CAVEAT EXCHANGER: "DE JA VU ALL OVER AGAIN"

by Mark Lee Levine, CRE

This article focuses on the risks a taxpayer takes when undertaking an exchange, with escrow, where the escrow party (intermediary) defaults.

INTRODUCTION

The author hopes that Yogi Berra[1] will indulge the incorporation of his cryptic one liner, "De ja vu all over again," in the title to this manuscript. This sardonic phrase seems to be most apropos, given that the author has argued on prior occasions that we should change the tax-deferred exchange rules by simplifying the process to defer gain when we "sell" and reinvest the *proceeds* from the "sale." The potential pitfalls outlined in this article support that position.

Taxpayers have been forewarned on numerous occasions,[2] when undertaking tax-deferred exchanges and using intermediaries (escrow parties), that the area can be complex. Care must be exercised to comply with the requirements in the Federal tax law for exchanges. It behooves all of us to reflect on the basic requirements for a tax-deferred exchange, whether undertaking a simultaneous exchange or a non-simultaneous (deferred) exchange.[3]

Once the fundamental requirements for the use of a tax-deferred exchange under Code §1031,[4] with their rules,[5] and the use of an intermediary[6] have been reviewed, the exchange can be examined to see what happens if an escrow agent does not perform.[7] *The bottom line is that the exchange treatment may be lost.*

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HISTORICAL PERSPECTIVE OF CODE §1031 AND NONSIMULTANEOUS EXCHANGES

The historical position under Code §1031, back in 1921[8] and up until approximately 1968[9] seldom addressed an exchange that did *not* occur simultaneously, between the "buyer" and the "seller." That is, under normal circumstances, the buyer will transfer his or her monies or other payment for the property, and the seller will transfer his or her property to the buyer. However, with the advent of a few cases, followed by the *Starker* cases[10] and the changes in the 1984 Code,[11] the issue arose as to the requirements necessary to undertake an exchange where the parties do not transfer their properties at a simultaneous point. In most instances, the non-simultaneous exchange results in the taxpayer-seller transferring his or her property, often identified as "**relinquished property**,"[12] now, for the promise, and support for that promise, to receive other like-kind, qualified Code §1031 property, at a later date and on a timely basis.[13]

With the advent of the non-simultaneous flavor of exchanges, there was a need to determine many of the guidelines that would apply in such settings. Questions arose as to who might hold the property on either side, either the property relinquished by the seller or that transferred by the buyer; and, who would control the timing of these events? Does the concept of constructive receipt[14] apply? What constitutes a "sale," as opposed to an "exchange?" And, there were a myriad of other questions. Some of these queries were answered as a result of Regulations.[15]

CURRENT CONCERNS

Many issues remain that were not resolved by the Regulations. Therefore, numerous Private Letter Rulings, cases and other authorities have addressed the conundrum of tax issues that have arisen because of non-simultaneous exchanges. These concerns relate to the essence of this article, with particular emphasis on the question as to what happens when someone who is acting as a qualified intermediary,[16] within the meaning of the Regulations mentioned, defaults or fails to properly act? Does this mean that the taxpayer will be given some relief position, or is the taxpayer burdened with the failure of the intermediary to comply with the requirements to assure the tax-deferred status as an exchange? In most instances, the answer, coming from the cases, Rulings, and other authorities, is that it is the taxpayer that suffers the adverse consequences of the failure of the intermediaries to act properly.

One of the main concerns arose because of the nature of Code §1031 and the Regulations, relative to the non-simultaneous exchange, sometimes referred to as a *"deferred exchange,"* (as labeled in the Regulations). This is when a third-party acts on behalf of a party or parties, thereby hopefully preventing adverse tax results. When such third-party (intermediary) is used, a common issue that could result in a position in favor of the government and against the taxpayer is an argument that, while a taxpayer might have transferred his or her property to such intermediary, with the intent to receive like-kind qualified property in an exchange, it may be argued that the seller is deemed to have received the property (often cash) acquired by the intermediary, because the seller has "control" over the transaction. (This issue is sometimes labeled as a "constructive receipt" issue.)

To avoid this issue, the Regulations that were promulgated under Code §1031 provided that a third-party, not an agent (intermediary) of the seller, should hold the funds in question that might be paid, by a buyer, allowing the intermediary to hold those funds to avoid both the actual and constructive receipt of the monies by the taxpayer-seller, and to otherwise comply with Code §1031.

Without attempting to cover in detail these Regulations, noted under Treasury Reg. §1.1031(k), the essence is that the intermediary must act independently, and according to proper instructions, to hold the funds, as indicated previously.

The problematic issue is:

What if the intermediary fails to act properly and is in violation of the intermediary's contract with the seller? Can this lead to adverse tax implications for the buyer? A failure to properly act may be the result of the intermediary's negligence, fraud, theft, or other improper actions. However, even if the actions are improper, and this gives rise to a claim, civilly, by the taxpayer-seller against the intermediary, the tax question remains: Is the seller's potential exchange damaged by the intermediary's improper actions?

The author has addressed this issue in prior articles and presentations relative to situations where the taxpayer is damaged because the intermediary, maybe involuntarily, is facing a bankruptcy. In the articles indicated, a few cases were mentioned where the courts have shown little sympathy or empathy for the taxpayer who was damaged, through no intentional act by the taxpayer,

when such bankruptcy occurs. That is, as many familiar with exchanges know, the technical requirements of timing the investment normally dictate that the property relinquished by the seller must also result in the seller timely identifying the replacement property. A "timely" basis for identification normally means that within 45 days from the transfer of the relinquished property by the seller to the intermediary, the seller must identify the property the seller is to receive. (Further, there is generally a 180-day rule that requires the taxpayer to not only identify the property, but also to actually close and receive the replacement property within 180 days of the transfer of the relinquished property by the taxpayer-seller; there are few exceptions.)

The cases in question create a problem for the taxpayer-seller, because the taxpayer, in attempting to meet all of the requirements of Code §1031, (including the Regulations to timely replace the relinquished property), may be thwarted as a result of the taxpayer discovering that the intermediary, who was to handle the transaction, was placed into bankruptcy. This has occurred.

The conclusions by *all* of the courts in these cases have been that the taxpayers are *not* entitled to any relief from the adverse tax implications that might be present for the taxpayer-seller in failing to meet Code §1031 on a timely basis for replacement, even though the taxpayer was not the generating cause of the failure to timely meet the requirements. Although the tax law contains relief provisions in other Sections of the Code, no such provision exists in this Section; and, no court has allowed the taxpayer to simply avoid the timing requirements that are required under the Code and the Regulations indicated simply because the taxpayer's intermediary failed to properly and timely meet the requirements of the Code.

This issue has been further addressed with a more abhorrent fact situation in a setting where the intermediary absconded with the "escrowed" funds. The question that must now be addressed is whether, in this extreme case, the taxpayer would receive any relief relative to the tax issue (and without regard to the more important issue of receiving a return of funds because of the criminal actions by the intermediary).

IMPACT OF DEFAULT IN THE TIMELY MEETING OF REPLACEMENT RULES WHEN THE INTERMEDIARY COMMITS A CRIMINAL ACT

Taxpayers have been forewarned on numerous occasions, when undertaking tax-deferred exchanges and using intermediaries (escrow parties), that the area can be complex. Care must be exercised to comply with the requirements in the Federal tax law for exchanges. It behooves all of us to reflect on the basic requirements for a tax-deferred exchange, whether undertaking a simultaneous exchange or a non-simultaneous (deferred) exchange.

Thus, the focus of this Note is to deal with the question of the timely performance of exchange requirements for a non-simultaneous exchange under Code §1031. This issue was recently examined by the 1999 Court of Appeals decision out of Georgia on the issue of a non-simultaneous exchange that failed to meet timing requirements because of the intermediary's conversion of the funds that were to be held in escrow for and on behalf of the taxpayer.

The issue was addressed in the case of *Deer Creek, Inc. v. Section 1031 Services, Inc., et. al.*, 510 F.E.2d 853 (Ga. App. 1999). In the Georgia *Deer Creek* case, a number of individuals undertook Code §1031 transactions and utilized a Company entitled Section 1031 Services, Inc., to support the requirements under Code §1031 for an intermediary or facilitator to complete the exchange requirements.

Mr. James Gideon owned the Section 1031 Services Company. Allegedly, Gideon commingled funds in the escrow account, withdrew millions of dollars of those funds, and, as one might guess, chose to leave the country. The net result was that there were a number of individuals who attempted to try to collect "their" monies from the account. Although the case focused on the basic position of "who gets stuck" with the loss of the monies, since there were multiple parties involved and a limited amount of funds that were available, the case also, implicitly, raised the issue, for tax people, of the impact of such position on the Code §1031 transaction. (Obviously, this was the lesser issue for the taxpayers. Although the failure of the reinvestment to meet Code §1031 might have been present, the issue for the plaintiff was to seek a return of the monies, even if that meant paying taxes out of such funds.)

The Court ruled on the propriety of the claims by the various plaintiffs as to the amount of monies that were available. It was not a tax case. However, one can see the impact on the exchange position by the failure of timely completion of the Code §1031 issue.

This is not the only case in which there has been a potential loss of the deferred exchange position because of a failure to meet the requirements in a timely fashion under Code §1031 for replacing the property. It is not the only case in which funds have been lost because of an intermediary or third-party absconding or failing to account for funds that were in their control.

CONCLUSION

All of the cases in which a third-party has control of funds that are owned by another party should give each transferor of those funds cause to consider, as a paramount issue, the protection of those funds. The key issue should be the assurance that the funds will be properly directed and utilized as required by the owner of those funds. Unfortunately, there has been, and continues to be, too much focus by taxpayers on saving taxes and eliminating that burden. Taxpayers have often thrown caution to the wind in many instances in failing to use reasonable steps, whether personally, or through their representative, to protect their funds. This must be the primary concern for the taxpayer.

There has been a tendency by some to merely push the safety of funds issue aside as one that is an unusual, hybrid, and erratic mutation that will never occur. However, a series of cases on intermediaries being placed into bankruptcy, in which trustees have contended that the monies held by the intermediary are in fact those of the trustee, and not those of the seller, coupled with the recent *Deer Creek* case in which the intermediary absconded with the funds, should direct the taxpayer's attention to the need to ignore the tax implications until they, *first*, address the security implications, for the taxpayer's funds. Once the funds are properly protected, the need to meet the requirements for the tax-deferred exchange treatment of those funds can be addressed as a secondary issue. REI

NOTES

1. With thanks to Yogi Berra
2. For an examination of this issue, addressed in previous articles, see Levine, Mark Lee, *Exchanging Real Estate*, Vol. 2, Page 10-168a, published by Professional Publications and Education, Inc. (1999). See also the article by Levine, Mark Lee, "The Impact of A Tax-Deferred Exchange Under Code §1031 When An Intermediary Enters Bankruptcy," *Journal of Property Management* 20, Institute of Real Estate Management (November/December, 1998).
3. The question as to undertaking a simultaneous exchange or a non-simultaneous exchange was not a topic in most instances until the advent of the now-famous *Starker* decisions. These included: *Bruce Starker v. United States (Starker I)*, 75-1 U.S.T.C. 9443 (D.C. Ore. 1975); *Starker, T. J., v. United States (Starker II)*, 77-2 U.S.T.C. 9512, 432 F. Supp. 864 (D.C. Ore. 1977); and *Starker, T. J., v. United States (Starker II on Appeal)*, 79-2 U.S.T.C. 9541, 602 F.2d 1341 (9th Cir. 1979), aff'g and rem'g 77-2 U.S.T.C. 9512, 432 F. Supp. 864 (D.C. Ore. 1977.
4. Code §1031 is technically referred to as 26 U.S.C.A. Section 1031, but will be referred to herein by reference to the general label of "Code §1031."
5. Code §1031 generally provides that gain will not be recognized under the Internal Revenue Code for Federal income tax purposes if there is an exchange of property that meets certain requirements; *e.g.*, it was used in the trade or business or for investment. For more details and a discussion of these requirements, see Code §1031(a) and a discussion of the exchange rules in the Levine text, cited *supra*, Footnote 1.
6. Intermediaries became a topic of discussion as a result of the modifications in 1984 to Code §1031, allowing a non-simultaneous exchange and the advent of the promulgation of Regulations under Code §1031, specifically, Treasury Reg. §1.1031(k). For further details on intermediaries, see Treasury Reg. §1.1031(k)-1(g).
7. The question as to the impact of a default by an intermediary on the Code §1031 tax-deferred exchange has been discussed in cases where a default occurred. Specifically, some of these cases are enumerated in the article, cited *supra*, Footnote 1.
8. Code §1031 in 1921. See the Levine text, *supra*, Note 1, Chapter 1.
9. *Redwing Carrier v. Tomlinson*, 399 F.2d 652 (5th Cir., 1968).
10. See *supra*, Footnote 2.
11. See Footnote 8.
12. "Relinquished property" is that property transferred by the seller.
13. See Code §1031(a)(3).
14. "Constructive receipt" is a term that denotes a *deemed* receipt of the property, even if there is not an actual receipt.
15. Treasury Reg. §1.1031(k).
16. "Qualified intermediary" is defined in Treasury Reg. §1.1031(k).