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Explanation of why access to 1031 exchange funds is limited - by Pamela Michaels

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A significant challenge for some investors, especially in New York and New Jersey due to the scarcity of attractive investment property, is ensuring compliance with the requirements of §1031. One requirement is the restriction on the use of exchange proceeds held by the qualified intermediary. The exchange proceeds must be used exclusively for the purchase of replacement property during the exchange period or returned to the investor after the expiration of the exchange period absent special circumstances.

Although the 1031 exchange rules provide investors with the flexibility to take up to 45 calendar days to identify replacement property and a maximum of 180 calendar days to purchase identified replacement property, there are specific restrictions limiting the investor's access to exchange proceeds held by the qualified intermediary during the exchange period. U.S. Treasury Regulation, Section 1.1031 (k)-1(g)(6) limits the taxpayer's ability "to receive, pledge, borrow or otherwise obtain the benefits of money or other property before the end of the exchange period. The taxpayer may have rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property on or after:

(A) The receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement; or

(B) The occurrence after the end of the identification period of a material and substantial contingency that: (1) relates to the deferred exchange; (2) is provided for in writing; and (3) is beyond the control of the taxpayer and of any disqualified person (as defined in paragraph (k) of this section) other than the person obligated to transfer the replacement property to the taxpayer."

Although a through discussion regarding the impact of the foregoing G(6) restrictions is beyond the scope of this article, the following are noteworthy limitations on the ability of a qualified intermediary to release exchange proceeds:

• During the 45 day identification period: The qualified intermediary cannot release exchange proceeds during the 45-day identification period—unless it is for a replacement property purchase or deposit on a replacement property under contract.

• After the expiration of the 45 day identification period:

1. If, after the expiration of the 45-day identification period, the taxpayer has not identified any replacement property, the qualified intermediary can return the proceeds on day 46. Once proceeds are returned to the investor, the 1031 exchange is over.
2. If the taxpayer has identified replacement property and the 45-day identification period has passed, exchange proceeds may only be returned if (a) the taxpayer has acquired all identified replacement property; or (b) the exchange period has expired. Note the exchange period expires on the earlier of 180 calendar days after the sale of the relinquished property or the date the taxpayer's tax return is due or filed, whichever is earlier. Thus, if an investor's tax returns are due on April 15th and this happens to be in the midst of the 180-day period, an investor seeking the return of exchange proceeds may file their tax return and cause the exchange period to end prior to the expiration of the 180-day exchange period. This would allow the release of exchange proceeds from the qualified intermediary's account.

An investor who is still within their 45-day identification period can revoke and replace any prior identification in whole or part. For instance, if an investor originally identified three properties and within the 45 days decides to only purchase one replacement property, the investor may revoke the original identification and submit a new identification listing only one replacement property prior to the expiration of the 45-day identification period. If this revocation is done, then the exchange will end after the purchase of the one replacement property and any funds remaining in the exchange account may be returned to the investor on the 46th day. The funds returned will be considered cash boot and are generally taxable to the extent the investor has a capital gain tax consequence. If the original identification of three replacement properties is not revoked and only one property is purchased, the exchange funds cannot be returned to the taxpayer pursuant to the G-G restrictions until the end of the exchange, generally the 180th day. Thus, even if the investor declares they do not wish to purchase any additional replacement properties, the qualified intermediary must hold the exchange proceeds until the 180-day exchange period has expired or the investor's tax return is filed.

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