Revisiting qualified escrows and qualified trusts: What you need to know when entering a 1031 exch.

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Recently a number of taxpayers have been second guessing their decision to do a 1031 exchange, over concerns for the safety of their funds, causing Qualified Intermediaries (QI) to revisit Safe Harbor Number Two.

There are four Safe Harbors in Section IRC 1031 available to the taxpayer:

1. Use of Security or Guaranty Agreement Â§1031(k)-1(g)(2);
2. Use of a Qualified Escrow or Qualified Trust Â§1031(k)-1(g)(3);
3. Use of a Qualified Intermediary Â§1031(k)-1(g)(4); and
4. Interest or Growth Factor Â§1031(k)-1(g)(5).

Qualified Intermediaries have been using the safe harbor regulations of 1991 to provide an added layer of protection to the taxpayer. Since the adoption of these regulations, nearly all exchanges are structured using the QI Safe Harbor. If you have recently been involved in a 1031 Exchange, in all likelihood there was a QI facilitating the transaction. The role of the QI is to acquire the relinquished property from the taxpayer, transfer it to the purchaser, then acquire the replacement property from the seller and transfer it to the taxpayer completing the exchange. The QI directly receives the monies from the transfer, and purchases the replacement property on behalf of the taxpayer.

Since the regulations allow for the use of multiple safe harbors, taxpayers can utilize Safe Harbor No. 2, Qualified Escrows (QEs) or Qualified Trusts (QTs) providing reinforced security for taxpayers. As a QI holding taxpayers monies, preservation and availability of the exchange proceeds are of the utmost importance. We need to make the taxpayer feel secure and ensure the funds will be accessible for closing on their replacement property.

A QE account, by written agreement, elects an escrow holder in addition to the QI to watch over the exchange proceeds. The escrow holder is not allowed to be the taxpayer or a disqualified party as defined in IRC Section 1.1031(k)-1(k)(2), (k)(3), or (k)(4). One of the two classifications of a disqualified party is a person who is an agent of the taxpayer at the time of the transactions. This includes anyone who has acted as the taxpayer's employee, attorney, accountant, investment banker, broker, real estate agent at the time transaction.

Additionally, the escrow agreement must follow "the (g)(6) limitations," setting limits on receiving, pledging, borrowing or obtaining benefits of the exchange funds contained in Treasury Regulations Sections 1.1031(k)-1(g)(6).

Mirroring the QE, a QT must be established with a written trust agreement, the trust agreement must follow "the (g)(6) limitations," limiting the taxpayer on receiving, pledging, borrowing or obtaining benefits of the exchange funds, the trustee is not the taxpayer or a disqualified person as defined in IRC Section 1.1031(k)-1(k)(2), (k)(3), or (k)(4), with the added exception that the relationship between the taxpayer and the trustee cannot be considered a relationship under Section 267(b) defined as follows:

A person who assumes a relationship with the taxpayer as described in IRC Section 267(b) or Section 707(b). Combining these two sections, examples of disqualified parties are as follows:

* Family members (siblings, spouses, ancestors, and lineal descendants);

* An individual and an entity (corporation or partnership) wherein the individual owns, directly or indirectly, 50% or more in value of that entity;

*Two entities in which the same individual owns, directly or indirectly, 50% or more of each;

* An estate in which the taxpayer is either the executor or beneficiary of the estate; and

* A trust in which the taxpayer is the fiduciary and the related party is a beneficiary either of that same trust or a related trust or fiduciary of the related trust.

Entities that qualify as escrow holders and trustees are banks and title insurance companies. The taxpayer needs to be aware that bank and administration fees may apply in order to use Safe Harbor No. 2.

The taxpayer greatly benefits from either of these arrangements knowing that an additional party will be safeguarding their exchange funds and securing the taxpayer's monies from bankruptcy or creditor claims against the QI. The insurance of QEs and QTs will have more Intermediaries re-evaluating the necessity of their fidelity bond and perhaps utilize this Safe Harbor more frequently.

Taxpayers should carefully choose their qualified intermediary and fully analyze the expertise as well as the financial stability of the entity providing the service. Taxpayers can seek out a host of Certified Exchange Specialists (CES) nationwide by visiting the Federation of Exchange Accommodators site at www.1031.org.

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