WHEN IS AN EXCHANGER ENTITLED TO RECEIVE FUNDS FROM THE EXCHANGE ACCOUNT?

For those seeking to understand the quandary of when and under what circumstances a Qualified Intermediary (“QI”) can and will release exchange funds, the answer is neither arbitrary or capricious, but rather, lies in understanding the safe harbor provisions of the IRS 1991 Treasury Regulations.

It is quite common for a taxpayer — after closing escrow on the relinquished property and during the pendency of the 180 day exchange period — to decide he does not want to move forward with the exchange; or the exchanger may have acquired some of the identified replacement property and decide that he does not want to acquire additional property. It is then that the exchanger will politely ask the QI to release the exchange proceeds. Unfortunately, pursuant to the safe harbor provisions of the 1991 Treasury Regulations, the QI cannot release exchange proceeds except under certain specifically enumerated circumstances.

When the taxpayer learns that the QI will not simply give him back his money, the common response is “Why does the QI care if I get my money since I have to pay taxes on it anyway?” Unfortunately, many of these taxpayers believe there is a grand scheme by the QI’s to retain the taxpayers’ money for their own benefit. That is simply not the case. To better understand why a taxpayer cannot simply demand the return of the exchange funds at any time requires an understanding of what a safe harbor is.

What is a Safe Harbor?

“Safe Harbor” is a term that refers to a specific procedure, which — if followed — will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of section 1031 and will help ensure that the transaction will qualify under section 1031 for non-recognition of capital gain tax.

The (g)(6) Limitations: i.e. the Safe Harbor that dictates when a QI can pay funds to an exchanger:

An exchange will fail to qualify under IRC §1031 if a taxpayer is deemed to be in actual or constructive receipt of the relinquished property sale proceeds (i.e. the exchange proceeds) or other property before he receives like kind replacement property. Likewise, the exchange will also fail if an agent of the taxpayer receives money or other property for the taxpayer, because the taxpayer will be deemed in constructive receipt of that money or other property. Thus, it is critical to the success of an exchange that the QI avoid being deemed an agent of the taxpayer. To avoid being deemed an agent of the taxpayer, a QI must abide by

Section_1.1031(k)-1(g)(6) of the Treasury Regulations, which provide that an agreement between a QI and a taxpayer must expressly limit the taxpayer's rights to receive the exchange funds and that any such agreement will be deemed to limit the taxpayer's rights under the safe harbor provisions only if it provides for the QI to pay funds under the following circumstances:

(1) After the acquisition by the taxpayer of all identified replacement property to which the taxpayer is entitled under the exchange agreement;

(2) After the 45th day expires if the taxpayer has failed to identify any replacement property;

(3) After the 45th day if there remains unacquired identified replacement property and there occurs a material substantial contingency after the end of the identification period that relates to the exchange, is provided for in writing, and is beyond the control of the taxpayer and of any disqualified person;

(4) After the expiration of the 180 day exchange period.

Accordingly, once the exchange agreement is executed and the funds are disbursed to the QI, the taxpayer cannot simply change their mind and demand their money back. The funds cannot be disbursed to the taxpayer except under the above stated circumstances.

Why does the QI care whether the taxpayer receives exchange funds during the exchange?

The regulations expressly state that if the QI abides by the (g)(6) limitations, it will not be deemed an agent of the taxpayer (and therefore disqualified to act as a QI) and the taxpayer will not be deemed in constructive receipt of the money. On the other hand, if the QI decides to arbitrarily release funds to a taxpayer who is demanding this money, the IRS could and likely would argue that the (g)(6) limitations on the funds were illusory because the QI selectively ignored them, as such, the limitations are really meaningless as to *all* exchangers the QI assists. The catastrophic end result being that the IRS could very likely disallow *all* exchanges being handled by that QI. No reputable QI would or should risk its ability to act as a QI or put its exchangers' transactions at risk. Taxpayers looking to find a QI should consider the integrity and reputation of the QI. If a QI is willing to arbitrarily release funds to one taxpayer, it will jeopardize every exchange it handles. And, that QI will certainly will not look favorable in an IRS audit.

Common Questions about the (g)(6)limitations:

(1) *Can the exchanger ever receive funds prior to expiration of the 45th day?*

Yes. If an exchanger identifies property as the only property to be acquired in the exchange *and* he thereafter acquires that property, any remaining funds may be released to the exchanger because he will have acquired all property identified under the agreement and the exchange will be deemed completed.

(2) *If the taxpayer identifies 3 properties, but purchases 1 of those properties, can he receive remaining funds from the exchange account if he tells the QI that he only intended to buy 1 property?*

The taxpayer may obtain the remaining funds in the exchange account only under very specific circumstances. The regulations permit identification of alternative properties rather than multiple properties. If a taxpayer simply identifies three properties without stating whether it is an alternative or multiple identification, then the taxpayer will be deemed to have identified multiple properties and will not be entitled to receive the remaining funds in the exchange account except to complete the purchase of the additional identified property or upon the expiration of the 180th day.

If, however, the taxpayer expressly states in the exchange agreement and/or the identification notice that he only intends to acquire 1 of 3 alternative properties identified and that the QI is obligated to acquire only one such property on behalf of the exchanger, then the QI could safely release any remaining funds in the exchange account after the acquisition of that one identified property. In other words, under those circumstances, it would be clear that the exchanger received all the property that he was entitled to receive under the exchange agreement and the exchange will be deemed completed.

(3) *What is a material substantial contingency beyond the control of the taxpayer*?
Many taxpayers believe that they can successfully demand a return of the exchange funds when they demonstrate that they are unable to successfully negotiate contracts for the property they identified. Unfortunately, the IRS concluded otherwise. In fact, according to the conclusions of the IRS in its Private Letter Ruling 200027028 –there are several types of material substantial contingences that it believes are not “beyond the control of the exchanger” as follows:

(1) The purchase terms are uneconomical and or unfavorable.
(2) The seller may believe the property is worth far more than when the exchanger originally inquired about the purchase
(3) The seller is demanding an unfair price and/or unfair terms;
(4) The seller’s circumstances have changed and he is no longer willing to accept a note or may believe that his property is now worth far more than when the exchanger originally inquired about the purchase of the property.

(5) The exchanger, in good faith, unsuccessfully attempts to acquire the replacement properties but simply cannot conclude a binding agreement.

Under all of the above stated circumstances, *the IRS stated that "it is within the [exchanger]'s control to decide to meet the seller' s demands or walk away from an uneconomic business deal."* [Emphasis added.]

CONCLUSION

In sum, it is extraordinarily important that taxpayers understand that once the exchange funds are received by the QI, those funds are subject to the (g)(6) limitations and that those limitations are neither arbitrary nor capricious. Therefore, all taxpayers should carefully review the (g)(6) limitations prior to proceeding with an exchange transaction and should make alternative plans if funds might be needed prior to the time limitations outlined under section (g)(6).