There is a trade-off when a taxpayer is conducting a 1031 exchange with a qualified intermediary.

For the taxpayer to not *recognize the gain* on the sale, the taxpayer must give up some control over the exchange proceeds during the exchange period.

To be a valid 1031 exchange agreement, the contract must include provisions that limit the taxpayer from having either actual or constructive receipt of the proceeds of the sale during the exchange period. Basically, you can’t have access or control over the exchange funds, but you can use them at any time to purchase the designated replacement property.

Treasury Regulation Section 1.1031(k)-1(g) sets forth a safe harbor for a qualified intermediary, the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of Section 1031 and its regulations.

Treasury Regulation Section 1.1031(k)-1(g)(4)(iii) requires that, for an intermediary to be a qualified intermediary, the intermediary must enter into a written "exchange" agreement with the taxpayer under which the qualified intermediary receives the funds from the sale of the Relinquished Property, holds the funds in the interim, then uses the funds to purchase the Replacement Property.

Treasury Regulation Section 1.1031(k)-1(g)(6) provides that an exchange agreement with a qualified intermediary must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money during the exchange period. This is often called the “G(6)” limitation.

The safe harbor provisions of 1031 cease to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Thus, an exchange agreement is ineffective or invalid unless it prohibits the taxpayer from having access or control over the exchange funds (Section 1.1031(k)-1(g)(4)(iv).

A qualified intermediary should not disburse a taxpayer's exchange funds early, even if the taxpayer wants to pay taxes on the gain.

If the qualified intermediary does not follow the terms of its own exchange agreement or the IRS’s G(6) limitation, the qualified intermediary may be deemed to be an agent or proxy of the taxpayer, rather than a legitimate neutral third party administrator, and agents or proxies are disqualified from facilitating 1031 exchanges as a qualified intermediary.

A more significant concern is that if a qualified intermediary disregards the terms of its own exchange agreements and flouts the letter and spirit of the Treasury Regulations by disbursing exchange proceeds during the exchange period in violation of the G(6) limitation, it is possible that IRS could assert that the G(6) provisions are meaningless to the qualified intermediary, then regard the qualified intermediary an agent or proxy of all the intermediary’s clients, thus jeopardizing all exchanges conducted by all of the customers of the qualified intermediary. This across-the-board disqualification is the real risk of not following the rules.

The G(6) limitation sets out the times under which a qualified intermediary may disburse exchange proceeds to taxpayers. The Treasury Regulations provide that exchange proceeds cannot be disbursed by a qualified intermediary before:

* Midnight of the 45-day (identification period), if there are no replacement properties designated (or the designation is revoked in writing to the qualified intermediary during the 45-day period); OR
* If there has been a designation of replacement property and 45-day identification period has elapsed, upon the receipt of all identified replacement properties to which the taxpayer is entitled to receive as like-kind real property; OR
* Midnight of the 180-day exchange period.

It is the qualified intermediary's role to act as a legitimate third-party administrator in conformity with the Internal Revenue Code, the Treasury Regulations, and the terms of the exchange agreement to conduct like-kind exchanges, and to insulate taxpayers from actually or constructively receiving the exchange proceeds during the exchange period.

These G(6) limitations are not elective and must be adhered to throughout the 1031 exchange period.

Disregarding the rules could potentially jeopardize the exchange transactions for all clients of a qualified intermediary. This could have significant legal and tax consequences for all concerned.