Investors Title Exchange Corporation
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The Exchange

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Certified Exchange Specialists on Staff

"I Want My Money Now!" Constructive Receipt Issues in a 1031 Exchange

By Carol A. Hayden, Executive Vice President Investors Title Exchange Corporation

Suppose that you have just closed a purchase transaction and recorded the deed. You inform the seller that he can pick up his sales proceeds, but the seller responds, "Oh, by the way, I want to do a 1031 exchange." Is it too late? What about the client who transfers relinquished property in a properly structured exchange, acquires replacement property with part of the exchange funds, and now wants the remaining exchange funds? Can he get his money now? Both of these scenarios involve the possible constructive receipt of exchange funds by the taxpayer. As tax-deferred exchanges become more commonplace, it is important to recognize and understand constructive receipt issues that could cause unexpected tax results.

The 1991 Treasury Regulations

In 1991, the IRS issued final regulations governing non-simultaneous exchanges and provided safe harbors for taxpayers to utilize. With regard to constructive receipt, §1.1031 (k)-1(f)(1) states that if the taxpayer is in constructive receipt of money or other property, "the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property." Subsection (f)(2) elaborates further, saying, "[t]he taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given." In other words, it is not merely sufficient for exchangors to avoid physically touching exchange funds, and the penalty for having access in any form during the transaction is fatal.

Qualified Intermediary Safe Harbor

The most widely-employed safe harbor under the regulations has been the use of a qualified intermediary (QI). The first step to avoid constructive receipt is to ensure that the QI is not related to, or an agent of, the taxpayer. Any person, including an attorney, investment banker, employee, accountant or real estate agent who has represented the taxpayer in any matter during the last two years will be considered an agent who is disqualified from serving as QI.

The second consideration in avoiding constructive receipt is to ensure that the exchange agreement is in place by the closing of the first relinquished property. The exchange agreement must restrict the taxpayer's right to receive funds from the QI during the exchange period. If the relinquished property closing occurs before these limitations are in place, the taxpayer has the legal right to demand the sales proceeds. Regardless of whether or not he has actually received the funds, he is in constructive receipt of funds, and the transaction will be deemed a taxable sale.

Therefore, it is advisable, *well before closing*, to routinely inquire of sellers if they intend to structure a 1031 exchange. The seller may not have considered this option, or may not even be aware of this opportunity to defer capital gains taxes. Real estate professionals dread that telephone call received weeks, days or even hours after a closing from an angry taxpayer who discovered that it is too late to structure a 1031 exchange.

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ITEC, founded in 1988, is a leading qualified intermediary in like-kind exchange transactions, facilitating as many as 200 exchanges per month involving properties throughout the United States.

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Essential Elements of the Echange Agreement Governing Constructive Receipt

Treasury Regulation § 1.1031(k)-1(g)(6) sets forth the safe harbor restrictions and limitations that must be present in an exchange agreement in order for the taxpayer to avoid constructive receipt of exchange funds. The agreement must provide that the taxpayer has no right to receive, pledge, borrow, or obtain the benefits of the money or other property the QI is holding before the end of the exchange period. The exchange period is the 180-day maximum time frame between the transfer of the relinquished property and the acquisition of the replacement property. However, the exchange agreement may provide for an early release of funds to the taxpayer in the following limited circumstances:

A) If no replacement property has been identified, the taxpayer may receive funds after the 45-day identification period expires; or

B) If the taxpayer has identified replacement property, the taxpayer may receive remaining funds after he has acquired all of the replacement property to which he was entitled to acquire under the exchange agreement;

If the taxpayer or QI waive any of the g(6) limitations contained in the exchange agreement, the taxpayer will be considered in constructive receipt of the funds, and the entire transaction will be deemed a sale and purchase rather than an exchange. A Private Letter Ruling (PLR 200027028) issued by the IRS in 2000 reiterated the Service's position that the exchange agreement cannot be amended to allow early release of the funds in violation of the (g)(6) limitations. In addition, the Service held that the default under a contract or inability of the taxpayer to enter into a contract on the identified property does not substantiate an early release of the funds.

Practical Examples

Scenario One: In a properly structured exchange with a QI, the taxpayer transfers relinquished property worth $100,000.00, and thirty days later acquires one replacement property for $90,000.00. When may he receive the remaining $10,000.00? He must wait until the end of the 45-day i.d. period to receive these funds. Under the exchange agreement, he is entitled to identify additional replacement property within the 45-day i.d. period. But, if he does not identify additional replacement property, he will have acquired all the property he was entitled to acquire under the exchange agreement, and may receive the remaining funds on day 46.

Scenario Two: In a slightly different scenario, the taxpayer transfers relinquished property worth $100,000.00, and thirty days later identifies three (3) replacement properties. On day 50, he acquires one of the identified properties for $90,000.00. When may he receive the remaining $10,000.00? The g(6) limitations allow him to receive remaining funds only after he has received *all* the property he was entitled to receive. Because he identified three properties, he must wait until after the 180-day exchange period expires to receive his remaining exchange funds. Otherwise, he will have waived the restrictions in the exchange agreement and be in constructive receipt.

The early release of $10,000.00 in the preceding examples would not simply generate tax consequences on the $10,000 boot received by the taxpayer, but would put the taxpayer in constructive receipt, destroying his entire exchange. The replacement property identification may not be altered or amended after the 45-day identification period expires, so the taxpayer's intentions should be carefully considered when identifying replacement property.

Summary

Early recognition of exchange opportunities is vital so that an exchange can be structured within the safe harbors. A properly drafted exchange agreement executed before the first closing ensures that the taxpayer will not be in constructive receipt of funds generated from the sale. A review with the taxpayer of the restrictions that the exchange agreement places on his exchange funds will enable the taxpayer to comply with the constructive receipt requirements and properly plan the transaction. The safe harbors provided in the 1991 Treasury Regulations have made exchanging real property easier and safer than ever before. Choosing a QI who also understands constructive receipt requirements can help your client achieve his exchange goals successfully.

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