February 22, 2006

Show Me The Money:
New Rules Offered for Like-Kind Exchange Funds

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As like-kind exchanges continue to grow in number and size, many of the details involved are being focused upon with renewed energy. Some of the "nuts and bolts" are vital to the qualification of an exchange. Others go to minimizing taxable "boot" or relate to proper post-exchange tax reporting. New proposed regulations, actually "reproposed regulations," were just issued addressing one of these details.

Frequently, like-kind exchanges under Internal Revenue Code section 1031 occur in two stages, with the transfer of the relinquished property occurring up to six months before the acquisition of replacement property. This format is commonly called a "deferred exchange." The new proposed regulations provide rules regarding the taxation of "qualified escrow accounts," "qualified trusts," and other escrow accounts, trusts, or funds used during deferred exchanges of like-kind property.

Background

Code section 468B(g) provides that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax and that the Secretary shall prescribe regulations providing for the taxation of such accounts or funds.

In general, section 7872 of the Code recharacterizes a below-market loan (a loan in which the interest rate charged is less than the applicable federal rate (the "AFR"), a rate published monthly by the Internal Revenue Service) as an arm's-length transaction in which the lender makes a loan to the borrower at the AFR, coupled with imputed payments to the borrower sufficient to fund the additional interest that the borrower is treated as paying on that loan. The amount, timing and characterization of the imputed payments to the borrower under a below-market loan depend on the relationship between the borrower and the lender.

Regulations under section 1031 provide safe harbors that allow taxpayers engaging in deferred exchanges of like-kind property to avoid being determined to be in actual or constructive receipt of the proceeds from the sale of the taxpayers' relinquished property during the period between transfer of the relinquished property and acquisition of the replacement property. The proceeds may be held in a "qualified escrow account" or "qualified trust" or may be held by a "qualified intermediary."

The proposed regulations apply the same rules to all escrow accounts, trusts, and funds used during deferred exchanges. Additionally, the same rules apply equally in the context of exchanges that are intended to qualify as like-kind but fail to satisfy a requirement of section 1031. Therefore, these regulations propose to apply to "exchange funds," defined as the relinquished property (if held in kind), cash, or cash equivalent that secures an obligation of a transferee to transfer replacement property, or the proceeds from a transfer of relinquished property, held in a qualified escrow account, qualified trust, or other escrow account, trust, or fund during a deferred exchange. (The following discussion will focus on the typical case where a qualified intermediary is used.)

New Regime

The proposed regulations under section 468B, provide that exchange funds held by qualified intermediaries in connection with deferred like-kind exchanges are characterized either (1) as the taxpayer's funds or (2) as loans from the taxpayer to the qualified intermediary (or other exchange facilitator)

As a general rule, the proposed regulations provide that exchange funds are treated as loaned by a taxpayer to a qualified intermediary, and the qualified intermediary takes into account all items of income, deduction, and credit (including capital gains and losses). If, however, the exchange agreement with the qualified intermediary specifies that all the earnings attributable to exchange funds are payable to the taxpayer, the exchange funds are not treated as loaned from the taxpayer to the qualified intermediary, and the taxpayer takes into account all items of income, deduction and credit (including capital gains and losses). For purposes of determining whether all earnings attributable to exchange funds are payable to the taxpayer, payments from the exchange funds, or from the earnings attributable to the exchange funds, for the taxpayer's transactional expenses are treated as first paid to the taxpayer and then paid by the taxpayer to the recipient. Transactional expenses included the costs of land surveys, appraisals, title examinations, termite inspections, transfer taxes, and recording fees. A qualified intermediary's fee is a transactional expense only if the exchange agreement provides that (1) the amount of the fee payable to the qualified intermediary is fixed on or before the date of the transfer of the relinquished property by the taxpayer (either by stating the fee as a fixed dollar amount in the agreement or determining the fee by a formula, the result of which is known on or before the transfer of the relinquished property by the taxpayer), and (2) the amount of the fee is payable by the taxpayer regardless of whether the earnings attributable to the exchange funds are sufficient to pay the fee.

The proposed regulations provide special rules under section 7872 for the treatment of loans to qualified intermediaries in connection with a section 1031 deferred exchange, under which below-market qualified intermediary loans are treated as compensation-related loans. Therefore, the qualified intermediary is treated as paying interest on the "loan" and (to the extent that the qualified intermediary keeps the earnings on the exchange fund) the taxpayer is treated as paying those amounts back to the qualified intermediary as a fee. (The ramifications of this rule are illustrated in an example below.)

The proposed regulations provide an alternative rate (the 182-day rate) for qualified intermediary loans for purposes of section 7872. This rate is equal to the investment rate on a 182-day Treasury bill determined on the auction date that most closely precedes the date that the "loan" is made.[1]

A qualified intermediary loan may be excepted from the application of section 7872 only if the loan qualifies for the $10,000 *de minimis* exception in section 7872(c)(3) for compensation-related loans.

Example

(i) T enters into a deferred exchange with a qualified intermediary. The exchange agreement between T and the qualified intermediary provides that no earnings will be paid to T. The exchange funds held by the qualified intermediary pursuant to the exchange agreement are treated as loaned to the qualified intermediary. On January 1, 2006, T transfers property with a fair market value of $1,000,000 to the qualified intermediary. The qualified intermediary sells the property and deposits the $1,000,000 of proceeds in a money market account. On March 1, 2006, the qualified intermediary uses $1,000,000 of the funds in the account to purchase replacement property identified by T, and transfers the replacement property to T. The amount loaned for purposes of section 7872 is $1,000,000 and the loan is outstanding for two months. Assume that the 182-day rate under paragraph (a)(4) of this section is 1 percent, compounded semiannually.

(ii) The loan from T to the qualified intermediary is treated as a compensation-related demand loan. Because there is no interest payable on the loan from T to the qualified intermediary, the loan is a below-market loan under section 7872. Under section 7872, the forgone interest is $1,667 ($1,000,000 *1% * 2/12). The $1,667 is deemed transferred as compensation by T to the qualified intermediary and retransferred as interest by the qualified intermediary to T on March 1.

These rules are proposed to apply, in the case of section 468B, to transfers of property made by taxpayers and, in the case of section 7872, to qualified intermediary loans issued after the date the regulations are published as final regulations. However, a transition rule provides that, with respect to transfers of property made by taxpayers after August 16, 1986, but on or before the date these regulations are published as final regulations, the IRS will not challenge a reasonable, consistently applied method of taxation for income attributable to exchange funds.

Although this seems like a lot of fuss over a relatively minor aspect of a like-kind exchange, it is of major significance to qualified intermediaries who frequently earn most of their "fee" from the float on the exchange fund. Moreover, as the amounts being held in exchange accounts by qualified intermediaries continue to rise dramatically, the tax treatment of these amounts becomes increasingly significant. Perhaps the most important ramification of these rules for transferors of relinquished property arises in situations where the qualified intermediary retains some or all of the income generated by the exchange fund. In these cases, the proposed regulations impute an interest payment from the qualified intermediary to the taxpayer and then a fee payment from the taxpayer back to the qualified intermediary. The result is interest income to the taxpayer matched by an expenditure (the fee to the qualified intermediary) that is not deductible against ordinary income.

[1] This rate is based on semi-annual compounding and may be found at www.publicdebt.treas.gov.