DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF CHIEF COUNSEL

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The Honorable Christopher J. Dodd
United States Senator
30 Lewis Street, Suite 101
Hartford, CT 06103

Attention:

Dear Senator Dodd:

I am responding to your inquiry, dated February 12, 2009, on behalf of your constituent, . He asks for relief from paying capital gains tax on gains realized in 2008 on a disposition of property intended to be part of a deferred like-kind exchange under section 1031(a) of the Internal Revenue Code (the Code).

Last year, disposed of property (relinquished property) through a qualified intermediary (QI). The QI was to sell the relinquished property for cash and use it to acquire like-kind replacement property, which the QI would transfer to within the statutory exchange period set forth in section 1031(a)(3). However, before completing the exchange, the QI became insolvent and filed for bankruptcy. As a result of this failure, will not receive the replacement property and will likely receive only some of the cash from the sale of the relinquished property at the conclusion of the bankruptcy proceedings.

I hope that the following general information is helpful to you in responding to .

Generally, gross income includes all income regardless of its source, including gains from dealings in property (section 61 of the Code). A taxpayer does not recognize gain or loss, however, if he or she exchanges relinquished property held for productive use in a trade or business or for investment solely for like-kind replacement property held for productive use in a trade or business or for investment (section 1031(a)(1) of the Code).

To defer recognition of gain on the disposition of property in a deferred like-kind exchange, the taxpayer must—

- Identify the replacement property to be received in the exchange within 45 days after the date the taxpayer transfers the relinquished property; and

- Receive the replacement property before the earlier of (i) 180 days after the date he or she transfers the relinquished property or (ii) the due date (including extensions) of the taxpayer's income tax return for the year in which the taxpayer transfers the relinquished property ("statutory replacement period") (section 1031(a)(3) of the Code).

For certain cash sales of property, the taxpayer can defer recognition of gain in a like-kind exchange only if the taxpayer meets one of the safe harbors provided in the Income Tax Regulations (the Regulations). For example, if a taxpayer uses a QI to facilitate the like-kind exchange, and the QI (not the taxpayer) receives and holds the cash proceeds from the sale of the relinquished property, then the taxpayer is treated as not having actual or constructive receipt of the cash for section 1031 purposes. The QI must perform certain additional functions, including acquiring replacement property with the cash proceeds from the sale of the relinquished property and transferring the replacement property to the taxpayer (section 1.1031(k)-1(g) of the Regulations).

If the QI fails to acquire the replacement property and transfer it to the taxpayer within the statutory replacement period, the taxpayer cannot defer recognition of gain on transfer of the relinquished property under section 1031 of the Code. The taxpayer must currently recognize and report in income any gain realized on the disposition of the relinquished property through the QI.

If a taxpayer sustains a loss during the taxable year that is not compensated for by insurance or otherwise, the taxpayer can deduct the loss from gross income (section 165(a)(1) of the Code). These losses generally include losses incurred in a trade or business, losses incurred in any transaction entered into for profit, and losses from theft (section 165(c) and (e) of the Code). If the facts and circumstances surrounding transaction show that he sustained a loss due to the QI's actions, he may be able to deduct this loss from gross income, but only in the year the loss is sustained. A loss is sustained in the year that it is evidenced by closed and completed transactions and fixed by identifiable events occurring in that taxable year (section 1.165-1(d) of the Regulations).

We are aware that taxpayers who entered into a deferred like-kind exchange may have financial hardships where a QI filed for bankruptcy and did not complete the exchange. For this reason, we are considering some type of relief for taxpayers in this situation.

I hope this information is helpful. If we can assist you further, please contact me or at .

Sincerely,

Michael J. Montemurro
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)