Who is Disqualified from Facilitating a 1031 Like-Kind Exchange?

Creation of the Role of Qualified Intermediary in the Treasury Regulations

Prior to the Internal Revenue Code Section 1031 Treasury Regulations issued in 1991 governing exchanges, it was difficult to arrange for the Exchanger's Buyer to actively participate in the Exchanger's exchange transaction. It could not be accomplished without the Buyer's significant involvement. However, Buyers were not typically motivated to assist in the Seller's attempt at tax deferral. The 1991 Regulations sought to deal with this thorny problem by creating a new entity known as a Qualified Intermediary (QI).

The QI would serve as an Intermediary to whom the Exchanger's Relinquished Property would be transferred, and from whom it would be transferred to the Exchanger's Buyer. Additionally, the QI would acquire Replacement Property from a Seller and transfer it to the Exchanger. Hence, the Exchanger would not do an exchange with a Buyer or Seller but with the QI. Since both Relinquished and Replacement Properties passed between the Exchanger and QI, the QI was referred to as an "Intermediary," but what makes the Intermediary *qualified*?

Persons Disqualified to Act as Intermediary

To answer this, it is helpful to review the regulations to see what persons are specifically not qualified to facilitate an exchange. Anyone who is not disqualified should then be considered qualified. Also, it should be noted that, although in these regulations (and the Tax Code) there are references to persons, that term is also deemed to refer to other entities, as well. In general, an agent or related party of the Exchanger is disqualified. The regulations state:

> "The person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction"

If any of this group of persons provided services within two years of the sale of the Relinquished Property, that person (or entity) is disqualified. There are several exceptions, and the primary one pertains to financial institutions. This exception applies where the entity has provided "routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company." So, for example, a company who provides routine banking services or escrow services can still be qualified to act under these rules.

Related Parties as Qualified Intermediaries

As for having a related party act as the QI in an exchange, the rules make reference to code sections 267(b) and 707(b). The rules in these code sections apply specifically to an Exchanger wishing to buy Replacement Property from an individual or entity to whom the Exchanger is related, however the disqualified person rules borrow from these provisions.

The related party rules primarily disallow a person from acting as QI if they are a familial relation to the Exchanger. With regard to entities in which the Exchanger may have an ownership interest, the related party rules provide that a greater than a 50% interest between the Exchanger and a Replacement Property Seller will cause the transaction to be disallowed. For instance, if Exchanger A wished to buy his Replacement Property from a two-member LLC of which A and B were equal members, the transaction would be allowed since A does not have a greater than 50% interest in the LLC. Not so if A has a greater than 50% interest.
The disqualified person rules mirror the related party rules with one significant difference. For the disqualified person rules, the 50% interest rule is reduced to 10%. So, in the example above, because A has a membership interest of greater than 10%, he could not serve as a QI.

Additional Exchange Company Roles

Although here we are specifically addressing persons disqualified from acting as Qualified Intermediaries, it should be noted that there are similar roles that may also be serviced by an exchange company, from which such persons would be similarly disqualified. These roles include those of qualified escrow agent, trustee of a qualified trust and, for reverse 1031 Exchanges, Exchange Accommodation Titleholder (EAT). Acting in any one of these capacities would require that the service provider not be a disqualified person.

In Summary

In summary, to act as a Qualified Intermediary, a person or entity must not be a disqualified person under the applicable regulations. Persons who are agents of the Exchanger, defined as having done work for the Exchanger during the prior two-year period, are disqualified. This rule does not apply if the service provided has merely consisted of routine financial services during that period.

Additionally, a related party cannot provide QI services if that party is one of enumerated types of relations to the Exchanger or if the Exchanger has an interest in the service provider greater than 10%. Finally, if a person is not disqualified, then the person is qualified.