



1031 exchanges: Are You Truly Neutral?

With the increasing popularity of Section 1031 “like-kind exchanges,” more and more attorneys are becoming involved. But the rules are complex, and the Internal Revenue Service and the Tax Court have made it clear that the legal requirements for a successful exchange must be followed carefully and strictly.

The Concept of Neutrality

One of the underlying concepts of a successful 1031 exchange is the mandatory requirement that not one penny of the sales proceeds be available to the seller of the relinquished property (unless the transactions do not take place).

Conceptually, the relinquished property is sold and the sales proceeds are held in escrow by a neutral party — typically by an intermediary or escrow agent — until the replacement property is obtained.

In order to make absolutely sure that the taxpayer does not have control or access to the funds during this interim period, the IRS requires that this agent not be the taxpayer or a related party. The holder of the escrow account can be an attorney or a broker engaged primarily to facilitate the exchange. But here’s the kicker: An attorney who has represented the taxpayer on other matters during the previous two years is ineligible to be the neutral party.

An Experienced Accounting Professional Can Help

The rules surrounding Section 1031 exchanges are complex, and clients are well advised to seek both legal and

tax accounting advice. It's important that they meet with an experienced accounting professional to determine whether the savings gained by using a like-kind exchange will make up for the lower cost basis on their new property.

Clients may also benefit from discussing whether it makes sense to obtain new investment property in the first place (e.g., should they remain a landlord, or are they better off paying the capital gains tax and pocketing the balance of sale proceeds?).