WHAT IS "CONSTRUCTIVE **RECEIPT**" IN A 1031 EXCHANGE?

In order to qualify for tax deferral under IRC § 1031, the taxpayer must meet certain requirements. One of these requirements is that the taxpayer cannot have actual or constructive receipt of the proceeds from the relinquished property sale during the exchange period. See Treas. Reg. §1.1031(k)-1(f)(1).

Likewise, actual or constructive receipt of money or property by an agent of the taxpayer (as determined under general legal principles) will be considered actual or constructive receipt by the taxpayer and the transaction will fail to qualify for tax deferral. See Treas. Reg. §1.1031(k)-1(f)(2).

Actual receipt is an easily understandable concept in that it occurs when the taxpayer actually receives money or the benefit of the money.

Constructive receipt occurs when the funds are credited to the taxpayer, set apart for them or otherwise made available so that they may draw on those funds at any time or after notice of intention to draw upon the funds. It is not necessary for the taxpayer to have actual receipt of funds to be in constructive receipt of them.

Some examples of constructive receipt are as follows:

- A check received by the taxpayer from the closing agent is considered actual receipt of funds even if the taxpayer never cashes the check.

- A closing on the sale of property with no agreement in place that restricts the taxpayer's access to the exchange proceeds as required under Treas. Reg. §1.1031(k)-1(g)(6) will eliminate the possibility of deferral under §1031 even if the taxpayer never actually receives any of the proceeds. (See more on this topic, continued)

- Funds that are held by the attorney/closing agent post-closing are deemed to be constructively receive by the taxpayer because an escrow/closing agent is an agent of the taxpayer/seller.

How to avoid constructive receipt:

To prevent actual or constructive receipt, a taxpayer must utilize one of the safe harbors provided for in the Treasury Regulations under §1.1031(k)-1(g) ("Regulations"). One of these safe harbors is the use of a qualified intermediary.

A "qualified intermediary" is a third party who enters into a written exchange agreement with the taxpayer prior to the sale of the relinquished property and thereafter, pursuant to the terms of the agreement, acquires the relinquished property from taxpayer and transfers it to a buyer and acquires the replacement property and transfers it to the taxpayer. The exchange agreement must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the proceeds except as provided under section (g)(6) of the Regulations.

Therefore, to ensure a successful exchange, it is always important to engage the services of a Qualified Intermediary such as Old Republic Exchange Company as early as possible prior to the sale of your investment property to ensure that your funds are handled properly and that all necessary documentation is in place.

Old Republic Exchange Company is knowledgeable, strictly complies with the 1031 exchange rules, and has had its documents thoroughly vetted to insure against any detrimental constructive receipt of funds by exchanging taxpayers
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To learn more, please contact

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