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How does IRS Notice 2020-23 affect the G(6) restrictions on 1031 exchange funds? - by Lynne Bagby

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Lynne Bagby

Many New England real estate investors enquire about receiving sale proceeds from a 1031 exchange transaction if they are unable to locate suitable replacement property within the 45-day identification deadline—and more recently, by the deadline extensions in IRS Notice 2020-23. This Notice extended the 45- and 180-day deadlines for 1031 exchange investors closing between April 1, 2020 and May 31, 2020 until July 15, 2020.

Keep in mind, the normal G(6) restrictions on exchange proceeds outlined below apply regardless of the Notice 2020-23 extension which allows investors more time to locate and close on replacement property due to business restrictions related to the health pandemic. Although this Notice provided clarity on the dates being extended, this notice did not provide much guidance on many other unanswered issues related to 1031 exchange deadlines and did not provide the automatic 120-day extensions that has been customary in many other disaster declarations.

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.

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 in a 1031 exchange 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 exchange 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 properties 2 and 3. Once they purchase 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.

Lynne Bagby, CES is the New England division manager for Asset Preservation, Inc., Boston.