Disbursement of Exchange Funds.

The most controversial open issue involves situations in which the taxpayer considers the transaction to be over and demands the exchange funds but a (g)(6) event has not occurred. A (g)(6) event is an event under the deferred exchange regulations that allows the taxpayer to receive cash. Under Reg. Section 1.1031(k)-1(g)(6), a taxpayer may have rights to receive cash or other property not of like kind: (i) after the end of the exchange period (the earlier of 180 days after the transfer of the relinquished property or the due date of the taxpayer's return for the year of such transfer, including extensions); (ii) after the end of the 45-day identification period; (iii) upon or after the receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement; or (iv) upon or after the occurrence after the end of the identification period of a material and substantial contingency that relates to the deferred exchange, is provided for in writing, and is beyond the control of the taxpayer or any disqualified person (other than the person obligated to transfer the replacement property to the taxpayer).

Taxpayers often want to receive exchange funds prior to the occurrence of one of the above (g)(6) events. The transaction is not in fact over under the terms of the exchange agreement, but the taxpayer considers it finished and wants the balance of the exchange funds, including interest or a growth factor. These cases present difficult issues for intermediaries. The question of early distributions from an exchange account has been extensively discussed and debated in light of PLR 200027028 (April 10, 2000) (provision in original exchange agreement to allow early release of funds violates safe harbor because contingency was within the control of the taxpayer) and Florida Industries Investment Corporation and Subsidiaries v. Commissioner, T.C. Memo 1999-346, aff'd per curium in an unpublished opinion (11th Cir. 2001) (appeal only of the Section 1033 and related penalty issue) (premature receipt of boot evidenced the constructive receipt of all sales proceeds and disqualified the entire exchange). See Weller, "Early Distributions From 1031 Exchange Accounts - Another Look at a Strange New Ruling," 93 J. Tax'n 73 (August 2000); Levine, "Premature Distributions From Section 1031 Exchange Account – New Ruling Provides Guidance," 93 J. Tax'n 7 (July2000).

The three basic scenarios involving premature disbursements are as follows: (1) the taxpayer wants to cancel the exchange and demands the exchange funds prior to the end of the identification period (e.g., the day after the relinquished property closes and the funds are received by the intermediary); (2) the taxpayer timely identifies replacement property, but the property is sold to another person or the taxpayer no longer wants the property, and the taxpayer demands the exchange funds prior to the end of the 180-day exchange period; and (3) the taxpayer timely identifies multiple properties and receives one of the properties, but the taxpayer wants any balance of the exchange funds and interest or a growth factor immediately thereafter (i.e., prior to the end of the 180-day period) while there remains identified but unacquired property.

The first two scenarios present an issue for the intermediary and other persons who exchange with the intermediary (not necessarily the taxpayer). The taxpayer will be taxed on the transaction in any event. The taxpayer just wants the exchange funds and wants them yesterday. If the intermediary simply complies with the taxpayer's demand and disburses the funds without more, are the restrictions contained in that intermediary's agreement empty and meaningless words? If an intermediary

engages in a course of conduct whereby it regularly disregards the terms of its agreements, do all persons who exchange with the intermediary effectively have the immediate ability or unrestricted right to receive the exchange funds at any time? See Reg. Section 1.1031(k)-1(g)(4)(vi). This is a serious risk that intermediaries must avoid. Florida Industries shows that conduct inconsistent with the terms of an exchange agreement may be fatal. While the court analyzed only the conduct involved in that particular case, there is no reason why conduct in other cases would be irrelevant. Conduct in other cases may evidence the true intentions of the parties or of the intermediary in particular. The principles set forth in Florida Industries could easily be extended to reach such a result.

In the first scenario, the intermediary should point out the terms of the exchange agreement to the taxpayer, explain the legal and practical problems to the taxpayer and hopefully persuade the taxpayer to wait peacefully until the end of the 45-day period. If the taxpayer is unconvinced, continues to demand the funds and threatens to sue the intermediary or otherwise disrupt its business, the intermediary has a tough decision to make. To avoid and settle an actual or potential dispute, the intermediary could pursue an alternative course of action. The intermediary could agree to rescind the agreement in exchange for a complete release of all claims under these circumstances. If this course of action is undertaken, the rescission, settlement and release should be fully documented in writing. It is uncertain whether the IRS or the courts would find the intermediary's conduct to be inappropriate in such a case.

In the second scenario, the taxpayer has identified replacement property but no longer desires to receive any of those properties. The intermediary should undertake the same course of action as in the first scenario and hopefully convince the taxpayer to wait until the end of the 180-day period. If the taxpayer threatens to sue the intermediary or otherwise disrupt its business, the parties could enter into a written amendment to the agreement to avoid a dispute and settle all claims. The amendment could provide that the taxpayer revokes all identified replacement properties, agrees that the transaction is completed and that the requirements of Section 1031(a)(3) can no longer be met, acknowledges that the taxpayer will be fully taxable on the transaction, and agrees to indemnify, defend and completely release the intermediary from any and all claims arising out of the transaction. The amendment could set forth its business purpose, the facts relating to the failure to acquire the replacement properties, the frustration of the purpose of the original agreement and similar recitals. In addition to any additional fees to be paid to the intermediary, the amendment would be supported by consideration in the form of the release of the intermediary, including (without limitation) complete release of its obligation to acquire any of the identified replacement properties.

In the third scenario, the taxpayer has acquired one or more replacement properties but there remains identified, but unacquired property. The taxpayer demands any remaining exchange balance and interest or a growth factor before the end of the exchange period. Some intermediaries simply pay out the remaining funds and interest thereon without further action. That conduct may not be prudent since a (g)(6) event may not have occurred. The answer to this scenario depends on whether the taxpayer has received all of the replacement property to which the taxpayer is entitled under the exchange agreement. See Reg. Section 1.1031(k)-1(g)(6)(iii)(A). If so, a (g)(6) event has occurred and there is no problem disbursing the remaining funds and interest to the taxpayer. But it is unclear what this means:

"the receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement." By simply identifying a replacement property does the taxpayer become entitled to receive it under the terms of the exchange agreement? Intermediaries might easily be in breach of their obligations if taxpayers actually became entitled to receive replacement property merely by identifying it. Moreover, the regulation expressly refers to property which the taxpayer is entitled to receive under the exchange agreement, not all of the replacement property that the taxpayer has identified. The regulation could have said identified rather than entitled but did not do so.

If the taxpayer or other parties must do more before the taxpayer becomes entitled to receive an identified property (e.g., enter into a purchase contract, remove contingencies and close escrow), are these conditions and further acts within the control of the taxpayer? If so, is there a conflict between provisions (A) and (B) of Reg. Section 1.1031(k)-1(g)(6)(iii)? Provision (A) would be within the control of the taxpayer while provision (B) expressly states that the contingency must be beyond the control of the taxpayer. We simply do not know what Reg. Section 1.1031(k)-1(g)(6)(iii)(A) means. It may or may not apply to the third scenario depending on the facts, the terms of the exchange agreement and a court's interpretation of the term "entitled." Unlike the first two scenarios, the taxpayer has tax risk since the replacement property that has already been acquired may not qualify for exchange treatment if the entire transaction is poisoned. Accordingly, the safe course of action for all concerned is to wait until the expiration of the 180-day exchange period.

If that is not feasible, the parties could enter into a written amendment containing terms similar to the amendment used in the second scenario. The taxpayer could revoke the identification of the unacquired replacement property, acknowledge and agree that he has received all of the replacement property which the taxpayer is entitled to receive under the exchange agreement, and release the intermediary from any further obligations under the exchange agreement. The regulations do not address the issue of post-transfer amendments and only discuss revocation of a property identification for purposes of Reg. Section 1.1031(k)-1(c)(6). An identification of property may only be revoked for identification purposes if the revocation is made within the 45-day period. But there are good reasons to believe that such amendments should be acceptable to the IRS or the courts. Reg. Section 1.1031(k)-1(g)(4)(vi) may even contemplate the possibility of such amendments in providing that the safe harbor "ceases to apply" when the taxpayer has an immediate ability or unrestricted right to receive money or other property (rather than providing that the safe harbor never applies at all).

There seems to be no good policy reason for the exchange funds to be continued to be held by the intermediary in any of these scenarios. But contracts are contracts and rules are rules. If the parties depart from the terms of the agreement or the (g)(6) limitations, they should do so only for solid business reasons, with full disclosure and understanding of the risks, and through a written amendment that documents the transaction. The court in Florida Industries mentioned the possibility of a written amendment to the agreement and noted that the parties never entered into one. In the absence of such precautions, an intermediary who makes premature disbursements to taxpayers upon demand may run the risk of disqualifying exchanges. Florida Industries confirms the worries of many Section 1031 practitioners. Departures from the terms of an escrow or exchange agreement may be fatal. In the most egregious cases, the entire transaction may be taxable ab initio.

Intermediaries should make sure that their agreements comply with the safe harbors in general and the (g)(6) limitations in particular and that they then faithfully observe the terms of their agreements. Florida Industries shows that conduct counts more than words. Any departures from the terms of the agreement should be strongly discouraged. If subsequent events give rise to a potential departure, the parties should carefully resolve the issue in writing. If necessary, the parties could enter into a written amendment to the agreement. That is the proper way to modify a contract, not through a course of dealing totally at odds with its terms.

PLR 200027028 (April 10, 2000) involves a pre-transfer amendment to a standard exchange agreement to allow the QI to distribute funds if the exchanger, after identifying one or more replacement properties and negotiating in good faith, is unable to conclude a binding agreement to purchase the property. The IRS held that such an exchange agreement would not meet the requirements of Reg. Section 1.1031(k)-1(g)(6)(iii). The ruling generated controversy. It was perceived by some as a ruling request designed to fail and one that, ordinarily, would and should not have been sought. The QI involved in the ruling may have had a conflict of interest if it earned more income, directly or indirectly, by having the ruling fail and retaining the exchange funds. Perhaps the QI simply wanted clarification of the rule for the benefit of a client. But in that case, why not simply withdraw the ruling request when it appeared that it would fail?

Most commentators believe that PLR 200027028 has a very limited scope. First, it addresses a pre-transfer amendment to a standard exchange agreement (i.e., a provision in the original exchange agreement) intended to comply with Reg. Section 1.1031(k)-1(g)(6). It does not analyze a subsequent "post-transfer" or "midstream" amendment. Second, the ruling addresses only two narrow situations where a taxpayer identifies (1) multiple replacement properties intending to acquire all of them, and (2) only one replacement property but fails to negotiate a satisfactory acquisition agreement with the seller. Finally, the Service was not asked to interpret the scope of Reg. Section 1.1031(k)-1(g)(6)(iii)(A) (which allows the disbursement of funds on or after the receipt of all replacement property that the taxpayer is "entitled" to receive under the exchange agreement).

A more common fact pattern than the two situations addressed in the ruling is the identification of multiple properties with the taxpayer intending to acquire only one of the alternative properties. This situation has been described as "bought one money left over" (BOMLO). The BOMLO problem can be solved in the original exchange agreement or in the exchanger's identification notice by providing that the QI is obligated to acquire only one of the identified properties. Following the acquisition of the first property, the QI will have no further obligations to acquire and transfer any additional properties. The taxpayer will then have clearly received all of the replacement property that the taxpayer is entitled to receive under the exchange agreement. Reg. Section 1.1031(k)-1(g)(6)(iii)(A) should permit release of the funds after the first and only replacement property is acquired and transferred to the taxpayer. In other scenarios, it remains unclear whether a midstream amendment to an exchange agreement will be respected, assuming it is supported by bone fide business considerations. There is no tax abuse or evasion involved. The taxpayer is obligated to report the failed exchange as a taxable sale, just as much as if the taxpayer waited the full 180 days to receive the exchange funds. There is simply no good legal, policy or other reason to prohibit such amendments, provided that they are not a fait accompli at the inception of the transaction. Only in that case would

such amendments render the identification and safe harbor requirements meaningless.

In Florida Industries the accommodator was a disqualified person (the taxpayer's attorney). The case holds that violating the terms of an exchange agreement and allowing the premature release of exchange funds may evidence constructive receipt of the entire exchange balance ab initio and cause the entire transaction to be taxed. The court in Florida Industries specifically noted that the parties to the escrow agreement never modified, amended or supplemented the agreement. Moreover, the court stated that "it is significant that the escrow agreement did not identify what portion of the escrowed sales proceeds was to be used to purchase replacement property and what portion was to remain as boot under Section 1031." Thus, the question remains open as to whether an agreement can be modified to provide for the release of funds without prejudicing Section 1031 treatment for replacement properties previously received.

A Field Service Advice also emphasizes that the terms of an original exchange agreement and the course of dealing of the parties must comply with the (g)(6) limitations. FSA 200048021 (August 29, 2000) involved an escrow agent who did not satisfy the definition of a QI. Among other things, the escrow agent did not acquire or transfer the properties involved in the exchange. The FSA concerns a father who transferred the relinquished property to his children and attempted an exchange. While an exchange agreement was drawn up with a party acting as "escrow agent," it appears that the agreement was never followed. The children paid the purchase price to the taxpayer's law firm, not the escrow agent. The taxpayer was then in constructive receipt of the sales proceeds since the law firm, as the taxpayer's agent, received the funds prior to the taxpayer's receipt of the replacement property. The terms of the exchange agreement were also deemed to violate the (g)(6) limitations. The agreement may have been interpreted to allow for the taxpayer to obtain funds prior to the receipt of replacement property if a sales contract was presented to the taxpayer but the taxpayer rejected it after the 45-day identification period. See also PLR 200027028 (taxpayer's inability to enter into a binding agreement to acquire replacement property after negotiating in good faith is not a contingency "beyond the control of the taxpayer" or otherwise a (g)(6) event).