INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Number: **200130001**
Release Date: 7/27/2001
Index Nos.: 1031.05-00
Control No.: TAM-119763-99/CC:ITA:B5

March 1, 2001
Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's ID No:

Years Involved:

LEGEND:

Taxpayer H =
Taxpayer W =
RQ1 =
RQ2 =
RQ3 =
RP =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Date 11 =

Purchaser 1 =
Purchaser 2 =
Purchaser 3 =
Seller =
Bank =
Accommodator =
Rental Firm =
$a =
$b =
$c =
$d =
$f =
$g =
$h =
x% =
y% =
State W =
State X =

ISSUE:

Is the transaction, or series of transactions, described below a like-kind exchange qualifying for tax deferral under § 1031 of the Internal Revenue Code?

FACTS:

Taxpayer H and Taxpayer W, a married couple, have engaged in a transaction (or series of transactions) involving the disposition of relinquished properties (RQ1, RQ2 and RQ3) and the acquisition of replacement property (RP). The relinquished properties and replacement property are all located in State X. The chronology of events constituting the transaction(s) follows:

On Date 1 Taxpayer W entered into a contract to sell RQ1 to Purchaser 1 for $a. On Date 2, Taxpayers entered into a contract to purchase RP from Seller (consisting of land and an office building) for $b. On Date 3, Taxpayers entered into a written agreement with QI that QI would acquire and hold title to RP to "enable the completion of the exchange of real property." Pursuant to this written agreement with QI, Taxpayers assigned the contract to purchase RP to QI on the same Date 3. By an instrument showing an execution date of Date 4, but an acknowledgment date of Date 3, Taxpayers purportedly assigned their rights to the sales agreement pertaining to the sale of RQ1 to Accommodator.

On Date 4, Seller quitclaimed RP to Accommodator and Accommodator mortgaged RP to Bank to secure an acquisition indebtedness of $c. Of that amount, $b was to secure the advance for the purchase price of RP. The balance amount of $d was originally requested to finance improvements to RP. However, Taxpayers were not approved for this additional amount.[1]

On Date 5, Taxpayers and QI entered into an additional contract (styled "Contract to Exchange Real Estate") to exchange RQ1 for other property "to be determined" (and not otherwise specified in the writing). Also on Date 5, Taxpayers transferred RQ1 to Purchaser 1 for $a. The proceeds from the sale of RQ1 were used to cover debts and liens against RQ1 plus realty fees and taxes.

Also on Date 5, Taxpayers mortgaged RQ2 and RQ3 to Bank as security for amounts not to exceed $b. This second mortgage was required by Bank to secure the x% interest in RP to be transferred by QI to Taxpayers.[2] Thereupon, QI transferred x% of RP to Taxpayers on Date 6 (just three days later). On Date 7, Taxpayers transferred this x% interest to Rental Firm, Taxpayers' wholly-owned LLC.

As an incident to this phase of the transaction(s), by an instrument dated Date 3, Taxpayers leased from QI the remaining y% interest in RP retained by Accommodator at the rate of $f per month on an "Absolute Net Basis." This was approximately the same amount payable to Bank each month on the RP mortgage. On Date 5, Accommodator assigned all leases and rents to Bank.

On Date 8, Taxpayers entered into an agreement to sell RQ2 and RQ3 to Purchaser 2 and Purchaser 3. On Date 9, Taxpayers and QI entered into an additional agreement (styled "Contract to Exchange Real Estate") to exchange RQ2 and RQ3 for other property "to be determined" (and not otherwise specified in the writing). By an instrument signed on Date 9 and acknowledged on Date 10, Taxpayers assigned their interest in the Date 8 sales agreement to Accommodator. On Date 10 Taxpayer W transferred RQ2 to Purchaser 2 for $g. Also on Date 10 Taxpayer W transferred RQ3 to Purchaser 3 for $h. The proceeds from these sales were paid to discharge the mortgage debt owed on RP by Taxpayers and QI, in addition to mechanics liens, and

---

[1] The loan officer was asked why the mortgage collateral agreement was not rewritten if the loan was for $b rather than $c. He explained that Bank was not concerned about the discrepancy because it was, in any event, fully secured.

[2] According to the loan officer, a second mortgage collateral agreement was necessary to ensure that the proceeds received from the sales of all the relinquished property would go to payoff the mortgage given to finance the purchase of RP.

amounts payable as attorneys fees and commissions. Bank certified the mortgage debt on these properties was fully satisfied and discharged. On Date 11, Accommodator transferred the remaining y% of RP to Taxpayers and Taxpayers thereupon transferred this interest to Rental Firm.

No written notices of assignments of purchase contracts to Accommodator pertaining to any of the relinquished properties, RQ1, RQ2 or RQ3 were given to the purchasers of these properties. The warranty deeds conveying these relinquished properties to Purchasers 1, 2 and 3 do not mention any involvement by Accommodator. None of the agreements between Taxpayer and Accommodator of Date 3 or Date 5 (whereby Accommodator agreed with Taxpayers to serve as an intermediary and specifically to exchange RQ1 for other property) or of Date 9 (whereby Accommodator agreed with Taxpayers to serve as an intermediary in the exchange of RQ2 and RQ3 for other property) include any provision that expressly limits Taxpayers rights to receive, pledge, borrow or otherwise obtain the benefits of the sales proceeds of any of the relinquished properties (RQ1, RQ2, RQ3) before Taxpayers' direct acquisition of RP.

APPLICABLE LAW:

Section 1031(a)(1) of the Code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(3) provides that for purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if -
(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
(B) such property is received after the earlier of - (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

Section1.1031(k)-1(f)(1) of the Income Tax Regulations generally provides that a transfer of relinquished property in a deferred exchange is not within the provisions of § 1031(a) if, as part of the consideration, the taxpayer receives money or other property. It further provides that in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives

money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not an deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(g)(4)(i) of the regulations provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of § 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and 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 qualified intermediary is not the agent of the taxpayer.

Section1.1031(k)-1(g)(4)(ii) provides that the above paragraph (g)(4)(i) applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in paragraph (g)(6) of this section.

Section 1.1031(k)-1(g)(4)(iii) provides that a qualified intermediary is a person who - (A) is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and (B) enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(4)(iv) provides that regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of paragraph (g)(4)(iii)(B) of this section an intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property. Paragraph (g)(4)(iv) further provides that an intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person. Paragraph (g)(4)(iv) also provides that an intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

Section 1.1031(k)-1(g)(4)(v) provides that solely for purposes of paragraphs

(g)(4)(iii) and (g)(4)(iv) of this section, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

Section 1.1031(k)-1(g)(6)(i) provides as additional restrictions on safe harbors under paragraphs (g)(3) through (g)(5), (including the safe harbor pertaining to the qualified intermediary at (g)(4)) that an agreement limits a taxpayers rights as provided in this paragraph (g)(6) only if the agreement provides that the taxpayer has no rights, except as provided in paragraph (g)(6)(ii) and (g)(6)(iii) of this section, to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

ANALYSIS AND RATIONALE:

Fundamentally, the characterization of transactions as tax-deferred exchanges depends on whether the transactions constitute exchanges. As provided in § 1.1031(k)-1(f)(1), if the taxpayer actually or constructively receives money or other property in exchange for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property. The safe harbor rules of § 1.1031(k)-1(g) provide institutionalized mechanisms for preventing actual or constructive receipt by a taxpayer of money or other property in a deferred exchange. The mechanism which Taxpayers attempted to use is the “qualified intermediary" safe harbor set forth and outlined in paragraph (g)(4) of this regulation. However, the rules for application of the qualified intermediary safe harbor to a transaction or series of transactions are specific and exact. If those rules are not followed with precision, the integrity of the transaction as an exchange qualifying for deferral under § 1031 is jeopardized. In the transactions at issue, Taxpayers failed to comply with at least two requirements of the “qualified intermediary” safe harbor. These deficiencies are discussed below.

A. The Notice Requirement:

The safe harbor rules pertaining to the qualified intermediary permit either direct deeding of relinquished property to the purchaser (assuming prior compliance with requirements of assignments to the intermediary and notices to all parties to the

purchase contract) or actual transfer of relinquished property to the intermediary followed by transfer to the ultimate purchaser.[3]

In none of the transactions described did Accommodator receive an actual transfer of relinquished property. Rather, in each instance, the sales contracts pertaining to the relinquished property were assigned to QI. Then the relinquished property was deeded directly to the purchaser of the relinquished property. Also, no written notice was ever given to the purchasers of the assignments of these purchase contracts to QI. Section 1.1031(k)-1(g)(4)(v) provides that an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. In this case, the purchasers were not notified in writing of the assignment. Therefore, QI cannot be treated as having entered into the agreement to sell such properties. As a result of their noncompliance with the written notice requirement, Taxpayers are treated as if they transferred the property directly to the sellers for money or other property with no involvement of a qualified intermediary in that sale except, perhaps, as an agent or nominee. Absent the involvement of a qualified intermediary as such, the form of each described transaction is that of a separate sale and a separate purchase to which § 1031 does not apply. Accommodator cannot be classified, in any event, as a qualified intermediary in these transactions because it did not acquire the relinquished properties, either actually or constructively, as required by § 1.1031(k)-1(g)(4)(iii).

Taxpayers assert that the purchasers of the relinquished properties in the transactions at issue had actual notice of the assignments to Accommodator and that, therefore, Taxpayers are in substantial compliance with the notice requirement. They note that the settlement statements for the sales of RQ1, RQ2 and RQ3 all list Accommodator as the seller. However, listing of Accommodator as the seller in a settlement statement is also consistent with treatment of Accommodator as an agent or nominee of the seller. It does not constitute written notice of an assignment of rights to Accommodator. Taxpayers also submitted a letter written by Accommodator to Taxpayers' representative, dated January 19, 2000, stating that, to the best knowledge of Accommodator in all of Accommodator's transactions, "the Purchasers were advised of an Assignment of the Contract and were provided with appropriate documents to support said assignment." However, the statement in the letter is not competent evidence of compliance with the regulations because it was not an unequivocal statement that purchasers were given written notice of the various assignments and was not submitted under penalties of perjury. It is a statement dependent on the "best

---

[3] See generally §§ 1.1031(k)-1(g)(4)(iv)(B) and (C), 1.1031-1(g)(4)(v) and 1.1031(k)-1(g)(8) Example 4 of the regulations and Rev. Rul. 90-34, 1990-1 C.B. 154 (authorizing direct deeding of relinquished property and replacement property).

of the knowledge of the writer" rather than a sworn affirmation of a specific material fact. In addition, Taxpayers submitted written statements from each of the purchasers of the relinquished properties, each asserting that it had received, in the month of the sale of the relinquished property, written notice of the particular assignment from Taxpayers to Accommodator. However, none of these statements affirm that notice was timely given and none were submitted under penalties of perjury.

Taxpayers were given ample notice of Service's tentative position that the safe harbor rules pertaining to qualified intermediaries were not followed in that no written notice of the assignments were given to the purchasers of the relinquished property. Since Taxpayers have not produced sufficient evidence of compliance with this requirement, we conclude that Taxpayers failed to satisfy the § 1.1031(k)-1(g)(4)(v) requirement of written notice of assignment.

B. The Limitation of Taxpayers' Rights to Proceeds of Relinquished Property:

As provided in §1.1031 (k)-1(g)(4)(i) and (ii), in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, for assurance that the qualified intermediary is not deemed an agent of the taxpayer and that the taxpayer is not in constructive receipt of proceeds of sale of relinquished property, there must be an agreement between the taxpayer and the qualified intermediary expressly limiting the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. In the present case, Taxpayers entered into two exchange agreements with Accommodator. The first agreement, executed on Date 5, pertained to the exchange of RQ1. The second agreement, executed on Date 9, pertained to the exchange of RQ2 and RQ3. However, neither exchange agreement expressly limited Taxpayers' rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

Taxpayers argue that they have substantially complied with this requirement of the qualified intermediary safe harbor. They urge that as a practical matter, the exchange agreements with QI limit and restrict Taxpayers' access to proceeds derived from the sale the RQ1, RQ2 and RQ3 and that under the agreements, Accommodator could use such proceeds only to acquire like-kind property, i.e., other real estate. In fact, however, neither agreement expressly limits or requires the acquisition of only like-kind replacement property. Paragraph 2 of each agreement provides:

> [Accommodator] agrees to convey to [Taxpayers] the following described real estate, situated in the TO BE DETERMINED county of [blank space], [State W], to-wit: TO BE DETERMINED Known As TO BE DETERMINED with easements and rights of way appurtenant thereto, all improvements thereon and all fixtures of a permanent nature, currently on the premises, except TO BE DETERMINED

> in their present condition, ordinary wear and tear excepted, and the following personal property: TO BE DETERMINED by a good and sufficient TO BE DETERMINED warranty deed (and bill of sale).

Thus, there is really no limitation under this agreement as to what use is to be made of the proceeds of the relinquished property, either to convey real or personal property, like-kind or non-like-kind property in State W (rather than State X where RQ1, RQ2, RQ3 and RP are all situated).

Taxpayers cite paragraph 3 and 5 of Addendum A of both contracts as constituting restrictions of Taxpayers' access to exchange funds. In both documents these paragraphs provide:

> 3. THE EXCHANGE EQUITY PROPERTIES TO BE CONVEYED TO FIRST PARTIES [Taxpayers] SHALL BE DISIGNATED (sic) IN ACCORDANCE WITH SECTION 1031 OF THE INTERNAL REVENUE CODE ON OR BEFORE ...[a date which was 45 days from the date of transfer of the relinquished property]. THE DATE OF CONVEYANCE OF ALL THE SAID EXCHANGE PROPERTIES SHALL BE NO LATER THAN ...[a date which was the last day of the exchange period].
>
> 5. SHOULD ANY PORTION OF THE EXCHANGE EQUITY NOT DESIGNATED AS PROVIDED FOR IN THE ADDENDUM UNDER 3. ABOVE, SECOND PARTY [Accommodator] SHALL HAVE THE OPTION OF PAYING FIRST PARTY ANY BALANCE REMAINING IN CASH, CASHIERS CHECK OR CERTIFIED FUNDS ON ... [a date which was after the identification period].

Amendment 1 to the exchange agreement, dated Date 4 (prior to the execution of the exchange agreement that it purported to amend), directed Accommodator to acquire RP and to thereupon convey an undivided x% of RP to Taxpayers as a conveyance in the exchange equity. In addition, the minutes of a Special Meeting of Board of Directors of Accommodator, dated Date 9, contains a written identification of the replacement property. Taxpayers argue that they were not entitled to release of the exchange equity and that, according to these documents, they were not in actual or constructive receipt of the proceeds of the relinquished property.

These documents all show a clear intent by the parties to complete some sort of exchange. The Accommodator was plainly limited in discretion as to the use of the exchange proceeds and property. However, there were no limits as to Taxpayer's access to or use of the proceeds of the relinquished properties. Absent such limitations, there is no applicable safe harbor.

With respect to safe harbors generally, if a safe harbor is not effective in a given transaction, the Service must characterize the transactions in accordance with their substantial character. In this case, the transactions appear to be more in the nature of a series of interrelated purchases and sales of real property, sold and acquired by Taxpayers H and W with assistance of Accommodator serving as their agent or nominee. Inasmuch as there were no express limitations on access or use of the exchange funds derived from the sales of RQ1, RQ2, and RQ3, Taxpayers H and W were in constructive (if not in actual) receipt of non-like-kind property. Since no written notice was given of assignment of Taxpayers' interests in the contracts of sale of RQ1, and RQ2, and RQ3, Taxpayers' transfer of these properties to the respective purchasers constituted sales that were separate from the purchases of undivided interests in RP. Accordingly, gain must be reported and recognized to the extent of the amount of gain realized in each of the sales transactions.

CONCLUSION:

The series of transactions engaged in by Taxpayers as described in this case were not like-kind exchanges qualifying for tax deferral under § 1031 of the Code, but rather were a series of purchases and sales taxable under § 1001.

****

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

- End -