

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:

April 10, 2000

Legend:

Exchangor =  
Trustee =

Dear

This is in response to your representative's letter dated February 8, 2000 requesting a private letter ruling with respect to the application of § 1.1031(k)-1(g)(6)(iii) of the Income Tax Regulations. You have requested a private letter ruling that a proposed amendment to an exchange agreement between Exchangor, a qualified intermediary, and a client of Exchangor ("owner") seeking to exchange like-kind property under § 1031 of the Internal Revenue Code would meet the exchange agreement requirements of §§ 1.1031(k)-1(g)(4) and (6). Exchange agreement requirements are those requirements that must be met in order for an accomodator to qualify for the qualified intermediary safe harbor provisions under § 1.1031(k)-1(g)(4) of the regulations. Exchangor proposes to make a similar amendment to its standard qualified trust agreement with Trustee.

FACTS:

Under its standard exchange agreement, no amounts held by Exchangor, the qualified intermediary, shall be paid, loaned, pledged or otherwise made available to the owner no earlier than the day following the expiration of the exchange period unless either of the following events has occurred: (i) the owner has failed to identify any replacement property on or before the end of the identification period, or (ii) the owner has received all of the identified replacement property to which the owner is entitled under the exchange agreement. A similar limitation is contained in Exchangor's standard qualified trust agreement with Trustee.

Increasingly, owners are requesting Exchangor to distribute the funds held in their exchange account in the following situations:

(1) Owner identifies three replacement properties with the intent of acquiring all three properties. The aggregate fair market value of the three replacement

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properties equals the fair market value of the relinquished property. In accordance with the terms of the exchange agreement, Exchangor, as qualified intermediary, acquires and transfers two of the properties to the owner. Owner, after negotiating in good faith with the seller of the remaining identified replacement property, is unable to reach an agreement with the seller. Owner thereafter requests that Exchangor distribute to him the remaining cash prior to the end of the exchange period.

(2) Owner properly identifies a single replacement property but, after the close of the identification period and after negotiating in good faith with the seller of the identified replacement property, the owner is unable to reach an agreement for the purchase of the property. Owner requests that Exchangor distribute the cash to him prior to the end of the exchange period.

To address these situations, Exchangor wishes to amend its standard exchange agreement and its standard qualified trust agreement to add an additional event after which occurrence the restriction that no amounts held by the qualified intermediary shall be paid, loaned, pledged or otherwise made available to the owner would expire. The proposed amendment provides that this third event would occur when the “owner, after negotiating in good faith with the seller (or sellers) of all identified Replacement Properties which have not yet been acquired, is unable to conclude a binding agreement (or agreements) for the purchase of all of such properties, but in such case, only at the time all Replacement Properties for which binding agreements (or agreement) have been concluded have been acquired.”

LAW:

Section 1031(a)(1) 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 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 (the “identification period”), or 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 tax return for the taxable year in which the transfer of the relinquished property occurs (the “exchange period”).

Paragraph (g)(4)(i) of § 1.1031(k)-1 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

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§ 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.

Paragraph (g)(4)(ii) of § 1.1031(k)-1 of the regulations provides that paragraph (g)(4)(i) of this section 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.

Paragraph (g)(6) of § 1.1031(k)-1 provides that (i) an agreement limits a taxpayer's 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.

Paragraph (g)(6)(ii) of § 1.1031(k)-1 provides that the agreement may provide that if the taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period.

Paragraph (g)(6)(iii) of § 1.1031(k)-1 provides that the agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after (A) the receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement, or (B) the occurrence after the end of the identification period of a material and substantial contingency that (1) relates to the deferred exchange, (2) is provided for in writing, and (3) is beyond the control of the taxpayer and of any disqualified person (as defined in § 1.1031(k)-1(k)), other than the person obligated to transfer the replacement property to the taxpayer.

Example 2 of § 1.1031(k)-1(g)(8) provides in part as follows:

(8) Examples. This paragraph (g) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of \$100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of

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a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified as provided in paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 2. (i) On May 17, 1991, B transfers real property X to C, and C deposits \$100,000 in escrow as security for C's obligation to perform under the agreement. Also on May 17, B identifies real property J as replacement property. The escrow agreement provides that no funds may be paid out without prior written approval of both B and C. The escrow agreement also provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) B may demand the funds in escrow at any time after the later of July 1, 1991, and the occurrence of any of the following events--

(1) real property J is destroyed, seized, requisitioned, or condemned, or

(2) a determination is made that the regulatory approval necessary for the transfer of real property J cannot be obtained in time for real property J to be transferred to B before the end of the exchange period;

(B) B may demand the funds in escrow at any time after August 14, 1991, if real property J has not been rezoned from residential to commercial use by that date; and

(C) B may demand the funds in escrow at the time B receives real property J or any time thereafter.

Otherwise, B is entitled to all funds in escrow after November 13, 1991. The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as described in paragraph (k) of this section. Real property J is not rezoned from residential to commercial use on or before August 14, 1991.

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(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. From May 17, 1991, until August 15, 1991, B did not have the immediate ability or unrestricted right to receive money or other property before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the \$100,000 in escrow from May 17, 1991, until August 15, 1991. However, on August 15, 1991, B had the unrestricted right, upon notice, to draw upon the \$100,000 held in escrow. Thus, the safe harbor ceased to apply and B was in constructive receipt of the funds held in escrow. Because B constructively received the full amount of the consideration (\$100,000) before B actually received the like-kind replacement property, the transaction is treated as a sale and not as a deferred exchange. The result does not change even if B chose not to demand the funds in escrow and continued to attempt to have real property J rezoned and to receive the property on or before November 13, 1991.

(iii) If real property J had been rezoned on or before August 14, 1991, and C had purchased real property J and transferred it to B on or before November 13, 1991, the transaction would have qualified for nonrecognition of gain or loss under section 1031(a).

#### ANALYSIS AND CONCLUSION:

In both situations described above, Exchangor asserts that the proposed amendment sets forth a "material and substantial contingency" that (a) relates to the deferred exchange, (b) is provided for in writing, and (c) is beyond the control of the taxpayer and of any disqualified person.

Regarding the first situation described above, Exchangor argues that an owner, after negotiating in good faith with the seller of the identified replacement property, cannot be expected to acquire the replacement property at an uneconomical price (i.e., a price above its fair market value), or pursuant to unfavorable purchase terms. It is beyond the owner's control to force the seller of the identified replacement property to sell his property for a fair price under fair terms.

Moreover, Exchangor notes that, in certain cases, the seller's circumstances may have changed since the time the owner first identified the property as a replacement property. For example, the seller may no longer be willing to accept the owner's note, or may now believe his property is worth far more than when the owner originally

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inquired about the purchase of the property. If the owner, in good faith, has attempted (albeit unsuccessfully) to acquire all remaining identified replacement properties, but cannot conclude a binding agreement, he should not be required to wait until the end of the exchange period to receive the benefits of any remaining cash.

Exchangor argues that there are equally compelling reasons for allowing the owner in the second situation described above to receive the cash prior to the end of the exchange period. Since the owner only identified one replacement property, which he was unable to acquire, he will have to recognize the full amount of the gain on the failed exchange. Therefore, there is no reason to require that the owner wait until the exchange period expires to receive any money or other property held by Exchangor.

The proposed amendment to Exchangor's standard exchange agreement and standard qualified trust agreement "relates to the deferred exchange" as provided in § 1.1031(k)-1(g)(iii)(B)(1), and meets the "provided for in writing" requirement of § 1.1031(k)-1(g)(iii)(B)(2). Therefore the issues to be resolved are (a) whether the inability to conclude a binding purchase agreement after making good faith attempts to do so is a "material and substantial contingency" and (b) whether the proposed amendment meets the "beyond the control of the taxpayer" requirement of § 1.1031(k)-1(g)(iii)(B)(3).

We conclude that the proposed amendment is beyond the scope of § 1.1031(k)-1(g)(6)(iii) of the regulations. It does not qualify under paragraph (g)(6)(iii)(A) because the owner has not received all of the replacement property to which the owner is entitled under the exchange agreement.

We also conclude that the proposed amendment does not qualify under paragraph (g)(6)(iii)(B), the third requirement of which is the occurrence after the end of the identification period of a material and substantial contingency that is beyond the control of the taxpayer and of any disqualified person (as defined in § 1.1031(k)-1(k)). The amendment is too broad to qualify under subdivision (B). In essence, the amendment would apply to any case where the owner, after bargaining in good faith, could not acquire one or more of the identified replacement properties.

Consider example (2) of § 1.1031(k)-1(g)(8) (set forth above). Although an example in a regulation generally does not establish rules beyond those enunciated in the regulation itself, an example is intended to illustrate how the regulation should be interpreted. In example 2, actions of a party not involved in the exchange (government agency's seizure, requisition, or condemnation of the replacement property or government agency's failure to approve a request to rezone or approve the transfer of the replacement property) or an act beyond anyone's control (destruction of the replacement property) are contingencies that are beyond the owner's control. Thus, although the types of contingencies that are beyond the control of the taxpayer are not limited to those set forth in the example, we do not think that the contingencies

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described by Exchangor in its proposed amendment are beyond the owner's control. Unlike the qualifying contingencies in the example, it is within the owner's control to decide to meet the seller's demands or walk away from an uneconomic business deal.

Accordingly, we rule that Exchangor's standard exchange agreement and standard qualified trust agreement, as amended, do not meet the requirements of § 1.1031(k)-1(g)(6)(iii) of the regulations.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,  
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(Income Tax and Accounting)  
By: Kelly Alton  
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Branch 5