

Final Regulations Under Code Secs. 468B and 7872— A Win for Independent Qualified Intermediaries and Their Advocates

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John A. Sikora examines the final regulations relating to the application of Code Secs. 468B and 7872 to exchange funds held by qualified intermediaries and others in connection with exchange transactions.

Final regulations relating to the application of Internal Revenue Code Sections¹ 468B and 7872 to exchange funds held by qualified intermediaries and others in connection with exchange transactions were released in July 2008 and apply to transactions occurring on or after October 8, 2008 (“final regulations”).² Although the Treasury and the IRS rejected arguments that these sections do not or should not apply to deferred exchange transactions governed by Code Sec. 1031, many made by commentators principally concerned for the well being of non-bank affiliated intermediaries, the final regulations include interest rate testing standards and, more significantly, a generous exemption from such application that should satisfy many who voiced objection to the proposed regulations issued in 1999 (“1999 proposed regulations”) or 2006 (“2006 proposed regulations”). The exemption should mean that most exchange transactions will not be materially affected by the final regulations.

The Deferred Exchange Safe Harbors

Prior to amendment in 1984, Code Sec. 1031 did not state that a like-kind exchange must be completed

within a limited period in order to qualify for non-recognition treatment thereunder.³ Changes in that year⁴ added the 45-day identification and 180-day replacement property acquisition⁵ requirements applicable to all deferred exchange transactions.⁶

However, conflict between long-standing agency and constructive receipt principles, on the one hand, and practical matters such as the desires to structure deferred exchange transactions using hired accommodation parties and to secure the other exchanging party’s obligations, on the other hand, existed. The IRS issued proposed regulations in 1990⁷ and final deferred exchange regulations in 1991⁸ (“deferred exchange regulations”) to address it. The deferred exchange regulations established the qualified intermediary, qualified escrow account and qualified trust safe harbors.⁹

A qualified intermediary acts as the other exchanging party in a taxpayer’s exchange transaction, for which it receives a fee.¹⁰ Properly drafted exchange documents will provide for the transfer of the taxpayer’s relinquished property to a buyer, the qualified intermediary’s receipt of the sale proceeds, later acquisition of replacement property and transfer of that property to the taxpayer, and required limitations on the taxpayer’s rights to money or property held by the intermediary.¹¹ The intermediary, then, has custody of the sale proceeds and typically invests them until

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needed to acquire the replacement property that will be transferred to the taxpayer. If the qualified intermediary safe harbor is satisfied, the intermediary will not be considered the agent of the taxpayer for purposes of Code Sec. 1031, and the taxpayer will not be considered in constructive receipt of the sale proceeds or property held by the intermediary.¹²

Qualified escrow accounts and qualified trusts are arrangements pursuant to which a third party (other than the other exchanging party in the taxpayer's exchange) holds cash or a cash equivalent (e.g., the sale proceeds from the disposition of relinquished property in an exchange using an intermediary) for later use by the other party (such as an intermediary) to acquire replacement property. Properly drafted documentation restricts the taxpayer's rights with respect to any money or property held by the escrow holder or trustee until the happening of certain events.¹³ If a qualified escrow or qualified trust safe harbor is properly used, the taxpayer will not be considered in constructive receipt of the funds or property held by the escrow holder or trustee.

The growth of an industry to provide qualified intermediary services followed release of the deferred exchange regulations. The use of qualified escrow accounts and qualified trusts did not, however, become routine.¹⁴

The deferred exchange regulations also provide that a taxpayer may receive an interest or growth factor in connection with a deferred exchange.¹⁵ The term "interest or growth factor" generally refers to an additional amount of money or property the taxpayer is entitled to receive from the other exchanging party, which depends upon the length of time between the taxpayer's transfer of the relinquished property and receipt of the replacement property.¹⁶

An agreement to deliver an interest or growth factor promptly became, following release of the deferred exchange regulations, and currently remains, the norm in typical deferred exchange transactions using a qualified intermediary.¹⁷ The portion of the interest earned on the sale proceeds that intermediaries agree to deliver to their customers, however, varies. While some intermediaries have long paid all of the interest to the taxpayer, others pay only a part or perhaps none, justifying the retention of some or all as the payment of compensation for the services they provide.

The deferred exchange regulations state that the interest or growth factor received by the taxpayer is to be treated as interest, regardless of whether it is paid to the taxpayer in cash or in property.¹⁸ Accordingly,

even if the intermediary uses the amount of the interest or growth factor to purchase replacement property, the associated income will be taxed currently as interest income and not deferred under Code Sec. 1031.

This rule has worked well and has been easily applied in situations in which the intermediary delivers (in like kind or other property or money) all the interest earned on the sale proceeds to the taxpayer. In those situations, exchange proceeds are typically deposited in money market or other accounts at banks upon the closing of the transfer of the relinquished property, and the parties prepare exchange and tax reporting documentation that usually provides for the reporting of the interest to the taxpayer under its taxpayer identification number.

The application of this rule, and general tax principles, would also seem to apply quite straightforwardly to the treatment of the total interest income in situations in which the intermediary retains some portion of the interest. In that case, many assumed the intermediary would include the portion of the interest it retained in its income (either by including the total interest in its income and claiming a deduction for the amount delivered to the taxpayer, or by including the net of those two amounts) and the taxpayer would include only that part of the total interest income it received. If that was the proper treatment, all of the interest income would find its way to a return and be subject to current taxation as interest. The proposed regulations and the final regulations under Code Secs. 468B and 7872 show that the Treasury and IRS have concluded that the proper tax treatment of the transaction is not quite that straightforward.

Code Sec. 468B and Proposed Regulations

Code Sec. 468B was added in 1986 and amended in 1988. It addresses the treatment of payments to, and the income earned with respect to, a "designated settlement fund," which is defined, in part, to mean a fund established pursuant to a court order to extinguish a taxpayer's tort liability for certain claims.¹⁹

Code Sec. 468B(g) provides, in part, that "nothing 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"²⁰ and that the "Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise." The government's ex-

planation of the 1999 proposed regulations, the 2006 proposed regulations and the final regulations cite the quoted text as authority for their issuance.

The 1999 proposed regulations provided rules for the taxation of the income earned on a qualified escrow account or qualified trust used in a deferred exchange. The rules stated that, except for purposes of determining whether a transaction qualifies as a deferred exchange, the taxpayer was generally treated as the owner of the assets held in the qualified escrow account or qualified trust, and, therefore, that it must take all related items of income, deduction and credit of the qualified escrow or qualified trust into account. The 1999 proposed regulations also provided, however, that if, under the facts and circumstances, the other party to the taxpayer's exchange, such as a qualified intermediary, had the beneficial use and enjoyment of the assets, then that party would be considered the owner of the assets in the qualified escrow account or qualified trust and would be required to take such items into account and, further, that in such circumstances the situation may be characterized as a below-market loan from the taxpayer to the other party to the exchange with respect to which Code Sec. 7872 could be applicable.

The 2006 proposed regulations provided that exchange funds held by a qualified intermediary, escrow holder or trustee (or other holder of exchange funds) should generally be treated as if initially received by the taxpayer and then loaned to such party, that such a "loan" should be tested under the below-market interest rules of Code Sec. 7872 and that the holder must take into account all items of income, deduction and credit attributable to the exchange funds.²¹ Importantly, however, the 2006 proposed regulations stated that funds were not to be so treated "if, in accordance with an escrow agreement, trust agreement, or exchange agreement, as applicable, all the earnings attributable to a taxpayer's exchange funds are paid to the taxpayer."

Tax Consequences of the Proposed Regulations

Generally, if the holding of exchange funds by an intermediary, escrow holder or trustee is treated as a loan from the taxpayer, the holder would recognize as income the entire amount earned on the exchange funds and, effectively, claim a deduction for the portion of those earnings it transfers to the taxpayer with respect to that loan (or for the portion it uses on the taxpayer's behalf to purchase replacement property). The taxpayer would, under those circumstances,

recognize as income the portion of those earnings actually transferred to it (or so used on its behalf).

Further, if the holding of exchange funds is treated as a loan from the taxpayer to the holder of the funds and the holder pays insufficient interest to the taxpayer under the testing rules and rates of Code Sec. 7872 such that interest is to be imputed to the taxpayer, the imputed amount will be treated as transferred by the holder of the exchange funds to the taxpayer as interest and paid by the taxpayer to the holder for its services. The holder of the funds will claim the imputed amount as an interest deduction and recognize a corresponding amount as compensation income.

The taxpayer will recognize the imputed amount as interest income. It will, however, not receive a corresponding current deduction for that amount, as the amount will be capitalized as part of the cost of acquiring the replacement property in the exchange transaction. The taxpayer will, therefore, receive a tax benefit for the amount of the imputed interest income it recognizes only through possible subsequent depreciation deductions with respect to the replacement property or an increased basis in the replacement property at the time of a later taxable disposition of it.

Objections Followed

Some commentators objected on theoretical grounds to the proposed application of Code Secs. 468B and 7872 to deferred exchange transactions and the treatment of the holding of exchange funds as a loan. These were discussed and dismissed by the government.²²

Intermediaries not affiliated with banks, and their advocates, also objected on business grounds. They asserted that if the holding of exchange funds is a loan and the holder (such as an intermediary) that does not pay all of the interest earned on the exchange funds to the taxpayer is required to impute interest on the exchange funds, taxpayers will demand that the interest amount be paid to them and, as a result, such intermediaries might fail, reduce their workforces or need to charge higher fees.

They argued the proposals favored the large, bank-affiliated intermediary, suggesting that, as a result of the relationship with the bank, such intermediaries are able to obtain consideration that might not be deemed "attributable to a taxpayer's exchange funds" under the regulations (e.g., by means of the bank's offering of a rate of return on the affiliate intermediary's deposit accounts that is less than the bank group actually earns on those

funds, or by the bank's issuing of inter-company credits to the exchange affiliate based on deposit volume), and that as a result such an intermediary could more easily avoid the characterization of its holding of exchange funds as a loan under the proposed regulations. They concluded these circumstances would, under the proposed regulations, place many small business intermediaries at a serious competitive disadvantage, asserting that they would need to significantly change their business models and large bank-affiliated intermediaries would be unaffected by the proposed changes.

While noticed, the proposed regulations and the rather intense debate among independent and some larger bank-affiliated intermediary advocates which followed was of little interest to those intermediaries that have consistently paid all earnings on exchange funds to customers, an approach that is, and has long been, common in states such as Wisconsin where title insurance underwriters and title agencies are the most common providers of intermediary services, flat intermediary fees are the norm, and independent intermediary companies have a relatively small market share. The proposals did not threaten such intermediaries or the typical business arrangement with their customers.

Final Code Sec. 468B and 7872 Regulations

Treatment As a Loan

The final regulations adopt the loan approach used in the 2006 proposed regulations. Reg. §1.468B-6(c)(1) states that, as a general rule, "exchange funds" are to be treated as loaned from a taxpayer to an "exchange facilitator." If a transaction is to be so treated as an "exchange facilitator loan," the regulations provide that the exchange facilitator must take into account all items of income, deduction and credit attributable to the exchange funds and that the loan is (unless exempt) subject to the below-market loan rules of Code Sec. 7872.²³ The loan is generally treated as a demand, compensation-related loan for those purposes,²⁴ and any imputed amount is recognized in the year earned or credited rather than in the year paid.²⁵

Definitions and Related Issues

Exchange Funds

Reg. §1.468B-6(b)(2) states that "exchange funds means relinquished property, cash, or cash equivalent

that secures an obligation of a transferee to transfer replacement property, or proceeds from a transfer of relinquished property, held in a qualified escrow account, qualified trust or other escrow account, trust or fund in a deferred exchange."²⁶ The meaning of the term is, however, somewhat unclear, as it is difficult to discern a specific meaning that considers fully both the construction of the definitional sentence and the language regarding it in the preamble.

The best reading²⁷ of the actual text seems to be that, to be exchange funds, the thing under consideration must be:

1. held in a qualified escrow account, qualified trust or other escrow account, trust or fund;
2. so held in a deferred exchange; and
3. either:
 - a. relinquished property, cash or cash equivalent that secures an obligation of a transferee to transfer replacement property; or
 - b. proceeds from a transfer of relinquished property.

Initially, while examples in Reg. §1.468B-6(e) and the preamble make it clear that bank deposits of sale proceeds by an intermediary in the typical deferred exchange situation would be considered exchange funds, if a qualified escrow account or qualified trust is not used and the proceeds are not held in another kind of escrow account or trust, then the only text in the definition that could capture such a deposit by the intermediary would be the reference to "fund." An author of the final regulations confirmed, in an informal discussion, that the word "fund" is intended to include an intermediary's deposit account.

As to item number 2 above, the term "deferred exchange" is defined for purposes of the final regulations by reference generally to the deferred exchange regulations. Reg. §1.1031(k)-1(a) states that a deferred exchange is "an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the 'relinquished property') and subsequently receives property to be held either for productive use in a trade or business or for investment (the 'replacement property')." It would seem, then, that a "deferred exchange" might be understood to commence under the final regulations either with the transfer of relinquished property or some earlier date when the taxpayer enters into an agreement with respect to that transfer and receipt of property.

The preamble to the final regulations states, however, that that definition of "exchange funds"

encompasses “transactions contemplated in Reg. §1.1031(k)-1(g)(3) [the qualified escrow account and qualified trust provisions] in which, for example, a transferee of the relinquished property pays a deposit before the property is transferred.” Does this mean the term “exchange funds” includes earnest money payments made by the buyer of relinquished property to an earnest money escrow holder, which are advances by the prospective buyer that may be paid significantly in advance of the relinquished property closing, the execution of an exchange agreement or even the decision by the taxpayer to transfer the property as relinquished property? Hopefully not.²⁸ Or, would—as seems the intent of the author—that be the case only if the earnest money is held in a qualified escrow account or qualified trust, a circumstance which, in practice, probably rarely occurs? (*I.e.*, in those cases in which a qualified escrow account or qualified trust (as defined in the deferred exchange regulations) is used in connection with an exchange, it is likely to be established upon the closing of the transfer of the relinquished property, not when a potential buyer of the relinquished property pays earnest money to an escrow agent pursuant to a purchase contract.)

Another confusing aspect of the definition of exchange funds is the reference to “relinquished property.” (See 3(a) above.) If items 1 through 3 above accurately state its necessary conditions, then in what sense is relinquished property “held in a qualified escrow account, qualified trust or other escrow account, trust or fund,” as those terms are defined in the regulations or commonly understood, in a typical exchange transaction? Is the suggestion it might be held in a trust? If security for a transferee’s obligation to transfer replacement property, the relinquished property would typically be subjected to the terms of a mortgage or deed of trust, depending on the state in which the property is located; while the purpose of the instruments is similar, only the latter might generally be considered a trust instrument.

Or does the fact “relinquished property” is included in the definition indicate that items 1 through 3 above do not accurately state its necessary conditions? If so, is the first clause of the definition, which is set forth in 3(a) above (“relinquished property, cash or cash equivalent that secures an obligation of a transferee to transfer replacement property”), a complete, independent statement of things that will be considered exchange funds? In other words, might it be the case that, to be exchange funds, the thing under consideration must either be:

1. relinquished property, cash or cash equivalent that secures an obligation of a transferee to transfer replacement property; or
2. proceeds from a transfer of relinquished property held in a qualified escrow account, qualified trust or other escrow account, trust or fund in a deferred exchange?

Some clarification of the meaning of the term would be helpful.

Exchange Facilitator

Reg. §1.468B-6(b)(3) states that “exchange facilitator means a qualified intermediary, transferee, escrow holder, trustee, or other party that holds exchange funds for a taxpayer in a deferred exchange pursuant to an escrow agreement, trust agreement or exchange agreement.” Thus, the final regulations can apply to typical multi-party situations in which the deferred exchange transaction participants are taxpayer and intermediary, the uncommon two-party deferred exchange situation in which a party (*e.g.*, other than an exchange accommodator) that acquires the relinquished property has agreed to transfer replacement property to the taxpayer to complete the exchange and any deferred exchange transaction in which the qualified escrow account or qualified trust safe harbor arrangement is used.

Exchange Facilitator Loan

Reg. §1.468B-6(c)(1) indicates that an “exchange facilitator loan” generally exists if exchange funds are treated as loaned from a taxpayer to an exchange facilitator under the regulations.

Exception if All Earnings Attributable to the Exchange Funds Paid to Taxpayer

The final regulations also adopt the principal exception to exchange facilitator loan treatment included in the proposed regulations. Reg. §1.468B-6(c)(2) states that exchange funds will not be treated as loaned from a taxpayer to an exchange facilitator, and that the taxpayer (as opposed to the exchange facilitator) is to take earnings thereon into account, if, “in accordance with an escrow agreement, trust agreement or exchange agreement, as applicable, all of the earnings attributable to the taxpayer’s exchange funds are paid to the taxpayer.”

While, at first glance, it would seem that calculating the amount of earnings “attributable” to a particular taxpayer’s exchange funds, and therefore the amount that must be paid to the taxpayer in order for this ex-

ception to apply, would be objective and easy, some commentators questioned whether, if the exchange facilitator and the depository institution in which the exchange funds were deposited are related, a portion of the earnings the depository institution earned in the ordinary course of its business on customer deposits should be considered as being “attributable” to the taxpayer’s exchange funds. Others noted that internal credits were sometimes issued between such related entities and suggested such amounts should be treated as being “attributable” to the taxpayer’s exchange funds. Questions were also raised regarding situations in which the exchange facilitator maintains a master account, presumably in its name, and sub-accounts in the name of customers, with returns paid on each; the issue was whether all or part of the total return on the accounts should be considered “attributable” to the taxpayer’s exchange funds.

Rather than trying to resolve conflicting views regarding such matters and tie these kinds of consideration or payments to taxpayer exchange funds, which would likely have required complex and lengthy rules, the government explained that it favored a definitive test pursuant to which, if the exchange facilitator holds all of the taxpayer’s exchange funds in a “separately identified account,” the earnings credited to that account will be deemed to be all of the earnings attributable to the taxpayer’s exchange funds.²⁹

A “separately identified account” is defined as one established under the taxpayer’s name and taxpayer identification number with a depository institution.³⁰ The regulations also state that a “sub-account” will be treated as a separately identified account if the master account under which it is created is established with a “depository institution,” the depository institution identifies the sub-account by the taxpayer’s name and taxpayer identification number and the depository institution specifically credits earnings to the sub-account.³¹ The regulations do not, however, define the term “depository institution.”

If the exchange facilitator does not open a separate account or use such sub-accounts in connection with exchange transactions and, instead, commingles a taxpayer’s exchange funds with other funds or assets, all the earnings attributable to the taxpayer’s exchange funds will be deemed paid to the taxpayer (and the exception to exchange facilitator loan treatment will, therefore, apply) only if all of the earnings attributable to the commingled funds or assets that are allocable, on a *pro rata* basis, to the taxpayer’s exchange funds are paid (or treated as paid) to the taxpayer. The regula-

tion requires, in making the *pro rata* allocation, the use of a “reasonable method that takes into account the time that the exchange funds are in the commingled account, actual rate or rates of return, and the respective account balances.”³² So, to secure the protection of the exception, intermediaries using commingled accounts must properly allocate, and actually pay, or be treated as paying, the earnings on the commingled account to the applicable taxpayers.

An example in the regulations also indicates that payments of marketing fees to an intermediary as compensation for its use of the payor as a depository institution for exchange funds will not be considered earnings “attributable” to a taxpayer’s exchange funds.³³ Accordingly, under the plain meaning of the regulations, it appears an intermediary may enter into referral arrangements with banks, for which it receives and retains a fee, without upsetting the application of the exception to the exchange transactions that produced the deposits.

Payments of “transactional expenses” from the taxpayer’s exchange funds, or the earnings on those funds, are treated as if first paid to the taxpayer and then paid by the taxpayer to the vendor.³⁴ The term “transactional expenses” generally has the same meaning as “transactional items” under the deferred exchange regulations.³⁵ Reg. §1.1031(k)-1(g)(7)(ii) states that such items are those that “relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statements as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees).”

Thus, under these rules, the payment of such expenses by the holder of the exchange funds directly to the vendor will not upset the use of the exception. Transaction participants and their advisors should, as previously when using a deferred exchange safe harbor, exercise caution doing so. If the items that are paid from proceeds held by, for example, an intermediary, qualified escrow account holder or qualified trustee do not constitute transactional items, the taxpayer risks loss of the protection of the deferred exchange safe harbor.³⁶ For this reason and other reasons, advisors often recommend avoiding the making of payments to third parties from exchange funds after the funds are received by the facilitator, and recommend taking steps to confirm that, for example, the source of amounts paid to persons other than the seller at the closing of the replacement property is not (unless clearly constituting transactional items) the exchange funds (*i.e.*,

that the source of the payment is the taxpayer's own funds or replacement property loan proceeds).³⁷

The regulations also provide that the fee for the services of an exchange facilitator is not a transactional expense unless the escrow agreement, trust agreement, or exchange agreement, as applicable, provides that (1) the amount of the fee payable to the exchange facilitator is fixed on or before the date of the transfer of the relinquished property by the taxpayer (either by stating the fee as a fixed dollar amount in the agreement or determining the fee by a formula, the result of which is known on or before the transfer of the relinquished property by the taxpayer); and (2) the amount of the fee is payable by the taxpayer regardless of whether the earnings attributable to the exchange funds are sufficient to pay the fee.³⁸

Interestingly, although the final regulations state that transactional expenses of the taxpayer paid by an exchange facilitator from earnings attributable to exchange funds will be treated as first paid to the taxpayer and also set forth the conditions for treatment of exchange facilitator fees as transactional expenses, the regulations do not explicitly address the facilitator's most common use of such earnings, namely, as one source of funds for payment of purchase price to a seller of replacement property. Hopefully, this common use of earnings by a facilitator (such as an intermediary) will be considered the payment of earnings on exchange funds to the taxpayer under Reg. §1.468B-6(c)(2)(i).

Exemption for Loans Not Exceeding \$2 Million Outstanding for Less Than Six Months

Reg. §1.7872-5(b)(16) states that an exchange facilitator loan is exempt from the below-market loan rules if "the amount of the exchange funds ... treated as loaned does not exceed \$2,000,000 and the duration of the loan is 6 months or less." The regulations explain the exemption by stating that such transactions in which the exchange funds do not exceed \$2 million involve "interest arrangements [which] do not have a significant effect on the Federal tax liability of the borrower or the lender."³⁹

The six-month period differs from the 180-day deferred exchange period. A six-month period may be as short as 181 days and as long as 184 days. Unfortunately, this means that, even for smaller transactions, if some but not all of the exchange funds are used to acquire replacement property, the holding of the funds does not qualify for the exception provided in

Reg. §1.468B-6(c)(2) and insufficient interest is being paid to the taxpayer under the imputed interest standards, transaction participants will want to make sure that the remainder of the exchange funds are paid to the taxpayer before the end of the six-month period (but after, of course, the date when that would be appropriate under Reg. §1.1031(k)-1(g)). In addition, the six-month period may be shorter than the period within which a taxpayer is allowed to complete its exchange; a taxpayer may have additional time to do so in the case of a presidential declared disaster.⁴⁰

An exchange facilitator may, at a particular time, be holding proceeds from the disposition of more than one of a taxpayer's properties. This may be the case with respect to the taxpayer's disposition of more than one real property, or in the case of an ongoing exchange program of personal property (for example, under Rev. Proc. 2003-39). The regulations do not explicitly state whether the \$2 million amount applies to each relinquished property disposition or is an aggregate amount applicable to all proceeds being held by a particular facilitator.

While taxpayers might assert that a separate \$2 million amount applies for each relinquished property if transferred pursuant to separate exchange agreements, the better reading of the final regulations is probably that the \$2 million limitation applies with respect to proceeds received by a facilitator from all relinquished properties transferred as part of what would be considered the "same" deferred exchange (as that term is generally understood with respect to certain provisions in the deferred exchange regulations). The regulations state that the exemption applies to "an" exchange facilitator loan, the explanation of exchange facilitator loan refers to exchange funds being treated as loaned to "an" exchange facilitator, the definition of exchange funds refers, in part, to proceeds received in "a" deferred exchange and the definition of exchange facilitator refers to the holding of exchange funds in "a" deferred exchange.

Absent further guidance, it seems reasonable to assume that references to "a" deferred exchange might be analogous to the interpretation of the term "same exchange" that has evolved under Reg. §1.1031(k)-1(b)(2)(ii) or, with respect to exchange programs, the meaning of a "separate and distinct exchange" under Rev. Proc. 2003-39.⁴¹ While no specific definition of the term "same exchange" is included in Reg. §1.1031(k)-1(b)(2)(iii), most would conclude, for example, that related properties transferred to the same buyer pursuant to the same or related purchase agreements would be considered part of the

same exchange.⁴² As to exchange programs, Rev. Proc. 2003-39 provides that the taxpayer's transfer of each relinquished property or group of relinquished properties and the taxpayer's corresponding receipt of each replacement property or group of replacement properties with which the relinquished property or group of relinquished properties has been matched by the taxpayer is treated as a separate and distinct exchange for purposes of Code Sec. 1031.

But, could a taxpayer, if holding multiple relinquished properties, each having equity of less than \$2 million and a cumulative equity in excess of \$2 million, to be sold in circumstances in which the transfers would probably be considered part of the "same" exchange under the deferred exchange regulations (e.g., such as in circumstances in which the transfer of related properties will be to one buyer, pursuant to the same purchase contract, and to be closed on the same day) avoid the application of the final regulations by executing separate exchange agreements with different intermediaries for each property or by using the same intermediary but also using a separate qualified escrow account or qualified trust, in each case with a different vendor, for each property? The regulations do not specifically address the question, and the issue is debatable. While Reg. §1.468B-6(c) does state that exchange funds are treated as loaned from a taxpayer to "an" exchange facilitator, if the suggestion made above that "a" deferred exchange under the final regulations is analogous to the term "same" exchange under the deferred exchange regulations is correct, the intent of the regulations might be that a taxpayer may not do so.

The addition of the \$2 million exemption illustrates the effectiveness of the advocacy by and on behalf of certain intermediaries. The \$2 million exemption appears (based on information in T.D. 9413) to be twice the highest amount suggested by commentators. Further, the amount seems to have been selected for reasons having little to do with statistics relating to the size of exchange transactions, and apparently was based on the Small Business Administration's definition of a small intermediary business.⁴³ The regulations also state that the IRS may increase the amount.⁴⁴

AFR for Exchange Facilitator Loans

If a transaction does not fall within the exception or the exemption referred to above and is subject to the below-market rules, the applicable federal rate used to test the transaction is the lower of two rates, namely the regular short-term AFR (as of the day on which the loan is made), compounded semiannually, or "the 91-

day rate," which is "equal to the investment rate on a 13-week (generally 91-day) Treasury bill with an issue date that is the same as the date that the exchange facilitator loan is made or, if the two dates are not the same, with an issue date that most closely precedes the date that the exchange facilitator loan is made."⁴⁵

The alternative (91-day) rate was included in the final regulations in response to assertions an alternative rate included in the 2006 proposed regulations (a rate based on a 182-day Treasury bill) was too high, given that exchange funds are typically held in demand deposit accounts and rarely held by the facilitator for an entire 180-day exchange period. The ability to use the lower of the two testing rates will be helpful to transaction principals; a survey of the rates over the last five years shows that the 91-day rate was less than the short-term AFR approximately two-thirds of the time. Moreover, although the rates have tended to be similar from time to time, differences approaching 100 basis points were occasionally noted.

Summary—Typical Intermediary Transaction in Which Proceeds Deposited at Bank

Transfers of relinquished property in deferred exchange transactions in which greater than \$2 million in proceeds are held by a qualified intermediary in an account that does not constitute a separately identified account are (unless Reg. §1.468B-6(c)(2)(ii)(B) applies) considered exchange facilitator loans from the taxpayer to the exchange facilitator that must be tested under the below-market interest rate rules. The lower of two alternative AFRs is to be used. If the interest required under these rules exceeds the amount of the earnings on the proceeds the intermediary is obligated and actually pays (or is deemed to pay) to the taxpayer (or uses on the taxpayer's behalf to purchase replacement property), such excess is interest that is deemed to be transferred by the intermediary to the taxpayer and then paid by the taxpayer to the intermediary as compensation for its services.

Effective Date

The regulations state an effective date of July 10, 2008. Reg. §1.468B-6(f) states, however, that it applies to transfers of relinquished property by taxpayers on or after October 8, 2008, and Reg. §1.7872-5(d) states that it applies to exchange facilitator loans issued on or after October 8, 2008. T.D. 9413 suggests the date the provisions are to become applicable was

delayed in order to allow exchange facilitators sufficient time to make changes to accounting, control and reporting systems and to revise exchange documents to comply with the final regulations.

While welcome, the delay will not likely be sufficient for some exchange intermediaries. For example, many in the title insurance business (underwriters and agencies) provide intermediary services. Because some such intermediaries are not associated with a trade association or corporate affiliate that would regularly send information regarding such exchange-related developments and because their principal focus is on other business lines, some providers may not yet be aware of the regulations.

Other Effects of Regulations— Observations

While not upsetting the basic theoretical structure of the proposed regulations (*i.e.*, that as a general rule the exchange funds are considered loan proceeds transferred from taxpayer to exchange facilitator), independent intermediaries and their advocates were successful in motivating changes included in the final regulations which, as a practical matter, may call into question the utility of the regulatory exercise.

For example, the \$2 million exemption will probably cover most exchange transactions. Accordingly, the new rules will have no effect in a significant number of cases.

Further, although there are areas in which all of the interest earned on the exchange balance is, and has long been, typically paid to the taxpayer (and, separate accounts are, and have long been, the norm),⁴⁶ transaction participants and their advisors in such regions will need to modify their exchange practices because, under the regulations, small and practically irrelevant “foot faults” may subject them to potentially adverse consequences (at least the need to examine the application of, and reporting requirements imposed by, the final regulations to the subject transaction).

For example, taxpayers and their advisors in those cases have historically paid little attention to the precise name under which an intermediary account has been opened.⁴⁷ An intermediary might open the separate account only in its name, or perhaps in its own name with a reference to the name of the taxpayer (*e.g.*, “XYZ Title Company, qualified intermediary under Exchange Agreement dated ___/___/2008 with ABC, Inc. (‘Exchanger’)” or “XYZ Title Company, qualified intermediary, f/b/o ABC, Inc. (‘Exchanger’)”).

One would expect such approaches given the text of the deferred exchange regulations.⁴⁸

Such transaction participants and advisors will now, for transactions that do not qualify for the \$2 million exemption, need to confirm that the account is “under the taxpayer’s name.” Establishing an account using both the intermediary and taxpayer names will, hopefully, be considered the opening of an account “under the taxpayer’s name” under Reg. §1.468B-6(c)(2).⁴⁹ Intermediaries in Wisconsin and other areas commonly solicit and use the taxpayer’s identification number in opening the account that will hold the taxpayer’s exchange funds. Any intermediary seeking to establish a “separately identified account” under the final regulations will need to be sure they routinely do so.

Taxpayers and their advisors seeking the protection of a “separately identified account” will need to modify standard exchange documentation so that it requires the intermediary or other exchange facilitator to maintain the proceeds in an account which satisfies the regulatory requirements for such status. Also, they will need to add to the preferred “interest factor” exchange document text which, prior to the Code Sec. 468B regulations need only have stated, with respect to the interest factor, that the intermediary has an obligation to deliver money or property which depends on the application of a rate of return (determined, by way of example, by reference to some market interest index or a specific bank account) to the exchange balance for the period commencing with the transfer of the relinquished property and ending with the acquisition of the replacement property. Language stating, for example, that an amount equal to the earnings credited on the account holding the funds shall be paid (subject, of course, to the limitations of Reg. §1.1031(k)-1(g)(6)) to the taxpayer will now need to be added.

It is unfortunate that the final regulations do not include an exception for short holdings of exchange funds by intermediaries. Replacement property acquisitions sometimes follow relinquished property transfers within a day or few days. This is not uncommon, for example, in connection with the closing of the acquisition of a parked replacement property (*i.e.*, parked under Rev. Proc. 2000-37); for example, the taxpayer might close the transfer of a relinquished property using a qualified intermediary on day 1, at which time the intermediary would receive and deposit the proceeds and acquire replacement property from an exchange accommodation title holder, and transfer it to the taxpayer, in each case pursuant to the deferred exchange regulations, on day 2 or day 3. A separate account is not typically opened

by the intermediary in such situations, not because the taxpayer intends to compensate the intermediary further by allowing it to retain interest, but principally because it would be inconvenient to do so given the short period during which the intermediary will hold the funds. Unfortunately, in such situations, if the proceeds exceed \$2 million, transaction principals will now probably open a separate account for the transaction, notwithstanding the inconvenience of doing so, that the earnings for such short periods will often be relatively small and that making an allocation with respect to the applicable deposit account under Reg. §1.468B-6(c)(2)(ii)(B) is an alternative.

Pending further guidance regarding how and when the \$2 million exemption applies to transfers of more than one relinquished property, taxpayers holding more than one property (in which they have greater than \$2 million in equity) they wish to transfer in exchange transactions may, if using intermediaries that pay insufficient interest under the imputed interest rules, decide the cautious approach is to use different qualified intermediaries (or use qualified escrow accounts or qualified trusts, each being with a different vendor) for each property if there is even some small question that a taxing authority might assert that the transfers of those relinquished properties should be considered part of the “same” exchange under the deferred exchange regulations or “a” single exchange under the final regulations.

The explicit reference in the final regulations to marketing fees (that might be paid, for example, by banks to intermediaries), the exclusion of such amounts from the definition of earnings “attributable” to a taxpayer’s exchange funds and the provisions making the earnings on only a sub-account of a master account the measure of the earnings “attributable” to the taxpayer’s exchange funds makes it possible intermediaries will seek, and vendors will tailor, financial arrangements that will help intermediaries retain desired portions of earnings on

exchange funds without straying outside the protection of the separately identified account exception to loan treatment. To the extent such arrangements are a means to maximize the total “return” on exchange proceeds, perhaps they serve a useful purpose.

On the other hand, such arrangements may provide an easy means to elude the spirit of the final regulations and, as a result, not be a desirable outcome from the perspective of the authors of the regulations. For example, what level (if any) of intermediary marketing fee is too generous to the intermediary, what ratio of master account interest rate to sub-account interest rate too high? Finally, because one assumes the specifics of such arrangements may not always be disclosed by intermediaries to customers, their increased use is not in the interest of greater intermediary and transaction transparency.

Despite high profile defaults in recent years, exchange intermediary failures have apparently continued.⁵⁰ The Treasury Inspector General for Tax Administration and IRS have taken note.⁵¹ The ability to commingle funds received from many exchanges has apparently facilitated the unauthorized or inappropriate use of exchange funds by, and resulted in the failures of, some intermediary companies. The final regulations do nothing to dissuade the continued use of commingled accounts⁵² and may facilitate or motivate their continued use.

Conclusion

The \$2 million exemption to loan treatment set forth at Reg. §1.7872-5(b)(16) will significantly reduce the effect of the final Code Sec. 468B and 7872 regulations. Nevertheless, all exchange transaction participants will need to consider the final regulations and potentially modify their practices and documentation to properly reduce or eliminate imputed interest income under the new rules.

ENDNOTES

* This article does not constitute legal, tax or other advice, and neither the author nor Weiss Berzowski Brady LLP is rendering any professional services in connection with its publication, distribution or use. Readers should always consult with appropriate tax, legal and other advisors regarding any transaction and their particular situations.

¹ Unless the context suggests otherwise, references to “Code Sec.” herein refer to a section of the Internal Revenue Code, and references to “Reg. §” herein refer to a section of the Treasury Regulations.

² See T.D. 9413.

³ Further, in *T.J. Starker*, CA-9, 79-2 USTC ¶9541, 602 F.2d 1341, the court held that an exchange qualified for nonrecognition of gain under Code Sec. 1031 even though the property to be received by the taxpayer was received more than a year after the transfer of the taxpayer’s property.

⁴ Act Sec. 77 of the Deficit Reduction Act of 1984 (P.L. 98-369).

⁵ The replacement property must be acquired before the earlier of 180 days after the taxpayer’s transfer of property (the relinquished property) that begins an exchange or the due date (including extensions) for the taxpayer’s

return for the year in which that property is transferred.

⁶ Code Sec. 1031(a)(3).

⁷ See Notice of Proposed Rulemaking, 55 FR 95, at 20278.

⁸ T.D. 8346, 1991-1 CB 150.

⁹ The deferred exchange regulations also include a safe harbor, which allows certain security or guarantee arrangements.

¹⁰ One of the fundamental requirements for nonrecognition treatment under Code Sec. 1031 is the existence of an exchange, which involves a transfer of property to and receipt of property from another party. On occasion, exchanges

will be closed in which another transaction principal is the other exchanging party. In the overwhelming majority of exchange transactions, however, a qualified intermediary is used.

¹¹ See *Deferred Exchanges—Selecting a QI and Documenting the Transaction With It*, J. TAX'N (Nov. 2007).

¹² Reg. §1.1031(k)-1(g)(4).

¹³ See Reg. §1.1031(k)-1(g)(3) and (6).

¹⁴ The use of qualified escrow accounts or qualified trusts may, however, be increasing in response to highly publicized intermediary defaults over the last few years. Some concluded that their greater use should be part of a regulatory regime to protect consumers against intermediary default. See Petition for a Rulemaking to Establish a Registration Process and Appropriate Operational Standards for Exchange Facilitators submitted on behalf of the Federation of Exchange Accommodators to the Federal Trade Commission by correspondence dated August 6, 2007. The FTC denied the Petition on August 18, 2008.

¹⁵ Reg. §1.1031(k)-1(g)(5).

¹⁶ Reg. §1.1031(k)-1(h)(1).

¹⁷ Thus, exchange documentation with a qualified intermediary typically provides that the exchange balance or value, which is a usually a defined term and a measure of the amount the intermediary must use to acquire replacement property (or, if not all so used, pay to the taxpayer), will be increased for an interest factor.

¹⁸ Reg. §1.1031(k)-1(h)(2).

¹⁹ Code Sec. 468B(d)(2).

²⁰ The quoted text was initially set forth at Act Sec. 1807(a)(7)(D) of the Tax Reform Act of 1986 (P.L. 99-514). The conference committee report for P.L. 99-514 states: "The conference agreement provides that except as provided in regulations escrow accounts, settlement funds, or other funds are subject to current taxation. If the contribution to such an account or fund is not deductible, then the account or fund is taxable as a grantor trust." A footnote to this text states that this "provision reverses the finding in Rev. Rul. 71-119, 1971-1 CB 163." See 1986-3 CB 844-45.

²¹ See 71 FR 25, at 6231, and following.

²² See T.D. 9413, IRB 2008-34, 404 for a discussion of the theoretical objections and the government's responses.

²³ Reg. §1.7872-16(a).

²⁴ Reg. §1.7872-16(b) and (c).

²⁵ See Reg. §1.7872-16(h).

²⁶ Reg. §1.468B-6(b)(2).

²⁷ This reading gives proper consideration to all punctuation.

²⁸ If that is the case, the six-month period referred to below in connection with the \$2 million exemption would apparently begin on the date the earnest money is first so paid, which would adversely affect the use of the exemption; exchange participants would hope this in not the meaning of the regulations. Further, which alternative condition, as between 3(a) and 3(b) in the text above, would describe the earnest money?

²⁹ Reg. §1.468B-6(c)(2).

³⁰ *Id.*

³¹ *Id.*

³² An example of a calculation allocating earnings to a taxpayer's exchange funds is included at Reg. §1.468B-6(e), Example 9.

³³ Reg. §1.468B-6(e), Example 7. Note, however, that the intermediary and depository institution in the example are related.

³⁴ Reg. §1.468B-6(c)(2)(ii)(C).

³⁵ Reg. §1.468B-6(b)(4)(i).

³⁶ See Reg. §1.1031(k)-1(g)(7).

³⁷ Reg. §1.468B-6(e), Example 2 describes a situation in which the holder of exchange funds pays survey costs relating to the replacement property, and states that the expenditure is a "transactional expense." As indicated, some advisors prefer such amounts be paid directly by the taxpayer or its lender, and certainly would dissuade payment during the period prior to the replacement property closing. Even assuming the cost of a survey can be a transactional item under the deferred exchange regulations, the concern would be the risk that the property for which the survey was obtained is not ultimately acquired as a replacement property in the exchange. See Reg. §1.1031(k)-1(g)(7)(ii).

³⁸ Reg. §1.468B-6(b)(4)(ii).

³⁹ Reg. §1.7872-5(a)(1). Also, Reg. §1.7872-5(a)(2) states that "if a taxpayer structures a transaction to be loan [exempt under Reg. §1.7872-5(b)(16)] and one of the principal purposes of so structuring the transaction is the avoidance of Federal tax, then the transaction will be recharacterized as a tax avoidance loan as defined in section 7872(c)(1)(D)."

⁴⁰ See Rev. Proc. 2007-56, IRB 2007-34, 388.

⁴¹ Rev. Proc. 2003-39, IRB 2003-22.

⁴² Other situations may not be as clear.

⁴³ See Announcement 2007-35, IRB 2007-15, 949, which states that "the applicable size standard for determining what constitutes a small business with respect to the 2006 proposed regulations is \$2 million in annual gross receipts, the SBA's definition of a small business for NAICS code 531390." Whether the concerns that motivated the \$2 million exemption should have produced such a significant change is a legitimate question.

⁴⁴ Reg. §1.7872-5(b)(16).

⁴⁵ Reg. §1.7872-16(d).

⁴⁶ This is the case in parts of the upper Midwest.

⁴⁷ This has particularly been the case in which the taxpayer used a large bank or title insurance underwriter, parties believed to be the safest of intermediary selections. The credit crisis has affected decision making with respect to intermediary selection, and made constant investigation of intermediary capability and the depository institutions used by the intermediary even (if possible) more important, which may have also lead to greater interest in the name on accounts.

⁴⁸ See Reg. §1.1031(k)-1(g)(4)(vi) and (6).

⁴⁹ This is certainly not clear, and confirmation regarding whether this approach satisfies the regulations would be welcome. If this is not permitted under the final regulations and an exchange facilitator must open the account only in the taxpayer's name, there will be some tension between the final regulations and parts of the deferred exchange regulations (e.g., Reg. §1.1031(k)-1(g)(3)(ii), (4)(v) and (6)(i)). Moreover, news reports on September 18, 2008, indicated the IRS is considering recognizing the use of joint accounts between taxpayers and qualified intermediaries in deferred exchanges. Finally, if only the taxpayer's name may appear, practical obstacles opening accounts in which the name on the account (i.e., the taxpayer) and the authorized signatory (the exchange facilitator) differ will probably also exist.

⁵⁰ See *Behind the Boom and Bust of Real-Estate Player Vesta*, WALL ST. J., July 30, 2008.

⁵¹ See Treasury Inspector General for Tax Administration report issued August 27, 2008, entitled *Guidance Could be Enhanced for Deciding to Use a Qualified Intermediary in Like-Kind Exchanges*.

⁵² This, admittedly, is not the focus of the regulations.

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