
The Role of the Qualified Intermediary in a 1031 Exchange: Who Can Audit?

By Patrick Harrigan, President/COO, Certified Exchange Specialist®
Gain 1031 Exchange Company, LLC

1031 exchanges are an increasingly popular tool for real estate investors and businesses when selling real estate. A 1031 exchange, also known as a like kind exchange, is a method for any taxpaying individual or entity to defer paying capital gains taxes on a real estate sale. As the name implies, the seller or taxpayer cannot sell the real estate outright. The property must be exchanged for another piece of real estate.

The most popular method for completing a 1031 exchange is a deferred exchange using a Qualified Intermediary. In a deferred exchange, the taxpayer sells a relinquished property and then acquires a replacement property at a later time. The Internal Revenue Code has laid out certain hoops for the taxpayer to jump through to effectuate the entire transaction as a valid exchange. One of those hoops is that the taxpayer must not have actual or constructive receipt of the proceeds funds from the sale of the relinquished property during the exchange.¹ The Qualified Intermediary is hired to hold those proceeds to avoid receipt by the taxpayer.

Qualifying to act as a 1031 exchange intermediary is determined for each exchange by the relationship between the taxpayer and the prospective intermediary. An intermediary may be qualified to act as an intermediary for one taxpayer and not for another.

The definition of Qualified Intermediary is set forth in the Treasury Regulations and was created to ensure that the party playing this role is independent of and not subject to influence by the taxpayer.² The Treasury Regulations provide that any person or entity can act as an intermediary unless they fall into one of three categories of persons or entities that are disqualified. Those categories are (1) an agent of the taxpayer (2) someone related to the taxpayer and (3) someone related to the taxpayer's agent.³

1. AGENT

The Treasury Regulations state that someone who has acted as the taxpayer's employee, attorney, accountant, investment banker, real estate agent or broker within two years prior to the date of the closing of the sale of the relinquished property is the agent of the taxpayer and is disqualified to act as the intermediary for that taxpayer.⁴ This means a seller of property cannot have their attorney, real estate agent, etc. hold their proceeds if they intend to complete a 1031 exchange. Also disqualified are all attorneys in the same firm as the seller's attorney and any real estate agent in the same brokerage as the seller's real estate agent. The regulations then proceed to state two exceptions to the disqualification of an agent.

¹ Reg. 1.1031(k)-1(g)(1)

² Reg. 1.1031(k)-1(g)(4) and Reg. (1.1031(k)-1(k)(1)

³ Reg. 1.1031(k)-1(k)

⁴ Reg. 1.1031(k)-1(k)(2);

Exception 1

The regulations except out services that are routine financial, title insurance, escrow or trust services performed by a financial institution or title insurance company.⁵ Thus, those businesses do not become an agent of the taxpayer based on their routine activities and are allowed to act as intermediaries.

Exception 2

The regulations also except out services performed by the agent “for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under Section 1031.”⁶

What this exception means is unclear. It seems that under this exception someone who would otherwise be disqualified as the taxpayer’s agent is not disqualified based on working with the taxpayer on specific properties that are part of a 1031 exchange. However, it seems counterintuitive to allow an agent who is working directly with the taxpayer on exchange properties, to act as the intermediary, since that agent is certainly not a disinterested party. If the attorney (or real estate agent, accountant, etc. as applicable) within the last two years engaged in any activity, such as discussing a real estate sale that is not part of an exchange, giving estate planning advice or any other non-real estate advice, that activity would push the attorney back into the disqualified agent category and the attorney could not serve as intermediary. There has been no definition from the IRS or tax courts on what services would or would not apply under this exception.⁷ One possibility is that this exception is limited to only providing Qualified Intermediary services.⁸

An attorney relying on this exception to provide legal services and act as Qualified Intermediary for a client would need to decline to discuss any non-exchange legal matter with the client. The attorney should also have an internal file search system in place to search for any legal work done by the attorney for that client going back two years. The same restrictions will apply for real estate agents. The ambiguity of this exception carries significant risk for attorneys/agents by opening the possibility of invalidating a client’s exchange and facing the resulting liability.

2. RELATED PARTY

A party who is related to the taxpayer also cannot act as that taxpayer’s intermediary.⁹ For this purpose typical related parties include:¹⁰

1. Family members (siblings, spouse, ancestors and lineal descendants);
2. An individual and a corporation where the individual owns more than 10% of the stock;
3. Two corporations that are part of the same controlled group (Parent-Subsidiary or Brother-Sister corporations);
4. A fiduciary and beneficiary of a trust;
5. A corporation and a partnership if the same person owns more than 10% of each;

⁵ Reg. 1.1031(k)-1(k)(2)(ii)

⁶ Reg. 1.1031(k)-1(k)(2)(i)

⁷ Tax-Free Exch Under § 1031 § 6:34(2009) , § 6:37(2013)

⁸ Tax-Free Exch Under § 6:37(2013)

⁹ Reg. 1.1031(k)-1(k)(3); Frank J. Blangiardo v. Commissioner, T.C. Memo. 2014-110, 6/9/2014

¹⁰ The definition of related party includes other relationships

The idea of disqualifying a related party is logical. For instance, someone who is the taxpayer's brother is not a disinterested third party and is unable to provide the proper distance from the taxpayer to avoid the taxpayer having "constructive" receipt of the exchange funds. This lack of objectivity would also apply to a business that is owned (more than 10%) by the taxpayer and to the other related parties under the definition.

3. RELATED TO OR AFFILIATED WITH AGENT

If the taxpayer's attorney or real estate agent cannot be the intermediary, neither can any person or business affiliated with that attorney or real estate agent. This third category is often lesser known, yet no less important. In fact, due to its unfamiliarity in the marketplace it may be the most important category and a trap for the unwary. It states that anyone related to a disqualified agent, as defined above, also becomes disqualified.¹¹

This particular exception usually comes into play when the intermediary is related to the agent through some sort of business entity. For example, a title company owned by an attorney or real estate agent is disqualified to act as an intermediary under this category. Since the attorney is disqualified, so is any business, such as a title company, owned by that attorney even if the attorney is only a partial owner. This also applies to a title company that is owned (wholly or in part) by a real estate agent/broker.

Also, note that the definition of related parties includes corporations within the "same controlled group."¹² This definition comes into play for any agent that is part of a larger corporate family. For instance, a large real estate brokerage that lists a taxpayer's property for sale is that taxpayer's agent. If that brokerage is part of a larger corporate family, any related corporate company is disqualified from providing intermediary services.

Summary

Any person or entity that is an agent of the taxpayer, related to the taxpayer or affiliated with the taxpayer's agent cannot play the role of Qualified Intermediary for that taxpayer. Professionals in the real estate industry can benefit from being aware of the role of the Qualified Intermediary in 1031 exchanges in order to avoid invalidating their client's exchange and thus causing their client a large and unnecessary tax bill.

¹¹ Reg. 1.1031(k)-1(k)(4)

¹² I.R.C. Section 267(b)