



1031 Like-Kind Exchange Pitfalls to Avoid

by **Greg Lehrmann, Attorney**

Double Board Certified • Commercial and Residential Real Estate Law

The Big Picture

Internal Revenue Code Section 1031 and its accompanying regulations impose strict procedural and documentation requirements that must be satisfied to qualify for deferral. A taxpayer's good faith intent to reinvest in replacement property after a sale is not sufficient to meet the requirements of Section 1031. To preserve eligibility for tax deferral, the following common pitfalls must be carefully avoided.

Exchange Pitfall No. 1—Trying to set up an exchange after closing your sale.

One of the most frequent conversations I have with sellers begins with "Greg, I just closed on a real estate sale, and I heard I won't have to pay taxes if I do an exchange." Sometimes they add, "Don't worry, I haven't touched the money."

It is true that a taxpayer intending to complete a 1031 exchange cannot take actual receipt of the sale proceeds. However, simply avoiding direct possession of the funds—such as not cashing the check—does not necessarily preserve the ability to complete an exchange. If the sale closes without properly executed exchange documents in place, the seller is deemed to have control over the proceeds. The legal doctrine governing this is known as "constructive receipt."

In *Crandall v. Commissioner*, T.C. Summ. Op. 2011-14 (2011), a taxpayer sold investment property in Arizona and purchased replacement property in California. Without executing any exchange documents, the taxpayer directed the Arizona title company to wire the sale proceeds directly to the California title company handling the purchase. The Tax Court held that the transaction constituted a taxable sale because the procedural requirements of IRC Section 1031 had not been satisfied.

Exchange Pitfall No. 2— Not understanding what it takes to defer *some* gain.

Many taxpayers have completed what they believed to have been a valid 1031 exchange, only to later learn from their tax advisor that they gained no tax benefit. This often happens because (a) they assume that simply reinvesting any portion of their sale proceeds into new property automatically defers taxes, and (b) their qualified intermediary (QI) failed to ask critical questions or provide accurate guidance.

Taxpayers do not defer taxes on the first dollar reinvested in replacement property unless their tax basis in the relinquished property is zero. This is because taxpayers only defer gain on the amounts *in excess of basis* that is invested in replacement property.

Exchange Pitfall No. 3—Not understanding what it takes to defer *all* gain.

Some taxpayers mistakenly believe that simply reinvesting the amount of their gain is enough to defer all taxes. In reality, full tax deferral under Section 1031 requires reinvestment of all net equity from the sale and replacement of any debt that was paid off—either by obtaining new financing on the replacement property or by contributing an equivalent amount of additional cash. Put another way, the replacement property must be purchased for at least the same total value as the relinquished property (net of closing costs), and the taxpayer cannot receive or retain any cash from the transaction. Only when these conditions are met can full tax deferral be achieved.

Exchange Pitfall No. 4— Not understanding what types of property qualify.

On one hand, some taxpayers attempt to sell or acquire property that was not, or will not be, held for business or investment purposes. Properties held primarily for sale, or those used excessively for personal purposes, do not qualify for a Section 1031 exchange.

On the other hand, some taxpayers take an overly narrow view of what qualifies, missing valuable opportunities to reduce management burdens or enhance cash flow through strategic exchanges. All real estate in the United States that is held for use in a trade or business or for investment is “like-kind” to all other real estate in the United States that is held for use in a trade or business, or held for investment. For a more detailed discussion, see my article *Turning Buildings and Land Into Opportunity*. https://excel1031exchange.org/2024/11/01/buildings_into_opportunity/

Exchange Pitfall No. 5— Using a person who is disqualified to act as a QI.

Section 1031 requires the taxpayer to use a QI in the exchange. A good QI coordinates with the taxpayer’s legal and tax advisors, prepares all required exchange documents, and oversees each closing to ensure compliance with Section 1031 rules. The QI facilitates both the sale of the relinquished property and the purchase of the replacement property, securely holds exchange proceeds until needed, and provides guidance, documentation, and timelines throughout the exchange process. Some taxpayers do not know that the QI may not be a family member, employee, real estate professional or a tax or legal advisor who has given tax or legal advice within the past two (2) years. Using a QI who is disqualified could invalidate the exchange.

Exchange Pitfall No. 6—Not consulting with a tax advisor before initiating the exchange.

It is essential for taxpayers to consult with a qualified tax advisor who understands their individual circumstances before proceeding with a 1031 exchange. While many exchanges are relatively straightforward, others can involve complex issues and require careful judgment. Additionally, some taxpayers may have suspended or carryforward losses that could be applied to offset any boot received in the transaction. Taxpayers should thoroughly review their own tax position and evaluate the potential benefits and implications of a 1031 exchange in consultation with experienced tax and legal advisors familiar with their specific facts and situation.

Exchange Pitfall No. 7— Not safeguarding exchange funds.

QIs in 1031 exchanges are not regulated by the federal government or by most states. Consequently, there are no uniform standards governing how exchange funds are held, invested or protected. Moreover, QIs are not required to carry insurance or other safeguards. Taxpayers must therefore carefully assess the financial stability and trustworthiness of any QI they consider engaging. If exchange funds are lost or misappropriated, and the QI lacks adequate protections, the resulting loss falls on the taxpayer.

The Takeaway

When completing a tax-deferred exchange, good-faith intent alone is not sufficient to satisfy IRS requirements. Engaging qualified tax advisors and an experienced, specialized QI is essential to ensure the exchange is properly structured, compliant, and achieves the intended tax deferral.

About Us

Greg Lehrmann is the founding member of Excel 1031 Exchange with 42 years of experience in commercial and residential real estate. For the past three decades he has dedicated his career to 1031 exchange work and has handled tens of thousands of exchanges throughout the country.

Mr. Lehrmann is a distinguished attorney double board certified in commercial and residential real estate law by the Texas Board of Legal Specialization. Only 2% of attorneys in Texas meet this exacting standard. He has a B.B.A. with honors in accounting from The University of Texas and a J.D. from The University of Texas School of Law.



 www.excel1031exchange.org  greg@excel1031exchange.org  (512) 213-9571

NOTICE: Neither Greg Lehrmann, Excel 1031 Exchange, LLC, nor its affiliated companies, officers, directors or employees (Excel 1031) intend that the information contained in the foregoing is anything other than general information for discussion purposes only. It is not Excel 1031's intent to provide tax or legal advice to any person or entity. For any tax or legal advice specific to your situation you are encouraged to consult with a tax advisor or attorney of your choice.