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## Risk Management in a Like-Kind Exchange

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**By Ed Horan, Certified Exchange Specialist®**

The objective in risk management is to do your job as professionally as possible, while at the same time reducing your collateral risks. In other words, don't create unnecessary risks and liabilities for yourself while just trying to do your job.

### **Refer to a Professional**

All of the many actions required in a real estate transaction impose risk and liability on the part of real estate professional and their clients. To reduce this risk, savvy real estate agents quickly refer their clients to a specialist -- whether it is to a home inspector, a loan officer, a settlement attorney, a CPA, or if the client wishes to do a like kind exchange, to an expert qualified intermediary (QI). A recent article in The Washington Post told how a real estate agent suggested a seller do an exchange. The seller agreed, but unfortunately the agent did not refer the owner to a QI. The owner went to settlement and then learned he had not done an exchange. He had to pay over forty thousand dollars in capital gains tax.

The owner's question was a simple one: "Who is responsible?" Is it the real estate agent, the settlement agent or the tax advisor? It is probably anyone who knew the owner wanted to do an exchange but failed to refer him to a professional exchange QI.

The first risk management lesson for real estate professionals should be that whenever there is a discussion with a client about doing an exchange, they immediately refer the client to an experienced qualified intermediary.

On their own, real estate investors need to learn about exchanging and to seek out a professional QI. Those qualified intermediaries with the Certified Exchange Specialist (CES)® designation from the national Federation of Exchange Accommodators (FEA) have the proven knowledge and experience to reduce the investor's risk and successfully complete the exchange.

## **Risk Management within the Exchange**

Once an investor has engaged a QI, the obvious goal is to take the actions that are necessary to properly complete the exchange and successfully defer all of the gain from the sale of their investment or business property.

In an exchange there are a number of steps that must be completed on time. If one or more of these steps is not completed, then there is a risk the exchange will not be successful. To reduce the risk of this happening, the exchanger should make certain each of the required steps occurred. A checklist of the required and suggested actions in an exchange can be found at <http://www.1031.us/PDF/ExchangorChecklist.pdf>.

Internal Revenue Code Section 1031 provides that a property qualifies for a like-kind exchange and non-recognition of the capital gain if both the property being sold, the relinquished property, and the replacement property are held either for productive use in a trade or business or for investment. Also to qualify, the replacement property must be identified within 45 days of transfer of the first relinquished property, and the transfer of the replacement property must occur within 180 days of the transfer of the relinquished property, or the federal tax due date, including extensions, whichever occurs first. Both properties must be in the United States. In addition to being certain the property qualifies, the taxpayer must also meet the reinvestment requirements if all of the gain is to be deferred.

## **Risk in Execution of the Exchange**

When selecting a QI the taxpayer wants to be certain the QI is not disqualified. If a totally independent entity is not being utilized to insure proper control of the escrow funds and serve as the QI, the exchanger should seek legal review of regulation Section 1.1031(k)-1(k) to be certain a “disqualified person” is not involved.

When the QI is first engaged they will require a copy of the sales contract for the property being sold and information as to who will be performing the settlement or escrow. The QI can then prepare the required documentation. This includes the Exchange and Escrow Account Agreement, the Assignment of Contract, the Notification of Assignment, and instructions to the settlement agent/attorney. It is essential that the required documentation be completed before the relinquished property is transferred to the buyer. An exchange may not be initiated once the relinquished property is transferred at settlement to the buyer.

After settlement of the relinquished property, the proceeds (exchange escrow funds) are sent directly to the QI by the settlement agent. To avoid risk the taxpayer should receive no funds at settlement, as any funds received from the buyer or settlement agent become taxable income.

The next step for the exchanger is to identify the potential replacement property. The identification must be in writing, be signed by the exchanger, be unambiguous, and normally be sent to the QI. Special rules exist for identification of replacement property to be built, or identification of a partial interest in the replacement property. If the identification is not made

by midnight of the 45th day, the QI must terminate the exchange and return the escrow funds to the taxpayer. The taxpayer is at risk if the exchange is not properly and timely identified. After the 45th day only the properties previously identified may be purchased as part of the exchange.

To reduce the risk of an identified property not being available, exchangers are encouraged to write a contract as soon as possible on the desired replacement property. A contract may be written at any time, but transfer of the replacement property to the exchanger before settlement of the relinquished property is not allowed. If a reverse exchange is necessary, Revenue Procedure 2000-37 must be closely followed.

The improper payment of escrow funds by the QI can create significant risk. The funds held by the QI may only be used for a deposit or toward purchase of the replacement property after the contract has been assigned to the QI. In addition to the assignment of the replacement property contract, the QI will provide the Notification of Assignment to all parties of the contract and provide instructions to the settlement agent/attorney. This documentation must be completed before the transfer from the seller to the exchanger.

The exchanger has 180 days from the transfer of the relinquished property to receive all of the replacement properties. If the federal tax due date will occur before the 180th day, then the exchanger must file an on-time extension in order to get the full 180 days to complete the exchange. When a replacement property is being built, there is great risk that it cannot be transferred by the 180th day. Exchangers should avoid starting the 180 day exchange period until they are certain they will be able to receive the replacement property prior to the 180th day. If the replacement property cannot be transferred in time, the QI must terminate the exchange and return any escrow being held.

The last task for the exchanger is to complete IRS Form 8824 and submit it with his regular federal tax return. To reduce the risk of submitting an incorrect report, and costing themselves money, exchangers should go to <http://www.1031.us> for step-by-step instructions on how to complete the [Form 8824](#).

For taxpayers wishing to do a like kind exchange, the bottom line is to trust their exchange to a Certified Exchange Specialist®.

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*This publication is designed to provide accurate information on tax-deferred exchanges. The publisher is not engaged in rendering legal or accounting services. If legal or tax advice is required, the services of a competent professional should be sought.*