Identifying Common Problems & How to Avoid Them

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Constructive Receipt Issues

Requirement in Regulations

- Each Agreement must provide that the taxpayer has no right to: "receive, pledge, borrow or otherwise obtain the benefits of money or other property before the end of the exchange period."

  — Treas. Reg. §1.1031(k)-1(1)(g)(6)

Requirement in Regulations

- Return of Exchange Funds
  - Prior to end of identification period the taxpayer determines that there is no suitable property to trade in to and requests a return of the deposit
  - Prior to the end of the exchange period taxpayer decides that he/she does not wish to acquire any of the identified property
    - Could not negotiate an agreeable purchase price
    - Property sold to another party

Requirement in Regulations

- Despite client willingness to pay the capital gain, such distributions are not permitted by the regulations nor the terms of the Exchange Agreement

Return of Excess Funds after Property Acquisition

- Taxpayer may have identified up to 3 replacement properties, one is acquired and additional cash sits in the exchange account
- Regulations allow disbursement upon "The receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement."—Treas. Reg. §1.1031(k)-1(1)(g)(6)(iii)(A)

Return of Excess Funds after Property Acquisition

- Taxpayer could use the additional funds towards purchasing an additional identified property, even if never an intent to do so
- Most QIs deal with this with some type of provision in the Exchange Agreement or the Designation Notice
  - If more than one New Asset has been identified, signify the number that Exchangor intends to acquire: __________. Treasury Regulations Section 1.103(k)-(c)(4) generally allows for designation of up to three properties; see the Regulations for provisions permitting designation of more than three properties.

Failure to Make Property Identification

- Taxpayer calls after day 45 and indicates he/she could not find any property and requests a return of the deposit
- Possible that the taxpayer made proper identification to someone other than the QI
  - Under the regulations, proper identification can be made to "the person obligated to transfer the replacement property" or "any person involved in the exchange other than the taxpayer or a disqualified person." — Treas. Reg. §§1.1031(k)-1(c)(2)(i), 1.1031(k)-1(c)(2)(ii)

Payment of Transactional Costs

- QIs are frequently requested to pay out from exchange funds a wide variety of costs associated with the exchange transaction
- Regulations state a two prong test for allowable pay outs: "transactional items that relate to the disposition of the relinquished property or the acquisition of the replacement property **and** appear under local standards in the typical closing statement as the responsibility of a buyer or seller —— Treas. Reg. §1.1031(k)-1(g)(7)(ii)

Payment of Transactional Costs

- Regulations contain specific examples such as commissions, pro-rated taxes, recording fees, transfer taxes and title company fees
- Attorney fees, accountant fees, qualified intermediary fees, EAT fees and loan fees could be problematical

Earnest Money

- Very common for the taxpayer to request earnest money for replacement property be paid out of the exchange account
- Could be a problem if the taxpayer is contractually obligated to pay the earnest money and the rights under the contract to purchase the replacement property have not yet been assigned to the QI.
- At times the taxpayer will put down earnest money before the exchange account gets funded and will ask the QI for reimbursement
- Best practice is for the QI to replace the earnest money and have the party holding the earnest money return it to the taxpayer

Timing Related to the Receipt of the Exchange Agreement

- Timing Related to the Receipt of the Exchange Agreement
- At times exchange proceeds will be wired to the QI prior to the receipt of the exchange agreement
- Under what terms and restrictions are the funds being held
- Can taxpayer call prior to the receipt of the Exchange Agreement and indicate he/she changed their mind and are foregoing the exchange

QI Right to Resign

- Many exchange agreements have provisions allowing the QI to resign
- If the QI has this right, but does not elect it to happen does that mean the taxpayer has the potential ability to receive the exchange funds prior to the expiration of the designation and exchange periods?
- On occasion the taxpayer will request a QI to resign and will appoint a successor QI

QI Right to Resign

- Definition of a QI is an entity that "acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property and transfers the replacement property to the taxpayer seller — Treas. Reg. §1.1031(k)-1(g)(4)(iii)(B)
- If the QI entity changes between the sale of the relinquished property and the acquisition of the replacement property, not possible to meet the definition

Property Identification Issues

Property Identification Issues

- The regulations provide that "Replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise send before the end of the identification period".

—Treas. Reg. §1.1031(k)-1(g)(6)

Property Identification Issues

- The identification may properly be made in the contract for the purchase of replacement property but it should not be confused with an "exchange cooperation clause" in the contract
- The relinquished property may have multiple owners but only one signs on behalf of others such as husband signing on behalf of he and his wife
- Taxpayer attorney signs for taxpayer under a power of attorney or as attorney in fact

Property Identification Issues

- Taxpayer identifies a group of contiguous buildings for sale by a single owner and expects this to constitute a single identification for purposes of the three property rule
- Often several exchangers will wish to join together to co-own a replacement property. Instead of identifying the fractional interest they expect to receive, they simply identify the whole property by address

Property Identification Issues

- The "incidental property rule" allows a taxpayer not to be required to identify incidental property that typically is transferred with the primary property if the value of the incidental property does not exceed 15% of the aggregate fair market value of the property. Since it is not necessary to identify the incidental property, frequently Taxpayers fail to take into consideration that this property needs to be like-kind to the relinquished property
- When selling a business and acquiring a new business, even if the businesses are the same or similar, must identify the component assets of the business

Assignment of Contract Rights

Assignment of Contract Rights

- The QI is generally brought into the transaction to become a buyer of the Taxpayer's relinquished property and a seller of replacement property to the Taxpayer via an Assignment of Contract Rights and written notice of the same to all parties to the agreement
  - Must provide the written notice to all parties to the agreement, not just the primary party or the representative party of multiple buyer or sellers

Assignment of Contract Rights

- Often there may be co-owners and buyers or sellers and Taxpayer tends to provide notice to the "other side" and not his/her co-buyers or co-sellers
- When the Taxpayer is selling or buying a fractional interest in a property, the Taxpayer should assign only his/her fractional interest
- When taxpayer is selling a dual use property such as a residence where a portion is used for business purposes, the assignment should relate to the percentage of the business use portion and not simply the whole of the property

Minimizing Boot

Minimizing Boot

- Often a Taxpayer will seek the maximum loan to value possible when applying for a loan on Replacement Property. In the case of an exchange, the Taxpayer needs to determine how much cash will go into the new property and fund the difference with a new loan
  - This issue commonly arises when the Taxpayer is arranging for a loan on Replacement Property for an EAT in a reverse exchange. The EAT requires 100% financing which may come from an institutional lender, but when property is transferred from EAT to the Taxpayer the loan to the EAT needs to be paid down by the amount of cash the Taxpayer realizes from the sale

Minimizing Boot

- When selling relinquished property Taxpayers should avoid giving buyers a credit against the purchase price for rent and security deposits, rather should pay buyer directly for the applicable amounts

Minimizing Boot

- Taxpayer's receipt of a note constitutes non-like kind property received in an exchange and is taxable boot
  - Most common way of dealing with this is for Taxpayer to "redeem" the note from the QI for cash equivalent
  - Taxpayer advances the cash that he/she will receive over time from the note
  - May want to assign the note to the taxpayer after the exchange is completed to avoid any question of actual receipt

Minimizing Boot

- Taxpayer may wish to take some of the money from the exchange for personal use
  - Can be taken out at the time of the settlement but taxpayer should modify the Assignment of Contract to provide that something less than 100% of the contract rights are being assigned to the QI
  - Alternatively the client can leave some portion of the cash in the exchange account and receive it after the exchange period is over

Settlement Statement & Settlement Agent

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- No requirement that the Qualified Intermediary executes the HUD/Closing Statement although common practice in different areas of the country
- May be advisable to pro-rate rent and security deposits "outside of closing" to avoid having sale proceeds diminished by items pertaining to income

Settlement Statement & Settlement Agent

- When the taxpayer's attorney acts as settlement agent an argument can be made that the attorney is the taxpayer's agent and the taxpayer is in constructive receipt of exchange funds. One noted author makes the argument that many advisors are innocent of the tax risks involved and may be jeopardizing the nontaxability of the client's exchange by serving as closing attorneys.