# Obtaining Deferral for Non-Deferred Aspects of an I.R.C. §1031 Exchange

*Roger McEowen (roger.mceowen@washburn.edu)*
*Professor of Agricultural Law and Taxation, Washburn University School of Law*
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### Overview

The TCJA eliminated tax-deferred like-kind exchanges of personal property for exchanges completed after 2017. However, exchanges of real estate can still qualify for tax-deferred treatment if the exchange involves real estate that is "like-kind." But, what if the exchange involves non-like-kind cash "boot" or otherwise fails the requirements of the Code? Is there a way to still achieve tax deferral?

"Fixing" a tax-deferred exchange that has failed – it's the topic of today's post.

### Code Requirements

The tax deferral of an IRC §1031 exchange is only achieved if the requirements of IRC §1031 are satisfied. If the requirements are not satisfied, the exchange is taxable as a sale or exchange under the general rules of IRC §1001.

There are four basic requirements to achieving tax-deferred treatment under IRC §1031:

- There is an exchange of property rather than a sale; *IRC §1031(a)(1).*
- The property exchanged and the property received must be like-kind real estate;
- The property exchanged and the property received must both be held for the productive use in a trade or business or for investment; and
- The exchange of properties must be simultaneous, or the replacement property must be identified within 45 days of the exchange and the identified property must be received within 180 days of the identification or the due date of the return (including extensions), if shorter. *IRC §§1031(a)(3)(A)-(B)((ii).*

### Interaction of IRC §1031 and IRC §453

If an exchange satisfies the requirements of IRC §1031, but property is received that is not like-kind (such as money or other non-like kind property, the recipient of the property recognizes gain to the extent of the sum of the money and the fair market value of the non-like-kind property received. *I.R.C. §1031(b).* That means that tax deferral is not achieved with respect to the non-like-kind property (or "boot") received in the exchange. But a taxpayer may elect to recognize the gain on the boot under the installment method of I.R.C. §453. Similarly, a taxpayer that fails to satisfy the requirements of IRC §1031 may be able to defer gain on the transaction under IRC §453 by properly structuring the sale.

### Treasury Regulation Example

Treasury Regulation §1.1031(k)-(1)(j)(2)(vi), Example 4, indicates that a buyer's installment note issued to a seller qualifies for installment treatment under IRC §453. In the Example, the buyer offers to buy the seller's real property, but doesn't want to have the transaction structured as a like-kind exchange. As a result, the seller enters into an exchange agreement with a qualified intermediary to facilitate the exchange. Under the agreement, the seller transfers the real property to the qualified intermediary who then transfers the property to the buyer. The buyer pays $80,000 cash and issues a 10-year installment note for $20,000. The Example specifies that the seller has a bona fide intent to enter into a deferred exchange, and the exchange agreement specifies that the seller cannot receive, pledge, borrow or otherwise obtain the benefits of the money or other property that the qualified intermediary held until the earlier of the date the replacement property is delivered to the seller or the end of the exchange period. The Example also points out that the buyer's obligation bears adequate stated interest and is not payable on demand or readily tradable. The qualified intermediary acquires replacement property having a fair market value of $80,000 and delivers it, along with the $20,000 installment obligation, to the seller.

While the $20,000 of the seller's gain does not qualify for deferral under IRC §1031(a), the seller's receipt of the buyer's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of installment reporting of gain under IRC §453. Thus, the Example concludes that the seller may report the $20,000 gain on the installment method on receiving payments from the buyer on the obligation

**Safe Harbor**

A safe harbor exists that provides protection against an IRS assertion that a taxpayer is in actual or constructive receipt of money or other property held in a qualified escrow account, qualified trust, or by a qualified intermediary. *Treas. Regs. §§1.1031(k)-1(g)(3)-(4); T.D. 8535 (Jan. 1994).* With respect to a qualified intermediary, the determination of whether a taxpayer has received payment for purposes of IRC §453 is made as if the qualified intermediary is *not* the taxpayer's agent. *Treas. Regs. §§1.1031(k)-1(j)(2)(ii); (g)(4).* Thus, when a taxpayer transfers property under such an arrangement and receives like-kind property in return, the transaction is an exchange rather than a sale, and the qualified intermediary is *not* deemed to be the taxpayer's agent. *See Priv. Ltr. Rul. 200327039 (Mar. 27, 2003).* Similarly, when a buyer places money in an escrow account or with the qualified intermediary, the seller is *not* in constructive receipt of the funds if the seller's right to receive the funds is subject to substantial restriction. *See, e.g., Stiles v. Commissioner, 69 T.C. 558 (1978).* The Treasury Regulations state that any agency relationship between the seller and the qualified intermediary is disregarded for purposes of IRC §453 and Treas. Reg. §15a.453-1(b)(3)(i) in determining whether the seller has constructively received payment. *Treas. Reg. §1.1031(k)-1(j)(2)(vi), Example 2.*

**Exchange Transaction Example**

Assume that Molly Cule owns a tract of farmland that she uses in her farming business and would like to exchange it for other farmland in an I.R.C. §1031 transaction. Bill Bored and Molly enter into a purchase contract, calling for Bill to buy Molly's farmland. The purchase contract clearly states that Bill must accommodate Molly's desire to complete an IRC §1031 exchange and states that Molly desires to enter into an IRC §1031 exchange. Molly and a qualified intermediary then enter into an exchange agreement specifying that the qualified intermediary agrees to acquire Molly's farmland and transfer it to Bill. The agreement also states that the qualified intermediary will acquire like-kind farmland and transfer it to Molly. Molly assigns her rights in and to the farmland she gave up to the qualified intermediary. She also assigns her rights to the qualified intermediary in all contracts she enters into with the owner who holds title to the replacement farmland.

The exchange agreement requires Molly to identify replacement farmland within 45 days of the initial exchange and to notify the qualified intermediary of the identified parcel within that 45-day period. The exchange agreement allows Molly 180 days from the date of the first exchange to receive the identified property.

The exchange agreement specifies that the qualified intermediary will sell Molly's farmland and hold the sales proceeds until the qualified intermediary buys replacement farmland. When the replacement farmland is purchased, it will then be transferred to Molly.

***Structured sale aspect.*** The exchange agreement says that if the transaction qualifies under I.R.C. §1031, but Molly receives "boot," the qualified intermediary and Molly must engage in a structured sale for the boot. This is to bar Molly from having any right to receive cash from the exchange. Similarly, the exchange agreement contains additional language stating that if the transaction fails to qualify for I.R.C. §1031 treatment for any reason, the qualified intermediary and Molly must engage in a structured sale. The structured sale involves the qualified intermediary making specified periodic payments to Molly pursuant to an installment sale agreement (based on the consideration the qualified intermediary holds) coupled with a note for a set number of years. Thus, the exchange agreement is drafted to specify that if an installment sale results, Molly will report each payment received into income in the year she receives it.

***The assignment agreement.*** If the installment sale language is triggered, the exchange agreement specifies that the qualified intermediary will assign its obligations to make the periodic payments under the installment note to an assignment company pursuant to a separate assignment agreement between the qualified intermediary and the assignment company. Molly is not a party to this agreement. The assignment agreement requires the qualified intermediary to transfer a lump sum to the assignment company. The lump sum amount equals the discounted present value of the stream of payments that the qualified intermediary must make under the installment note and exchange agreement. In return, the assignment company assumes the qualified intermediary's obligation to pay Molly. Thus, the assignment company becomes an obligor under the installment note.

As discussed above, Example 4 of Treas. Reg. §1.1031(k)-1(j)(vi), involves an installment note that the buyer issues to the seller of the property. That note qualifies for installment treatment under I.R.C. §453. In the example involving Molly, it is the qualified intermediary that issues the note. While the regulation states that the qualified intermediary is not the agent of the Molly for purposes of IRC §453, that is only the case until the earlier of the identification (or replacement) period, or the time that Molly has the unrestricted right to receive, pledge, borrow or otherwise benefit from the money or other property that the qualified intermediary holds. Treas. Reg. §1.1031(k)-1(j)(2)(ii). But, the risk of Molly being in constructive receipt of the buyer's funds is eliminated if the exchange agreement is drafted carefully to fit within the safe harbor.

### Alternative Approach

As an alternative to the approach of the example involving Molly, what if a different taxpayer, Millie, engaged in a similar transaction and used installment reporting but received all of the cash up front via a loan. Will an arrangement structured in this manner achieve tax deferral?

**Facts of the example.** Millie sells an asset to Howard's Exchange Service (HSE) and HSE resells the asset to Andy. Millie receives a loan from Usurious Bank, an independent lender shortly after selling the asset to HSE for an amount equating the selling price to HSE. The repayment of the loan is funded by installment payments over a period of time that HSE makes to Usurious Bank. Three escrow accounts are established with an escrow company affiliated with Usurious Bank. The escrow company, on a monthly basis, takes funds from HSE and moves it into Escrow Account No.

1 as an interest payment on the loan; then to Escrow Account No. 2 (which is designated as Millie's account); and then to Escrow Account No. 3 to pay interest on the loan. The transactions are conducted as automatic debit/credit transactions that occur on a monthly basis over the length of the installment period.

**Analysis.** IRC §453 requires that the initial debt obligation be that of the *buyer* of the property for the seller to receive installment treatment on the proceeds of sale. If the obligor is someone other than the buyer, the debt is treated as payment on the sale. *Treas. Reg. §15a.453-1(b)(3)(i).* Thus, for installment sale treatment to result, HSE must be both the buyer of the asset *and* the obligor on the installment note rather than only being the obligor. This means that the transaction must be structured such that the obligation is due to Millie from Andy, followed by a substitution of the obligor via an independent transaction in which Andy assigns the obligation. In *Rev. Rul. 82-122, 1982-1 C.B. 80, amplifying Rev. Rul. 75-457, 1974-1 C.B. 115,* the substitution of a new obligor on the note and an increase in the interest rate, together with an increase in the amount paid monthly to reflect the higher interest rate, was not considered to be a satisfaction or disposition of an installment obligation within the meaning of I.R.C. §453B(a).

As for the escrow accounts, generally an installment note of the buyer cannot be used as security or pledged to support any other debt that benefits the seller. If that happens, the net proceeds of the debt are treated as a payment received on the installment sale. *See IRC §453A(d)(1); Treas. Reg. §15A.453-1(b)(3)(i); Rev. Rul. 79-91, 1979-1, C.B. 179; Rev. Rul. 77-294, 1977-2, C.B. 173; Rev. Rul. 73-451, 1973-2, C.B. 158.* However, there is an exception to this "pledge rule" that triggers gain recognition if the seller uses an installment obligation to secure a loan. Property that is used or produced in the trade or business of farming is not subject to the rule. *I.R.C. §453A(b)(3)(b).* Thus, a taxpayer who sells farmland (or other farm property) in an installment sale may use that installment receivable as security, or in a pledged manner, to borrow funds from a third party. The third party should collateralize the payments and file a UCC-1 to formally pledge and secure the installment payments

**Conclusion**

Tax-deferred exchanges post-2017 are limited to real estate exchanges. Normally, only the like-kind portion of the exchange qualifies for deferral. However, if an exchange involving farm property is structured properly, tax deferral can be achieved for the entire transaction. Careful drafting of the contracts involved is critical.