

Limitations on The Safe Harbors: The “(g)(6)” Restrictions



The Treasury Regulations for tax deferred exchanges under IRC §1031 established 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. 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. Treas. Reg. §§1.1031(k)-1(g)(2)-(5). 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). The safe harbors are not satisfied if these “(g)(6)” restrictions are not placed upon the Exchanger, even if the Exchanger never actually receives the exchange funds. Treas. Reg. §1.1031(k)-1(g)(8), Example 2(ii). The Exchanger may have access to the exchange funds prior to the end of the Exchange Period only upon the following exchange terminating events:

- A. Immediately after the end of the 45-day Identification Period if the Exchanger has not identified any Replacement Property.** Example: The exchange begins on April 1 when Exchanger transfers the Relinquished Property to a buyer. If Exchanger does not identify any Replacement Property, then the exchange will terminate at midnight on May 16. The exchange funds may be returned to the Exchanger on May 17.

- B. Upon receipt of all of the identified Replacement Property to which the Exchanger is entitled under the exchange agreement, but only after the end of the Identification Period.** Example (i): Using the facts above, except that Exchanger identifies a single Replacement Property on or before May 16 (i.e. day 45) and acquires that Replacement Property on May 25. The exchange will terminate on May 25, and any remaining exchange funds may be returned to the Exchanger after the closing. Treas. Reg. §1.1031(k)-1(g)(6)(iii)(A). Example (ii) Same facts except that Exchanger acquires the Replacement Property on April 15. Exchanger must wait until the end of the Identification Period to receive the unused exchange funds, because the Exchanger still has 31 days remaining in which to identify additional Replacement Properties. Example (iii): Same facts except that Exchanger identifies three Replacement Properties, Blackacre, Whiteacre and Greenacre. Exchanger does not identify these properties as “alternate” properties, even though Exchanger only intends to acquire one property. On May 25, Exchanger acquires Greenacre, leaving a balance of \$30,000 of unspent exchange funds. Since Exchanger properly identified other properties, which could potentially be acquired, Exchanger has not actually acquired all of the Replacement Property to which Exchanger is entitled. Therefore, return of the remaining exchange funds prior to the expiration of the 180-day Exchange Period would violate the (g)(6) restrictions and cause the entire transaction to be taxable.

- C. Upon the occurrence after the end of the Identification Period of (1) a material and substantial contingency, (2) related to the exchange, (3) provided for in writing, and (4) 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.** Treas. Reg. §1.1031(k)-1(g)(6)(iii)(B). Although the Treasury Regulations provide very few examples, zoning, inspection, or loan issues to which the contract is contingent may rise to the level of this four-pronged test. The IRS views this exception very narrowly, noting in PLR200027028 that the failure of a taxpayer and seller to agree upon contract terms for acquisition of a Replacement Property was not beyond the control of the taxpayer. The IRS explained, “it is within the owner’s control to decide to meet the seller’s demands or walk away from an uneconomic business deal.” To avoid violation of the (g)(6) restrictions, resulting in denial of §1031 tax-deferral treatment, the Exchanger should always consult with a tax advisor as to whether the occurrence of a particular contingency is sufficient to qualify under this provision.