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THERE'S NO HARBOR LIKE A SAFE HARBOR

While Section 1031 has been in the Internal Revenue Code since 1921, it has been enhanced and expanded numerous times since inception. The 1991 regulations provided several "safe harbors" to protect transactions from being disallowed. These "safe harbors" define the edge of safety and effect when an exchangor is entitled to the receipt of exchange proceeds and are commonly referred to as the (g)(6) restrictions as derived from 1.1031(k)-1(g)(6).

The driving force of the (g)(6) provisions is the limitation that the exchangor has no rights (provided for in writing) to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period. The net cash is sequestered away from the exchangor and placed in the hands of the Qualified Intermediary. In essence, the exchangor has no rights to the funds, only the property that can be acquired with the funds.

Full tax deferral of capital gain tax is achieved when the exchangor has gone even or up in value, used all of the cash in the qualified escrow account and replaced the debt given up with new debt on the acquired property. Some exchangors will request that they receive cash at the time of closing to address other personal or business matters. The only conflict that surfaces is that by taking cash, they do so with the understanding that it may constitute taxable "boot" upon receipt.

Whether cash is or is not taken at closing, the next time period that the Exchangor can have access to the escrow funds is at midnight of the 45th day if no replacement property is identified. In this case, the exchange terminates and all of the proceeds are directed back to the exchangor. No penalty is assessed for this failed exchange and the taxpayer is now obligated to address the capital gain tax and recapture of previously taken depreciation.

If replacement property is properly identified within the 45 day time period, the next opportunity for cash is once all of the identified property has been acquired or midnight of the 180th day, whichever comes first. The only time the 180th day is interrupted is if the date falls beyond the due date of the taxpayer's tax return. In this case, the taxpayer (ie: Exchangor) is encouraged to file for an extension of the due date to take full advantage of the exchange period. Exchanges must be conducted within the same tax year even if they pass through a year end which would normally create a carry-over situation.

If an Exchangor identifies three possible replacement properties and elects in the letter of identification to acquire only of the three identified properties, then once the one property is acquired, any residual cash in the exchange is returned to the exchangor as taxable "boot" and the exchange is concluded.

Section 1031 is rule driven, abide by its warnings and stay out of stormy seas!