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In A Like-Kind Exchange, What If a Qualified Intermediary fails?

-by Neil E. Harl

The economic and financial trauma of roughly the past 30 months has taken a toll on many financial institutions and organizations, including qualified intermediaries utilized in like-kind exchanges. The failure of qualified intermediaries or the inability to perform has caused immense concern among taxpayers and tax practitioners alike.

In early March, 2010, the Internal Revenue Service published guidance for a “safe harbor” for like-kind exchanges where the qualified intermediary defaults on its obligation to acquire and transfer the replacement property. If the requirements are met, none of the amounts involved need to be reported as gain by the taxpayer unless and until payments are received by the taxpayer.

Functions of a qualified intermediary

The regulations make it clear that a taxpayer may use a qualified intermediary to facilitate a like-kind exchange. The qualified intermediary (who cannot be the taxpayer or a “disqualified person”) may enter into a written agreement limiting the taxpayer’s rights to obtain the benefits of the funds or other property held by the qualified intermediary and acquires the relinquished property from the taxpayer, transfers the relinquished property, and transfers the replacement property to the taxpayer, all in accordance with the written agreement. A disqualified person includes someone who is an agent of the taxpayer at the time of the transaction.

A taxpayer’s regular attorney can be a disqualified person. A major reason for a qualified intermediary (or a qualified escrow account or a qualified trust) is to shield the taxpayer from actual or constructive receipt of the amounts involved under the installment sale rules. If the actual or constructive receipt rules apply, the transaction is treated as a sale and not a deferred like-kind exchange.

The “safe harbor” in Rev. Proc. 2010-14

Rev. Proc. 2010-14 makes it clear that IRS and the Department of the Treasury believe that a taxpayer who, in good faith, sought to complete an exchange but could not do so because of default by the qualified intermediary (QI), should not be required to recognize the gain from the failed exchange until payments are received attributable to the relinquished property. The relief is in the form of requirements imposed by Rev. Proc. 2010-14. The requirements mirror, to a considerable degree the rules applicable to installment sales.

Who is eligible? The “safe harbor” rules apply to taxpayers who (1) transferred relinquished property in accordance with the regulations; (2) properly identified replacement property

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within the identification period (unless the qualified intermediary defaulted during that period); (3) did not complete the like-kind exchange solely because of a default by the qualified intermediary that becomes subject to a bankruptcy proceeding under the United States Code or a receivership proceeding under federal or state law; and (4) did not, without regard to any actual or constructive receipt by the QI, have actual or constructive receipt of the proceeds from disposition of the relinquished property or any property of the QI prior to the time the qualified intermediary entered bankruptcy or receivership. For this purpose, relief of a liability pursuant to the exchange agreement prior to the QI default is disregarded.  

Consequences for the taxpayer. Under the safe harbor, no gain is recognized from actual or constructive receipt until payment is received. The gain, if any, is recognized as required by the safe harbor gross profit ratio method. Under that method, the portion of any payment attributable to the relinquished property that is to be recognized is determined by multiplying the payment by a fraction, the numerator of which is the taxpayer’s gross profit and the denominator is the taxpayer’s contract price.  

The term “payment” is defined as a payment of “…. proceeds, damages, or other amounts attributable to the disposition of the relinquished property (other than selling expenses). …”, whether paid by the qualified intermediary, the bankruptcy or receivership estate of the QI, the QI’s insurer or bonding company or any other person. “Satisfied indebtedness” is not considered to be a “payment attributable to the relinquished property.” The term “gross profit,” means the selling price minus the taxpayer’s adjusted income tax basis (increased by any selling expenses not paid by the QI using proceeds from the sale of the relinquished property). The selling price of the relinquished property is generally the amount realized on the sale of the relinquished property, without reduction for selling expenses. However, if a court order, confirmed bankruptcy plan or written notice from the trustee or receiver specifies, by the end of the first taxable 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 is considered to be 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. The “contract price” is the selling price of the relinquished property minus the amount of any satisfied indebtedness not in excess of the basis of the relinquished property. The term “satisfied indebtedness” means any mortgage or other encumbrance on the relinquished property that was assumed or taken subject to by the buyer or was satisfied in connection with the transfer of the relinquished property. It is important to note that the amount of any 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. Any depreciation recapture is included in income in the taxable year the gain is recognized to the extent of the gain recognized in that taxable year.

A loss deduction may be claimed if payments are not in excess of the basis (technically if payments are less than the basis). For purposes of imputed interest, the property is deemed sold on the date of confirmation of the bankruptcy plan or other court order that resolves the taxpayer’s claims against the QI. Thus, if the only payment in full satisfaction of the taxpayer’s claim is received by the taxpayer on or before the date that is six months after the safe harbor date, no interest is imputed. 

Effective date

The “safe harbor” rules are effective for taxpayers where like-kind exchanges fail due to a QI default occurring on or after January 1, 2009.

Comment period

The IRS has invited comments on the safe harbor which are to be submitted on or before April 12, 2010. The comments are to be sent to:

Internal Revenue Service
ATTN: CC:PA:LPD:PR
(Rev. Proc. 2010-14), Room 5203
Ben Franklin Station
P.O. Box 7604
Washington, D.C. 20044

ENDNOTES

1 Treas. Reg. § 1.1031(k)-1(g)(4).
3 Rev. Proc.. 2010-14, 2010-1 C.B. __.
4 Rev. Proc. 2010-14, § 4.01, 2010-1 C.B. __.
5 See Treas. Reg. § 1.1031(k)-1(g)(4).
6 Id.
7 Treas. Reg. § 1.1031(k)-1(g)(1), (2).
8 Treas. Regs. 1.1031(k)-1(g)(4)(i)(B), (6)(i).
10 Treas. Reg. § 1.1031(k)-1(a).
11 Id.
12 2010-1 C.B. __.
13 Rev. Proc. 2010-14, § 2.05, 2010-1 C.B. __.
14 2010-1 C.B. __.
15 See I.R.C. § 453.
16 Treas. Reg. § 1.1031(k)-1(g)(4).
17 Rev. Proc. 2010-14, § 3, 2010-1 C.B. __.
18 Id.
19 Rev. Proc. 2010-14, § 4.01, 2010-1 C.B. __.
20 Rev. Proc. 2010-14, § 4.03, 2010-1 C.B. __.
BANKRUPTCY

GENERAL

PREFERENTIAL TRANSFERS. The debtor operated a corn and soybean seed company which contracted with seed growers on an annual basis. For many years the payment for the prior year’s seed crop from each grower was made on May 1 or within ten days after pricing of the seed when the pricing occurred after May 1. Seed pricing occurred after the seeds were tested to determine whether the seeds met the minimum standards set by the debtor. In the year before filing for bankruptcy, the debtor changed the payment time to June 10, which fell within 90 days before the bankruptcy petition. The bankruptcy trustee petitioned to recover the payments as preferential under Section 547(b). The debtor argued that the payments were not made for an antecedent debt, Section 547(b)(2), because payments were not required until the seeds were bagged and sold. The court held that the debtor became obligated for payment when the seeds were tested, which occurred prior to payment; therefore, the payments were made for an antecedent debt. The debtor also argued that the payments were a contemporaneous exchange for new value under Section 547(c)(1). The court held that no new value was acquired by the payments since the seeds were grown and delivered prior to payment. Finally, the debtor argued that the payments were made in the ordinary course of business under Section 547(c)(2). The court noted that this argument would have succeeded if the payment timing had not changed in the year before the bankruptcy filing; however, the ordinary course of business created between the debtor and the seed growers had been to pay by May 1. Since the payment timing was changed, the payments were no longer made in the ordinary course of business, as defined by the parties. In re Patriot Seeds, Inc., 2010 Bankr. LEXIS 294 (Bankr. C.D. Ill. 2010).

FEDERAL TAX

DISCHARGE. The debtors filed for Chapter 7 and failed to provide notice of the bankruptcy proceedings and schedules to the IRS. Instead, the debtors sent notice to the U.S. District Attorney. The court held that notice to the U.S. District Attorney was insufficient notice to the IRS because the U.S. District Attorney did not take action on court proceeding notices for another agency without requests from the agency. After the case was closed, the IRS petitioned for a reopening of the case for a determination that the tax claims were not discharged for failure to provide notice to the IRS. The IRS did not have actual or constructive notice of the bankruptcy. The court held that the taxes were not discharged because the IRS did not receive notice. The court refused to vacate the Chapter 7 case because it would result in significant disruption and prejudice to creditors. In re Cassara, 2010-1 U.S. Tax Cas. (CCH) ¶ 50,258 (Bankr. E.D. La. 2010).

ESTATE PROPERTY. The debtors, husband and wife, filed for Chapter 13. The wife owned an IRA which was funded by receiving funds from a deceased parent’s IRA. The debtors claimed the funds in the IRA as exempt under Section 522(d)(12) as retirement funds. The court held that the wife’s IRA was not eligible for the exemption because the wife could withdraw the funds at any time and the IRS was not exempt from taxation. In re Chilton, 2010-1 U.S. Tax Cas. (CCH) ¶ 50,275 (Bankr. E.D. Tex. 2010).

FEDERAL FARM PROGRAMS

No items.

FEDERAL ESTATE AND GIFT TAXATION

No items.

FEDERAL INCOME TAXATION

CHILD TAX CREDIT. The IRS has published a discussion of the Child Tax Credit for 2009 returns. (1) Amount - With the Child Tax Credit, taxpayers may be able to reduce the federal income tax by up to $1,000 for each qualifying child under the age of 17. (2) Qualification - A qualifying child for this credit is someone who meets the qualifying criteria of six tests: age,