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How a Failed 1031 Exchange Can Become an Installment Sale

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INTRODUCTION

A year ago, I proposed that an installment sale, and a structured sale in particular,[1] could ameliorate a §1031 [2] exchange that, despite good intentions, does not come to fruition.[3] That idea provoked interest, discussion, and disagreement. With a little more time and thought, I revisit this topic here.

In this second analysis, which I imagine will incite continued interest, discussion, and disagreement, I discuss additional nuances of the structured sale as a fallback to the failed 1031 exchange. Since the preparation of the exchange agreement prior to the consummation of any exchange is pivotal, I outline the mechanics of the deferred exchange and the structured sale, and how such mechanics are evidenced in the exchange agreement.

This article will discuss §1031 exchanges and how they interact with the installment sale rules of §453. Then, I address the implications of including language in a deferred exchange agreement that states a seller and qualified intermediary must engage in a structured sale for any boot [4] in the exchange, or for the entire consideration if the deferred exchange fails to close in compliance with §1031. Lastly, the article will address whether a seller can report gain on a failed deferred exchange transaction (or on the amount of boot in a completed exchange) under the installment method as the seller receives periodic payments.

SECTION 1031 REQUIREMENTS

Section 1031 exchanges allow taxpayers to exchange business or investment property for like-kind business or investment property without payment of tax. The rationale is similar to §351 and other non-recognition provisions, in that the taxpayer is not cashing out of his investment, but is continuing it in a different form.

Taxpayers must meet the statutorily imposed requirements of §1031 to defer tax on an exchange. Otherwise, the exchange would be taxable as a sale or exchange under the general rules set forth in §1001. Section 1031 contains four fundamental requirements, most of which seem axiomatic. Although this article will not delve into the finer points of these four requirements, it is important to be mindful of them.

First, there must be an exchange of property, and not a sale.[5] Thus, a taxpayer generally cannot receive "sales proceeds" from the buyer. Second, the property exchanged and the property received must be of like-kind.[6] Generally speaking, the exchange of real property for real property (even raw land for a building) works, but the exchange of a female cow for a male bull does not.[7] Notably, some kinds of property, even if like-kind, do not qualify for the benefits of §1031.[8] These include stocks, bonds, notes, partnerships interests, etc.[9] Third, the property exchanged and the property received must both be held for productive use in a trade or business or for investment.[10] Section 1031 does not confer deferral benefits on personal use property.

Fourth, and perhaps most important for this discussion, §1031 imposes identification and timing requirements. When properties are not exchanged simultaneously, the Code requires taxpayers to identify replacement property within 45 days of the exchange.[11] As a general rule, a taxpayer can identify up to three properties.[12] Alternatively, the taxpayer can identify any number of properties if their aggregate fair market value (as of the end of the identification period) does not exceed 200% of the fair market value of the relinquished property.[13]

Once identified, the taxpayer has 180 days (from the date of the first exchange) to receive the identified property.[14] This 180-day period can be shortened by the due date of the taxpayer's return.[15] Given that this tax return rule includes extensions, and that taxpayers can get automatic extensions, probably the only effect of this time-shortening rule is to ensure that taxpayers extend the due date for filing their returns. Nonetheless, as we'll discuss further below, these timing and identification requirements can be problematic. If taxpayers stumble and fail to meet §1031 requirements, all too often it is because of these rules.

TYPES OF EXCHANGES

There are three types of §1031 exchanges. The most basic (and least common) is a simultaneous exchange. A taxpayer may undertake a simultaneous exchange if he finds a third party who wants his property, and the taxpayer wants property the third party owns. For example, the taxpayer may own a delivery van in his business, which is expanding. He trades it to A who owns a large truck. A's business is downsizing, and A needs more vans than trucks.

For obvious reasons, the timing and identification requirements discussed above do not apply in a simultaneous exchange. Besides simultaneous exchanges, the Code contemplates deferred exchanges. In a deferred exchange, the taxpayer gives up his relinquished property and has 45 days to identify replacement property and 180 days to receive such property.[16] These temporal requirements prevent the taxpayer from deferring the choice of which replacement property to receive.

The regulations provide a safe harbor for taxpayers assigning relinquished property in a deferred exchange to a qualified intermediary ("QI"),[17] a qualified escrow ("QE") account,[18] or a qualified trust ("QT").[19] Under the safe harbor, the QI, QT or QE, after receiving the relinquished property, sells the relinquished property, holding the sale proceeds until it later purchases replacement property and assigns it to the taxpayer. Provided the taxpayer complies with the deferred exchange rules, he will not be deemed to be in actual or constructive receipt of the funds held by the QI, QT or QE.[20] Furthermore, while the QI, QT or QE holds the funds, the taxpayer cannot have an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by the QI, QT or QE.[21]

A third type of exchange is the reverse exchange, and while not the focus of this article, it deserves brief mention. A reverse exchange is essentially the opposite of a deferred exchange.[22] In a reverse exchange, an exchange accommodation titleholder ("EAT") acquires the replacement property and holds it during the 45-day identification period (when the taxpayer identifies the relinquished property) and during the 180-day transfer period (by the end of which the transfers must be complete). In a reverse exchange, the onus is on the taxpayer to *sell* the relinquished property within 180 days. (In contrast to a deferred exchange, where the onus is on the taxpayer to *buy* replacement property within 180 days.)

BOOT AND THE INSTALLMENT METHOD

Generally, if an exchange would be within the provisions of §1031(a), but for the fact that the property received consists of qualifying property and other property or money, the gain, if any, to the recipient is recognized to the extent of the sum of the money and the fair market value of the other property received.[23]

A taxpayer may elect to recognize the gain on the "other property," i.e., the boot, under the installment method under §453 [24] to the extent the exchange qualifies under §§1031 and 453. Section 453 generally requires that if a taxpayer disposes of property and is to receive one or more payments in a later year, the taxpayer's profit on the sale is to be included in income proportionally as the payments are received.[25] In this manner, a taxpayer can defer tax on the sale of property.

There has long been interaction between §§1031 and 453. In Rev. Rul. 65-155,[26] the IRS ruled that a taxpayer who claimed the benefits of §1031 in an exchange involving additional cash payments to be received in installments in subsequent years, could elect to use the installment method of reporting such payments, provided the transaction otherwise qualifies as an installment sale under §453. The taxpayer agreed to exchange investment property for like-kind property, cash and a note. The five percent interest-bearing note called for payment in annual installments in the seven succeeding taxable years.

The IRS found the situation in Rev. Rul. 65-155 analogous to the facts in Rev. Rul. 75,[27] which ruled that the gain recognized on the sale of a taxpayer's residence could be reported on the installment method, where the purchase of a new residence results in partial nonrecognition of gain on the sale. As a result, the IRS ruled that the taxpayer may elect to use the installment method of reporting the cash payments, provided the transaction otherwise qualifies as an installment sale under §453.

Similarly, in PLR 8836006,[28] the IRS ruled that the taxpayers could elect to recognize boot under the installment method. Taxpayer A, Taxpayer B, and Taxpayer C each owned one-third undivided interests as tenants in common in three separate parcels, buildings D, E, and F. The three buildings were held for productive use in a trade or business or for investment for many years. Taxpayers A, B, and C as tenants in common of buildings D, E, and F intended to exchange their interests, so that Taxpayer B would own the entire interest in building D, and Taxpayers A and C would each own a one-half undivided interest as tenants in common in buildings E and F.

Because the buildings were of unequal value, Taxpayer B agreed to give Taxpayers A and C, in addition to his undivided interest in buildings E and F, a note in the amount of $X, payable in six annual installments. The IRS ruled that: (a) the proposed exchange qualified under §1031; (b) no gain or loss would be recognized by Taxpayer B; (c) Taxpayers A and C would report gain to the extent required by §1031(b); and (d) Taxpayers A and C could elect to recognize gain under the installment method under §453.

The §1031 regulations recognize that a buyer's installment note issued to a seller qualifies under the installment method.[29] In an example in the regulations, the buyer offers to purchase the seller's real property, but is unwilling to participate in a like-kind exchange. The seller then enters into an exchange agreement with a QI to facilitate the exchange. Pursuant to the exchange agreement, seller transfers real property to the QI, who then transfers it to the buyer. The buyer pays $80,000 in cash, and issues a 10-year installment note for $20,000.

In this example, the seller has a *bona fide* intent to enter into a deferred exchange. The exchange agreement provides that seller has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by the QI until the earlier of the date the replacement property is delivered to seller or the end of the exchange period. Buyer's obligation bears adequate stated interest and is not payable on demand or readily tradable. The QI acquires replacement property having a fair market value of $80,000 and delivers it, along with the $20,000 installment obligation, to the seller.

Under §1031(b), $20,000 of seller's gain (i.e., the amount of the installment obligation seller receives in the exchange) does not qualify for non-recognition under §1031(a). However, 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 §453. The example concludes that the seller may report the $20,000 gain under the installment method on receiving payments from the buyer on the obligation.

DEFERRED EXCHANGE AND INSTALLMENT SALE OVERLAP

As relinquished property and replacement property can have different values, a taxpayer can either give or receive non-qualifying property (i.e., taxable boot) without the entire transaction losing tax deferral under §1031. Generally speaking, boot is taxable upon receipt. If boot is received in a succeeding tax year, it generally would be taxed under the installment sale principles of §453. This could occur when the buyer of the relinquished property pays in both cash and a long-term note.

> *Example:* A taxpayer transfers a building worth $100 to a QI. The QI sells the building to a buyer for $60 cash and an installment note which requires buyer to make payments of $10 per year to

seller for the next four years. The QI purchases a replacement building for $60, and transfers the replacement building and the note to Taxpayer.[30]

When transactions overlap §§1031 and 453, §1031 generally controls the tax treatment. Indeed, the §1031 regulations state that "[e]xcept as otherwise provided, the amount of gain or loss recognized ... in a deferred exchange is determined by applying the rules of Section 1031 and the regulations thereunder." [31] The §1031 regulations contain specific rules for coordinating gain or loss determinations for deferred exchanges under §§1031 and 453. The §453 regulations for the most part defer to the regulations under §1031.[32]

Nevertheless, constructive receipt questions arise when a transaction overlaps these two Code sections. For example, when a QI is used in the exchange, one may question the applicability of the constructive receipt doctrine, since the QI could be deemed to be the taxpayer's agent. Similarly, in the case of QE and QT where cash (or a cash equivalent) provides security for the transfer of replacement property, one may question whether the taxpayer has actually or constructively received property at the commencement of the deferred exchange.

The constructive receipt doctrine prohibits taxpayers from deliberately turning their backs on income, from selecting the year in which they want to receive (and report) it. Income is constructively received if it is credited to the taxpayer's account, set apart or otherwise made available so that the taxpayer can draw upon it.[33] Conversely, there should be no constructive receipt if the taxpayer's control is subject to substantial limitations or restrictions.

Thus, if a corporation credits its employees with bonus stock, but the stock is subject to restrictions and is not available until some future date, the mere crediting of the stock on the corporate books does not constitute receipt.[34] However, a taxpayer is generally treated for tax purposes as receiving income or property received by the taxpayer's agent.[35] Moreover, taxpayers are not entitled to report gain under the installment method if they directly or indirectly control the sales proceeds or receive the economic benefit therefrom.[36] Furthermore, §453 expressly adopts constructive receipt concepts, providing that payments include amounts actually or constructively received in the taxable year.[37]

The Treasury regulations provide certain safe harbors under which taxpayers are treated as not being in actual or constructive receipt of money or other property held in a qualified escrow account, qualified trust, or by a QI.[38] In the case of a QI, the §1031 regulations generally provide that the determination of whether a taxpayer has received payment for purposes of §453 is made as if the QI is not the agent of the taxpayer.[39] In such a transaction, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange. The determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the QI is not the agent of the taxpayer.[40]

Moreover, money deposited in an escrow account or with a QI by the buyer is not deemed to be constructively received by the seller if the seller's right to receive the funds is subject to substantial limitations and restrictions.[41] Any agency relationship between the seller and QI is disregarded for purposes of §453 and Regs. §15a.453-1(b)(3)(i) in determining whether the seller is in receipt of payment.[42] Thus, constructive receipt issues do not appear to prevent a taxpayer receiving payment in a future year in a deferred exchange from recognizing gain pursuant to the installment sale rules of §453, assuming the taxpayer meets the safe harbor enunciated in the Treasury regulations.

In addition to addressing constructive receipt, the coordination rules determine the duration of the overlap between §§1031 and 453. As a general rule, the coordination rules cease to apply as of the end of the exchange period, or earlier if the taxpayer obtains an immediate ability or unrestricted right to receive, borrow or obtain the benefits of the property held by the QI, QE or QT.[43] Once a taxpayer obtains these powers, the taxpayer has constructive receipt for purposes of §1031.

The coordination rules also provide that a QI is treated as a QI even though the QI ultimately fails to acquire identified replacement property and transfer it to the taxpayer.[44] This rule leads to perhaps the simplest case where the installment sale rules overlap with the deferred exchange rules: the failed deferred exchange that bridges taxable years.

> *Example:* The taxpayer transfers his relinquished property to the QI, which sells it to a buyer in year one. However, QI does not purchase replacement property, and in year two, at the end of the 180-day window, the QI returns the funds to the taxpayer. Since the taxpayer has sold his property and received the funds in a succeeding taxable year, the taxpayer should treat the receipt of funds as an installment sale, reporting the sale proceeds in year two.[45]

BONA FIDE INTENT

The final part of the coordination rules concerns *bona fide* intent. To fall within the coordination rules, the regulations require a taxpayer to have a *bona fide* intent to enter into a deferred exchange at the beginning of the exchange period.[46] According to the regulations, a taxpayer will be treated as having a *bona fide* intent "only if it is reasonable to believe, based on all of the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period." [47]

In *Smalley v. Comr.*,[48] the taxpayer entered into agreements granting a third party the right to remove timber from his land in exchange for payment to an escrow agent who applied the funds to the purchase of other timber realty. The taxpayer argued this qualified as a tax-deferred like-kind exchange. The IRS contended that the timber and the real property were not of like-kind, and that the taxpayer lacked a *bona fide* intent to enter into the like-kind exchange.[49]

Although the taxpayer's exchange failed, the court concluded that various factors indicated that the taxpayer, at the beginning of the exchange period, had a *bona fide* intent to acquire like-kind property before the end of the exchange period. The court noted that:

> (1) the agreement the taxpayer and a buyer executed, expressly made the transaction conditioned on "reasonable cooperation and a tax-free exchange qualifying under Section 1031";
>
> (2) the taxpayer used a qualified escrow account and a proper escrow agent as required by Regs. §1.1031(k)-1(g)(3);
>
> (3) the taxpayer identified and received the replacement properties within the 45-day and 180-day periods as required by §1031(a)(3);

(4) the taxpayer testified credibly that he intended to have a like-kind exchange; and

(5) in planning the transaction, the taxpayer relied on advice from a well-known timber taxation expert and from his long-time accountant.[50]

Bona fide intent should evidently be measured at the inception of an exchange transaction.[51] A contractual provision in the exchange agreement requiring a structured sale if the §1031 exchange fails, arguably does not evidence a lack of intent to effect a §1031 exchange. While it may suggest an alternative intent or a fallback to prevent receiving cash, it does not suggest that the intent to effect a §1031 exchange is not primary.

Moreover, some of the case law suggests a completed exchange may manifest intent. For example, in *Magneson v. Comr.*,[52] the taxpayers exchanged real property with a third party and contributed the acquired property to a limited partnership in exchange for a general partnership interest. The court held that, at the time of the exchange, the taxpayers' intent was to hold the acquired property for investment, thus satisfying §1031.

The court had to determine if the contribution of property to a partnership, in exchange for an interest in the partnership, constitutes "holding the property for investment purposes," within the meaning of §1031.[53] The court held that a change in the mechanism of ownership, which does not affect the amount of control or the nature of the underlying investment, does not preclude nonrecognition treatment under §1031.[54]

Bolker v. Comr.[55] raises another side of this intent issue. The taxpayer caused his wholly-owned corporation to undertake a plan of liquidation, and the taxpayer acquired property, tax-free, in exchange for the redemption of his shares. The taxpayer transferred the property to a QI who sold the property to a third party, transferring exchange property back to the taxpayer. The IRS argued that the corporation (not the taxpayer) was the proper party to the exchange, as the corporation had been in discussions with the third party regarding the sale of the property prior to the liquidation.[56] Finding that the individual taxpayer was the proper party to the exchange and that he had the requisite intent, the court approved the §1031 exchange.

Examples in the regulations suggest that the *bona fide* intent requirement may be met when a board of directors authorizes a like-kind exchange.[57] Other factors which may suggest this requirement has been met may be the terms of the exchange agreement and the absence of other relevant facts indicating the taxpayer did not have a *bona fide* intent at the beginning of the exchange period to enter into a deferred exchange.[58] The preamble to the Treasury regulations states that "taxpayer will be treated as having a *bona fide* intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period." [59]

EXAMPLES

The following examples illustrate the interaction of §§1031 and 453, constructive receipt, time limitations and *bona fide* intent.

Example 1: Xavier Xchanger owns Blackacre, a parcel of real property.[60] Barry Buyer offers to purchase Blackacre, but Barry is unwilling to participate in a like-kind exchange. Xavier thus enters into an exchange agreement with Fred Facilitator, a QI, under which Xavier retains Fred to facilitate an exchange of Blackacre. On September 22, 2004, pursuant to the agreement, Xavier transfers Blackacre to Fred, who then transfers it to Barry for $100,000 in cash. On that date Xavier has a *bona fide* intent to enter into a deferred exchange. The exchange agreement provides that Xavier has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by Fred until the earlier of the date the replacement property is delivered to Xavier or the end of the exchange period. On March 11, 2005, Fred acquires replacement property having a fair market value of $80,000 and delivers it, along with the remaining $20,000 from the transfer of Blackacre to Xavier.

Xavier recognizes gain to the extent of the $20,000 cash he receives in the exchange.[61] Any agency relationship between Xavier Xchanger and Fred Facilitator is disregarded for purposes of §453 and Regs. §15a.453-1(b)(3)(i) in determining whether Xavier is in receipt of payment.[62] Accordingly, Xavier is not treated as having received payment on September 22, 2004, on Fred's receipt of payment from Barry Buyer for the relinquished property. Instead, Xavier is treated as receiving payment on March 11, 2005, on receipt of the $20,000 in cash from Fred. Subject to the other requirements of §§453 and 453A, Xavier may report the $20,000 gain in 2005 under the installment method.

Example 2: The facts are the same as in Example 1 except for the following.[63] Xavier Xchanger transfers Blackacre to Fred Facilitator on December 1, 2004. The exchange agreement provides that Xavier Xchanger has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by Fred Facilitator until the earliest of (1) the end of the identification period if Xavier has not identified replacement property; (2) the date the replacement property is delivered to Xavier; or (3) the end of the exchange period. Although Xavier has a *bona fide* intent to enter into a deferred exchange at the beginning of the exchange period, Xavier does not identify or acquire any replacement property. In 2005, at the end of the 45-day identification period, Fred delivers the entire $100,000 from the sale of Blackacre to Xavier.

Here, Xavier Xchanger realizes gain to the extent of the amount realized ($100,000) over Blackacre's adjusted basis ($60,000), or $40,000.[64] Because Xavier has a *bona fide* intent at the beginning of the exchange period to enter into a deferred exchange, Fred is not considered Xavier's agent, even though Xavier fails to acquire replacement property.[65] Furthermore, Fred is a QI even though Fred does not acquire and transfer replacement property to Xavier.[66] Thus, any agency relationship between Xavier and Fred is disregarded for purposes of §453 and Regs. §15a.453-1(b)(3)(i) in determining whether Xavier is in receipt of payment. Accordingly, Xavier is not treated as having received payment for the relinquished property on December 1, 2004, on Fred's receipt of payment from Barry Buyer. Instead, Xavier is treated as receiving payment at the end of the identification period in 2005 on receipt of the $100,000 in cash from Fred. Subject to the other requirements of §§453 and 453A, Xavier may report the $40,000 gain in 2005 under the installment method.

Example 3: The facts are the same as in Example 1 except for the following.[67] Instead of paying $100,000 in cash, Barry Buyer pays $80,000 in cash and issues a 10-year installment obligation for $20,000. Barry's obligation bears adequate stated interest and is not payable on demand or readily tradable.

The $20,000 of Xavier Xchanger's gain (i.e., the amount of the installment obligation Xavier receives in the exchange) does not qualify for non-recognition.[68] Xavier's receipt of Barry Buyer's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of §453 and Regs. §15a.453-1(b)(3)(i) in determining whether Xavier is in receipt of payment.[69] Accordingly, Xavier's receipt of the obligation is not treated as a payment. Subject to the other requirements of §§453 and 453A, Xavier may report the $20,000 gain under the installment method on receiving payments from Barry on the obligation.

BUSTED 1031 EXCHANGE

Despite the best intentions, taxpayers routinely fail to complete §1031 exchanges. One reason for such missteps may be attributable to, or at least exacerbated by, the cottage industry spawned by §1031. Numerous exchange facilitators, intermediaries, escrow companies, and others of similar ilk utilize §1031 as their bread and butter; some are more cautious than others, but mistakes do occur.

This article does not focus on how a deferred exchange can fail, but rather on the implications of an exchange agreement which states that a seller must complete a structured sale if the parties fail to close in compliance with §1031. Moreover, the article considers whether a taxpayer who has not met the requirements of §1031 can defer gain under §453 by undertaking a transaction in a structured sale.[70]

Exchange Transaction

To illustrate how an installment sale may be useful in a failed deferred exchange, consider the following; referred to as the "Exchange Transaction" (1) the seller ("Seller") holds property held for productive use in a trade or business or for investment ("Property"), and wishes to exchange such Property for like-kind Property pursuant to §1031; (2) A buyer (the "Buyer") and Seller enter into a purchase contract, calling for the Buyer to purchase Seller's Property, and containing provisions requiring Buyer to accommodate Seller's desire to consummate a §1031 exchange; and (3) the Seller has a *bona fide* intent to enter into a §1031 exchange.

The Seller and the QI enter into an agreement (the "Exchange Agreement"), which provides that the QI agrees to acquire the Property from the Seller ("Relinquished Property"), to transfer the Relinquished Property to the Buyer, to acquire like-kind Property ("Replacement Property"), and to transfer the Replacement Property to the Seller. The Seller assigns to QI all of Seller's rights in and to the Relinquished Property, and all of Seller's rights in the contracts to be entered into between the Seller and the owner who holds title to the Replacement Property.

Among other provisions, the Exchange Agreement requires the Seller to identify Replacement Property within 45 days of the initial exchange ("Identification Period"). The Seller must identify the Replacement Property to the QI (and as required by pertinent Treasury regulations) before the end of the Identification Period. Once identified within the Identification Period, the Exchange Agreement allows Seller 180 days (from the date of the first exchange) to receive the identified Property ("Exchange Period").

Under the Exchange Agreement, the QI will sell the Relinquished Property, holding the sale proceeds until the QI purchases Replacement Property, which the QI will transfer to the Seller. If the sum of the aggregate cash consideration to be paid by the QI for the purchase of the Replacement Property exceeds the cash proceeds from the Relinquished Property, the Seller must provide the excess amount required to consummate the acquisition of the Replacement Property to the QI. While the QI holds the funds, the Seller can have no immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of any money or other property held by the QI.

The Exchange Agreement specifies that if the Exchange Transaction qualifies under §1031, but the Seller receives "boot," the QI and Seller are obligated to engage in a Structured Sale for the "boot," so that Seller has no right to receive any cash from the Exchange Transaction. Moreover, the Exchange Agreement provides that if the Exchange Transaction fails to qualify under §1031, the QI and Seller are obligated to engage in a Structured Sale. Thus, Seller has no right to receive in cash any portion of the funds held by the QI, even if the Exchange Period expires and no Replacement Property has been transferred to the Seller.

As part of the Exchange Agreement, the QI is obligated to make specified periodic payments for a stated number of years (collectively, the "Periodic Payments") if the requirements of §1031 are not met (such Periodic Payments being based on the entire consideration held by the QI), or if any boot will be transferred to Seller (in such event, the Periodic Payments being based on the amount of such boot). The Exchange Agreement contemplates first and foremost an exchange qualifying under §1031 between the QI and the Seller, and the Seller has a *bona fide* intent to effect such an exchange. If and only if such §1031 exchange cannot be completed, or if boot remains upon the conclusion thereof, the Seller intends that Periodic Payments thereafter received pursuant to the Exchange Agreement will qualify for installment sale reporting under §453. The Exchange Agreement provides that the QI enters into an installment sale agreement with the Seller with a note ("Installment Note"), specifying the Periodic Payments.

The Installment Note forbids Seller from transferring, selling, assigning, pledging or encumbering its rights to receive future payments. Any attempt by Seller to transfer, sell, assign, pledge or encumber its rights to future payments is void. Assuming the Structured Sale qualifies as an installment sale under §453, the Seller will report the Periodic Payments as income as he receives them.

Once it is clear that there is boot on the exchange, or once it is clear that the §1031 exchange fails in its entirety because no Property has been identified before the expiration of the Identification Period, or no Replacement Property has been acquired before the expiration of the Replacement Period, the QI will assign its obligations to make Periodic Payments under the Installment Note to an assignment company ("Assignment Company"), which will accept such assignment and agree to make the Periodic Payments (the "Assignment"). The Assignment is made under an Assignment Agreement between the QI and the Assignment Company, and the Seller is not a party.

Under the Assignment Agreement, the QI transfers a lump sum to the Assignment Company, representing the discounted value of the stream of payments QI is obligated to make under the Installment Note and Exchange Agreement. In return, Assignment

Company assumes QI's payment obligations to Seller. Thus, Assignment Company becomes an obligor under the Installment Note.

QI and Assignment Company negotiate the amount of the lump-sum payment specified in the Assignment Agreement based on prevailing discount rates and other factors. Assignment Company may (but, depending upon which Assignment Company is involved, may not be obligated to) purchase an annuity contract from an insurance company ("Insurance Company"). If Assignment Company purchases such an annuity, it will name Assignment Company as purchaser and Seller as beneficiary.

After the Assignment, Assignment Company will make all remaining Periodic Payments required under the Installment Note. Once Seller is informed of the Assignment, Seller will look to Assignment Company as the primary source of Periodic Payments.

Installment Note Issued by QI, Not Buyer

In the structured sale, the Seller must either accept Replacement Property under §1031, and/or agree to accept an Installment Note at the beginning of the Exchange Transaction. Indeed, at the inception of the transaction, the Seller is prohibited from receiving cash, and is obligated to receive Periodic Payments if the §1031 exchange is not possible, or if the §1031 exchange includes boot (in the latter event, the Periodic Payments being for such boot). Moreover, the Seller has a *bona fide* intent to enter into a deferred exchange. However, unlike Example 4 of Regs. §1.1031(k)-1(j)(vi), the Installment Note is not issued by the Buyer, but is issued by the QI.

The issuance of the Installment Note by the QI may raise concerns of constructive receipt. For example, the QI is not treated as the agent of the taxpayer for §453 purposes; however, that treatment ceases to apply at the earlier of (i) the end of the Identification Period or Replacement Period, or (ii) the time the taxpayer has an unrestricted right to receive, pledge, borrow or otherwise obtain the benefit of money or other property held by the QI.[71] If the QI waits until after the end of the exchange period to distribute an installment note, the non-agency rules may at that point no longer apply. In this event, the taxpayer could be deemed to be in constructive receipt of the cash then held by the QI.

This may present a catch-22. If the QI promises to issue an installment note to the taxpayer prior to the end of the Replacement Period (e.g., day 179 or 180), then (i) the seller may fall outside the QI safe harbor, because the exchange agreement violates the general "(g)(6)" requirements, and (ii) the non-agency §453 rule may not apply at the time of distribution because the taxpayer may arguably have "obtained the benefit of" the cash held by the QI (i.e., it is only because the QI is holding the Buyer's cash that the QI is able to issue a note).

However, this catch-22 risk should not materialize. Indeed, at the beginning of the Exchange Transaction, the Seller agrees to receive solely Periodic Payments for any boot. Furthermore, also at the beginning of the Exchange Transaction, the Seller agrees that if the deferred exchange cannot be completed, it will only receive Periodic Payments for the entire amount. At the time the Seller enters into the Exchange Agreement, the QI is not the Seller's agent pursuant to the safe harbor. The Seller is bound by the Exchange Agreement, just as he would be bound by any other contract with a third party.

Moreover, in no event does the Seller ever have access to cash in the Exchange Transaction, nor the benefit of cash. The Seller has no right to pledge, borrow against or otherwise derive benefits from the funds held by the QI. In fact, any violations of these provisions would presumably constitute a breach of contract between the parties. Under any of the doctrines and agency principles addressed above, the restrictions imposed by the Exchange Agreement, which is signed by the Seller and the QI, constitute persuasive arguments against the application of the constructive receipt doctrine.

Bona Fide Intent and the Exchange Agreement

The Seller enters the Exchange Agreement with the intent to effectuate a tax-free exchange qualifying under §1031, and if it fails, to consummate a Structured Sale. Presumably, this contingency does not negate the Seller's *bona fide* intent to effect a §1031 exchange. In fact, the execution of the Exchange Agreement provides evidence of Seller's intent to engage in the exchange.

Moreover, Seller's use of the QI in the Exchange Transaction also provides evidence that the parties had the requisite intent for the exchange. The language in the Exchange Agreement that provides for an installment sale (as a default) should not be construed as changing the primacy of the Seller's intent when he enters into the transaction.

The premise of the Exchange Transaction is a §1031 exchange, and an installment sale only if the §1031 exchange fails or if there is boot, and in the latter event, the installment sale only up to the amount of such boot. The premise of a regular §1031 exchange is a §1031 exchange, and if it fails, a cash transaction to the Seller. The sole difference between these two is the result prevailing if the §1031 exchange fails. It is difficult to see how a cash transaction (the result if a regular §1031 exchange fails) should be viewed as more of a significant event bearing on the Seller's *bona fide* intent to effect an exchange than the alternative of an installment sale.

Plainly, the possibility that a regular §1031 exchange may fail does not spoil or disqualify a §1031 exchange.[72] Of course, there must be a *bona fide* intent to effect an exchange. As stated in *Smalley*, however, if the taxpayer had a *bona fide* intent to carry out a like-kind exchange at the beginning of the Exchange Period, the fact that he failed to complete the exchange does not necessarily mean that the Seller failed to have the requisite intent.

In the Exchange Transaction, the Exchange Agreement specifies that the Seller intends to carry out the exchange. It could be argued that the Seller's intent is weakened by the provisions in the Exchange Agreement calling for the Seller and QI to carry out an installment sale if the §1031 exchange fails. However, the installment sale here does not appear to be elective on the part of the Seller.

Rather than receiving cash upon the failure of the §1031 exchange, the Seller enters (at the outset of the Exchange Transaction) the binding commitment that, rather than receiving cash if the §1031 transaction fails, the Seller *must* receive an installment note. In executing the Exchange Agreement with such provisions, the Seller is parting with substantial legal rights. There are elements of the Exchange Transaction that are within the control of the Seller, including what property to designate, and once designated, the terms and conditions under which to close on the Replacement Property (including the results of the title reports and physical inspections). Yet, these elements are arguably present in *any* §1031 exchange.

Other Doctrines

The cash equivalency doctrine (which is similar to constructive receipt) focuses primarily on deferred payment obligations the taxpayer can readily discount. In an Exchange Transaction, the Seller cannot convert the annuity into cash, and has no rights to the annuity. The Seller is not even a party to the transaction between the Buyer and the Assignment Company. The documents forbid the Seller from transferring, assigning, selling or encumbering rights to future payments.

In fact, any attempt by a Seller to sell, transfer or assign his rights to future payments is void. On the surface, this would seem to preclude application of the cash equivalency doctrine. An Exchange Transaction merely adds another obligor to the mix. The only uncertainty when the Seller signs sale documents is whether the Seller will eventually end up with like-kind property or with an installment note.[73]

Another tax doctrine worthy of note is the economic benefit doctrine. It is triggered when money or property has been transferred to an arrangement (such as a trust) for the sole economic benefit of the taxpayer, even if the money is not necessarily available at any time. Fortunately, the authorities contain no suggestion that the Exchange Transaction would run afoul of the economic benefit doctrine.[74] The Seller is not a party to the transaction between the third party and the Buyer, and the Seller has no rights in the annuity. Adding an attempted §1031 exchange into the mix, which turns out to fail, and then by contract reverts to an Exchange Transaction should not affect the application of the economic benefit doctrine.

CONCLUSION

The growth of the §1031 exchange industry speaks volumes for the tax benefits of exchanges, and perhaps for the fascination taxpayers have for rolling their gain into replacement property. Still, undertaking a §1031 exchange can generate enormous pressure for a taxpayer. Given that most people believe real estate is not fungible, taxpayers face a daunting task when seeking to locate replacement property. Actually closing on replacement property while keeping one eye on the ticking clock can prove troublesome.

Every taxpayer choosing to undertake a §1031 exchange presumably expects to obtain new property while simultaneously deferring tax. In the event replacement property is not acquired, taxpayers can find themselves with unanticipated cash and a current tax bill. In this unforeseen, but all too frequent scenario, an Exchange Transaction may provide relief.

Although a taxpayer would not obtain the complete deferral benefits provided by a §1031 exchange, an Exchange Transaction would allow the Seller to report gain on the sale of his property over time as payments are received. Moreover, given that a taxpayer started the transaction wanting to exchange property, it is likely that he does not want or need cash currently. Thus, an Exchange Transaction may be appropriate.

There may be refinements in this proposed template, and practitioners and taxpayers should tread carefully. The documents are likely to be key to successfully navigating a transaction from an unsuccessful §1031 exchange to a successful Exchange Transaction. However, if my thoughts are correct, they suggest that careful up-front planning may shield taxes that otherwise would become due upon a failed §1031 exchange.

Footnotes

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[1]For the definition of a structured sale, see Wood, "Structured Installment Sales as a Backup to §1031 Exchange," 48 *Tax Mgmt. Memo.* 91 (3/19/07).

[2]Unless otherwise noted, all references in this article to sections refer to the Internal Revenue Code of 1986 and the regulations promulgated thereunder, as amended and in

effect at the relevant time (and referred to as the "Code").

[3]*See* Wood, "Structured Installment Sales as a Backup to §1031 Exchange," 48 *Tax Mgmt. Memo.* 91 (3/19/07).

[4]"Boot" refers to money or other property in a tax-free exchange. *See* Regs. §1.1031(b)-1.

[5]§1031(a)(1).

[6]*Id.*

[7]Regs. §§1.1031(a)-1(c), 1.1031(e)-1.

[8]§1031(a)(2).

[9]§1031(a)(2).

[10]§1031(a)(1).

[11]§1031(a)(3)(A).

[12]Regs. §1.1031(k)-1(c)(4)(i)(A).

[13]Regs. §1.1031(k)-1(c)(4)(i)(B).

[14]§1031(a)(3)(B)(i).

[15]§1031(a)(3)(B)(ii).

[16]§1031(a)(3).

[17]Regs. §1.1031(k)-1(g)(4).

[18]Regs. §1.1031(k)-1(g)(3).

[19]*Id.*

[20]Regs. §1.1031(k)-1(f)(2).

[21]Regs. §1.1031(k)-1(g)(6).

[22]*See* Rev. Proc. 2000-37, 2000-40 I.R.B. 308, *as modified by* Rev. Proc. 2004-51, 2004-33 I.R.B. 294.

[23]§1031(b).

[24]A detailed review of §453 is beyond the scope of this article. One rule of §453 worth mentioning here is that installment sale reporting is mandatory if the other requirements of §453 are met. Taxpayers can elect out of installment sale reporting. Without an affirmative act by the taxpayer to opt out of installment sale treatment, the general rule requires installment sale reporting. §453(d).

[25]§453(b)(1).

[26]1965-1 C.B. 356.

[27] 1953-1 C.B. 83.

[28] June 6, 1988.

[29] Regs. §1.1031(k)-1(j)(vi), Ex. 4.

[30] *See* Regs. §1.1031(k)-1(j)(2)(vi), Ex. 4. Note that Example 4 portrays the taxpayer as receiving the replacement property in the tax year after transferring the relinquished property (though still within the 180-day window). The regulations suggest (but do not expressly state) that the same result would be achieved when the taxpayer transfers the relinquished property and receives the replacement property and installment note within the same tax year.

[31] Regs. §1.1031(k)-1(j)(1).

[32] Regs. §15a.453-1(b)(3)(i).

[33] *See* Regs. §1.451-2(a).

[34] *See* PLR 7927001; *Comr. v. Tyler*, 28 B.T.A. 367 (1933).

[35] See *Rossi v. Comr.*, 41 B.T.A 734, 738 (1940); *Best v. Comr.*, 26 B.T.A. 1070 (1932), *acq.*, 1933-1 C.B. 2 (1933).

[36] *See Roberts v. Comr.,* 643 F.2d 654, 656 (9th Cir. 1981).

[37] *See* Regs. §15a.453-1(b)(3)(i).

[38] *See* Regs. §§1.1031(k)-1(g)(3), (4), and T.D. 8535 (Jan. 1994).

[39] *See* Regs. §§1.1031(k)-1(j)(2)(ii), (g)(4).

[40] *See* generally PLR 200327039 (Mar. 27, 2003).

[41] *See Stiles v. Comr.*, 69 T.C. 558, 563 (1978).

[42] Regs. §1.1031(k)-1(j)(2)(vi), Ex. 2.

[43] Regs. §1.1031(k)-1(j)(2)(i), (ii).

[44] Regs. §1.1031(k)-1(j)(2)(ii).

[45] Regs. §1.1031(k)-1(j)(2)(vi), Ex. 2. *See also Smalley v. Comr.*, 116 T.C. 450, 458 (2001).

[46] Regs. §1.1031(k)-1(j)(2)(iv).

[47] *Id.*

[48] 116 T.C. 450 (2001).

[49] *Id.* at 460.

[50] *Id.* at 464.

[51] *See* Regs. §1.1031(k)-1(j)(2)(iv).

[52]753 F.2d 1490 (9th Cir. 1985). In *Magneson*, the Ninth Circuit ruled in favor of the taxpayer. However, courts outside the Ninth Circuit may not apply the same reasoning as in *Magneson*.

[53]*Id.* at 1496.

[54]*Id.* at 1497.

[55]81 T.C. 782 (1983), *aff'd*, 760 F.2d 1039 (9th Cir. 1985). In *Bolker*, the Ninth Circuit ruled in favor of the taxpayer. However, courts outside the Ninth Circuit may not apply the same reasoning as in *Bolker*.

[56]81 T.C. at 798.

[57]Regs. §1.1031(k)-1(j)(2)(vi), Exs. 5 and 6.

[58]*Id.*

[59]T.D. 8535.

[60]*See* Regs. §1.1031(k)-1(j)(2)(vi), Ex. 2.

[61]§1031(b).

[62]Regs. §1.1031(k)-1(j)(2)(ii).

[63]*See* Regs. §1.1031(k)-1(j)(2)(vi), Ex. 3.

[64]§1001.

[65]Regs. §1.1031(k)-1(j)(2)(ii), (iv).

[66]Regs. §1.1031(k)-1(j)(2)(ii).

[67]*See* Regs. §1.1031(k)-1(j)(2)(vi), Ex. 4.

[68]§1031(b).

[69]Regs. §1.1031(k)-1(j)(2)(iii).

[70]*See* Wood, "Breathing Life into Installment Sales," 108 *Tax Notes* No. 3, 201 (7/11/05).

[71]Regs. §1031(k)-1(j)(2)(ii).

[72]*See, e.g., Smalley v. Comr.*, 116 T.C. 450 (2001).

[73]*See Reed v. Comr.*, 723 F.2d 138 (1st Cir. 1983).

[74]*Sproull v. Comr.*, 16 T.C. 244 (1951); Rev. Rul. 60-31, 1960-1 C.B. 174.