IRS Provides Limited Relief for Section 1031 Exchanges That Fail Due to Default by a QI

By Richard M. Lipton and Louis S. Weller

If a qualified intermediary files for bankruptcy or is put into receivership, a taxpayer probably will not be able to complete a planned nonrecognition exchange under Section 1031, and may lose some or all of the exchange proceeds as well. A new Revenue Procedure uses installment sale principles to delay the taxpayer's recognition of gain on the sale of the relinquished property if the QI is bankrupt or in receivership—but will not apply if the QI defaults for other reasons.

RICHARD M. LIPTON is a partner in the Chicago office of the law firm of Baker & McKenzie LLP, and is a past chair of the ABA Tax Section. He is a regular contributor to THE JOURNAL as well as co-editor of its Shop Talk column. LOUIS S. WELLER is a principal with Deloitte Tax LLP in San Francisco and its National Director for Real Estate Transaction Planning. He has previously written for THE JOURNAL.

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In Rev. Proc. 2010-14, 2010-12 IRB 456, the IRS addressed a problem that had plagued numerous taxpayers—a like-kind exchange which failed due to a default by the qualified intermediary (QI), as a result of the QI's insolvency, on its obligation to acquire and transfer replacement property to the taxpayer. The Procedure contains a safe harbor method under which some affected taxpayers can avoid reporting gain or loss from these transactions prior to receipt of funds from the defaulting QI or its bankruptcy estate. Although the relief provided is not as widely applicable or generous as had been hoped by some commentators,[1] it will provide certainty where none previously existed.

DEFERRED NONRECOGNITION EXCHANGES

Under Section 1031(a), no gain or loss is recognized on an exchange of property held for productive use in a trade or business or for investment (the "relinquished property") if the property is exchanged solely for property of like-kind that is to be held either for productive use in a trade or business or for investment (the "replacement property"). Since the enactment of Section 1031(a)(3) in 1984, simultaneous exchanges in which the taxpayer and a counterparty simply trade the relinquished property for the replacement property have become relatively rare.

Instead, most exchanges are structured as "deferred exchanges" in which, pursuant to a written exchange agreement, the taxpayer transfers the relinquished property and subsequently receives replacement property. Under Section 1031(a)(3), the taxpayer must:

1. Identify the replacement property within 45 days of the transfer of the relinquished property (the "identification period"), and
2. Acquire the replacement property within 180 days of the transfer of the relinquished property, or by the due date of the taxpayer's return (including extensions) for the year of the transfer of the relinquished property, if sooner (the "exchange period").

The seminal deferred exchange that led to adoption of Section 1031(a)(3) involved a transaction in which the transferee of the taxpayer's relinquished property facilitated the exchange by purchasing replacement property for transfer to the taxpayer.[2] In 1991, however, Reg. 1.1031(k)-1(g) established several alternative structural vehicles to implement deferred exchanges. The most widely used structure, validated by Reg. 1.1031(k)-1(g)(4), allows a taxpayer to use a QI to facilitate a like-kind exchange by replacing the actual transferee of the taxpayer's relinquished property (the "purchaser") or the transferor of the

taxpayer's replacement property (the "seller") as the party with whom the taxpayer actually conducts an exchange, i.e., the taxpayer's exchange counterparty.

The QI and the taxpayer are required to enter into a written exchange agreement under which the QI acquires the relinquished property from the taxpayer, transfers the relinquished property to a third party (the "purchaser"), acquires the replacement property from the owner of that property (the "seller"), and then transfers the replacement property to the taxpayer. If a taxpayer transfers relinquished property using a QI, the taxpayer's transfer of the relinquished property to the QI, and the subsequent receipt of the replacement property from the QI, is treated for purposes of Section 1031(a)(3) as if the taxpayer exchanged property with the QI, allowing the taxpayer to satisfy the "exchange" requirement of Section 1031, since neither the purchaser nor the seller is involved in the swap.

Further, use of a QI in connection with a deferred exchange serves to avoid constructive receipt of cash by the taxpayer. Under Reg. 1.1031(k)-1(a), if a taxpayer actually or constructively receives money in the full amount of the consideration for the relinquished property (the "exchange funds"), the transaction is a sale and not a deferred like-kind exchange. Under Reg. 1.1031(k)-1(f)(2), the determination of whether and the extent to which a taxpayer is in actual or constructive receipt of money or other property which is not like-kind with the relinquished property is made under the general rules concerning actual or constructive receipt and without regard to the taxpayer's method of accounting. Generally, actual or constructive receipt of money by an agent of the taxpayer is actual or constructive receipt by the taxpayer.

Were it not for the Regulations governing deferred like-kind exchanges, in most situations a QI would be treated as an agent of the taxpayer, because the QI acts at the taxpayer's direction and has no economic ownership interest in either the relinquished property or the replacement property. Under Reg. 1.1031(k)-1(g)(4)(i), however, a QI is not considered the agent of the taxpayer for purposes of determining whether the taxpayer is in actual or constructive receipt of money before the taxpayer receives like-kind replacement property from the QI. The Regulations thus provide a safe harbor assuring taxpayers that IRS will not assert that exchange funds held by a QI are deemed held by the taxpayer.

A QI must satisfy certain requirements to avoid being treated as an agent of the taxpayer. Under Reg. 1.1031(k)-1(k), the QI cannot be the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first relinquished property, except that routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company are not taken into account.[3]

In addition, the QI must not be related to the taxpayer under the rules of Sections 267(b) and 707(b), but with a lower 10% threshold for deemed relationships between entity owners and entities. The exchange agreement also must satisfy the requirements of Reg. 1.1031(k)-1(g)(6) concerning limitations on the taxpayer's powers with respect to the money held by the QI until one of several conditions is satisfied, essentially restricting access to the proceeds until the end of the identification period if the taxpayer does not have any outstanding identified potential replacement properties at that time, or, if there are identified properties that have not been acquired, to the earlier of acquisition of all of them or expiration of the exchange period.

A deferred exchange is not the only situation in which a taxpayer can enter into a like-kind exchange with the assistance of an intermediary party. Under Rev. Proc. 2000-37, 2000-2 CB 308, in a "reverse" exchange, pursuant to a "qualified exchange accommodation agreement" a person—the exchange accommodation titleholder (EAT)—will take qualified indicia of ownership of property (usually legal title) and, as a result, will be treated as the owner of the property for tax purposes, even if under the general rules of agency, the EAT might be viewed as the agent for the taxpayer.[4]

The transaction is treated as if the taxpayer exchanged property with the QI, since neither the purchaser nor the seller is involved in the swap.

The law on whether actual acquisition of replacement property by a taxpayer who has not yet transferred relinquished property is uncertain, and many advisors are uncomfortable with "pure" reverse exchanges. There also are technical issues associated with such transactions. Rev. Proc. 2000-37 permits taxpayers to engage in "safe harbor" reverse exchanges under which the EAT can hold property (either relinquished property or, more commonly, replacement property) for the taxpayer for a period of up to 180 days for purposes of completing a reverse exchange, i.e., an exchange in which the taxpayer usually acquires the replacement property before the relinquished property is sold. Two types of these transactions are used, often referred to as the "exchange-first" and the "exchange-last" formats:

1. In an exchange-first transaction, the taxpayer completes its exchange at the time the replacement property is being acquired by receiv-

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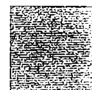
[1] See, e.g., "Connecticut Lawmakers Seek Relief for Companies Whose Like-Kind Exchanges Have Gone Sour," 2009 TNT 109-27 (letter dated 6/2/09 to Treasury Secretary Geithner from Sens. Dodd (D-Conn.) and Lieberman (I-Conn.) and Rep. Larson (D-Conn.)).

[2] See Starker, 602 F.2d 1341, 44 AFTR2d 79-5525 (CA-9, 1979).

[3] Reg. 1.1031(k)-1(k)(2). A special exception applies for certain banking and brokerage services. Reg. 1.1031(k)-1(k)(4)(ii).

[4] See generally Lipton, "New Revenue Procedure on Reverse Like-Kind Exchanges Replaces Tax Risk With Tax Certainty," 93 JTAX 327 (December 2000).



ing that property in exchange for transferring its relinquished property to the EAT. The EAT then holds the taxpayer's relinquished property until it is sold to the purchaser. The taxpayer's exchange is thus completed at the beginning of the transaction.

2. In the exchange-last model, the EAT simply acts as a buyer of the intended replacement property, acquiring the replacement property from the seller and holding it until the taxpayer can effect a sale of the relinquished property. The taxpayer's exchange occurs at that point, i.e., last.

These are sometimes referred to as property "parking arrangements," with the EAT as a parking agent. In the exchange-first, the relinquished property is parked. In the exchange-last, the replacement property is parked.

Rev. Proc. 2000-37 imposes several limitations on qualified exchange accommodation arrangements that parallel those imposed on deferred exchanges by Reg. 1.1031(k)-1. These include:

- The EAT must not be related to the taxpayer, under the same principles applicable to QIs.
- In exchange-last transactions, the intended relinquished properties must be identified within 45 days from the date an EAT acquires intended replacement property.
- Probably most significant, the duration of the EAT's ownership of parked property (whether relinquished property in an exchange-first or replacement property in an exchange-last) must not exceed 180 days.

QI MELTDOWNS

The paramount obligation of a QI in a Section 1031 transaction is to hold exchange funds during the exchange period and timely deliver them to acquire replacement property. If the QI fails to meet this fundamental duty for any reason, the exchanger's transaction will likely fail to achieve the deferral offered by Section 1031. More important, as some exchangers discovered in recent years, a QI's failure to adequately protect exchange funds can result in permanent loss of sale proceeds.

Because the exchange period may extend for a maximum of 180 days (other than in the event of a presidentially declared disaster), any delay in completing acquisition of replacement property may make a valid Section 1031 exchange impossible to complete.

A QI may fail to meet its obligation to deliver exchange funds to a replacement property closing for a variety of reasons. The QI may have placed the exchange funds in an illiquid investment, which causes them to be unavailable at the appointed time. This is apparently what happened with LandAmerica 1031 Exchange Services, Inc., which disclosed in a letter to clients that it was unable to meet liquidity demands when it could not access funds invested in auction rate securities on the collapse of the auction market.[5] Many exchangers have assumed that their exchange funds are always placed in highly liquid, highly secure vehicles such as money market accounts. Virtually no state or federal regulation, however, governs how or where a QI is obligated to hold exchange funds.

Similarly, exchange funds can be lost if they are simply misappropriated by an unscrupulous QI or diverted to fund other business activities of the QI or its owners.[6] Another incorrect assumption among exchangers is that QIs themselves, perhaps like other depository institutions, are state-chartered, highly regulated, or subject to licensure. In fact, until a very short time ago, the operations of QIs were largely unregulated.

During the last two years, several QIs failed spectacularly, including Southwest Exchange Corp., 1031 Tax Group, LLC, and LandAmerica Financial Group.[7] Claims for more than $800 million of exchange funds were filed in various bankruptcy courts as a result of these failures. As noted above, in virtually all these cases the QI failure prevented taxpayers from completing pending deferred exchanges—very few taxpayers had the wherewithal to substitute outside funds for the exchange funds that were held captive by the defaulting QI (or its receiver, bankruptcy trustee, or other party in control of the QI's assets).

The question then became: what happens in the event of such failure? In the normal case of a failed deferred exchange, the taxpayer is treated as having realized gain or loss in the year that the relinquished property was transferred, unless the exchange period extends to the following year and Reg. 1.1031(k)-1(j) allows the taxpayer to treat the transaction as an installment sale. If these rules applied, unfortunate taxpayers were faced with potential for gain recognition and tax liability in the year of their relinquished property transfers, with an uncertain future recovery of the exchange funds and potential for future offsetting loss reporting. This obviously was not a happy prospect for those affected.

THE NEW PROCEDURE

The IRS recognized in Rev. Proc. 2010-14 that in some situations taxpayers who initiated like-kind exchanges by transferring relinquished property to a QI are unable to complete these exchanges within the exchange period due to the failure of the QI to acquire and transfer replacement property to the taxpayer. In many of these cases, the QI goes into bankruptcy or receivership, thus preventing the taxpayer who entered into the exchange in good faith from obtaining immediate access to the proceeds of the sale of the relinquished property. The Service stated in section 4.01 of the Procedure:

"If a QI defaults on its obligation to acquire and transfer replacement property to the taxpayer and becomes subject to a bankruptcy or receivership proceeding, the taxpayer

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[5] See, e.g., In re LandAmerica Financial Group, 412 Bkrptcy. Rptr. 800, 2009 WL 1011647 (Bkrptcy. DC Va., 2009).

[6] See, e.g., In re The 1031 Tax Group, LLC, 374 Bkrptcy. Rptr. 78, 2007 WL 2298245 (Bkrptcy. DC N.Y., 2007).

[7] See also notes 5 and 6, *supra*.

generally may not seek to enforce its rights under the exchange agreement with the QI or otherwise access the sale proceeds from the relinquished property outside of the bankruptcy or receivership proceeding while the proceeding is pending. Consequently, the Service will treat the taxpayer as not having actual or constructive receipt of the proceeds during that period if the taxpayer reports gain in accordance with this revenue procedure."

Virtually no state or federal regulation governs how or where a QI is obligated to hold funds entrusted to it by a taxpayer as part of a planned deferred exchange.

Under section 3.01 of Rev. Proc. 2010-14, a taxpayer who satisfies four conditions is not required to recognize gain from a failed exchange until the tax year in which the taxpayer receives a payment attributable to the relinquished property. Specifically, for this rule to apply:

1. The taxpayer relinquished property to a QI in accordance with Reg. 1.1031(k)-1(g)(4).
2. The taxpayer properly identified replacement property within the identification period (unless the QI default occurred during that period).
3. The taxpayer did not complete the like-kind exchange solely because of a QI default involving a QI that becomes subject to a bankruptcy proceeding under the U.S. Code or a receivership proceeding under federal or state law.
4. The taxpayer did not, without regard to any actual or constructive receipt by the QI, have actual or constructive receipt of the proceeds from the disposition of the relinquished property or any property of the QI prior to the time the QI entered bankruptcy or receivership. For purposes of this fourth requirement, relief of a liability pursuant to the exchange agreement prior to the QI default, either through the assumption or satisfaction of the liability in connection with the transfer of the relinquished property or through the transfer of the relinquished property subject to the liability, is disregarded.

Section 4.02 of Rev. Proc. 2010-14 provides that a taxpayer who satisfies these requirements may report gain realized on the disposition of the relinquished property as the taxpayer receives payments attributable to the relinquished property, using the safe harbor gross profit ratio method described in section 4.03. Under this method, the portion of any "payment attributable to the relinquished property" is determined by multiplying the payment by a fraction (the "gross profit ratio") in which the numerator is the taxpayer's "gross profit" and the denominator is the taxpayer's "contract price." Three definitions are key to understanding the application of this method.

Payment attributable to the relinquished property. First, a "payment attributable to the relinquished property" means a payment of proceeds, damages, or other amounts attributable to the disposition of the relinquished property (other than selling expenses), whether paid by the QI, the bankruptcy or receivership estate of the QI, the QI's insurer or bonding company, or any other person. Unless debt exceeded adjusted basis (as discussed below), satisfied indebtedness is not a payment attributable to the relinquished property.[8]

Gross profit. Second, "gross profit" means the selling price of the relinquished property, minus the taxpayer's adjusted basis in the relinquished property (increased by any selling expenses not paid by the QI using proceeds from the sale of the relinquished property).[9] For purposes of applying this rule, the selling price of the relinquished property is generally the amount realized on the sale of the relinquished property, without reduction for selling expenses.

If, however, a court order, confirmed bankruptcy plan, or written notice from the trustee or receiver specifies, by the end of the first tax year in which the taxpayer receives a payment attributable to the relinquished property, an amount to be received by the taxpayer in full satisfaction of the taxpayer's claim, the selling price of the relinquished property is the sum of the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis) received or to be received and the amount of any satisfied indebtedness not in excess of the adjusted basis of the relinquished property.[10]

Contract price. Third, the "contract price" is the selling price of the relinquished property minus the amount of any satisfied indebtedness not in excess of the adjusted basis of the relinquished property.[11] For purposes of applying this rule, "satisfied indebtedness" means any mortgage or encumbrance on the relinquished property that was assumed or taken subject to by the buyer or satisfied in connection with the transfer of the relinquished property.[12]

A special rule applies where satisfied indebtedness exceeded the adjusted basis of the relinquished property.[13] In this situation, the amount of satisfied indebtedness in excess of the adjusted basis of the relinquished property is treated as a payment attributable to the relinquished property in the year in which the indebtedness is satisfied.

Gain recognition. Although section 4.01 generally provides for the deferral of gain recognition, any required depreciation recapture is taken into account under Sections 1245 and 1250. The recapture income, however, is included in income in the tax year in which gain is recognized only to the extent of the gain recognized in that year.[14] Thus, recapture is lim-

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[8] Rev. Proc. 2010-14, 2010-12 IRB 456, section 4.04(1).

[9] *Id.*, section 4.04(2).

[10] *Id.*, section 4.04(3).

[11] *Id.*, section 4.04(4).

[12] *Id.*, section 4.05.

[13] *Id.*

[14] *Id.*, section 4.06.

ited as to both amount and timing by the general rule in section 4.01.

The total gain recognized by the taxpayer under Rev. Proc. 2010-14 (including recapture income) does not exceed the sum of (1) the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis) and (2) the satisfied indebtedness not in excess of basis, minus (3) the adjusted basis of the relinquished property and (4) selling expenses. Adjustments to the gain determined using the safe harbor gross profit ratio are made in the last tax year in which the taxpayers receive a payment attributable to the relinquished property.[15]

Losses. The Service recognized in Rev. Proc. 2010-14 that taxpayers could recognize a loss as a result of a QI default. Under section 4.08, a taxpayer within the scope of the Procedure may claim a loss deduction under Section 165 for the amount, if any, by which the adjusted basis of the relinquished property exceeds the sum of (1) the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis)[16] plus (2) the amount of any satisfied indebtedness not in excess of basis. A taxpayer entitled to claim a loss deduction under this provision also may claim a loss deduction under Section 165 for any gain recognized in accordance with section 4 of Rev. Proc. 2010-14 in a prior tax year. The timing and character of any loss claimed by the taxpayer is determined under the general rules of the Code.[17]

Imputed interest. Since Rev. Proc. 2010-14 essentially adopts installment sale principles for exchanges that fail due to QI default, the IRS also addressed imputed interest. For purposes of applying the safe harbor gross profit ratio method to a transaction, the selling price, the contract price, and any payment attributable to the relinquished property must be reduced by the amount of any imputed interest allocable to the payment as determined under Section 483 or 1274, whichever applies.[18]

For purposes of applying Section 483 or 1274 to a transaction, the taxpayer is treated as selling the relinquished property on the date of the confirmation of the bankruptcy plan or other court order that resolves the taxpayer's claim against the QI (the "safe harbor sale date"), rather than on the date the relinquished property was actually sold to a buyer and exchange funds were deposited with the QI. As a result, if the only payment in full satisfaction of the taxpayer's claim is received by the taxpayer by the date that is six months after the safe harbor sale date, then no interest will be imputed on this payment under either Section 483 or 1274.

Few taxpayers had the funds to substitute for the exchange funds that were held captive by the defaulting QI (or its receiver, bankruptcy trustee, or other party).

In addition, the selling price determined under section 4.04(3) is used to determine whether Section 483 (in general, sales for $250,000 or less) or Section 1274 (in general, sales for more than $250,000) applies.[19]

Exchange facilitator loans. Another problem addressed in Rev. Proc. 2010-14 arises in situations in which the exchange funds held by the QI were treated as an "exchange facilitator loan" under Reg. 1.468B-6(c)(1). Under that provision, exchange funds held by the QI are generally treated as loaned from a taxpayer to the QI, and the QI must take into account all items of income, deduction, and credit attributable to the exchange funds, although the exchange agreement can provide that all the earnings attributable to the account are taxable to the taxpayer in certain situations.[20] The exchange facilitator loan is then subject to special rules in Reg. 1.7872-16 in order to determine whether it bears adequate stated interest, or, alternatively, whether interest will be imputed to be paid by the QI and earned by the taxpayer.

Section 4.09(2) of Rev. Proc. 2010-14 provides that in situations involving exchange facilitator loans that meet the requirements of Reg. 1.7872-5(b)(16), the IRS will continue to treat the loan as meeting the requirements of that provision until the safe harbor due date, even if the duration of the loan exceeds six months solely due to the QI default. Furthermore, if an exchange facilitator loan does not meet these requirements because the loan exceeds $2 million, the Service will not impute additional interest on the loan under Section 7872 after the date of the QI default. Interest may be imputed under Section 483 or 1274, however, as provided in section 4.09(1).[21]

Application. Rev. Proc. 2010-14 applies to taxpayers whose like-kind exchanges fail due to a QI default occurring after 2008. A taxpayer who is within the Procedure's scope may, subject to the limitations on credit or refund under Section 6511, file an original or amended return to report a deferred like-kind exchange that failed due to a QI default in a tax year ending before 2009, in accordance with Rev. Proc. 2010-14.[22] In other words, the Revenue Procedure effectively applies to all open tax years.

Examples

Rev. Proc. 2010-14, section 4.10, contains five examples that illustrate its application.

Example 1. In the first example, A (we'll call her Allie) is an individual

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15 *Id.*, section 4.08.

16 The reference to "satisfied indebtedness in excess of basis" does not make sense because section 4.04(8) applies only if payments, including satisfied indebtedness, are less than the adjusted basis of the relinquished property.

17 Rev. Proc. 2010-14, section 4.08.

18 *Id.*, section 4.09(1).

19 *Id.*

20 Reg. 1.468B-6(c)(2).

21 Rev. Proc. 2010-14, section 4.09(2).

22 *Id.*, section 5.

calendar-year taxpayer who owned a relinquished property with an FMV of $150 and an adjusted basis of $50. Allie enters into an agreement with a QI to facilitate a deferred like-kind exchange. On May 6 of year 1, as part of an intended exchange, Allie transfers the relinquished property to the QI, and the QI transfers the relinquished property to a purchaser in exchange for $150.

On June 1, Allie timely identifies a replacement property. On June 15, however, the QI notifies Allie that it has filed for bankruptcy protection and cannot acquire the replacement property. Consequently, Allie fails to acquire the replacement property within the exchange period. As of the end of year 1, the bankruptcy proceedings are ongoing and Allie has received none of the $150 of sales proceeds from the QI or anyone else.

On June 1 of year 2, the QI exits from bankruptcy and the bankruptcy court approves a report under which Allie will be paid $130 in full satisfaction of the QI's obligation under the exchange agreement. Allie receives the $130 payment on August 4 of year 2, and receives no other payments attributable to the sale of the relinquished property.

A taxpayer who satisfies the Procedure's conditions is not required to recognize gain from a failed exchange until the tax year in which the taxpayer receives a payment.

Under Rev. Proc. 2010-14, Allie is not required to recognize gain in year 1 because she did not receive any payments attributable to the relinquished property in that year. In year 2, Allie does recognize gain. For purposes of determining the amount recognized, Allie's selling price is $130 (the payment attributable to the relinquished property), and the contract price also is $130 because there was no satisfied or assumed indebtedness. Allie's gross profit is $80 (the selling price of $130 minus the adjusted basis of $50), and her gross profit ratio is 80/130 (the gross profit divided by the contract price). Allie must recognize gain in year 2 of $80 (the payment attributable to the relinquished property, $130, multiplied by the gross profit ratio of 80/130). Allie is not required to recognize as income the amount by which the proceeds received by the QI ($150) exceeded the amount she received ($130), but she also is not permitted to claim a loss under Section 165 because the payment attributable to the relinquished property exceeded her adjusted basis therein.

Example 2. In the second example, B (whom we'll call Bob), a calendar-year taxpayer, owns relinquished property with an FMV of $160 and an adjusted basis of $90. The property is encumbered by a mortgage of $60. Bob enters into a deferred exchange agreement with a QI. On May 6 of year 1, Bob transfers the relinquished property to the QI, which then transfers it to the purchaser. Out of the proceeds of the sale of the relinquished property, $60 is used to pay off the debt and the remaining $100 is retained by the QI.

On June 1, Bob timely identifies replacement property, but on June 15 the QI informs Bob that it has filed for bankruptcy and cannot acquire the replacement property. As of the end of year 1, the bankruptcy proceedings are ongoing. In September of year 2, the QI exits bankruptcy. In satisfaction of his claims, Bob receives $35 in year 2 and $35 more in year 3.

Under Rev. Proc. 2010-14, Bob is not required to recognize any gain in year 1 because Bob did not receive any payments attributable to the relinquished property in year 1 (the amount of the mortgage satisfied did not exceed Bob's adjusted basis in the relinquished property). Bob does recognize gain in years 2 and 3. The selling price is $130, consisting of the total $70 in cash Bob received plus the $60 mortgage that was satisfied.

Bob's contract price is $70, which is the selling price of $130 minus the mortgage of $60. His gross profit is $40 (selling price of $130 minus basis of $90), and the gross profit ratio is 40/70 (gross profit over contract price). Therefore, Bob must recognize gain of $20 in each of years 2 and 3, determined by multiplying the gross profit ratio of 40/70 times the $35 cash received in each of those years. Furthermore, Bob is not entitled to a loss deduction because the total amount of the payments received plus the mortgage satisfied ($130) exceeded his adjusted basis in the relinquished property.

Example 3. In the third example in Rev. Proc. 2010-14, the facts are the same as in Example 2 except that Bob's adjusted basis in the relinquished property is $40. As a result, Bob is considered to have received a payment in year 1 of $20, the amount by which the mortgage encumbering the relinquished property exceeded his adjusted basis.

Bob's selling price is $160, which is the full amount realized by the QI on the sale of the relinquished property because neither a court order, the bankruptcy plan, nor the trustee had specified by the end of year 1 the amount that Bob would receive in full satisfaction of his claims. His contract price is $120, which is the selling price of $160 minus the satisfied indebtedness not in excess of basis ($40). His gross profit is $120 (selling price of $160 minus basis of $40), and his gross profit ratio is 120/120. Accordingly, Bob must recognize gain of $20 in year 1, which is the deemed payment of $20 multiplied by the gross profit ratio of 1. The payments of $35 received in each of years 2 and 3 also would be taxable in full because the gross profit ratio is 1.

Example 4. In the fourth example, C (whom we'll call Charlie) owns relinquished property with an FMV of $100 and a basis of $40. Charlie enters into a deferred exchange agreement with a QI, and on May 6 of year 1 Charlie transfers the relinquished property to the QI which in

turn transfers the property to a purchaser for $100.

Charlie identifies replacement property on June 1, but on June 15 of year 1 Charlie is informed that the QI has entered into bankruptcy. The QI exits bankruptcy in September of year 2, and Charlie is informed that he will receive a payment of $35 in year 2 and may receive an additional payment in year 3, depending on certain facts and circumstances. In February of year 3, Charlie is informed that he will not receive an additional payment, so that the $35 received in year 2 is the total amount he receives.

Under Rev. Proc. 2010-14, Charlie is not required to recognize any gain in year 1. Charlie is, however, required to recognize gain in year 2 because his selling price is at that point regarded as $100 (the amount realized by the QI on the sale of the relinquished property) because the bankruptcy plan stated that Charlie may receive an additional payment in year 3. Accordingly, the bankruptcy plan did not specify by the end of year 2 the total amount that Charlie would receive in full satisfaction of his claims.

Charlie's contract price is $100, his gross profit is $60 (selling price minus basis), and his gross profit ratio is therefore 60/100. Accordingly, Charlie must recognize gain of $21 in year 2 (the $35 payment multiplied by 60/100). In year 3, Charlie is entitled to a loss deduction of $26, consisting of the amount by which the total payments he received ($35) were less than his basis of $40 in the relinquished property plus the $21 of gain recognized in year 2.

Example 5. In the fifth example, D (who we'll call Donna) owns relinquished property with an FMV of $150 and an adjusted basis of $100. Donna enters into a deferred exchange agreement with a QI, and on May 6 of year 1 she transfers the relinquished property to the QI who then transfers it to the purchaser.

Donna identifies replacement property on June 1, but on June 15 of year 1, the QI files for bankruptcy. Donna does not receive any distributions from the ongoing bankruptcy in year 1, but on July 1 of year 2 Donna is informed that the QI has exited bankruptcy and that she will receive $130 in full satisfaction of her claims on August 1 of year 3, which payment is made.

Under Rev. Proc. 2010-14, Donna is not required to recognize any gain in year 1 or year 2 because she did not receive any payments in those years. Because the selling price of the property was less than $250,000, however, Donna is subject to Section 483 because the payment in year 3 was due more than six months after the safe harbor sale date (the date the bankruptcy plan was finalized). Assuming that the interest computed under Section 483 is $5, Donna's selling price is $125 (the amount received, $130, less $5 of unstated interest), the contract price also is $125 (because there was no indebtedness), the gross profit is $75 ($125 selling price less basis of $50), and the gross profit ratio is 75/125. Therefore, in year 3 Donna must recognize gain of $75 ($125 received multiplied by the gross profit ratio of 75/125), and also must recognize imputed interest income of $5. Donna is not entitled to a loss deduction under Section 165 because the amount she received in exchange for the replacement property ($125) exceeds her basis.

ANALYSIS

There is much good news in Rev. Proc. 2010-14. Most important is that when a QI defaults, taxpayers who sold relinquished property pursuant to a deferred exchange agreement are not required to recognize the entire realized gain in the year of the sale. Before the issuance of this Procedure, there was considerable concern that the taxpayer could be deemed to be in constructive receipt of the amounts received by the QI, and there would be no nonrecognition under Section 1031 because the taxpayer never completed a like-kind exchange.

Furthermore, by adopting a modified installment sale approach in Rev. Proc. 2010-14, the Service has appropriately recognized that a taxpayer's gain should be based on amounts actually received plus the amount of any debt satisfied. By allowing taxpayers to first use their basis to offset any debt assumed or satisfied on transfer of relinquished property, Rev. Proc. 2010-14 reaches a result that will be favorable in most situations. (The IRS could have instead required the basis to be applied pro rata against all payments rather than first against any indebtedness assumed or satisfied, which would have had the effect of accelerating gain recognition.)

Nevertheless, there are several issues that taxpayers should be aware of.

> **Practice Notes**
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> Rev. Proc. 2010-14 recognizes that a taxpayer could have avoided an economic loss if it had used a qualified trust under Reg. 1.1031(k)-1(g)(3) in conjunction with a QI under Reg. 1.1031(k)-1(g)(4) in its exchange. Although a qualified trust usually costs more to implement than an exchange with a QI, the fact that a loss would be avoided as a result of a bankruptcy filing by the QI likely makes this up-front cost well worth incurring.

Failure due "solely" to QI default. In order to apply, Rev. Proc. 2010-14 requires that a taxpayer's failure to complete an exchange must be due "solely" to a QI default. It is not clear how literally this language will be applied, or what burden of proof will be placed on taxpayers to demonstrate that the condition has been satisfied.

In many instances, deferred exchanges that are commenced by taxpayers are not completed because the taxpayers decide against acquiring properties properly identified as potential replacement properties or because the identified properties prove impractical or impossible to

acquire despite taxpayer efforts. This might occur where a taxpayer is unable to secure mortgage financing sufficient to acquire a specific replacement property.

Taxpayers can first use their basis to offset any debt assumed or satisfied on transfer of the relinquished property, yielding favorable results in most situations.

Where a QI default occurs during the taxpayer's exchange period but after a decision has been made not to complete the exchange, may Rev. Proc. 2010-14 still apply? Reading the Procedure literally, this does not seem likely. If this is the case, what certification will taxpayers be asked to make in order to show that they satisfy the condition?

The same question can be asked about exchanges that fail due to taxpayers' failure to satisfy either the "qualified use" or like-kind standards under Section 1031. For example, what if the relinquished property was personally used by a taxpayer to the extent that it was not held for use in a trade or business or for investment?[23] In such circumstances, it does not seem that the QI default is the cause of the attempted exchange's failure or that the relief offered by Rev. Proc. 2010-14 will be available.

What about reverse exchanges? Rev. Proc. 2010-14 applies only to deferred exchanges and not, by its literal terms, to reverse exchanges under Rev. Proc. 2000-37. A reverse exchange can be structured as either an exchange-first or an exchange-last transaction, as discussed above.

If the EAT enters into bankruptcy in an exchange-first transaction, it would seem that the taxpayer would be concerned because the timing requirements for the reverse exchange would not be satisfied; the EAT would not be able to sell the relinquished property on a timely basis. The same concerns would arise in an exchange-last transaction in which the taxpayer would not be able to timely acquire the replacement property from an EAT that had filed for bankruptcy.

The Service may want to consider whether relief similar to that in Rev. Proc. 2010-14 should be provided to taxpayers who engage in reverse exchanges. Indeed, the IRS might have more flexibility in this regard because the requirements for reverse exchanges are not specified in Section 1031, so that the Service could relax the safe harbor time periods that are of its own making.

Imputing interest. The Service's insistence in Rev. Proc. 2010-14 that the imputed interest rules in Sections 483 and 1274 apply to payments may be theoretically correct, but it seems somewhat harsh. Most taxpayers whose QIs have defaulted will be receiving substantially less money than they had originally contracted to receive from the purchaser.

The IRS was somewhat helpful by providing that interest runs only from the date that the bankruptcy plan is finalized. Nevertheless, it would have been even better if the Service would have provided that no interest is imputed at all or, alternatively, that interest is imputed only to the extent that the total amount received exceeds the taxpayer's adjusted basis in the property (i.e., imputing interest on the gain element, if any, in the transaction).

For example, if a taxpayer with an adjusted basis of $100 in the relinquished property receives a payment of $70 more than one year after the bankruptcy plan is finalized, and assuming that the imputed interest is $5, the taxpayer would have an economic loss of $30 but report a tax loss of $35 ($100 basis less $65 imputed principal payment) and $5 of interest income. Depending on the character of the loss, the taxpayer might not be able to offset the interest income with the extra $5 loss, which would undoubtedly be viewed by the taxpayer as rubbing salt in its wounds.

QI default without bankruptcy. Rev. Proc. 2010-14 applies if a QI files for bankruptcy or enters into a receivership, but it does not apply if the QI simply defaults on its obligations. This would give potential leverage to a QI that has "evil intent" and wants to negotiate more favorable terms from its counterparties; the QI could simply threaten to default (and not file for bankruptcy) unless its counterparties agree to make payments to it. The IRS could have extended Rev. Proc. 2010-14 to address QI defaults as well as bankruptcy and similar proceedings.

Full satisfaction vs. contingencies. The "full satisfaction" requirement in section 4.04(3), which is illustrated in Example 3 of section 4.10 (discussed above), appears to be inappropriate if additional payments are contingent. This often is the case in a bankruptcy proceeding. In Example 3, the possibility that Charlie may receive an additional payment in the future means that Charlie is required to recognize gain in year 2, even though he will have a loss if no contingent additional payment is made. Bankruptcy judges need to have the flexibility to provide for contingent payments over time; the adverse tax consequences to the taxpayers whose money was tied up by the bankruptcy proceeding may provide an inappropriate incentive to limit any contingent payments to taxpayers (to their overall financial detriment).

Timing questions. Another problem involves the timing of gain and loss. In section 4.08, Rev. Proc. 2010-14 clearly allows a loss to be recognized when a gain arising from the exchange was recognized in a prior year due to basis recovery timing rules. Nevertheless, this rule does not explicitly state that a loss in a subsequent year can offset other gain, including gain that could arise from the receipt of boot (in the form of cash or failure to replace all of the debt that encumbered the relinquished property).

NOTES

[23] See, e.g. Moore, TCM 2007-134.

It would seem appropriate that the transaction should be viewed as a whole in order to determine whether the taxpayer should recognize gain or loss. Indeed, one of the problems with Rev. Proc. 2010-14 is the Service's insistence that the tax consequences of a QI bankruptcy be considered on a year-by-year basis, when it might be better to view the exchange transaction as remaining "open" until the bankruptcy is resolved.

Comments. In addition to promulgating rules relating to the exchanges that fail due to QI default, the IRS in Rev. Proc. 2010-14 solicits comments about whether additional guidance would be appropriate. One specific question for which comments were requested concerns the current provisions in the Regulations (permitting the use of qualified escrows and qualified trusts) that allow proceeds from the disposition of relinquished property to be held in such a way that they do not become property of the QI's bankruptcy estate. The Service sought comments as to whether these techniques should be available for use in a more efficient manner.

This request for comments points to one of the most important aspects of Rev. Proc. 2010-14, which is its recognition that a taxpayer could have avoided an economic loss if it had used a qualified trust under Reg. 1.1031(k)-1(g)(3) in conjunction with a QI (under Reg. 1.1031(k)-1(g)(4)) in its exchange. Although a qualified trust usually costs more to implement than an exchange with a QI, the fact that a loss would be avoided as a result of a bankruptcy filing by the QI likely makes this up-front cost well worth incurring.

CONCLUSION

We're taught when we're young not to look a gift horse in the mouth, and that admonition applies to Rev. Proc. 2010-14 in many ways.

In general, the relief that is provided is quite welcome. It would be harsh to force taxpayers who transferred funds to a QI that filed for bankruptcy to recognize gain when the exchange period ended after 180 days, where the taxpayers' access to those funds was blocked or uncertain. Gain recognition on the expiration of the exchange period would have added insult to injury for taxpayers who lost all or part of their funds when the QI filed its bankruptcy petition. In addition, by adopting installment sale principles, the IRS generously did not require taxpayers who engaged in exchanges with bankrupt QIs to recognize gain based on debt relief unless the debt exceeds the adjusted basis of the relinquished property.

On the other hand, it seems likely that some taxpayers will be disadvantaged by this new guidance. This will occur in situations in which the taxpayer becomes entitled to receive payments from the bankrupt entity on a contingent period over many years—the basis-allocation rules will result in gain recognition for taxpayers who are likely to realize a loss in the final analysis. The Service could have deferred gain computation and recognition in situations in which taxpayers are entitled to a contingent recovery for a limited period, e.g., up to three years. The practical effect of this provision is that different taxpayers may have different economic interests when it comes to receiving contingent payments; this may prove to be problematic for bankruptcy courts.

While most taxpayers who engage in an exchange with a QI that subsequently files for bankruptcy will be helped by Rev. Proc. 2010-14, the tax relief will be small comfort in comparison to the economic loss suffered. The key lesson of QI failures is that taxpayers would have been economically protected had they insisted on the use of a qualified trust or, alternatively, taken care in making sure that the QI used to facilitate the exchange had sufficient liquid assets to satisfy all claims. Although delayed gain recognition is a good thing, it will often offer only small compensation to taxpayers that have lost substantial portions of relinquished property sales proceeds due to QI failure. ■

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