Client Alert.

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Revenue Procedure 2010-14 – New Safe Harbor for Code Section 1031 Like-Kind Exchanges

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On March 5, 2010, the Internal Revenue Service ("IRS") issued Revenue Procedure 2010-14, providing a new safe harbor method of reporting gain or loss for certain taxpayers who enter into deferred like-kind exchanges under Section 1031 of the Internal Revenue Code ("Code") but fail to complete the exchange because a qualified intermediary defaults on its obligation to acquire and transfer replacement property.

BACKGROUND

Under Code Section 1031(a), no gain or loss is recognized if property held for productive use in a trade or business or for investment (the "relinquished property") is exchanged solely for property of a like kind to be held for productive use in a trade or business or for investment (the "replacement property"). Code Section 1031 also allows for deferred like-kind exchanges whereby, pursuant to an exchange agreement, the taxpayer (i) transfers relinquished property, (ii) identifies replacement property within 45 days of the transfer of relinquished property ("identification period"), and (iii) acquires replacement property within the sooner of (a) 180 days of the transfer of relinquished property and (b) the due date for the taxpayer's return (including extensions) for the year of the transfer of relinquished property ("exchange period").

Taxpayers may also use a qualified intermediary ("QI") to facilitate a like-kind exchange. In this scenario, the taxpayer, pursuant to an exchange agreement, would transfer relinquished property to the QI and subsequently receive replacement property from the QI. Pursuant to Treasury Regulations under Code Section 1031, the QI would not be considered an agent of the taxpayer. However, if the taxpayer actually or constructively receives money in the full amount of the consideration for the relinquished property, the transaction would not qualify as a deferred like-kind exchange under Code Section 1031. In addition, the taxpayer must not have rights to receive, pledge, borrow or otherwise obtain the benefits of the money or property held by the QI.

REVENUE PROCEDURE 2010-14

Recently, situations have arisen where taxpayers initiated a deferred like-kind exchange by transferring relinquished property to a QI but were unable to complete the exchange within the requisite exchange period solely because the QI failed to acquire and transfer replacement property (a "QI default"). This usually stems from the QI entering into bankruptcy or receivership, preventing the taxpayer from obtaining immediate access to the proceeds of the relinquished property's disposition. According to Revenue Procedure 2010-14, the IRS and the Treasury Department are generally of the view that a taxpayer who in good faith sought to complete a deferred like-kind exchange using a QI but who failed to complete the exchange solely because of a QI default where the QI became subject to a bankruptcy or receivership proceeding should not be required to recognize gain from the failed exchange until the taxable year in which the taxpayer receives a payment attributable to the relinquished property.

Revenue Procedure 2010-14 provides that if (i) there is a QI default where the QI becomes subject to a bankruptcy or receivership proceeding, and (ii) the taxpayer cannot enforce its rights under the exchange agreement with the QI or otherwise access the sale proceeds from the relinquished property, the taxpayer will not be treated as having actual or constructive receipt of the sale proceeds if the taxpayer reports gain on the disposition of the relinquished property in accordance with a "safe harbor gross profit ratio method" specified in Revenue Procedure 2010-14.

Revenue Procedure 2010-14 applies to taxpayers who (i) transferred relinquished property to a QI in accordance with the Treasury Regulations under Code Section 1031, (ii) properly identified replacement property within the identification period (unless the QI default occurs during that period), (iii) did not complete the like-kind exchange solely because of a QI default involving a QI that becomes subject to a bankruptcy or receivership proceeding, and (iv) did not, without regard to any actual or constructive receipt by the QI, have actual or constructive receipt of the proceeds from the disposition of the relinquished property or any property of the QI prior to the time the QI entered bankruptcy or receivership.

Safe Harbor Gross Profit Ratio Method. A taxpayer within the scope of Revenue Procedure 2010-14 would recognize gain on the disposition of the relinquished property as the taxpayer receives payments attributable to the relinquished property.[1] Under the safe harbor gross profit ratio method, the portion of any payment attributable to the relinquished property that is recognized as gain is determined by multiplying the payment by a fraction, the numerator of which is the taxpayer's gross profit[2] and the denominator of which is the taxpayer's contract price.

The total gain recognized under Revenue Procedure 2010-14 should not exceed the sum of (i) the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis), plus (ii) the satisfied indebtedness not in excess of basis, minus (iii) the adjusted basis of the relinquished property.

A taxpayer within the scope of Revenue Procedure 2010-14 may claim a loss deduction under Code Section 165 for the amount, if any, by which the adjusted basis of the relinquished property exceeds the sum of (i) the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis), plus (ii) the amount of any satisfied indebtedness not in excess of basis. A taxpayer claiming such a loss deduction may also claim a loss deduction under Code Section 165 for the amount of any gain recognized in accordance with Revenue Procedure 2010-14 in a prior taxable year.

In addition, for purposes of applying the safe harbor gross profit ratio method, the selling price,[3] the contract price, and any payment attributable to the relinquished property must be reduced by the amount of any imputed interest allocable to the payment as determined under Code Section 483 or 1274, whichever is applicable. For purposes of these Code Sections, the date of the confirmation of the bankruptcy plan or other court order that resolves the taxpayer's claim against the QI is treated as the date of sale of the relinquished property, so imputed interest would apply only if payment

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[1] For purposes of the safe harbor gross profit ratio method, a "payment attributable to the relinquished property" means a payment of proceeds, damages or other amounts attributable to the disposition of the relinquished property (other than selling expenses), whether paid by the QI, the bankruptcy or receivership estate of the QI, the QI's insurer or bonding company, or any other person. In general, satisfied indebtedness is not a payment attributable to the relinquished property, except that the amount of satisfied indebtedness in excess of the adjusted basis of the relinquished property is treated as a payment attributable to the relinquished property in which the indebtedness is satisfied. "Satisfied indebtedness" means any mortgage or encumbrance on the relinquished property that was assumed or taken subject to by the buyer or satisfied in connection with the transfer of the relinquished property.

[2] For purposes of the safe harbor gross profit ratio method, "gross profit" means the selling price of the relinquished property minus the taxpayer's adjusted basis in the relinquished property (increased by any selling expenses not paid by the QI using proceeds from the sale of the relinquished property).

[3] For purposes of the safe harbor gross profit ratio method, the "selling price" of the relinquished property generally is the amount realized on the sale of the relinquished property, without reduction for selling expenses.

is received more than 6 months after that date.

Revenue Procedure 2010-14 includes five examples of the application of its rules to various fact patterns.

CONCLUSION

Revenue Procedure 2010-14 provides guidance for taxpayers who in good faith sought to complete a deferred like-kind exchange using a QI but who failed to complete the exchange because of a QI default where the QI became subject to a bankruptcy or receivership proceeding. In general, Revenue Procedure 2010-14 introduces the safe harbor gross profit ratio method whereby taxpayers within the scope of Revenue Procedure 2010-14 would not be required to recognize gain from the failed like-kind exchange until the taxable year in which the taxpayer receives a payment attributable to the relinquished property.

Revenue Procedure 2010-14 is effective for taxpayers whose like-kind exchanges fail due to a QI default occurring on or after January 1, 2009.

