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## Details matter when it comes to 1031 exchanges

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Generally, a taxpayer who sells real estate must recognize gain or loss on the sale. Section 1031 of the Internal Revenue Code permits the taxpayer to defer the gain or loss on the sale of property that is held for productive use in a trade or business or for investment if certain requirements are met. Satisfying the exchange requirements is critical to defer gain recognition.

In a standard exchange, a taxpayer sells real property and, subsequently, acquires a second parcel of real property. In effect, the taxpayer uses the proceeds from the first sale to acquire a second parcel of real property. However, it is important to recognize that, in order to satisfy the 1031 requirements, the taxpayer may not have actual or constructive receipt of the proceeds from the first sale. The taxpayer is considered to have constructive receipt of the proceeds if the proceeds are credited to the taxpayer's account or otherwise can be drawn by him.

Using a qualified intermediary to hold the proceeds of the first sale generally precludes any IRS contention that the taxpayer constructively received the proceeds. A qualified intermediary is an independent third party which will hold the sales proceeds until a replacement property is identified and purchased.

To satisfy the 1031 requirements, the taxpayer must enter into an exchange agreement with the qualified intermediary. The agreement will obligate the qualified intermediary to (i) purchase the first property from the taxpayer; (ii) sell the first property; (iii) purchase the replacement property; and (iv) transfer the replacement property to the taxpayer. The agreement must also provide that the taxpayer cannot borrow against or pledge the sales proceeds. Otherwise, the taxpayer would be considered to be in constructive receipt of the proceeds.

Do not assume that the exchange agreement provided by your qualified intermediary contains all of the provisions needed to satisfy Section 1031. You would be well-advised to ask a tax or real estate lawyer to review the proposed exchange agreement. Reviewing the agreement should take little time and is well worth the expense considering the potential downside if the exchange agreement is not sufficient. An insufficient exchange agreement can result in gain recognition which could have been avoided.

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