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The top eight 1031 pitfalls and/or why did my tax-free exchange fail?

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The top eight 1031 pitfalls or why did my tax-free exchange fail?

1) Forty five days is not as long as you think. The 45-day identification period will absolutely evaporate. Rookie 1031 sellers will overestimate the cushion that 45 days provides. Veterans understand it is a ticking bomb and appreciate just how short a fuse 45 days can be. One should be very far along in the replacement property selection, and even in the due diligence, before pulling the trigger on a sale. Whatever extra time you can buy before closing on the sale of your property will be very beneficial in the replacement purchase segment of your transaction.

2) The seller who realizes you are up against a 1031 clock can become very inflexible in negotiating price and terms. Magnify this by 10 times if the seller becomes aware that his property is the last and only viable one that you identified during your 45-day ID period.

3) Be sure to put language in your letter of intent and in your purchase and sale agreement specifying that you will be doing a code Section 1031 exchange and that the other party will cooperate with any reasonable requests to accommodate your exchange. Why is this even necessary? See number 2! This is equally applicable whether you are the Buyer or the Seller in the transaction.

4) Most sellers don't appreciate being your #2 or #3 choice. They don't have any appreciation for how hard you worked to pare your long list of potential replacement properties down to a few back-ups of your #1 choice. The honor of being selected to hold their property off the market for six months while they breathlessly wait to see if your first choice falls through is lost on them. There is no glory to being your first runner-up so one needs to be fair when dealing with them. We will often have our clients negotiate the best deal they can and then tie up the back-up choices with an agreement that allows the seller to keep the property on the market and gives the buyer a right of first refusal.

5) Select your qualified intermediary with care. Remember, they have exclusive, unfettered access to your sales proceeds for six months. While it is rare, there have been cases of unscrupulous QI's heading for the Caymans with their clients' funds. If your QI is not well known to you or your trusted advisors, seek one with a bonding arrangement or a trust account for deposits. Request dual signatures be required to move proceeds from the account (yours and the QI). Whether well known or not, always ask for monthly statements from the institution holding the proceeds. It may help you sleep better at night.

6) If the due diligence on your first choice replacement property is surfacing serious potential obstacles, or your closing agenda is not proceeding smoothly, consider writing a second

non-refundable deposit to secure your back-up choice. A simple financial analysis will indicate whether the probability and tax consequences of a failed 1031 exchange with your first choice are overshadowed by the cost of this second deposit. It may be inexpensive insurance.

7) If you are buying replacement property that is being constructed or renovated in anticipation of a lease inception, be sure the property meets the substantial completion guidelines for the IRS. The IRS regs state that you cannot use 1031 proceeds to "pre-purchase" a property under construction that is not substantially complete. What does substantially complete mean? The best proof is a certificate of occupancy issued by the municipality. Next best is a certification from the lessee that the property has been completed for their occupancy. Merely having the tenant move in and begin operating isn't a safe harbor, but it does provide at least some substantiation. Uncompleted punch-list items are generally okay.

8) Due diligence is expensive and time consuming. You don't want to have to go through it on all three of your identified replacement properties. Ideally, you have lined up your first replacement choice far in advance of the closing of the property you are selling and can perform much of the due diligence before being constrained by the time limits in the 1031 Regs. In the end, bear in mind that the tax savings on an exchange will not make a bad property into a good decision. At best, it can make a marginal investment into an acceptable one. Uncle Sam is merely providing a cushion for estimates and assumptions that may not go as well as planned.

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