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Exchanging - Don't try it at home!

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The value of using a Qualified Intermediary (QI) when conducting a §1031 Tax-Deferred Exchange was recently affirmed in a US Tax Court opinion.

In *Crandall vs. Commissioner of Internal Revenue*, T.C. Summ. Op. 2011-14, 2011 TNT 32-7 the taxpayers intended to do a like-kind exchange under IRC §1031. However, rather than retaining the services of a QI, they decided to handle the exchange themselves: they sold investment property in Arizona, had the proceeds placed in escrow and later purchased replacement investment property in California using those funds.

The Problem: In addition to having the ability to control funds from their sale property, they failed to satisfy the statutory exchange requirement for a valid 1031. There was no "exchange" of real estate; just a taxable sale followed by a purchase of new property.

To create an exchange the QI and taxpayer must enter into an Exchange Agreement. Additionally, that QI must be assigned into each contract before it is transferred. Through the exchange agreement and assignments of contracts an "exchange" is created, even though title transfers directly between the taxpayer and respective buyer or seller.

Since there was no exchange agreement nor did the escrows restrict the taxpayers' ability to withdraw funds, the court held taxpayers had constructive receipt of sale proceeds and were required to pay not only capital gains taxes on the sale of the Arizona property, but also a hefty accuracy-related penalty!!

In its decision: "...The Court notes that...the result may seem somewhat harsh. However, Congress enacted strict provisions under Section 1031 with which taxpayers must comply."

As with most specialized transactions, it is advantageous to retain the services of a professional, knowledgeable QI whose documentation and procedures comply with §1031 regulations, and avoid the costly outcome of the do-it-yourselfers.

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