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“G6” restrictions of 1031 exchange proceeds: Why exchangers can’t have access to exchange funds - by Lynne Bagby

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Frequently asked questions by New England real estate investors, particularly those seeking tax deferral in a 1031 exchange are “What happens if I identify replacement property before the 45th day identification period deadline and the purchase transaction deal falls through?” Or, “I change my mind and decide to buy only one or not all of multiple identified replacement properties? Can I receive my exchange proceeds and when?”

To answer these questions, it is important to realize that a qualified intermediary (“QI”) must limit the taxpayer’s ability to access exchange funds held in the QI’s exchange account in order to meet the requirements specified in the U.S. Treasury Regulations. Although the deferred 1031 exchange rules provide the taxpayer with the flexibility to take up to 45 days to identify and a maximum of 180 days to purchase a replacement property or properties, there are specific restrictions placed on the taxpayer’s ability to access exchange proceeds in the possession of the QI during the exchange period.

SECTION 1.1031(k)-1(g)(6)

In a deferred exchange, U.S. Treasury Regulations, Section 1.1031(k)-1(g)(6), require stipulations in the exchange agreement which 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 upon or after:

a). The receipt by the taxpayer of all replacement property to which the taxpayer is entitled under the exchange agreement

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."

WHAT IS THE IMPACT OF THESE G6 RESTRICTIONS?

Although a thorough discussion is beyond the scope of this short article, the following are two examples that investors in the Northeast may face:

SCENARIO #1: The taxpayer identifies multiple replacement properties within the 45-day Identification Period. The taxpayer acquires one of these properties within the 45-day Identification Period and they would like to receive the remaining exchange proceeds (referred to as "cash boot") held in the QI's exchange account.

A SOLUTION: Revoke the identification of all other previously identified replacement properties so the remaining exchange proceeds can be released on day 46 by the QI. This can be accomplished because the taxpayer will have purchased all the replacement property they were entitled to purchase which is just the one identified replacement property.

SCENARIO #2: The taxpayer identifies multiple replacement properties and acquires at least one replacement property, but not all of the identified replacement properties. However, they are past the expiration of the 45-day Identification Period—and they would like to receive the remaining exchange proceeds held in the QI's account.

A SOLUTION: The remaining exchange proceeds must be held by the QI until either the end of the exchange period (day 181) or one of the occurrences specifically cited in the Section 1.1031(k)-1(g)(6) restrictions.

These two different scenarios highlight the importance of a taxpayer reviewing all aspects of a proposed 1031 exchange well in advance of closing with his tax and/or legal advisors. We are currently experiencing a robust seller's market in New England and this has led to a surge in 1031 exchange activity with some taxpayers opting to exchange for the first time to obtain tax deferral. Therefore, it is important to review all of the requirements under IRC Section 1031 to understand the options and limitations of this powerful tax code provision.

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