpayer deeds the relinquished property to the QI, the QI transfers the relinquished property to the buyer (and receives the sale proceeds), the QI then acquires the replacement property, and finally, the QI transfers title to the replacement property to the taxpayer. Provided other

requirements are met, “direct deeding” is allowed (the taxpayer deeds the relinquished property directly to the purchaser of the relinquished property, and the seller of the acquired property deeds the acquired property directly to the taxpayer), which keeps the QI out of the chain of title for the various properties. Regs. § 1.1031(k)-1(g)(4).

Just as real estate investors should perform due diligence on each investment property the investor contemplates purchasing, so too should investors perform due diligence on each QI whose services the investor contemplates using. Prior to authorizing the QI to act as the investor’s intermediary, the investor should be satisfied that the QI will fulfill the QI’s obligation to convey the replacement property to the investor or, if for some reason the section 1031 exchange is not completed, pay over to the investor proceeds from the sale of the investor’s relinquished property. Although many banks and title companies provide QI services, many other businesses that provide QI services are composed of nothing more than one person, or perhaps several individuals, who, in the spirit of American entrepreneurship, are trying to build a business.

The issue presented for investors is whether funds entrusted to a QI are protected from possible mismanagement or misappropriation. Although there are no statutory provisions in the IRC that protect investors from less than competent or honorable QIs, such provisions, even if they did exist, would, at best, only provide a remedy to an aggrieved investor.

According to *The Wall Street Journal*, there have been several recent court cases in which allegations have been made against independent QIs. One involves an individual and his two QI companies, Southwest Exchange Inc., based in Henderson, Nevada, and Qualified Exchange Services Inc., based in Santa Barbara, California. The allegations in those cases are that the owner of the QI companies “misappropriated more than \$95 million of customers’ proceeds to fund other business and personal activities.” An attorney for the QI companies has been quoted as saying, “the plaintiffs in these lawsuits [real estate investors who used the companies’ QI services] have used inflammatory language referring to people [the QI company defendants] as ‘thieves’ and alleging the stealing of money, but the real issue under the law is what

qualified intermediaries are able to do with the money they receive from their customers.”

“Another case involves 1031 Tax Group LLC, which filed for bankruptcy protection in New York on May 14[, 2007]. More than 300 investors across the country are owed an estimated 151 million” according to court documents filed in that case. In a sworn affidavit, the company’s owner “borrowed money from 1031 Tax Group to fund real estate investments” which were made by another company owned by the same person who owns 1031 Tax Group LLC. A lawyer for the owner of 1031 Tax Group LLC has said the owner “has done absolutely nothing wrong. . . . And by voluntarily placing the company into bankruptcy[,] he took the appropriate steps to protect his customers, though I understand their being upset.”

An investor from Portola Valley, California claims to be owed approximately \$3.3 million in the 1031 Tax Group case, and now faces the prospect of having to pay tax on the portion of those funds which represent capital gains. Unfortunately, this investor, like the other investors in these types of cases, did not receive the money upon which the tax is based.

Prior to using the services of a QI, investors should, at a minimum, investigate the QI’s viability and creditworthiness, as well as inquire into whether the QI will agree to provide some form of security (mortgage, standby letter of credit, third party guarantee) or agree that, during the section 1031 exchange, the investor’s funds will be placed in an escrow or trust account which is not controlled by the QI.

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Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Supreme Court, the United States Court of Appeals for the Ninth Circuit, and federal trial courts in the Northern District of California. He is a member of the American Bar Association and the Santa Clara County Bar Association.

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