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Escrows and the New 468B Regulations

By David E. Libman • Wood & Porter • San Francisco

On July, 9, 2008, in T.D. 9413, the Treasury published final regulations dealing with the taxation of escrows, trusts and other funds used in deferred exchanges. As M&A TAX REPORT readers are aware, Code Sec. 1031 allows for nonrecognition of gain or loss where business or investment property is exchanged solely for property of like kind. In the event the exchange involves not only like-kind property, but also money or other property (*i.e.,* boot), the recipient of the boot must recognize gain to the extent of the boot's fair market value.

Exchanges *via* Code Sec. 1031 may not be the most common M&A transaction, but business exchanges do occur and can sometimes work well. At one time, there was a raft of radio station deals done this way. Of course, quite apart from whole business sales, business entities can and do use Code Sec. 1031 for business property exchanges. Thus, these rules should remain of interest.

To navigate and facilitate exchanges, parties often use a qualified escrow, qualified trust and/or a qualified intermediary. Reg. §1.468B-6 focuses on who gets taxed while property and money travels through the hands of various parties and third parties during the like-kind exchange process.

Exchange Funds Taxed As Loans

The general rule is that exchange funds are treated as loans to the exchange facilitator. According to the Treasury regulations' lingo, the exchange facilitator is a qualified intermediary, transferee, escrow holder, trustee or anyone else who is holding exchange funds for the taxpayer in the like-kind exchange. Under Reg. §1.468B-6(c)(1), exchange funds transferred to an exchange facilitator as part of a like-kind exchange are generally treated as a loan from the taxpayer to the exchange facilitator. Cleverly, the Treasury calls these "exchange

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facilitator loans." The exchange facilitator takes into account the income, deductions and credits attributable to those exchange funds.

Example. Taxpayer wishes to participate in a deferred exchange arrangement with Recipient. Rather than enter into an escrow agreement, Taxpayer enters into an exchange agreement with a qualified intermediary (*i.e.*, an exchange facilitator). Pursuant to the exchange agreement, Recipient will pay $2.1 million to the qualified intermediary. The qualified intermediary will in turn deposit that amount into a depository institution under Taxpayer's name and taxpayer identification number.

The exchange agreement provides that the qualified intermediary will pay Taxpayer a stated rate of interest. The qualified intermediary invests the exchange funds and earns $40,000 on the same. The qualified intermediary then pays Taxpayer $28,000 based on the stated rate of interest in the exchange agreement. Reg. §1.468B-6(c)(1) applies. Taxpayer is considered to have loaned the exchange funds to the qualified intermediary. The income, deductions and credits attributable to those exchange funds must be taken into account by the qualified intermediary in computing his taxable income.

If the exchange agreement required the qualified intermediary to pay all earnings attributable to the exchange funds to Taxpayer, the general rule of Reg. §1.468B-6(c)(1) would not apply. Instead, the exception of Reg. §1.468B-6(c)(2) would apply, and the exchange funds would not be treated as a loan to the qualified intermediary.

Below-Market Exchange Facilitator Loans

Ordinarily, in applying Code Sec. 7872, a loan made at a rate below the applicable federal interest rate could be considered a gift of the amount of foregone interest, a compensation-related loan, or any other of a number of specified below-market loan types. However, if the "exchange facilitator loan" does not exceed $2 million in amount or six months in duration, it is exempt from the below-market interest rate rules set forth in Code Sec. 7872.

Exchange Funds Not Treated As Loans

The exchange funds will not be treated as loans to the exchange facilitator if the escrow agreement, trust agreement or exchange agreement provides that all earnings attributable to the exchange funds are paid to the taxpayer. Thus, the taxpayer (not the exchange facilitator) is attributed the income, deductions and credits of the exchange funds.

The regulations provide various methods of ensuring that all earnings of the exchange funds are paid to the taxpayer. Under one method, the exchange facilitator must hold all of the taxpayer's exchange funds in a depository institution under a separately identified account established with the taxpayer's name and taxpayer identification number.

Example. Taxpayer wishes to participate in a deferred exchange arrangement with Recipient. Rather than enter into an escrow agreement, Taxpayer enters into an exchange

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agreement with a qualified intermediary. Pursuant to the exchange agreement, Recipient will pay $2.1 million to the qualified intermediary. The qualified intermediary will in turn deposit that amount into a depository institution under Taxpayer's name and taxpayer identification number.

The exchange agreement provides that the qualified intermediary will pay Taxpayer a stated rate of interest. The qualified intermediary invests the exchange funds into a money market account with Bank (a depository institution) under Taxpayer's name and taxpayer identification number. All of the earnings attributable to that account will be paid to Taxpayer.

While the exchange funds are held in the money market account, the account earns $28,000 in interest. During that time, Bank invests the exchange funds and earns $40,000 on the same. At the end of that time period, the qualified intermediary uses the $2.1 million of exchange funds invested to purchase replacement property identified by Taxpayer. At that point, Bank pays Taxpayer the $28,000 of interest earned on the exchange funds to Taxpayer.

Because all of the earnings attributable to Taxpayer's exchange funds are paid to Taxpayer, those exchange funds are not treated as a loan from the Taxpayer to the qualified intermediary. Moreover, the $40,000 Bank earned from investing Taxpayer's exchange funds are not earnings attributable to Taxpayer.

Transactional Expenses

Under Reg. §1.468B-6, "transactional expenses" include the types of items one would expect in a typical real estate closing statement. They would include costs related to the acquisition and relinquishment of property that takes place in a deferred exchange. Transactional expenses could include such items as commissions, *pro rata* taxes, recording or transfer taxes and title company fees.

However, transactional expenses do not include fees for exchange facilitator services: (1) if the exchanged facilitator's fee "is fixed on or before the date of the transfer of the relinquished property by the taxpayer ..."; or (2) if the taxpayer must pay the exchanged facilitator's fee regardless of whether there are sufficient exchange funds earnings available to cover that fee.

If an escrow agreement allows an exchange facilitator to first deduct transactional expenses paid to third parties before paying the earnings in the escrow account to the taxpayer, those deducted transactional expenses will be treated as though they were first paid to the taxpayer. As a result, despite the deduction of transactional expenses, all earnings from the escrow account will still be attributable to the taxpayer's exchange funds. Hence, the exchange funds in the escrow account will not be deemed a loan from the taxpayer to the exchange facilitator.

Last Word

It's unlikely that Code Sec. 1031 will emerge as a major player in M&A transactions anytime soon. Still, exchanges under its purview are sometimes helpful. The new regulations—morphed from an otherwise largely irrelevant Code Sec. 468B—are worth a look.