LAST WORD

1031 Exchange Do's and Don'ts

Missteps of two firms shed spotlight on importance of hiring independent qualified intermediaries. **By Rochelle Stone**

POPULAR VEHICLE: From rental houses to commercial buildings, 1031 exchanges are used to buy and sell billions of dollars in real estate.

Real estate investors must be wise not only in choosing their purchases, but also in selecting the professionals who help them negotiate their acquisitions. That's why the recent failures of two 1031 real estate exchange companies created a stir among some investors as well as experts in the business of transferring properties.

For the first time in memory, millions of investor dollars have been jeopardized because of poor management practices, causing more than a flutter in the financial hearts of hundreds of investors. While these problems may be resolved, they serve as a stern warning to us all.

Benefits of 1031 exchanges

Although a part of the nation's tax code since 1921, 1031 exchanges did not enjoy wide popularity until about 30 years ago, thanks to a Ninth Circuit Court case known as the Starker ruling that focused on section 1031 of the tax code. Investors today routinely use the 1031 exchange process to leverage the sale of investment real estate or personal property. As of 2005, more than $200 billion of real assets changed hands through this mechanism, and millions of investors have benefited by preserving their equity. How so?

With 1031 exchanges, the investor has the potential for financial growth greater than an investor receives by simply buying and selling. He or she has the potential of saving between 15% and 30% or more in taxes because of the ability to defer tax obligations to a later date.

There are important rules for conducting 1031 exchanges. In addition to the new purchase being of equal or greater value than the sale, 1031 participants must identify the new purchase within 45 days of sale and complete the transaction within 180 days of sale. The investor also must place the proceeds in the hands of a neutral, qualified third party, which will complete the exchange of real estate within the 180-day period. All of which leads to a key question: How does one identify a third party to carry out the transaction?

What can go wrong

In two recent cases, Southwest Exchange and the 1031 Tax Group committed some serious errors in judgment and management. Rather than exchange clients' funds in separate accounts, they commingled or merged their operational funds with client funds for private company purposes.

Commingling might have helped the exchange companies, but it put investors at risk, especially when some needed their now unavailable funds to complete the transfer process. For any industry specialist, this practice raised a huge red flag.

Acquired by owners with little industry experience, the two companies didn't follow 1031 exchange practices. Their sloppy operations illustrate the right and wrong ways to conduct 1031 exchanges. The industry trade association that sets 1031 exchange standards suspended the two companies from membership for unethical practices. Fortunately, the industry has become so professionalized that the recent incidents stand out as rare exceptions.

Exchanges done the right way

Qualified intermediaries, or exchange accommodators as they are sometimes called, are specialists trained to facilitate the transfer of 1031 exchanges. In handling 1031 funds, qualified intermediaries establish individual accounts, making sure not to commingle their funds with client funds. The idea is to show transparency to the client at all times.

While banks or title companies include 1031 services as part of their larger operations, independent qualified intermediaries are dedicated solely to facilitating 1031 exchanges. Qualified intermediaries also provide transfer-related counseling, something that usually comes in handy when processing complicated real estate deals. Fees usually range between $500 and $1,000 per exchange, depending upon the complexity of the deal.

A respected trade association, The Federation of Exchange Accommodators (FEA), has developed standards for its 330 members that include background checks, independent FDIC-backed bank accounts for each transaction, fiduciary performance bonds, multiple signature requirements for fund transfers, and a code of ethics for the industry.

The FEA offers a comprehensive three-year training program that culminates with the Certified Exchange Specialist (CES) designation for participants who pass a rigorous examination.

Using experts such as 1031 exchange specialists is a sound step to protecting the financial investment throughout the entire transfer process. Just make sure you select someone who is experienced and is a specialist in 1031 exchanges and you'll be secure throughout the entire process.

Rochelle Stone, CES, is the CEO of Starker Services, an independent qualified intermediary. She is co-author of "Real Estate Exchange: Using Tax-Deferred Exchange in Real Estate Investment Management."