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Actual or Constructive Receipt of Funds During a Code Section 1031 Deferred Exchange is More Than a Bad Hair Day for the Taxpayer

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Background

Actual or constructive receipt of the exchange funds during a deferred exchange under IRC Section 1031 totally kills an exchange and any tax deferral opportunity. Treasury Regulation Section 1031(k)-1(f)(1) tells us that actual or constructive receipt of the exchange proceeds or other property (non-like-kind property) before receiving the like-kind replacement property causes the exchange to be treated as a taxable sale or exchange. This is the case even if the taxpayer later receives the like-kind replacement property. In accordance with Treasury Regulation 1.1031(k)-1(f)(2), a taxpayer is in constructive receipt of money or property if it is credited to his, her or its account; set apart for the taxpayer's use; or otherwise made available to the taxpayer.

The treasury regulations specifically tell us that security (such as a third party guarantee, letter of credit or mortgage) put in place to ensure a transferee (including the Qualified Intermediary) actually transfers the replacement property to the taxpayer does not constitute actual or constructive receipt of the exchange funds.

Last, where the exchange funds are held in a "qualified escrow account," no actual or constructive receipt exists by the mere fact that the escrow holds the funds. A qualified escrow account exists if two criteria are met:

Requirement #1: **The Escrow may not be established so that the holder of the funds is the taxpayer or a "disqualified person."**

Under Treasury Regulation Section 1.1031(k)-1(k), a disqualified person is:

- Any person or firm that acted as the taxpayer's employee, attorney, accountant, investment banker or business broker, or real estate agent within two (2) years prior to the transfer of the relinquished property (or when there are multiple relinquished properties, the time period starts at the transfer of the earliest relinquished property). For this purpose, some services are ignored such as services routinely provided

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by title insurance companies, escrow companies, and financial institutions.

- The attribution rules of IRC Sections 267(b) and 707(b) come into play, but we have to substitute 10% for 50% in applying these rules. So, for example, related persons include: the taxpayer's spouse, siblings, ancestors, and lineal descendants; a corporation or a partnership owned more than 10% by the taxpayer or a related person; or a trust in which the taxpayer or a related person is a beneficiary or the fiduciary.

Requirement #2: **The terms of the escrow must expressly provide that the taxpayer's rights to the funds are limited.**

The taxpayer cannot be allowed to receive, pledge, borrow against or otherwise obtain the benefits of the funds until after the exchange period expires, until after the 45 day identification period where the taxpayer failed the exchange by not identifying any replacement property, or after the time when the taxpayer has received all of the property identified within the 45 day identification period.

Chief Counsel Advice 201320511

Chief Counsel Advice 201320511 raises a not so obvious issue in the area of constructive receipt of exchange funds. An issue that likely occurs often.

In the CCA, Chief Counsel was presented with a taxpayer that was in the equipment rental business. It regularly engaged in Code Section 1031 deferred exchanges to dispose of its rental equipment and to obtain new rental equipment in a tax deferred environment. Machinery and equipment rental businesses, rental car businesses, trucking companies and airlines likely find themselves in this same predicament.

The taxpayer maintained various lines of credit that it used to assist in funding operations during parts of the year and to acquire new rental equipment. The lines of credit, as you may suspect, were secured by the equipment.

Under the exchange agreement, the two specific requirements of a qualified escrow were met, but the Qualified Intermediary was required to pay down the lines of credit with the exchange proceeds and then (through the taxpayer) use the same lines of credit to fund the purchase of the replacement property. Again, one would assume this often occurs in personal property exchanges by taxpayers in related or similar businesses.

The specific issue presented to Chief Counsel was whether the use of the exchange proceeds to pay down the taxpayer's debt (which may or may not have been directly related to the relinquished property) constituted constructive receipt by the taxpayer of the exchange funds, thereby killing the taxpayer's opportunity to obtain tax deferral. The taxpayer was getting the benefit of the exchange funds during the time the deferred exchange was ongoing.

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Chief Counsel, citing the boot netting rules, concluded in favor of the taxpayer and held no actual or constructive receipt existed. The new debt secured by the replacement property equaled or exceeded the debt secured by the relinquished property which was paid off in the exchange.

Put this Chief Counsel Advice in your bag of tricks. The issue may come up when taxpayers undertake personal or real property exchanges where a line of credit serves as security.

Posted in Individual Income Tax, Like-Kind Exchanges, Tax Planning

Tagged as Individual Taxes, IRC Section 1031, like-kind exchanges, Tax Planning

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