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Deferred Exchanges
—IRS Issues Proposed Rules for Escrow and Settlement Funds

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Among the many provisions added to the Internal Revenue Code by the Tax Reform Act of 1986 was section 468B, which addresses the taxation of a "designated settlement fund" established to satisfy a tort liability. The 1986 Act also included a provision, since codified (with some modification) as section 468B(g), to the effect that "[n]othing 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." Section 468B(g) also directs the Treasury to issue regulations addressing the taxation of such accounts and funds.

Regulations regarding the taxation of a "qualified settlement fund," or "QSF," were issued in 1992, but no other significant guidance was issued under section 468B before this year with regard to the treatment of other settlement funds and escrow accounts.

In January, the IRS issued proposed regulations to address the taxation of escrow accounts, settlement funds and similar arrangements, including accounts established in connection with deferred like-kind exchanges of property. The regulations include a proposed amendment to Reg. section 1.468B-1 that would permit an election to be made, with respect to a QSF created by a single transferor, to treat the QSF as a grantor trust, with the transferor being treated as the owner of the assets.

The proposed regulations are by their terms to apply, in general, to escrow accounts and funds established after the date final regulations are published. Even as proposed, however, the regulations should be considered in designing escrow arrangements intended to be funded at a later date, and may influence the treatment by the IRS of existing escrows and funds subject to section 468B.

Section 1031 Exchanges

The proposed regulations address the taxation and reporting of income of a "qualified escrow account" or "qualified trust," as those terms are used in Reg. section 1.1031(k)-1, that is established in connection with a deferred exchange of like-kind property described in Code section 1031.

Under the proposed regulations, the transferor ("T") of the relinquished property in a deferred exchange under section 1031 is treated as owning the assets held in the qualified escrow account or qualified trust. If, however, the subsequent owner of the relinquished property, or the "qualified intermediary" (within the meaning of the section 1031 regulations), has "all the beneficial use and enjoyment" of assets of an account or trust, then that person will be treated as the owner of the assets. Factors to be considered in determining whether someone other than T has the beneficial use and ownership of the assets in escrow include: (i) who enjoys the use of the earnings of the account or trust; (ii) who receives the benefit of any appreciation in the value of the assets in the account or trust; and (iii) who bears the risk of loss from a decline in value of the assets.

The proposed regulations also note that, if the transferee of the relinquished property or qualified intermediary is treated as the owner of the funds under the beneficial use and ownership rule, there may be an interest-free or other below-market loan to such owner with respect to which interest may be imputed under Code section 7872.

The escrow holder or trustee is required to report the income of the account or trust on Form 1099. The Form 1099 must show the escrow holder or trustee as the payor and must show, as payee, the owner of the assets under these rules.

The escrow holder or trustee must treat T as the owner of the account or trust for income reporting purposes, unless the holder or trustee receives a written statement within 30 days after the transfer of the relinquished property, signed by T and by the other person who is treated as the owner of the account under the regulations, that specifies the person to be treated as the owner of the assets in the account or trust. If such a statement is furnished, the escrow holder or trustee must treat the person specified in the statement as the owner of the account or trust assets and as the payee of the related income.

The Code provisions requiring information returns for payments of interest and dividends (IRC Search7RHSearch7RH6042, 6049) provide that, “except to the extent otherwise provided in regulations,” such returns are not required to be issued to certain persons, including corporations; and the regulations under these sections do not generally require that a Form 1099 be issued to a corporate payee. It is not clear whether the proposed regulations under section 468B(g) contemplate that Forms 1099 be issued without regard to that exception. One example in the proposed regulations involving a “contingent at-closing escrow” (described below) and corporate parties (Prop. Reg. Search7RH1.468B-8(j)) does conclude that the escrow holder must issue a Form 1099 to each corporation.

An escrow account or settlement fund which is neither a QSF nor a qualified escrow account or qualified trust established in connection with a deferred exchange, will generally be within the scope of the other rules described below.

Pre-Closing Escrow

A “pre-closing escrow” is defined in the proposed regulations as an escrow account, trust, or fund that is (i) established in connection with the sale or exchange of real or personal property; (ii) funded with a down payment or similar payment that is deposited into escrow before the exchange; (iii) used to secure performance by the purchaser of its obligations; and (iv) consists of assets that, together with the income earned thereon, will be paid to the purchaser or applied to the purchaser’s benefit when the property is sold or exchanged.

The purchaser is treated as owning the assets of a pre-closing escrow for purposes of taxation of the income earned with respect to those assets. The escrow agent or other person responsible for administering the escrow is required to report the income from the escrow on Form 1099, and the Form 1099 must show the administrator as the payor and the purchaser as the payee.

Contingent At-Closing Escrow

A "contingent at-closing escrow" is defined as an escrow account, trust, or fund that satisfies two requirements. First, the escrow must be established in connection with a sale or exchange, other than a stock-for-stock or other exchange to which Code sections 354, 355 or 356 apply, of real or personal property used in a trade or business or held for investment (including shares of stock or a partnership interest).

Second, the assets in escrow must be distributable (except for any assets set aside to pay taxes and expenses) (i) entirely to the purchaser, (ii) entirely to the seller, or (iii) between those parties, depending on whether events specified in an agreement between the buyer and seller that are "bona fide contingencies" occur or fail to occur. Events that are certain or reasonably certain to occur are not considered to be bona fide contingencies.

The proposed regulations provide that all items of income, deduction, and credit with respect to assets held in a contingent at-closing escrow must be taken into account by the purchaser until the "determination date." The "determination date" is the date by which the last of the events subject to a bona fide contingency, as specified in the parties' agreement, has either occurred or failed to occur.

From the determination date onward, the purchaser and the seller must each take into account the income, deductions, and credits from the escrowed assets in a manner corresponding to their ownership interests, apparently as determined by reference to the terms of the parties' agreement regarding their entitlement to those assets.

Within 30 days after the determination date, the purchaser and the seller must provide to the administrator of the escrow a statement signed by both parties that specifies the determination date and the purchaser's and seller's ownership interests in each asset in the escrow.

The administrator of the escrow is required to report the income from the escrow on Form 1099 to the appropriate payee or payees, that is, to the purchaser for the period prior to the determination date and thereafter to the parties in accordance with their ownership interests as set forth in the statement described above, if the statement is provided timely to the administrator. If such a statement is not received, the administrator must continue to treat the purchaser as the payee.

The proposed regulations caution that no inference should be drawn from the contingent at-closing escrow rules regarding the tax treatment of the escrow or of the parties under Code sections other than section 468B; and that it should not be inferred for purposes of other Code sections that there is a transfer of the assets in escrow on the determination date.

The preamble to the proposed regulations notes that, where there are multiple contingencies, the rules will allocate all of the income from the contingent at-closing escrow to the purchaser even though it may be clear, after the resolution of one or more contingencies, that some portion of the assets in escrow will be paid to the seller. This approach was adopted for simplicity and ease of administration. It seems that multiple escrow accounts might be used where a more precise allocation of income is desired by reference to the resolution of different contingencies; and that any misallocation of income would be minimized in multiple-contingency contexts if distributions from escrow are made in installments as the contingencies are resolved.

Disputed Ownership

The proposed regulations also address the treatment of an escrow account, trust, or other fund where the fund is established to hold money or other property subject to conflicting claims of ownership, such fund is subject to the continued jurisdiction of a court, and distributions cannot be made to a claimant or transferor without the approval of the court.

Space limitations do not permit a detailed description of the proposed treatment of such a fund or of the parties to such arrangements. In general, however, such a fund is taxed separately as a qualified settlement fund, and income from the assets transferred to the fund is therefore generally subject to tax at the rates applicable to trusts, if all of the assets transferred to the fund are "passive investment assets" such as cash or cash equivalents, stock, and debt obligations. In other cases, the fund is taxed as a C corporation.

Under a proposed amendment to the regulations under section 468B, however, if there is only one transferor to a QSF, the transferor may elect to cause the QSF to be treated as a grantor trust, all of the assets of which are treated as owned by the transferor.

The foregoing is, of course, only a brief summary of the recently proposed regulations under section 468B, which merit close scrutiny. There will surely be debate and comment on the proposed regulations, including, perhaps, criticism relating to situations where the regulations appear to require a counter-intuitive result.

For example, in many business transactions an amount paid by the purchaser but held in escrow pending the resolution of post-closing contingencies relating to, *e.g.*, discovery of breach of a representation made at closing, may be includible in consideration for purposes of computing the seller's gain or loss in the year of sale, but will be treated as owned by the purchaser under these proposed rules for purposes of reporting and taking into account the income on the assets in escrow.

In any event, it seems clear that, if the regulations are adopted as proposed or in similar form, they will change significantly the manner in which the parties to transactions (or to resolutions of disputes) involving escrows and settlement funds, and their escrow agents, are required to report and take into account income on assets held through such arrangements.