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to: Reid M. Huey
Associate Area Counsel (St. Paul)
(Large Business & International)

from: Michael J. Montemurro
Branch Chief, Branch 4
(Income Tax & Accounting)

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subject:

This Chief Counsel Advice responds to your request for advice dated June 13, 2012.

ISSUE

Does a taxpayer have actual or constructive receipt of relinquished property (RQ) sales proceeds for purposes of § 1.1031(k)-1 of the Income Tax Regulations if the RQ is security for lines of credit used to purchase the RQ and for general business operations and the taxpayer's qualified intermediary must use the proceeds to pay down amounts the taxpayer owes on the lines of credit?

CONCLUSION

The taxpayer does not have actual or constructive receipt of the RQ sales proceeds for purposes of § 1.1031(k)-1, by reason of the nature of the security burden and the debt pay-down arrangement.

FACTS

Taxpayer rents equipment to customers for use in farming, construction, manufacturing and warehousing. In 2003, Taxpayer implemented a Like-Kind Exchange Program (LKE Program) through which it defers the recognition of gain from the sale of its rental

equipment. Taxpayer entered into a Master Exchange Agreement ("MEA") with a qualified intermediary (QI) to engage in these multiple exchanges in its LKE Program.

The MEA is the written agreement between Taxpayer and QI for QI to acquire the RQ from Taxpayer, transfer the RQ, acquire the replacement property (RP) and transfer the RP to Taxpayer. In the MEA, Taxpayer makes a blanket assignment of its rights under sale and purchase contracts to QI and provides for written notification of the assignment to all parties.

Taxpayer maintains lines of credit with two creditors. The proceeds from the lines of credit are used to purchase RP. However, Taxpayer also uses proceeds from these lines of credit for other business purposes, not just the acquisition of RP. Pursuant to its agreements with these creditors, all rental properties, including properties relinquished and acquired in its § 1031 exchanges as RQ and RP, secure the outstanding balances on the lines of credit from the time Taxpayer acquires the property until it is sold. The outstanding balances on the lines of credit are also secured by Taxpayer's accounts receivable and new equipment held by Taxpayer for sale in the ordinary course of business. All property is separately listed as collateral for one or the other, but not both, of the lines of credit. The full value of the rental property secures the entire outstanding balances on the lines of credit.

The MEA provides that Taxpayer does not have the right to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by QI. The MEA also provides that QI must use the proceeds from the sale of RQ to the pay down Taxpayer's outstanding balances on the lines of credit. Consequently, the proceeds from the disposition of RQ as part of any exchange under the MEA are deposited directly into a joint QI/Taxpayer account and then immediately disbursed by QI to satisfy Taxpayer's obligation on one or the other line of credit. Under this arrangement, Taxpayer uses borrowed funds to acquire RP and complete its exchanges.

APPLICABLE LAW

Section 1031(a)(1) of the Code provides that no gain or loss is 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 that is to be held either for productive use in a trade or business or for investment.

Section 1.1031(k)-1(f)(1) of the regulations provides, in part, 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 the 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.

Section 1.1031(k)-1(f)(2) explains that, except as provided in § 1.1031(k)-1(g) (relating to safe harbors), for purposes of § 1031, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual or constructive receipt and without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt of money or property when the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt of money or property by an agent of the taxpayer is actual or constructive receipt by the taxpayer.

Under § 1.1031(k)-1(g)(4)(i), a qualified intermediary is not considered the agent of the taxpayer for purposes of section 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. Further, under § 1.1031(k)-1(g)(4)(ii), the agreement between the taxpayer and the qualified intermediary must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary.

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, 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)(6) requires that the exchange agreement between the taxpayer and the qualified intermediary provide that the taxpayer have no right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary before the end of the exchange period, other than those provided in § 1.1031(k)-1(g)(6)(ii) and (iii).

Section 1031(b) of the Code provides, in part, that in an exchange that would be within the provisions of § 1031(a) if not for the fact that the property received in the exchange includes non like-kind property or money, the gain, if any, to the recipient must be recognized but in an amount not in excess of the sum of the money and the fair market value of the non like-kind property.

Section 1.1031(b)-1(c) of the regulations provides that consideration in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money" for the purposes of § 1031(b). If, in an exchange described in § 1031(b), each party either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of other property or money, consideration given in the form of an assumption of liabilities (or the receipt of property subject to a liability) is offset against consideration received in the form of an assumption of liability (or transfer subject to a liability). Thus, when there are mortgages on both sides of the transaction, the mortgages are netted and the difference becomes recognized gain (boot) to the party transferring the property subject to the larger mortgage.

In Example (5) of § 1.1031(k)-1(j)(3), B, the transferor of relinquished property in a deferred exchange, transfers property that is encumbered with a $30,000 mortgage to C on May 17, 1991. C assumes the mortgage on that date. On July 15, 1991, B receives the replacement property and assumes a $20,000 mortgage encumbering the replacement property. The consideration received by B in the form of the liability assumed by C ($30,000) is offset by the consideration given by B in the form of the liability assumed by B ($20,000). The excess of the liability assumed by C over the liability assumed by B, $10,000, is treated as "money or other property." Thus, as provided in § 1031(b), B recognizes gain in the amount of $10,000.

Section 5.02 of Rev. Proc. 2003-39, 2003-1 C.B. 971, on *Joint Accounts,* provides that a taxpayer engaged in an LKE Program will not be considered in actual or constructive receipt of proceeds from the sale of relinquished property deposited into or held in a joint bank, trust, escrow, or similar account in the name of the taxpayer and the qualified intermediary, or in an account in the name of a third party (other than a disqualified person as defined in § 1.1031(k)-1(k)) for the benefit of both the taxpayer and the qualified intermediary, if:

(1) The account is used to collect, hold, and/or disburse proceeds arising from the sale of relinquished property for the benefit of the qualified intermediary;

(2) The agreement setting forth the terms and conditions with respect to the account requires authorization from the qualified intermediary to transfer proceeds from the sale of relinquished properties out of the account; and

(3) The agreement setting forth the terms of the taxpayer's and qualified intermediary's rights with respect to, or beneficial interest in, the account expressly limits the taxpayer's

rights to receive, pledge, borrow, or otherwise obtain the benefits of proceeds from the sale of relinquished property held in the joint account as provided in § 1.1031(k)-1(g)(6).

Section 5.02 of the revenue procedure further provides that the account may also be used by the parties for other purposes provided that the other use does not undermine the qualified intermediary's right to control the proceeds from the sale of relinquished property.

ANALYSIS

In the present case, proceeds from the disposition of the RQ are paid to the joint account controlled by Taxpayer and QI. The QI then disburses the RQ proceeds to pay down the debt on the Taxpayer's lines of credit, as required by the agreements with Taxpayer's lenders. Taxpayer then acquires RP by financing the acquisition with new debt in an amount that equals or exceeds the debt that encumbered the RQ.

Under its arrangements with QI and its lenders, QI must use the RQ proceeds, but not proceeds from its accounts receivable and new equipment sales, to pay down lines of credit. The field attorney argues that these arrangements taken together violate § 1.1031(k)-1(g)(6), which generally prohibits a taxpayer from obtaining the benefits of the RQ proceeds before the end of the exchange period. The field attorney argues that the debt pay-down arrangement results in Taxpayer actually or constructively receiving the RQ proceeds before the end of the exchange period. Under this argument, Taxpayer cannot defer the gain realized on its transfers of RQ under § 1031(a). We disagree with the field attorney's position.

The facts in the present case are similar to the situation described in Example 5 of § 1.1031(k)-1(j)(3). In the example, the taxpayer is relieved of debt on the transfer of RQ and incurs debt on the acquisition of RP. The example concludes not that the taxpayer has actually or constructively received all or a portion of the proceeds of the RQ, but rather that the boot received in the form of debt relief is offset by the debt assumed. Under the boot netting rules of § 1.1031(b)-1(c), the gain required to be recognized by the taxpayer in Example 5 is the excess of the debt relieved on the transfer of the RQ and the debt incurred on the acquisition of RP. While there are differences between the facts in Example 5 and those in the present case, the differences do not result in Taxpayer having actual or constructive receipt of the RQ proceeds for purposes of § 1.1031(k)-1.

In the present case, the debt that is secured by the RQ is incurred not only to purchase RQ but also for general business operations. In contrast, Example 5 provides only that the RQ is "encumbered by a mortgage of $30,000" and does not discuss when or why the property was encumbered. However, the result in Example 5 should not change if the debt was incurred as a result of a refinancing of the RQ, the proceeds of which were used for general business operations. That is, we not aware of any authority for making a distinction along the lines of the purpose of the encumbrance or whether the taxpayer

used the proceeds for more than the purchase of RQ. Consequently, the fact that the debt in the present case was incurred for more than the acquisition of the RQ should not result in actual or constructive receipt of the RQ proceeds when QI pays off the RQ debt.

Another difference between the facts of Example 5 and those of the present case is that the transferee of the RQ in Example 5 assumed the RQ debt whereas, in the present case, QI uses the RQ proceeds to pay down the RQ debt. That fact, however, should not result in actual or constructive receipt of the RQ proceeds. In *Barker v. Commissioner*, 74 T.C. 555 (1980), the Tax Court held that proceeds from the disposition of RQ can be used to pay off debt on the RQ without triggering gain if the taxpayer incurs or assumes a liability on the purchase of RP that equals or exceeds the debt on the RQ. In *Barker*, which was decided before the issuance of deferred exchange regulations of § 1.1031(k)-1, the taxpayer received cash in the exchange but was contractually obligated by the transferee of the RQ to use the cash to pay off the RQ debt. Thus, the Tax Court held that the boot netting principle in § 1.1031(b)-1(c) covers not just assumptions of debt but also situations in which the proceeds of the RQ are used to pay off RQ debt.

In the present case, the fact that the RQ debt is used not only to purchase RQ but also for general business operations, and the fact that QI uses the RQ proceeds to pay down Taxpayer's lines of credit, does not result in Taxpayer being in actual or constructive receipt of the RQ proceeds for purposes of § 1.1031(k)-1. Accordingly, Taxpayer's exchanges will qualify as like-kind exchanges under § 1031 if Taxpayer meets the other requirements of § 1031 and the regulations thereunder.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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