



HELPING YOUR CLIENTS AVOID THE MOST COMMON 1031 EXCHANGE MISTAKES

This article assumes you have a working knowledge of 1031 Exchanges. If not, please see "Review of 1031 Exchange Fundamentals" below.

According to intermediaries, attorneys and investment advisors, following are the most common mistakes made by investors with regard to 1031 exchanges.

Assuming they can do a 1031 exchange on a personal residence: While a variety of assets, such as boats or cattle, can qualify for 1031 exchanges, only real estate can be exchanged for real estate, and the only real estate that qualifies for an exchange is investment property. This includes rentals, property used in a business or land held for investment purposes. A building purchased to renovate and sell and land purchased for construction of homes or commercial buildings won't qualify since the owner doesn't intend to hold it for a period of time for investment reasons.

Trying to do an exchange on a property after selling it: Once the property has settled, it's too late to do an exchange. Sellers must set up an exchange agreement with a qualified intermediary before they sell their property. Qualified intermediaries are disinterested parties with no current relationship to the taxpayer. This would exclude your client's current attorney, accountant, financial advisor or agent. The intermediary holds the proceeds from the sale for the taxpayer until a replacement property is acquired.

Not choosing a reputable intermediary: Intermediaries don't need to be licensed or certified, so it's buyer beware when choosing them. In addition to intermediary firms, many title companies and banks now serve as qualified intermediaries. Select an intermediary that's knowledgeable, experienced and trustworthy and will deposit your money in a trust account in a reputable bank.

Many experienced commercial real estate professionals will make sure that intermediaries set up separate trust accounts for each seller, with the seller named as beneficiary. Money held by an intermediary is not federally insured unless it's in a bank. There have been cases where qualified intermediaries have gone bankrupt and people have lost their money. You only have the reputation of the intermediary to go on.

Not holding an investment property long enough: The IRS isn't specific about how much time you need to hold on to a property received in an exchange before selling it. However, quickly selling a property you bought through a 1031 exchange indicates that you didn't plan to hold it to generate investment income. A good rule of thumb, experts say, is to hold a property during two tax years. As an example, a rental bought under a 1031 exchange in May of 2004 and held at least until May 2005 would have been owned during two tax years. Investors considering a 1031 exchange should check with their tax advisor.

Not understanding the 45-day rule for identifying new property to purchase and the 180-day rule for buying it: The 45-day and 180-day periods are the most specific part of the code relating to 1031 exchanges. Sellers have until midnight on the 45th day after they've sold a property to identify up to three properties they may purchase with the proceeds from their sale. They have until midnight on the 180th day after the sale to buy at least one of these new properties.

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The typical way to identify a property is to notify your intermediary in writing of the properties you want to acquire. At this point, you don't need to have a contract to buy any of the properties. However, to defer your taxes on your gain, you must be specific about each piece of property you identify and the property you buy must come from this list.

The IRS has questioned taxpayers who haven't been specific enough about the property they want to buy. One taxpayer identified 100 acres somewhere and took title to only 75 acres in the exchange. This taxpayer won the subsequent IRS audit about the exchange. However, a taxpayer who only bought 50 of the 100 acres might not have because the property he bought differed so much from what he identified.

Don't assume that the 45 and 180 days are limited to normal business days and exclude weekends. Weekends also are included in the time period, and if the 445th day falls on a Saturday, Sunday or holiday, you must have your paperwork completed by the prior business day or you'll be disqualified.

Only Congress or the IRS can extend these deadlines and have done so in cases of widespread emergency or disasters. It was done after 9/11, the hurricanes in Florida and the fires in San Diego county, but never on a case-by-case basis.

Not giving yourself enough time to research properties to purchase: Many investors don't think through why they want to sell a property and what they want to buy. In a market where things have gotten expensive, often people sell a property because they think it is a good time, but they haven't thought enough about what they can buy.

Typically, 45 days isn't enough time for an investor to search out a new property and do the research on it to determine if it's a sound investment. Often they end up designating and buying property that's too expensive, requires too much debt, won't appreciate or doesn't meet their needs.

Investors should determine what they want to do before they sell, check the current market and determine if their buying assumptions are accurate and, instead of accepting an offer on your property and closing quickly, find a buyer who will let you have a long escrow period or extend the date of the sale so you can look for properties that fit your investment strategy and qualify for the tax savings of a 1031 exchange.