1031 Exchanges
Know Your Accommodator

By Nancy N. Grekin

The concept of nonrecognition of the gain or loss from exchanges of like-kind property for federal tax purposes embodied by Code § 1031 and its predecessors has been part of federal tax policy since the original Revenue Acts of the 1920s. Code § 1031 originated in the first Internal Revenue Code of 1939. The wording of Code § 1031 on its face seemed to permit a taxpayer to make use of nonrecognition only by exchanging property directly with another taxpayer. But, over the many years that like-kind exchanges have been permitted by the Code, taxpayers have tried an enormous number of structures to carry out nonsimultaneous exchanges in which the taxpayer sells relinquished property to a buyer and purchases replacement property from a different seller. Many cases and rulings resulted and the courts announced a basic requirement for deferred exchanges under Code § 1031: the taxpayer must have no right to the exchange funds while they are held by a third party after sale of the relinquished property and before purchase of the replacement property. *Maxwell v. United States*, 88-2 U.S. Tax Cas. (CCH) ¶ 9560 (S.D. Fla. 1988); *Klein v. Commissioner*, 66 T.C.M. (CCH) 1115 (1993). When the IRS finally adopted the deferred exchange regulations in 1991, Treas. Reg. § 1.1031(k)-1 et seq., the requirement that the taxpayer have "no right to receive, pledge, borrow or otherwise obtain the benefits of the funds until replacement property is received" was explicitly incorporated. See Treas. Reg. § 1.1031(k)-1(g)(6). The Regulations established a "qualified intermediary" safe harbor that permitted taxpayers to retain a third party to hold the exchange funds. If the taxpayer uses a qualified intermediary, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer. Id. § 1.1031(k)-1(g)(4)(i).

Accommodators proliferated as a result.

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Now virtually every deferred exchange makes use of a qualified intermediary to hold exchange funds. Many intermediaries are affiliates of banks and major escrow and title companies. Some are entities formed by individuals who may or may not have any knowledge of the complex and intricate requirements of the deferred exchange regulations and of the many cases and rulings decided by the courts and issued by the IRS. As a result, the knowledge and experience of accommodators varies extensively.

Two concerns with the choice of an accommodator have arisen: first, many accommodators prepare exchange documents for the taxpayer but will not provide any tax or structuring advice; and second, some private accommodators not affiliated with a bank, title, or escrow company have gone bankrupt and others have used taxpayer funds for personal purposes, resulting in the loss of the funds. Because an accommodator is holding the taxpayer's funds under an exchange agreement, which must provide that the taxpayer has no right to the funds, the selection of a knowledgeable and honest accommodator is very important. Attorneys often play a role in referring clients to an accommodator.

Problems and Issues with Accommodator Handling of Exchanges

As accommodators multiplied, many intermediaries decided not only to hold exchange funds but also to prepare all of the exchange documents for the taxpayer. The documents they provide are typically "cookie cutter" and prepared in-house, not necessarily by lawyers. These accommodators will not give any tax or structuring advice to taxpayers. In fact, they typically require that taxpayers waive any liability of the accommodator for the structure or qualification of the exchange; thus, taxpayers are left to their own devices to determine whether the exchange is properly structured.

It is curious that accommodators would want to perform this service; they are not lawyers and may not know or understand the intricacies of a 1031 exchange. By drafting documents, the accommodators likely subject themselves to potential liability for failure of the exchange. This is true notwithstanding their disclaimers and the taxpayers' waivers in the accommodator's engagement letter, which may be unenforceable as an attempt to waive responsibility for the accommodator's own negligence. These accommodators may not have liability insurance for document preparation, which could be deemed practicing law without a license, so that the taxpayer may be unable to recover damages if the exchange fails.

The practice of accommodators drafting exchange documents is likely the result of the belief that an exchange is an event and not a process. Handling an exchange is not merely a matter of drafting documents, however. Several documents and steps are required to carry out a qualified deferred exchange, and many cases and rulings have resulted in numerous traps for the unwary in documenting and structuring exchanges. The regulations require specific provisions in the documents to qualify the intermediary. Id. § 1.103(k)-1(g)(4)(iii). Without those provisions the intermediary will be disqualified, and the taxpayer will be deemed in constructive receipt of the exchange funds. A taxpayer should want someone drafting the documents and handling the exchange who is knowledgeable about Code § 1031 exchanges and the regulations and who can provide structuring advice.

In addition to the requirements for specific provisions in the exchange agreement, the accommodator is required to "acquire" both properties in the exchange. This acquisition may be, and usually is, handled with an assignment of contract rights, and if that is done, notice of the assignment must be given to the buyer or seller. If the assignment is not given or the notice not provided, the intermediary will not be qualified. If the intermediary is not qualified, the taxpayer will be deemed in constructive receipt of the exchange funds. Id. § 1.103(k)-1(g)(4)(vi). Even a step as seemingly innocuous as giving this notice can lead to disallowance because the IRS respects and enforces all requirements of the regulations. There has been a ruling in which the taxpayer failed to give notice of the assignment of the contract, and the exchange was disallowed for this reason (and other issues relating to compliance with the deferred exchange regulations). PLR 200130001.

The most troublesome aspect of the preparation of exchange documents by accommodators is that taxpayers have no access to advice regarding the structure and handling of the exchange unless they retain a tax adviser. The typical exchanger needs and requests advice on many aspects of an exchange including such issues as personal use of the property, de facto partnerships when there are multiple owners, how to calculate the time deadlines, how much the taxpayer must spend to have a fully deferred exchange, and designation and qualification of replacement property. A vivid example of problems that can arise if a taxpayer does not have a knowledgeable adviser occurred when a couple who held relinquished property jointly acquired the replacement property in an LLC of which they were both members. This procedure disqualified the exchange because the taxpayers were deemed to have acquired a partnership interest, not real estate. See Code § 1031(a)(2) (listing partnership interests as assets that fail to qualify for 1031 exchanges); *Bergford v. Commissioner*, 12 F.3d 166 (9th Cir. 1993). There are two ways this transaction could have been done properly: the taxpayers could have each taken his or her interest in a single-member disregarded LLC, or they could have conveyed the property to the LLC immediately after acquisition. A tax advisor with knowledge of 1031 exchanges would have structured the acquisition correctly.

Problems and Issues with the Integrity of the Accommodator

Many accommodators are private entities not affiliated with a title or escrow company. Occasionally the author has heard of individual natural persons acting as accommodators. Private entities often are not bonded, yet handle millions of dollars under a contract that recites that the taxpayer carrying out the exchange has no right to the funds.

An accommodator can go bankrupt, and, if it does, the funds will be in the bankrupt debtor's estate. An individual accommodator can die, and, if he or she does, the funds will be in the decedent's estate. An accommodator also can defalcate the funds. In any of these cases, the taxpayer will not have the funds available for acquisition of replacement property. There have been several cases in which these types of events have occurred.

In one case, a state agency had taken possession of the taxpayer's qualified intermediary, appointed a receiver, and frozen the assets of the intermediary. PLR 200211016. The taxpayer's funds were not released in time to close before the end of the 180-day exchange period because the intermediary's assets were frozen. Although the 180-day time limit for acquiring replacement property is not waivable and cannot be extended, the taxpayer in that case argued that the exchange period should have been suspended under Code § 6063(b), which provides that when the assets of a taxpayer are in the control or custody of a court, the running of the period of limitations for collection of tax is suspended for the period of the custody, plus six months. The IRS ruled that Code § 6063(b) did not apply and that, even under these circumstances, the exchange period would not be extended.

Another possible basis for extending the 180-day exchange period is Code § 7503, which provides that "[w]hen the last day prescribed under authority of the internal revenue laws for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or a legal holiday." That provision would appear on its face to apply to the time limits for identification and receipt of replacement property under Code § 1031; however, Rev. Rul. 83-116, 1983-2 C.B. 264, held that the coverage of Code § 7503 is limited to procedural acts required to be performed in connection with the determination, collection, or refund of taxes. The exchange period under Code § 1031 is not a procedural act in connection with the determination, collection, or refund of taxes, so Code § 7503 does not apply to extend the identification and exchange periods. Thus taxpayers whose funds are not available because of accommodation, dishonesty, or failure cannot extend the time for acquisition of replacement property.

In another case, an accommodator in Las Vegas was acquired by a businessman attempting to start up a new business. He apparently bought the company so he would have access to the funds it held. He took $95 million of exchange funds, of which $63 million was used to fund the start-up company and the balance of which was used to support his lavish lifestyle. The scheme worked as long as the real estate market soared and new exchange funds were being received by the company. When the real estate market slowed and with it the influx of funds, the accommodator had insufficient funds to disburse for taxpayers' acquisitions of replacement property. Peter C. Beller, *Other People's Money*, Forbes, Apr. 23, 2007, at 38.

Nevada is the only state in the country that regulates accommodators, but the only statutory requirements are to submit to a background check and post a $50,000 bond. Nev. Rev. Stat. § 645.6065. This accommodator had as much as $215 million in exchange funds on deposit during his ownership of the company covered only by the $50,000 bond. Interestingly, he apparently passed the background check with flying colors because he was the founder of a successful public company. He had been removed from the board of that company, however, for misusing investor funds, something that apparently did not come up in Nevada's background check.

How to Select an Accommodator

Both realtors and attorneys are often asked by clients to recommend an accommodator. Given the significant amount of money being handled by accommodators and the potential for a taxpayer to lose an exchange and his or her money, care should be taken to select an accommodator that is creditworthy and honest. Here are a few suggestions for how to choose and use an accommodator:

- An attorney or realtor who handles many exchanges should investigate all of the accommodators in his or her locale, including years of experience, capitalization, bonding, and staff knowledge of Code § 1031.
- An individual accommodator should not be used because of the risk of death or bankruptcy.
- An accommodator should be bonded and the amount of the bond disclosed to the referring attorney or realtor.
- If possible, background checks on the principals of the accommodator should be done.
- The accommodator should, in all transactions, segregate taxpayers' funds and deposit them in a federally insured, reputable financial institution.
- If the accommodator provides exchange documents for the client, the documents should be reviewed by a lawyer to determine if they comply with the deferred exchange regulations.
- The taxpayer should have professional tax advice available during the exchange and not be dependent on the accommodator for advice.

Conclusion

The qualified intermediary safe harbor in the deferred exchange regulations imposes numerous requirements to qualify an intermediary. Apparently the IRS will enforce even the most seemingly trivial of the requirements. Selection of the accommodator is critical to success of the exchange. Attorneys and realtors must protect their clients by ensuring that the accommodators they recommend are creditworthy and honest. It is remarkable that no state except Nevada regulates accommodators that hold funds of clients in the same manner as escrow agents who are always required to be bonded. Before you refer, know your accommodator! ■