CA FTB Denies Exchange

Based on Cast Out at Closing—Analysis and Response

1031 Knowledge

It's no secret that the California Franchise Tax Board ("FTB") has become very aggressive in challenging 1031 exchanges. In an audit, described in an Audit Issue Presentation Sheet dated September 4, 2013 (the "Audit"), the FTB held that an exchange failed based on a practice which has become commonplace: the distribution of a portion of the relinquished property sales proceeds to the taxpayer, as boot, at the relinquished property closing. The FTB's analysis suggests that a change in practice may be required to avoid running afoul of this new basis for challenging exchanges.

In the Audit, the taxpayer entered into an exchange agreement dated 2/24/09, which contained language typical in exchange agreements: "Seller/Taxpayer hereby relinquishes all of her rights in receiving any cash proceeds from this transaction, as Seller's net proceeds check is to be paid to [the qualified intermediary ("QI")]." The exchange agreement further contained the standard restrictions under Treas. Reg. 1.1031(k)-1 (g)(6).

Prior to the relinquished property closing on 3/12/09, the taxpayer sent an e-mail to the closing officer instructing the closing officer to release $150,000 of the proceeds from the sale of the relinquished property to the taxpayer. There was no reference to any document allowing the taxpayer to take the money and no communication to or from the QI. The taxpayer reported the amount as taxable "boot" on the taxpayer's 2009 tax return.

The FTB held that the ability of the taxpayer to direct that a portion of the sales proceeds be distributed to her, at the taxpayer's discretion, constituted "constructive receipt" of all of the sale proceeds, disqualifying the transaction from 1031 exchange treatment. The FTB cited Treas. Reg. 1.1031(k)-1(f)(2): "[t]he taxpayer is in constructive receipt of money or property at the time the money or property is . . . 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." The FTB found that the ability of the taxpayer to instruct the closing officer by simple notice showed that there were no restrictions on the taxpayer's access to the sales proceeds, and this constituted constructive receipt.

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The FTB also discussed Treas. Reg. 1.1031(k)-1(g)(4)(vii), which provides that "a taxpayer may receive money or other property directly from a party to the transaction other than the qualified intermediary" without affecting the QI safe harbor provisions. This subparagraph (vii) is typically relied upon for the proposition that a taxpayer can receive money directly from the closer without affecting the taxpayer's arrangement with the QI. The FTB held that the taxpayer was precluded from relying on subparagraph (vii), because the taxpayer, in the exchange agreement, had expressly relinquished "all of her rights in receiving any cash proceeds from this transaction, as Seller's net proceeds check is to be paid to [the QI]."

The FTB also pointed to another, independent basis for denying the 1031 exchange. There had been a clear (g)(6) violation when the QI distributed proceeds to the taxpayer, prior to the expiration of the exchange period, after the taxpayer had purchased only one of two identified replacement properties. But the FTB made clear that either issue (the receipt of cash at closing, or the (g)(6) violation) would have been enough to disqualify the 1031 exchange.

Given the position of the FTB regarding the receipt of cash at closing, how should the arrangement among the taxpayer, QI and closing officer be structured? It appears clear that the taxpayer should not have the unilateral right to instruct the closing officer to distribute cash to the taxpayer, from sales proceeds assigned to the QI, at the closing on the relinquished property. It appears equally clear that if all sales proceeds are assigned to the QI, then the taxpayer has relinquished the taxpayer's right to receive any of those sales proceeds.

The approach being used by Asset Preservation, Inc. involves the following: (i) if the taxpayer wishes to receive a portion of the sales proceeds as boot at the relinquished property closing, the taxpayer should expressly exclude this amount from the sale proceeds assigned to the QI in the exchange agreement; and (ii) the instructions from the QI to the closer should acknowledge the exclusion of this amount from assignment to the QI, and acknowledge that the taxpayer retains the right to receive this amount at the closing. This requires the taxpayer, as part of the exchange agreement, to disclose the amount of cash to be received by the taxpayer at the closing. Such a practice may be slightly inconvenient for the taxpayer but appears to be necessary in light of the FTB's position.

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