Tax Management Memorandum

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MEMORANDUM

Structured Installment Sales as a Backup to §1031 Exchange

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I.R.C. §1031.

INTRODUCTION

Years ago, my generation was accustomed to hearing, "it's a bird, it's a plane, it's Superman." And just like that, Superman would come to the rescue of some poor schnook who got himself into a jam. Sometimes bad guys were involved. Other times it was only hubris. Often, there was Lois Lane to consider. Superman frequently had to save people from potentially lethal situations. Yet, no matter what the cause or the potentially bleak outcome, Superman could fix everything.

In the grownup world, man's appeal remains strong. Just ask Jerry Seinfeld, whose character recites Superman dialogue (and reenacts heroic rescues) during numerous episodes of the eponymous sitcom. In the world of tax grownups, the need for rescue is often palpable. Clients often want their tax professionals to have supernatural powers in securing tax results. Of course, tax professionals know all too well that we possess no special powers. Post BOSS, Son of BOSS, FLIP, and OPIS, if it looks too good to be true, it probably is. If the tax public were more familiar with this mantra, many of the current spate of shelter cases could probably be resolved more amicably.

Although tax professionals possess only ordinary powers, there is one area where clients might think we possess superpowers. I am talking about a possible cure to a busted §1031[1] deferred exchange. Everyone knows that §1031 allows taxpayers to defer tax on the exchange of like-kind property, assuming certain requirements are met. When taxpayers do not meet the requirements of §1031, a tax-deferred like-kind exchange becomes taxable.

This can happen, for example, when a qualified intermediary receives real estate sales proceeds from the buyer of the relinquished property, but the taxpayer does not identify or close on replacement property within the time constraints imposed by §1031. Of course, there may be other reasons why a §1031 exchange goes awry. This article discusses §1031 exchanges, how they are supposed to work in theory, how they can fail, and how they interact with the installment sale rules of §453. Then, the article proposes a potential rescue to a busted §1031 exchange: the structured sale.

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. Its rationale is similar to §351 and other non-recognition provisions, in that the taxpayer is not cashing out of his investment, but merely 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.[2] Thus, a taxpayer generally cannot receive "sales proceeds" from the buyer. Second, the property exchanged and the property received must be of like-kind.[3] Generally speaking, the exchange of real property for real property works, but the exchange of a female cow for a male bull does not.[4] Notably, some kinds of property, even if like-kind, do not qualify for the benefits of §1031.[5] These include stocks, bonds, notes, partnerships interests, etc.[6] Third, the property exchanged and the property received must both be held for productive use in a trade or business or for investment.[7] 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.[8] As a general rule, a taxpayer can identify up to three properties.[9] 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.[10]

Once identified, the taxpayer has 180 days (from the date of the first exchange) to receive the identified property.[11] This 180 day period can be shortened by the due date of the taxpayer's return.[12] Given that this tax return rule includes extensions, and taxpayers typically can get an automatic extension for several months, probably the only effect of this time-shortening rule is to ensure that taxpayers extend the due date for filing their returns. Nonetheless, as is discussed 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) type 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 X who owns a large truck. X's business is downsizing, and X needs more vans than trucks. It does not take too much imagination to see that a simultaneous exchange, while simple, can pose challenges in locating suitable trading partners. For obvious reasons, the problematic 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.[13] These temporal requirements prevent the taxpayer from deferring the choice of which replacement property to receive. Without this rule, a taxpayer could wait years before making a decision, potentially accruing interest tax-free on funds held by others.

The regulations provide a safe harbor for taxpayers assigning relinquished property in a deferred exchange to a qualified intermediary (QI)[14], a qualified escrow (QE) account,[15] or a qualified trust (QT).[16] 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.[17] 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.[18]

A third type of exchange is called the reverse exchange. Although reverse exchanges are not the focus of this article, they deserve brief mention. A reverse exchange is essentially the opposite of a deferred exchange.[19] 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 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. (Contrast that to a deferred exchange where the onus is on the taxpayer to buy replacement property within 180 days.)

INSTALLMENT SALES

Setting aside the basics of §1031 exchanges, we now look at installment sales, something that on the surface has little to do with §1031. Section 453 generally requires that if a taxpayer disposes of property and receives one or more payments in a later year, the taxpayer's profit on the sale is included in income proportionally as payments are received.[20] In this manner, a taxpayer can defer tax on the sale of property.

Section 453 (as well as its accompanying sections, §§453A and 453B) can be complex, and it contains numerous rules that taxpayers must meet prior to a sale qualifying for installment sale reporting. 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.[21] As we'll see, the mandatory nature of installment sale reporting facilitates the cross-over rules between §§453 and 1031.

DEFERRED EXCHANGE AND INSTALLMENT SALE OVERLAP

Deferred exchanges offer taxpayers flexibility in that 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 received 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. Perhaps the simplest case of this would be a transaction where the replacement property has a smaller value than the relinquished property.

> *Example:* Suppose a taxpayer transfers a building worth $100 to a QI on September 22, 2006. On the same day, the QI sells the building to a buyer for $100 cash. On March 11, 2007, the QI purchases a replacement building for $80, and transfers the replacement building along with $20 to the taxpayer.[22]

When transactions overlap between a §1031 exchange and a §453 installment sale, §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."[23] The §1031 regulations contain specific rules for coordinating the determination of gain or loss for deferred exchanges under the exchange rules of §1031 and under the installment sale rules of §453. The §453 regulations for the most part defer to the regulations under §1031.[24]

When a transaction overlaps these two Code sections, constructive receipt questions arise. 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 a QE and a 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.

Section 453 expressly adopts constructive receipt concepts, providing that payments include amounts actually or constructively received in the taxable year.[25] To resolve these constructive receipt questions, 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.[26] Moreover, the §1031 regulations also state that the QI is not the taxpayer's agent for purposes of the deferred exchange rules.[27] In the case of a QE or QT, the §1031 regulations generally provide that whether a taxpayer has received payment for purposes of §453 is determined without regard to the fact that the transferee's obligation to convey replacement property to the taxpayer is secured by cash (or cash equivalent), if the cash (or cash equivalent) is held in a QE account or QT.[28]

Constructive receipt issues do not kick in to tax amounts transferred to a QI to pursue a §1031 exchange, and they also should not prevent a taxpayer from recognizing gain pursuant to the installment sale rules of §453. Besides 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.[29] Once a taxpayer obtains these powers, constructive receipt exists for purposes of §1031. In other words, the QI, QE, or QT is essentially disregarded for purposes of §453 until the time the safe harbor coordination rules would otherwise cease to apply, or the end of the exchange period.

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.[30] This rule leads to perhaps the simplest case where the installment sale rules overlap with the deferred exchange rules: the failed deferred exchange that crosses 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.[31]

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.[32] 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."[33] Examples in the regulations suggest that the *bona fide* intent requirement may be met when a board of directors authorizes a like-kind exchange.[34] 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.[35]

EXAMPLES

The interaction of §§1031 and 453, and the issues concerning constructive receipt, time

limitations, and *bona fide* intent hopefully can be clarified by reviewing a few examples.

Example 1: Xavier Xchanger owns Blackacre, a parcel of real property.[36] 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, 2005, 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, 2006, 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.[37] 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.[38] Accordingly, Xavier is not treated as having received payment on September 22, 2005, on Fred's receipt of payment from Barry Buyer for the relinquished property. Instead, Xavier is treated as receiving payment on March 11, 2006, 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 2006 under the installment method.

Example 2: The facts are the same as in Example 1 except for the following.[39] Xavier Xchanger transfers Blackacre to Fred Facilitator on December 1, 2005. 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 2006, 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.[40] 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.[41] Furthermore, Fred is a QI even though Fred does not acquire and transfer replacement property to Xavier.[42] 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, 2005, on Fred's receipt of payment from Barry Buyer. Instead, Xavier is treated as receiving payment at the end of the identification period in 2006 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 2006 under the installment method.

Example 3: The facts are the same as in Example 1 except for the following.[43] 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.[44] 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.[45] 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

With so many moving parts, it is no wonder that taxpayers routinely botch §1031 exchanges. Moreover, one reason for such missteps may be because, or at least exacerbated because, of the cottage industry spawned by §1031. There are numerous exchange facilitators, intermediaries, escrow companies, and others of similar ilk who utilize §1031 as their bread and butter; some are more cautious than others, but mistakes do occur.

Given the limited scope of this article, I focus exclusively on botches of deferred exchanges. In particular, I discuss taxpayers who fail to meet the 45-day identification period and/or the 180-day closing period. As a reminder, to achieve tax deferral under §1031 when undertaking a deferred exchange, a taxpayer must identify the replacement property within 45 days and actually must receive the replacement property with 180 days.

If the taxpayer is not able to comply with both the 45-day and 180-day requirements, a taxpayer cannot rely on §1031 to provide tax deferral. However, a question arises whether the taxpayer could then rely on *another* Code section to defer gain. Even though the Code and regulations allow a taxpayer undertaking a §1031 deferred exchange to treat a portion of the proceeds as an installment sale, if the §1031 requirements are not met initially, could the sales proceeds held by a QI, QE, or QT somehow be treated as an installment sale?

This article considers whether a taxpayer who has not met the requirements of §1031 can defer gain under §453 by undertaking a transaction called a structured sale.[46]

STRUCTURED SALE PRIMER

A structured sale is an offshoot of an installment sale. In a structured sale, a buyer of property in an installment sale assigns his payment obligation to a third party. This third party has greater financial strength than the buyer, and thus provides more practical safeguards for payment to the seller. Significantly, the terms of the note the buyer gives to the seller remain unchanged.

The details of a structured sale are simple. The buyer arranges to buy assets from the seller in an installment sale. The installment sale agreement obligates the buyer to make specified periodic payments for a stated number of years. The buyer may (or may not) make a down payment in the year of sale. The buyer gives the seller a note for the remaining purchase price. The buyer's obligation and note are personal to the buyer, and it may (or may not) be secured by the purchased assets. So far, this is merely an installment sale under §453, entitling the seller to report the payments as he receives them.

Yet, as the structured sale moniker suggests, here is where a "structure" is contemplated. After the sale, the buyer assigns his obligation to make payments on the note to an assignment company. This is accomplished by the buyer transferring a lump sum representing the discounted value of the stream of payments due under the installment

sale agreement. In return, the assignment company agrees to assume the buyer's payment obligations to the seller. This assignment transaction is between the buyer and the assignment company, and the installment seller is not a party.

After the assignment company accepts the assignment, it typically will purchase an annuity contract from a related life insurance company. This annuity will provide for all of the periodic payments required by the original installment agreement. Indeed, the life insurance company may make payments directly to the seller, solely for the convenience of the assignment company and the buyer.

Even though the buyer has assigned his obligation to make periodic payments, all terms of the installment agreement between the buyer and seller continue to apply, including any pledges of collateral. Once the seller is informed of the assignment, the seller will look to the assignment company as the primary source of payments. The issuing life insurance company often guarantees that it will pay all periodic payments coming due if it receives notice that the assignment company fails to pay.

BACKUP PLAN

Now that we've reviewed structured sale basics, let us return to the question whether a structured sale can rescue a taxpayer that has failed to meet the requirements of a §1031 exchange. Suppose a taxpayer transfers his relinquished property to a QI which then sells it. Despite the best of intentions, the taxpayer fails to identify replacement property within 45 days. Alternatively, perhaps the taxpayer duly designates within the 45-day window, but fails to receive replacement property within 180 days.

Can our taxpayer change his §1031 exchange midstream to become a structured sale? This is a complicated question, and there are many hurdles to leap before a busted §1031 deferred exchange can be considered to be a structured sale. Of course, it helps that a stand-alone structured sale appears to work under general tax principles of constructive receipt and economic benefit.[47]

However, can a structured sale save a busted deferred exchange that would not qualify for deferral under §1031? There appear to be two methods by which a structured sale might come to the rescue of a failed §1031 exchange, and each is worthy of discussion. First, the deferred exchange documents could provide for a structured sale. Second, the structured sale could be invoked outside of the transaction documents.

Ideally, of course, the structured sale would formally be made part of the deal documents. Still, it is curious to think how the structured sale could be woven into the fabric of the deal. Perhaps a clause in the contract could provide that if the replacement property is not identified by day 44 (or perhaps day 45), or if the replacement property is not received by day 179 (or perhaps day 180), then the QI would give the taxpayer a note in the amount of the proceeds from the sale of the relinquished property.

Thereafter, the contract could require the QI to transfer the funds to a third party assignment company in return for the assignment company accepting the responsibility to pay the note. Even if the contract does not expressly provide for the structured sale, perhaps it is possible for the structured sale still to be invoked.

CONSTRUCTIVE RECEIPT

Since the concept of constructive receipt is so important to §1031, it should come as no surprise that the §1031 regulations contain a separate discussion of it. The §1031 regulations provide that as a general rule:

> The taxpayer is in constructive receipt of money or property at

> the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given.[48]

For example, if a corporation credits its employees with bonus stock, but the stock is not available until some future date, a mere crediting of amounts on the corporate books does not constitute receipt.[49] Furthermore, the regulations provide that the taxpayer is not in constructive receipt if there are substantial limitations or restrictions on the taxpayer's control of the property.[50] Actual or constructive receipt by an agent of the taxpayer is actual or constructive receipt by the taxpayer.[51] In short, the constructive receipt doctrine prohibits taxpayers from deliberately turning their backs on income and selecting the year in which they want to receive (and report) the income.

Under the deferred exchange safe harbor, the application of the constructive receipt doctrine is limited. As noted earlier, a taxpayer is not in constructive receipt of funds held by a QI in a deferred exchange, since the QI is not an agent of the taxpayer.[52] This suggests that the QI would want to assign the funds to the assignment company prior to the expiration of the safe harbor. The safe harbor terminates at the end of the exchange period, or earlier if the taxpayer obtains an immediate ability or unrestricted right to receive, borrow or otherwise obtains the benefits of the property held by the QI.[53] Of course, this raises the question whether such an assignment could be viewed as the taxpayer obtaining the "benefit" of the funds, but there is little authority that sheds any light on the meaning of that term as used in the safe harbor.[54]

Once a transaction fails to meet the §1031 safe harbor, the special constructive receipt rules found therein no longer apply.[55] It would seem likely in such a situation that general constructive receipt rules would apply. Of course, under traditional constructive receipt principles, if payments are not credited to a claimant's account, set apart for him or otherwise made available so he may draw upon the settlement at any time, there should be no constructive receipt.

General constructive receipt rules seem not to ensnare the structured sale. If a buyer assigns an obligation to pay periodic payments to a third party in an independent transaction, the seller should not be deemed to have constructively received the sale proceeds, and should not have to accelerate his gain. The regulations define when income is constructively received by a taxpayer, but they do not suggest that rights under security instruments that protect installment sales trigger constructive receipt.[56] Indeed, the Installment Sales Revision Act of 1980 allowed for security instruments (such as a note or a standby letter of credit), giving them specific exemption from constructive receipt concerns. A security instrument merely ensures funds for the seller if the buyer or third party defaults.

If a §1031 deferred exchange fails and the QI assigns the sale proceeds to a third party assignment company, one might query whether the QI and the buyer could (or should) be viewed as having a buyer and seller relationship, as in a structured sale. Immediately prior to the assignment, the QI would be holding the funds from the sale. As soon as the deferred exchange safe harbor ceases to apply (i.e., when we know the exchange is busted), the QI would probably be considered the taxpayer's agent.

This suggests that assignments made after the loss of the safe harbor could be problematic. But, if the documents require the QI to proceed with the §1031 exchange, and only on its failure to then transfer the held funds to a designated assignment company (and *not* to the seller/taxpayer), how can the seller/taxpayer be deemed to be in

receipt of those funds?

Perhaps the IRS could argue that in such a case the QI should be considered to be the taxpayer's agent from the beginning if the §1031 exchange ultimately fails. The regulations define a QI as a person who, as required by the exchange agreement, acquires relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property and transfers the replacement property to the taxpayer.[57] Standing alone, this suggests that if all of the transaction steps are *not* completed, a QI would be the taxpayer's agent.

Yet, this ostensible retroactive loss of QI status (and retroactive creation of an agency relationship) seems not to occur. The regulations expressly provide that in the context of an overlap between §§1031 and 453, a QI will be treated as QI even though the QI ultimately fails to acquire identified replacement property and transfer it to the taxpayer.[58] Furthermore, a QI will likely retain his QI status even if no replacement property is identified.[59]

An example in the regulations -- which is discussed in detail above as Example 2 -- seems to confirm these conclusions.[60] Therein, the taxpayer transfers property to a QI, who then sells the property. The taxpayer, however, does not identify or acquire replacement property, and at the end of the 45-day identification period, the QI transfers the sales proceeds to the taxpayer. Given that the transaction spans two tax years, the example concludes that the taxpayer may report the sale in year two upon receipt of the sale proceeds.

Although reporting sale proceeds in year two suggests the QI is not the taxpayer's agent, the example goes much further. Regarding §453, the example expressly states that "any agency relationship between [the taxpayer and the QI] is disregarded." For purposes of §1031, the example provides that the QI is still treated as a QI, even though no replacement property is acquired, and the regulations expressly provide that a QI is not the taxpayer's agent.[61]

OTHER DOCTRINES

The cash equivalency doctrine (which is similar to constructive receipt) focuses primarily on deferred payment obligations that the taxpayer can readily discount. In a structured sale, 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. A structured sale merely adds another obligor to the mix. Adding an attempted §1031 exchange as a precondition to the structured sale transaction would appear not affect the application of the cash equivalency doctrine.[62] After all, the only uncertainty when the taxpayer signs sale documents is whether the taxpayer will eventually end up with like-kind property or with an installment note.

Another tax doctrine worthy of mention 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 isn't necessarily available at any time. Fortunately, the authorities contain no suggestion that the structured sale would run afoul of the economic benefit doctrine.[63] 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 a structured sale, should not affect the application of the economic benefit doctrine.

BONA FIDE INTENT

The regulations require a taxpayer to have a *bona fide* intent to enter into a deferred exchange at the beginning of the exchange period.[64] This *bona fide* intent requirement could pose a challenge to the efficacy of the structured sale in serving as an effective backup to a §1031 exchange which goes awry. 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."[65]

Clearly, a taxpayer would need to ensure that on day one he has a bona fide intent to acquire replacement property. However, could a taxpayer have a *bona fide* intent to accomplish a §1031 exchange, and as a backup to do an installment sale only if the §1031 exchange fails?

CONCLUSION

The growth of the §1031 exchange industry speaks volumes for how advantageous exchanges can be. 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 purchasing replacement property while keeping one eye on the ticking clock can prove troublesome. When one considers these timing requirements along with all of the other §1031 requirements, it is no wonder that some §1031 exchanges are not successfully completed.

Every taxpayer undertaking a §1031 exchange expects to obtain new property while simultaneously deferring tax. In the event replacement property is not acquired, taxpayers typically find themselves with a mound of unanticipated cash and a current tax bill. In this unforeseen, but all too frequent scenario, a structured installment sale may provide relief.

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

Of course, practitioners and taxpayers should tread carefully in these unchartered waters. The documents are likely to be key to successfully navigating a transaction from an unsuccessful §1031 exchange to a successful structured sale. If I am right about this, some careful up-front planning may shield taxes that otherwise would become due on a failed §1031 exchange.

Footnotes

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[1]Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[2]§1031(a)(1).

[3]*Id.*

[4]Regs. §1.1031(a)-1(c), (e).

[5]§1031(a)(2).

[6]*Id.*

[7]§1031(a)(1).

[8]§1031(a)(3)(A).

[9]Regs. §1.1031(k)-1(c)(4)(i)(A).

[10]Regs. §1.1031(k)-1(c)(4)(i)(B).

[11]§1031(a)(3)(B)(i).

[12]§1031(a)(3)(B)(ii).

[13]§1031(a)(3).

[14]Regs. §1.1031(k)-1(g)(4).

[15]Regs. §1.1031(k)-1(g)(3).

[16]*Id.*

[17]Regs. §1.1031(k)-1(f)(2).

[18]Regs. §1.1031(k)-1(g)(6).

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

[20]§453(b)(1).

[21]§453(d).

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

[23]Regs. §1.1031(k)-1(j)(1).

[24]Regs. §15A.453-1(b)(3)(i).

[25]Regs. §15A.453-1(b)(3)(i).

[26]Regs. §1.1031(k)-1(j)(2)(ii).

[27]Regs. §1.1031(k)-1(g)(4).

[28]Regs. §1.1031(k)-1(j)(2)(i). *See also* Regs. §1.1031(k)-1(g)(3).

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

[30]Regs. §1.1031(k)-1(j)(2)(ii).

[31]Regs. §1.1031(k)-1(j)(2)(vi), *Ex. 3. See also Smalley v. Comr.*, 116 T.C. 450, 458 (2001).

[32]Regs. §1.1031(k)-1(j)(2)(iv).

[33]*Id.*

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

[35]*Id.*

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

[37]§1031(b).

[38]Regs. §1.1031(k)-1(j)(2)(ii).

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

[40]§1001.

[41]Regs. §1.1031(k)-1(j)(2)(ii) and (iv).

[42]Regs. §1.1031(k)-1(j)(2)(ii).

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

[44]§1031(b).

[45]Regs. §1.1031(k)-1(j)(2)(iii).

[46]*See* Wood, "Breathing Life into Installment Sales," Vol. 108, No. 3, *Tax Notes* 201 (July 11, 2005).

[47]*See* Wood, "Breathing Life into Installment Sales," Vol. 108, No. 3, *Tax Notes* 201 (July 11, 2005).

[48]Regs. §1.1031(k)-1(f)(2).

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

[50]Regs. §1.1031(k)-1(f)(2).

[51]*Id.*

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

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

[54]For example, in TAM 20013001, the transaction failed to qualify under the safe harbor because the exchange documents simply failed to include the required restriction on the taxpayer's rights to the proceeds of the relinquished property.

[55]Regs. §1.1031(k)-1(n).

[56]Regs. §1.451-2(a).

[57]Regs. §1.1031(k)-1(g)(4)(iii)(B).

[58]Regs. §1.1031(k)-1(j)(2)(ii).

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

[60]*Id.*

[61]Regs. §1.1031(k)-1(g)(4)(i).

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

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

[64]Regs. §1.1031(k)-1(j)(2)(iv).

[65]*Id.*