Languishing Exchange Funds: Some Traps and Dodges

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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" (*Treas. Reg. 1.1031(k)-1*(c)(4)(A)). 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 usually 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

exchanger 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.

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 for the qualified intermediary ("QI" a/k/a "exchange facilitator") 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 assume 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 perfectly clear. 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 back to the exchanger. (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.