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Why investors' access to 1031 exchange funds are limited - by Lynne Bagby

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As more New England investment real estate owners are marketing their rental properties and would like to participate in a 1031 exchange at the time of sale, questions often asked are: "What if I can't find anything suitable to identify by the end of the 45--day Identification period?" or "What if I identify a property and I am unable to buy it—when can I get my money back from the qualified intermediary's account?"

A qualified intermediary that meets the "safe harbor" requirements specified in the U. S. Treasury Regulations must limit the taxpayer's ability to access the funds held in the qualified intermediary's exchange account. Although the 1031 exchange rules provide a taxpayer 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 taxpayer's access to exchange proceeds held by the qualified intermediary during the exchange period.

In a 1031 exchange, 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) provides 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 G(6) restrictions is beyond the scope of this article, the following are some practical considerations:

Scenario #1: The qualified intermediary cannot release exchange proceeds during the 45-day identification period—unless it is for a purchase of or deposit on a replacement property under contract.

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.

2. IF the taxpayer has identified replacement property, is past the 45-day identification period, and would like exchange proceeds returned, the taxpayer must either (a) close on all identified replacement property; or (b) the expiration 180-day exchange period in which case the exchange proceeds can be returned on day 181.

Scenario #2: In the event the taxpayer has identified replacement property within the 45-day identification period, is still within the 45-day identification period and would like to either revoke some or all of their identification and/or substitute new replacement property, the taxpayer must either: (a) revoke in writing the identified replacement property; or (b) substitute replacement property by sending a written revocation and identify the substituted replacement property). For example, if a taxpayer identifies three replacement properties and decides they only want to purchase one replacement property and receive the remaining exchange proceeds as taxable boot and they are within the 45 day Identification Period, they can revoke property 2 and 3. Once they purchase the replacement property 1, they have purchased all the property they are entitled to under the exchange agreement and therefore the remaining proceeds can be returned to the taxpayer.

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