Constructive Receipt

Lessons Learned from Crandall V. Commissioner

1031 Knowledge

A sale of property for cash or other property is generally a taxable event unless another provision of the Internal Revenue Code (IRC) permits tax deferral. Where tax deferral is available, the IRS and courts typically require strict compliance with the statute or regulations authorizing such deferral. One of the most commonly used statutes providing tax deferral is IRC Section 1031. This provision permits tax deferral when like-kind property is exchanged for other like-kind property. Although the exchange requirement might seem simple at first blush, §1031 and the regulations promulgated by the Treasury under authority granted by Congress, set forth specific procedures and documentation requirements which must be met at the time the relinquished property is transferred to a buyer if the exchange will involve a sale of relinquished property for cash or other non-like-kind property. This sort of transaction is commonly referred to as a delayed exchange. A taxpayer's intent to purchase replacement property following a sale is not enough to qualify for tax deferral under §1031.

The documentation requirements mostly relate to an income tax notion called "constructive receipt." Under this doctrine, a taxpayer has received property which the taxpayer controls or has access to, even if the taxpayer does not actually have possession of the property. Section 1.1031(k)-1(f)(2) states that a "taxpayer is in constructive receipt of money or property at any 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." The regulations describe various ways of avoiding the application of the constructive receipt doctrine where relinquished property is sold for cash or other like-kind property in the first phase of a tax-deferred exchange (e.g., the like-kind property is not merely swapped). Specifically, the regulations create several safe harbor arrangements, including the use of a qualified intermediary, qualified trust or qualified escrow to hold the sale proceeds during the period between the sale of relinquished property and the purchase of replacement property. Each of the foregoing arrangements requires the taxpayer to execute a written agreement that adequately limits the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefit of the sale proceeds during the exchange period.

The tax court illustrates the problem which arises when a delayed exchange is not properly documented at the time of the relinquished property sale. In *Crandall vs. Commissioner*, T.C. Summ. Op. 2011-14, 2011 TNT 32-7, a taxpayer sold an undeveloped parcel of land in Arizona which had been held for investment. The taxpayer intended to exchange out of the Arizona property and into a property in California located closer to the

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taxpayer's residence. Upon the sale of the Arizona property, the buyer's purchase money was deposited in an escrow account with the title company handling the closing in Arizona. The taxpayer later instructed the title company to transfer some of the escrowed funds to a title company in California who had been engaged to close the purchase of other investment property for the taxpayer. The property being acquired in the second escrow met the like-kind requirement under §1031.

However, instead of utilizing one of the safe harbor arrangements authorized in the regulations, such as using a qualified intermediary to facilitate the exchange, the taxpayer merely left the proceeds in the title company's escrow and told the escrow officer he was performing an exchange. The IRS subsequently disallowed the exchange on the grounds that the taxpayer had constructive receipt of the sale proceeds. The IRS assessed a tax on the sale, interest on the underpayment of tax and penalties. On appeal, the tax court ruled that the transaction was a taxable sale followed by a subsequent purchase because the escrow agreement did not expressly restrict the taxpayer's access to and use of the funds held in the escrow account. Lessons learned from *Crandall* include:

1. Although the taxpayer intended to set up the transaction which qualified for a 1031 exchange, it is well established that a taxpayer's intention to take advantage of tax laws does not determine the tax consequences of their actual transactions. [*See Bezdjian v. Commissioner* (1988) and *Carlton v. United States* (1960).]

2. The reinvestment of proceeds from a cash sale of an investment property into a second property will not qualify for the tax-deferral benefits under §1031. [*See Greene v. Commissioner* (1991); *Coastal Terminals, Inc. v. United States* (1963); *Estate of Bowers v. Commissioner* (1990); *Lee v. Commissioner* (1986).]

3. Since the escrow account did not limit the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of the proceeds nor anything else to properly reflect the transaction as a 1031 exchange, the account was not deemed a qualified escrow account.

4. It is essential to consult a qualified intermediary; have restrictions on the sale proceeds; and, execute exchange documents prior to closing.

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