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Like-kind exchange pitfalls or what not to do in a Section 1031 Exchange

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This article presents the reader with some of the things not to do in their Section 1031 Like-Kind Exchange.

1. Don't close before the documents are prepared and signed. Of everything that follows, this rule is so simple and so often overlooked. To obtain a valid exchange, the Qualified Intermediary (QI), not the client, has to be seen as selling the old property to the buyer and directly receiving funds from the closing. It does no good to close first and then call us; it's too late, the tax has been triggered.

2. Don't fail to identify your new property by the 45th day. Many exchanges fail, and taxes are unnecessarily triggered, by the client's failure to plan what they want to acquire with the money from the sale of their old property.

3. Don't fail to close by the 180th day, or your tax-return due-date, as extended. As in #2, the failure to plan leads clients to a taxable result. The deadline is the deadline, and unless the President declares a natural disaster, there are no extensions possible. If a zoning change or intricate financ-

ing is called for, plan ahead.

4. Don't attempt to deal with relatives, except on the property you are selling. Under the IRS Code, your relatives are your lineal ancestors, your lineal descendants, your siblings, your spouse and yourself. So, a relative may not provide you with the new property you want, but a relative may purchase the old property you have. The sole exception to the rule is when a direct swap of property is taking place in a simultaneous exchange; there relatives may trade properties with each other, provided both hold the property they receive from the other party for two additional years.

5. Don't fail to meet your strike price. Many clients call with the mistaken notion that only the profit has to be rolled over to effectuate a good Section 1031 Exchange. Not so! The entire price, less only the closing costs, is what must get rolled over to obtain a completely tax-free (actually, tax-deferred) Section 1031 Exchange. "But", you ask, "what about the mortgage, what happens to that?" The answer is that it gets paid off in the

first closing and must be reinstated in the second closing. The reinstatement amount, which is initially the size of the old mortgage, may be reduced by cash of your own added to the second closing.

6. Don't ask for funds from the first closing if you expect to need them for the second. It is possible to arrange for the payment of money to yourself at the first closing with the intention of recognizing tax on this "Boot." That's fine, but don't later go out and identify an expensive replacement property which will call for cash from you to close. You have hurt yourself in this circumstance, because you will have to add back the very cash you have paid tax upon, which otherwise would have been tax-free had you left the funds in the exchange.

7. Don't deal with "disqualified persons." This one comes up when the client asks why he cannot just let his brother-in-law, his lawyer or his accountant serve as the QI. All of these folks are disqualified persons, and thus ineligible to be the QI. Even an in-law is disqualified from serving as QI by an IRS mechanism called double attribution. Also disqualified: the stock or real estate broker, or workers or agents with whom the client has dealt in the past two years. If a disqualified person receives any of the exchange funds, the transaction fails on its face.

8. In an improvement ex-

change, don't fail to have the work in place by the 180th day. It is possible to construct new property on land of a non-relative with the proceeds of a Section 1031 Exchange, but the price must be spent on the land and its improvements by the 180th day, and the improvements must constitute real estate under state law. It is not sufficient to have the lumber or the windows paid for by the 180th day, nor is it sufficient to have these articles stored on the building site. The articles must be affixed to the land to be counted as valid expenditures.

9. Don't fail to ask about the depository bank and about the interest on your funds. In this practice, clients get their own, separate accounts, which bear daily interest. It has been the policy of this firm for the past 25 years to give clients interest.

We do not use "pooled" accounts which aggregate the funds of one client with those of another. We use a money-center bank which pays very nearly the prevailing federal funds rate on its accounts. We have direct access to each account to facilitate immediate closings. Wire transfers are possible on a moment's notice, up to 5:00 p.m. every business day.

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