Limitations on The Safe Harbors: The (G) (6) Provisions

The 1991 Treasury Regulations for tax deferred exchanges under IRC §1031 establishes four "safe harbors," the use of which allow a taxpayer (Exchanger) to avoid actual or constructive receipt of money or other property for purposes of completing a §1031 exchange. Although an Exchanger will not automatically be deemed to have constructive receipt of relinquished property sale proceeds if the safe harbor requirements are not met, compliance with the safe harbors should satisfy even a conservative tax advisor. The four safe harbors include (1) qualified intermediaries, (2) interest and growth factors, (3) qualified escrow accounts and qualified trusts and (4) security or guaranty arrangements. These safe harbors may be used singularly or in any combination as long as the terms and conditions of each can be separately satisfied.

The first three of the safe harbors require the exchange agreement between the Exchanger and the Qualified Intermediary to expressly limit the Exchanger's right to "receive, pledge, borrow, or otherwise obtain the benefits of money or other property" **before** the end of the 180-day exchange period, except as permitted by Treasury Regulation §1.1031(k)-1(g)(6)(i)-(iii). The safe harbors are not satisfied if these restrictions are not placed upon the Exchanger, even if the Exchanger never actually receives the exchange proceeds. Treas. Reg. §1.1031(k)-1(g)(8), Example 2(ii). The "cash out" provisions found in the Regulations allow the exchange agreement to remove these restrictions and grant the Exchanger access to the exchange proceeds before the end of the exchange period, but only under the following circumstances:

(A) If the Exchanger has not identified replacement property by the end of the 45-day identification period, then the exchange can be terminated and the Exchanger has the right to the exchange proceeds at any time. For example: On April 1, Exchanger "E" transfers the relinquished property to a buyer. If the Exchanger fails to identify any replacement property on or before May 16, then E may have access to the funds in the exchange account at any time after May 16. Treas. Reg. §1.1031(k)-1(g)(6)(ii).

(B) If, after the end of the identification period, the Exchanger has identified replacement property and receives all of the identified replacement property to which the Exchanger is entitled under the exchange agreement, then the Exchanger has the right to receive any remaining exchange proceeds even if it is prior to the end of the 180-day exchange period. For example, if E identified a single replacement property on May 15 and acquired that replacement property on May 25, then E could demand the balance of the remaining exchange proceeds at any time after that date since E had acquired ***all of the identified replacement property to which it is entitled under the exchange agreement.*** Treas. Reg. §1.1031(k)-1(g)(6)(iii)(A).

The provision in (B) is more problematic when the Exchanger identifies multiple replacement properties. For example: On April 1, E transfers the relinquished property to a buyer and the Qualified Intermediary "QI" receives $500,000 in exchange proceeds. On or before May 16, E properly identifies a ranch and two vacant lots as replacement property ***although E only intends to acquire the ranch.*** The 180-day period expires on September 28. On August 28, QI uses $300,000 to acquire the ranch for E as replacement property. The answer is unclear as to whether E has an immediate right to the $200,000 balance of the exchange proceeds. Some commentators believe that the QI should be allowed to pay any excess exchange funds to the Exchanger without having to wait for the expiration of the 180-day period. Other commentators argue that since the Exchanger has properly identified other properties, which he/she has not acquired, the Exchanger has not acquired ***all of the properties to which it is entitled.*** Therefore, the receipt of the remaining exchange funds prior to the expiration of the 180-day period could constitute constructive receipt of the exchange funds and possibly jeopardize the tax-deferred nature of the entire transaction.

(C) If, after the end of the identification period a material and substantial contingency occurs that: relates to the deferred exchange, is provided for in writing; and is beyond the control of the Exchanger and of any "disqualified person" other than the person obligated to transfer the replacement property to the Exchanger, then the Exchanger has the right to the exchange proceeds. Treas. Reg. §1.1031(k)-1(g)(6)(iii)(B). Although the Treasury Regulations provide very few examples, zoning problems or unsatisfactory structural inspections may rise to the level of a "material and substantial contingency." To avoid the possibility of constructive receipt of the exchange funds, the Exchanger should always consult with their tax advisor as to whether the occurrence of a particular contingency in their purchase contract could be considered a "material and substantial contingency" to qualify under this provision.

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