Excess Exchange Funds: Some Traps and Dodges

By Lee David Medinets, Esq., CES®

Very few exchangers or their tax advisors give any thought to an important option that they have when they identify replacement property. Let's say that they are using the 3-property rule. They identify Property 1, Property 2, and Property 3. They buy Property 1, covering all of their debt, but leaving $10,000 in their exchange account. Once they bought Property 1, they had no intention of buying any other replacement property. They are ready to pay taxes on $10,000 of boot. However, their exchange isn't over. Their exchange ordinarily ends when all identified property is acquired or after their 180-day exchange period passes or after their tax return is due for the year in which the exchange commenced. None of those events have happened yet, so the exchanger's money must sit in an exchange account, earning nominal interest or no interest at all, possibly for many months.

Fortunately, most exchangers use up their exchange funds when they acquire replacement property. However, the problem of languishing exchange funds is common enough, and a little foresight can often avoid it. If the exchanger intended to acquire only one of the three properties that it identified, then the ID notice could have identified Property 1 *or* Property 2 *or* Property 3. If that had been how the notice read, then the exchange would have ended as soon as Property 1 was acquired. Similarly, if the exchanger knew it would acquire *either* Property 1, *or else* Properties 2 *and* 3, that is what the ID notice could have specified, and again, there would be no languishing funds. The presumption in an ID notice is that *all* the identified properties will be acquired (i.e., "and"). The ID notice must be specific whenever the exchanger wants to identify property in the alternative (i.e., "or").

Exchangers should consider carefully before inserting an "or" designation in an ID notice. It can have unintended consequences in at least two cases: First, the taxpayer

might reconsider and decide to acquire more identified properties through the exchange. Second, when an exchange begins in the second half of the tax year, an "or" designation might inadvertently result in terminating an exchange in that tax year, depriving the exchanger of the option to defer recognizing boot until the following year.

Even when foresight is used, changed circumstance may make a taxpayer regret a conscious choice. However, the more common problem with "and/or" designations is that many exchangers, and even their tax advisors, do not apply sufficient foresight. Descriptions of this issue in exchange documents and even check-the-box ID notice forms may be ignored, misunderstood or misused. Therefore, Certified Exchange Specialists® ought to be prepared to explain the difference whenever there is interest in the subject. We must be able to make the distinction ourselves when we process transactions, and we must be prepared to apply the rules correctly, even if that means that funds must sit or that other replacement properties cannot be acquired.

A related problem arises whenever an exchanger asks to be reimbursed for out-of-pocket expenses while an exchange is pending.

The most conservative approach to this problem, obviously, is to refuse to make the reimbursement while the exchange is pending on the grounds that the IRS might view reimbursement as giving the exchanger actual receipt of exchange funds in violation of *Treas. Reg. 1.1031(k)-1(g)(6)*. On the other hand, *Treas. Reg. 1.1031(k)-1(g)(7)(ii)* creates an exception to the "*(g)(6)*" limitation on the use of exchange funds for:

> Transactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statements as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees)."

In the case of a reimbursement, we will assuming that the expense, whatever it was, would have been a proper transaction item if it had been paid directly by the QI. So, the fundament question is whether reimbursing the exchanger is equivalent to direct payment by the QI of that expense. The answer to that question is not clear. It reasonable to argue either in favor of or against making the reimbursement, and there are good QIs on both sides of the issue. My own approach has been to arrange for the QI to directly pay the expense and to have the third-party payee refund the original payment by the exchanger back to it. (This only works if the payee is cooperative, of course.) This strategy appears to me to comply with both the letter and spirit of the *(g)(7)(ii)* permission to use exchange funds to pay transaction items.

Some QIs are concerned even about this procedure. I believe that concern is unwarranted. However, I can not prove them wrong. Other QIs feel that even direct reimbursement is justified because, in substance, the money has been used to pay for a transaction expense. Of course, in 1031 exchanges form matters as much as substance, and I still believe that it is far preferable to avoid reimbursement and to directly fund the expense whenever possible. Again, I cannot prove my colleagues wrong.

Keep in mind that there are four basic reactions that the Service might have if it discovers that a reimbursement was made during an exchange. (1) It could approve reimbursement. (2) It could characterize the reimbursement as boot (which may or may not be offset by the original expense). (3) It could disapprove the entire exchange because the parties did not observe the *(g)(6)* limitations on the use of exchange funds. (4) It could view the reimbursement as a willful violation of the law and seek civil or criminal penalties (possibly against both the exchanger and the QI). The last option is unlikely, but it should be kept in mind because, if you believe in any particular case that such a reaction by the IRS might be justified, then you probably should not make the reimbursement.