



CPAs & Business Advisors

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Sec. 1031 exchanges

How to select a qualified intermediary

If you've ever participated in a Section 1031 exchange (also known as a like-kind exchange), you know the critical role that the qualified intermediary (QI) plays. Yet most states don't regulate the QI industry. Investors who fail to use *truly qualified* QIs could regret it.

Why QI selection matters

Under Internal Revenue Code (IRC) Sec. 1031, you can exchange business or investment property for property of a like kind without recognizing any gain or loss until you sell the replacement property. Most such exchanges are deferred exchanges, under which the seller has 45 days to identify a like-kind property and 180 days to invest the sale proceeds in that property.

But the IRC prohibits a taxpayer relinquishing property from gaining actual or constructive receipt of the property's proceeds. So the parties in a deferred exchange rely on a QI — similar to an escrow company — to hold the proceeds until they're transferred to acquire a replacement property.

Unfortunately, QIs aren't required to be bonded or insured or carry a minimum equity capitalization. *Anyone* can start up a QI and start administering Sec. 1031 exchanges.

After several high-profile incidents involving QIs that declared bankruptcy or otherwise were unable to fulfill their contractual obligations, misappropriated client funds, and breached their fiduciary duties, the IRS has warned real estate professionals and investors to exercise caution when selecting QIs. Problems with QIs can end up disqualifying the transaction for the gain deferral.

Factors to weigh

To protect your interests, consider the following criteria before retaining a QI:

Expertise. Make sure your QI has a thorough knowledge of the stringent requirements for Sec. 1031 exchanges and their interplay with other aspects of tax law. The QI should also work on your behalf to help you achieve your wealth management and business objectives. So confirm that the QI can handle all of your exchange needs — some QI firms lack the tax expertise to execute more complex exchange structures. Just one mistake in legal documentation could disqualify a Sec. 1031 exchange.

Control and controls. Research how the QI handles its clients' funds, including what measures it takes to protect funds and ensure liquidity, and whether you'll have any influence on how funds are invested. Find out if the QI commingles or segregates funds. The IRS considers commingled funds to be held as a loan to the QI for tax purposes, and clients are considered general creditors. Segregated funds are also treated as a loan to the QI, but they won't become part of the general asset pool in the event of the QI's bankruptcy.

You may prefer a QI that permits you to decide where the funds are deposited and in which types of accounts. Regardless, insist the QI disclose how it holds funds and earns revenue.



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Also inquire about the QI's internal controls and other fraud prevention efforts, such as internal audits and employee screening. Choose a QI that carries sufficient Errors and Omissions (E&O) insurance coverage to protect against loss from human error.

Fee schedule. You should understand the QI's fee schedule from the beginning. It could include transaction fees, hourly exchange consulting fees and interest sharing arrangements.

Look before you leap

When selecting a QI, keep in mind that the size of a QI firm is no guarantee — both regional and national exchange firms have declared bankruptcy. By understanding how a QI works and the investment and tax implications of deferred Sec. 1031 exchanges, you'll be better able to choose wisely. Also, work with your tax advisor to ensure that the deal is structured in such a way that it avoids recognition of gain or loss.