IRS Provides Relief for Taxpayers Unable to Complete Like-Kind Exchanges Due to Insolvent Qualified Intermediaries

By K. Eli Akhavan[1]

Background

Generally, a taxpayer does not recognize gain or loss when the taxpayer exchanges business or investment property solely for like kind property (the "1031 Exchange"). Instead, the taxpayer defers the gain or loss until the disposition of the property received in exchange by the taxpayer. In many situations, the purchaser does not hold the replacement property desired by the taxpayer so the taxpayer must engage in a three-party deferred exchange to achieve 1031 Exchange treatment. In order to qualify for this deferred exchange treatment, a taxpayer must generally identify the replacement property within 45 days of the transfer of the relinquished property and must acquire the replacement property within 180 days from the time that the taxpayer relinquishes the property for the exchange.

Taxpayers often use a "qualified intermediary" (the "QI") to facilitate a 1031 Exchange. In such a case, the taxpayer transfers the relinquished property to the QI, who then sells the property to a buyer. The QI acquires the replacement property with the sales proceeds of the relinquished property and transfers the replacement property to the taxpayer.

As long as the taxpayer receives the replacement property within the statutory time period and meets the other requirements of a 1031 Exchange, gain or loss will not be recognized on the exchange.

In the past few years, many QIs entered into bankruptcy or receivership proceedings. While most QIs are reputable companies, some QIs faced distress due to the fraudulent acts of a few employees who absconded with the QIs' funds driving them into bankruptcy. These proceedings blocked taxpayers who had initiated 1031 Exchange transactions from having access to the proceeds from the sale of their relinquished properties, and thus prevented them from consummating the 1031 Exchange in a timely manner. Taxpayers were concerned as to whether the original sale would now be taxed in full because they did not purchase replacement property within 180 days.

IRS Relief

In Revenue Procedure 2010-14 the IRS acknowledged the problem and granted relief to taxpayers who did not complete a timely like kind exchange because their QIs

[1] K. Eli Akhavan is a tax associate at Herrick, Feinstein LLP, http://www.herrick.com/sitecontent.cfm?pageid=15&itemid=11008. Eli is also a member of the American Bar Association's Section of Real Property Trust and Estate Law, where he serves on the Federal Taxation of Real Estate Committee, and the Section of Taxation.

entered into bankruptcy or receivership. Rev. Proc. 2010-14 allows eligible taxpayers to recognize gain or loss only upon the disposition of the relinquished property using a "gross profit ratio". In other words, an eligible taxpayer did not have to recognize current income due to a QI's bankruptcy once the 180 day period ended. In order to be eligible for this relief, taxpayers have to meet four requirements delineated in Rev. Proc. 2010-14:

- The taxpayer must have transferred the relinquished property to a QI pursuant to a 1031 Exchange;
- The taxpayer must have identified a replacement property within the statutory period (unless the QI default occurs during that period);
- The taxpayer did not complete the like kind exchange solely because of the QI's default; and
- The taxpayer did not have actual or constructive receipt of the proceeds from the disposition of the relinquished property before the QI entered the bankruptcy or receivership.

Rev. Proc. 2010-14 is effective for taxpayers whose 1031 exchanges failed due to a QI default occurring on or after January 1, 2009.

An eligible taxpayer will recognize gain on the disposition of the relinquished property using the "gross profit ratio method" and when the taxpayer receives payments attributable to that property. Under this method, the portion of any payment attributable to the relinquished property to be recognized as gain is determined by multiplying the payment by a fraction, the numerator of which is the taxpayer's gross profit with respect to the relinquished property and the denominator of which is the taxpayer's contract price for such property.

The following example illustrates the application of the gross profit ratio method:

Donald owns real property held for investment with a fair market value of $1500 and an adjusted basis of $500. On January 2, 2009, Donald transfers the property to a QI and the QI transfers the property to a third party for $1500. On March 1, 2009, Donald identifies the like kind replacement property. On June 15, 2009, QI notifies Donald that it has filed for bankruptcy protection and can neither purchase the replacement property nor return the $1500. On July 1, 2010, the QI exits from bankruptcy protection and pays Donald $1300 in full satisfaction of the QI's obligation.

Under Rev. Proc. 2010-14, Donald recognizes gain in 2010 and not in 2009 - the year in which the 180 day period had expired. Donald's selling price is $1300, as is Donald's contract price because there is no satisfied or assumed indebtedness. Donald's gross profit is $800 (the selling price ($1300) minus the adjusted basis ($500)). A's gross profit ratio is 800/1300 (the gross profit over the contract price). Therefore, A recognizes gain in 2010 of $800, which is the payment attributable to the relinquished property ($1300) multiplied by A's gross profit ratio (800/1300).

Please note that no loss is allowed to Donald even though he's receiving less than what the property was sold for. However, to the extent the $1300 payment would have been less than the adjusted basis, a loss would have been allowed to Donald.

If the taxpayer received $500 or less from the bankruptcy proceedings in 2010, no gain would be recognized and a loss could be taken in such year.

It should also be noted that it appears that the safe harbor of Rev. Proc. 2010-14 only applies where the QIs are in actual bankruptcy or receivership proceedings. If the QI never ended up in court, then Rev. Proc. 2010-14 does not appear to apply.

Although beyond the scope of this article, Rev. Proc. 2010-14 also provides rules for the treatment of satisfied indebtedness in excess of basis, income recapture and imputed interest computations.

It is equally important to note what this revenue procedure does not do. It does not get a taxpayer's money back from the QI. It only lessens the adverse tax consequences from failing to meet the deferred exchange provision. The chair and vice-chair of the Section's Federal Taxation of Real Estate Committee are working with the Tax Section to present proposals to the Treasury Department which would impose investment standards on QIs to help ensure that mishandling of taxpayer funds does not arise.

It goes without saying that you should always do your due diligence when selecting a QI.