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Regarding Coronavirus and 1031 exchange replacement property contracts - by Pamela Michaels

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Our worlds everywhere, but especially in New York City and the Northeast, have been turned upside down by the Coronavirus. Contracts are being renegotiated and terminated and force majeure clauses are being examined by legal counsel under a microscope. In some cases, the seller is no longer able to deliver the real property in accordance with its contract terms. If the contract was for a replacement property purchase in a §1031 exchange, what does this mean for the exchanger? The answer may depend on when this happens in a §1031 exchange.

U.S. Treasury Regulation, Section 1.1031 (k)-1(g)(6) (known as the G(6) restrictions) must be examined to determine the rights of an exchanger to access or receive exchange funds held in a Qualified Intermediary (QI) account in the event of cancellation of a replacement property contract and the exchanger's desire to terminate their rights to proceed with their exchange.

The G(6) restrictions limit 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."

Thus, the ability of a QI to release exchange proceeds can be summarized as follows:

During the 45-Day Identification Period

The QI 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 QI 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 a taxpayer'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.

3. The occurrence of a material and substantial contingency which meets the definition in subsection (b) above. Examples of such contingencies historically have included the loss of replacement property due to earthquakes, fires or other Acts of God. An exchanger may believe that the consequences of the coronavirus outbreak may have resulted in such an event, especially if any replacement contracts for sale have been terminated as a result and no other property was identified. Such exchangers wishing to have their proceeds released should consult with legal counsel as the improper release of funds may jeopardize any portion of the 1031 that was completed or violate the G(6) restrictions if the material and substantial contingency exception requirements are not met.

For exchangers who are still within their 45-day identification period and decide due to the coronavirus that they do not wish to proceed with the exchange, can simply notify their QI that they have not identified any replacement property and their exchange will end at midnight of the 45th day. Alternatively, if property was already identified but due to factors attributable to the coronavirus the exchanger wishes to select different properties to identify, the exchanger can revoke and replace any prior identification in whole or part within the 45-day identification period. 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. Exchangers should consult with their QI and legal counsel to ensure the revocation and replacement identification is properly executed to avoid issues which may arise if duplicate identifications are received.

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