Safe Harbor for 1031 Exchanges

IRS Provides Relief in Revenue Procedure 2010-14

1031 Knowledge

The Internal Revenue Service released Revenue Procedure 2010-14 providing guidance and a safe harbor for reporting capital gains and losses arising out of certain failed or incomplete 1031 exchange transactions. The Procedure covers situations in which the taxpayer's failure to complete the exchange resulted from the failure of the taxpayer's qualified intermediary (QI) to acquire and transfer replacement property to the taxpayer to complete the exchange within the time requirements of Section 1031. This Revenue Procedure responds to the hardship suffered by taxpayers who engaged qualified intermediaries who either filed for bankruptcy protection or where there was a defalcation of exchange proceeds.

A taxpayer falls within the safe harbor requirements of Rev. Proc. 2010-14 if he or she transferred relinquished property to a QI in a 1031 exchange, and: (A) Replacement property was properly identified within the 45-day Identification Period (unless the QI default occurred during the Identification Period); (B) the taxpayer is unable to complete the exchange due to the QI's default and the QI either files for bankruptcy protection or is subject to receivership proceedings under Federal or state law; and (C) the taxpayer has not had actual or constructive receipt of the proceeds from the sale of the relinquished property or any other property up to the date the QI entered bankruptcy or receivership.

For exchange transactions meeting the safe harbor requirements, the Procedure provides that the taxpayer will not be treated as having actual or constructive receipt of exchange proceeds on the expiration of the 180-day exchange period. Instead, the Procedure permits the taxpayer to report gain as exchange proceeds are received from the bankruptcy trustee or receiver under rules similar to those employed under IRS Section 453 (Installment Method). Under rules applicable prior to the issuance of the Procedure, it was unclear whether the taxpayer in a failed exchange would be deemed to be in constructive receipt of exchange proceeds on the expiration of the exchange period. Secondly, the safe harbor provides that any debt relief otherwise treated as a payment in the year the relinquished property was transferred to the qualified intermediary is limited to the amount by which the debt exceeds that taxpayer's adjusted basis in the relinquished property. This rule is more generous than the rule applicable under Section 453 which would treat the entire amount of debt relief as a payment received by the taxpayer in the year the relinquished property was transferred. The remainder of the Procedure describes the mechanics or reporting gain or loss as exchange funds are recovered from the qualified intermediary.

Effective Date: The Procedure is effective for transactions that fail due to QI default on or after January 1, 2009.

In conclusion, the security of exchange proceeds while in the possession of the QI has always been of paramount importance at Asset Preservation, Inc.

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