

Disqualified Parties and Using Your Attorney as the Qualified Intermediary

Why This Can Jeopardize the Exchange

An IRC §1031 tax deferred exchange can fail if the Exchanger has "actual or constructive receipt" of exchange proceeds or other property. Therefore, it is essential for the Exchanger to retain a Qualified Intermediary to satisfy the necessary "safe harbor" requirements under Treas. Reg. §1.1031(k)-1(g)(4). A "disqualified person" is defined in Treasury Regulation §1.1031(k)-1(k). A disqualified person is someone who is the agent of the Exchanger (taxpayer) at the time of the exchange. If a disqualified person performs the exchange and holds the exchange proceeds, the exchange may fail if the IRS determines that as a result of the disqualified party's involvement the Exchanger had "actual or constructive" receipt of the exchange funds. For purposes of this Regulation, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two year period preceding the date of the transfer of the first relinquished property by the Exchanger is treated as an agent of the Exchanger at the time of the exchange and, therefore, a disqualified person. Solely for purposes of this Regulation, there is an exception for the performance by a person of services for the Exchanger with respect to only exchanges of property under IRC §1031 and the performance by a person of routine financial, title insurance, escrow, or trust services for the Exchanger by a financial institution, title insurance company, or escrow company. These types of services shall not be taken into account as performances of services by a disqualified person. Treas. Reg. §1.1031(k)-1(k)(2). Other disqualified persons are any parties that are considered "related parties" to the Exchanger, or parties that are related to the Exchanger in that the Exchanger and the related party have more than a 10% interest in the respective related partnership, corporation, or trust. Treas. Reg. §1.1031(k)-1(k)(3), (k)(4). It is important to have a "safe harbor", such as the use of a Qualified Intermediary, to insure against the actual or constructive receipt of the exchange proceeds or property that would otherwise occur by using a disqualified person who will be considered the agent of the Exchanger. If a Qualified Intermediary is retained, the determination as to whether the Exchanger is in actual or constructive receipt of the exchange proceeds or other property is made as if the Qualified Intermediary is not the Exchanger's agent. Treas. Reg. §1.1031(k)-1(g)(4)(i).

To qualify as a "safe harbor", the Qualified Intermediary must be someone other than the Exchanger (taxpayer) or a "disqualified person." Treas. Reg. §1.1031(k)-1(g)(4)(iii). **Agents of the Exchanger at the time of the transaction are disqualified persons.** Examples of agents include the Exchanger's attorney if they have acted as the Exchanger's agent within the two-year period ending on the date of the transfer of the Exchanger's first relinquished property. **If an attorney has provided tax or legal services to the Exchanger within the two-year prescribed period, the attorney is a disqualified person.** Attorneys performing services solely in connection with exchanges are excepted from the disqualified person rule. However, this exception is extremely limited and an attorney proceeding under this exception should do so with extreme caution since the Exchanger could suffer severe adverse tax consequences if the attorney is determined to be a disqualified person with respect to the Exchanger's exchange. If an attorney is a disqualified person, the following are also disqualified: the attorney's law firm, a partner in the law firm who owns more than a 10% interest in the firm, any entity in which such partner owns more than a 10% interest, and any entity in which the law firm owns more than a 10% interest. This is because the regulations provide that a separate corporation or other entity in which the Exchanger or a disqualified person has a 10% or more interest also constitute a disqualified party. Treas. Reg. §1.1031(k)-1(k)(2)-(k)(4). While the Exchanger's attorney should not act as the Qualified Intermediary, they are invaluable to the Exchanger for tax and legal advice during the exchange.

Brief Exchanges

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