Audit Targets for Tax-Deferred Exchanges

It's starting to happen. While historically tax-deferred exchanges have not been a target for audit by the Internal Revenue Service, we are now hearing from tax professionals that more exchanges are being audited. This is particularly true for high-income Taxpayers with complicated real estate transactions. As real estate investors you may be interested in what the IRS auditors are being told to look for if they find an exchange on the tax return. The following is a short list of those audit points.

• Relinquished and Replacement Properties

• How did the Taxpayer use the relinquished property and replacement properties? Personal use as a second home or principal residence does not qualify. Properties held "primarily for sale" - builder/developer/rehab properties do not qualify.

• How long did the Taxpayer hold the relinquished and replacement properties?

• Exchange Documentation

• Is there a written exchange agreement? This is required even for a "simultaneous" exchange.

• Verify that the agreement was executed prior to closing of the sale. Watch for documents that are "as of" dated.

• Does the agreement specifically require the Taxpayer to identify replacement property that "qualifies" under §1031?

• Does the agreement contain the (g)(6) restrictions? These restrictions prohibit Taxpayer from receiving exchange funds prior to a technical exchange termination event.

• Qualified Intermediaries

• Is the Qualified Intermediary really qualified?

• Are they related to the Taxpayer?

• Are they an agent for the Taxpayer?

• Are they the attorney or accountant of the Taxpayer?

• Are they the escrow account holder? Traditional escrows do not meet the requirements of a Qualified Intermediary.

• Identification of the Replacement Property

• Carefully review the identification document. The 45-day identification period is the most difficult part of the exchange process for the Taxpayer. Be vigilant for fraud.

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• Is it dated “as of” a particular date?

• Verify which ID rule was used? 3-property? 200% rule? 95% exception?

• Does the ID meet the specific requirements of the rule? Be aware that the Taxpayer may have identified properties beyond those showing on the offered evidence.

• Does the identification accurately describe the properties? Any error could invalidate the identification and therefore the exchange.

• Did the proper Taxpayer sign the identification? Individual? Trustee of a trust?

• Acquisition of the Replacement Property

• The 45-day and 180-day deadlines are counted from the date the benefit and burdens of ownership shift to the Buyer. This is not necessarily the same date the deed records.

• Was the replacement property acquired within the 180-day exchange period?

• Exchange Funds

• Did the Taxpayer receive cash or other non-qualified property?

• Was the cash or non-qualified property received prior to a (g)(6) termination event? Did they have the right to receive the cash or non-qualified property prior to a termination event?

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