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TAX - DEFERRED EXCHANGES
AND BANKRUPTCY OF THE
QUALIFIED INTERMEDIARY:
LIGHTNING STRIKES AGAIN

BY

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**"TAX-DEFERRED EXCHANGES AND BANKRUPTCY OF THE
QUALIFIED INTERMEDIARY:
LIGHTNING STRIKES AGAIN (AND AGAIN)!"**

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I. INTRODUCTION: Most real estate practitioners, attorneys, accountants and others undertaking real estate transactions have certainly become very familiar with the concept of Federal Code Section 1031. (Code §1031 covering the area of tax-deferred exchanges. Code §1031 has been in the tax law since the 1920s.) 1/

Under Code §1031, the basic rule, for Federal tax purposes, 2/ is that gain or loss will not be recognized gain where there is an exchange of property that is held for productive use in a trade or business or for investment, where that property is exchanged solely for property of like-kind that is to be used in a trade or business or for investment. (There are additional requirements under Code §1031, but this is the general rule. 3/)

Although there are additional requirements to meet the test under Code §1031, the essence is to comply on a timely basis 4/ with the exchange of like-kind, qualified property.

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Since not all exchanges take place simultaneously, where the taxpayer surrenders or gives up his or her relinquished property and acquires replacement property, there is the possibility to use some other entity

or person to act to hold certain properties as what is often labeled as a "qualified intermediary." 5/ The qualified intermediary has specific requirements, as expressed in the Code under the Regulations addressing Code §1031. 6/

The intent of this short Note is not to examine in detail the requirements of Code §1031. It is assumed that the reader is basically familiar with the concept of postponing the income, where there is a disposition of property under Code §1031. For more details on this, see the authorities in the footnote. 7/

The purpose of this Note is to examine a situation where there has been an attempt to undertake a qualified tax-deferred exchange, but the taxpayer, to meet the requirements under the exchange rules, utilize an intermediary, as referenced earlier. That intermediary is to "hold" the property, as indicated, and possibly funds, to facilitate the transaction. In many of these circumstances it is necessary to use what is referred to as a "qualified intermediary" within the requirements of Code §1031 and the Regulations, as indicated.

This Note focuses on a case where an individual acted as a qualified intermediary, and, unfortunately for the taxpayer, defaulted and thereby committed criminal acts, and failed to properly account for funds, which created a major financial issue and tax issue for the taxpayer/transferor.

II. CONCERNS WITH INTERMEDIARIES: Although there are many concerns and requirements for qualified intermediaries, 8/ which are well-explained within Code §1031 and the Regulations, there are also practical problems or concerns if an intermediary does not properly perform in an honest manner and absconds with funds or fails to properly account for funds.

In reviewing concerns with intermediaries acting for taxpayers on exchanges, some time ago I became concerned with the issue as to the impact on the taxpayer's funds as well as the requirements under Code §1031 if the intermediary was forced into bankruptcy. At that time I wrote an article 9/ on these issues. In that article, I raised the concern with the issue as to an intermediary who is placed in bankruptcy. There were a few cases that issued on the specific point of the 180-day reinvestment requirement that applies under Code §1031(a). There were also concerns with funds that were potentially being lost by the taxpayer when the intermediary was forced into bankruptcy. Those cases created great consternation for the taxpayer, but, in most cases, eventually the taxpayer would receive a return of the taxpayer's funds held by the intermediary. However, in most of the cases there were delays, problems with the tax positions, and many dollars incurred for costs and attorney fees. Some of these cases included In Re San Diego Realty, Inc., 10/ In Re Exchanged Titles, Inc.; 11/ and In Re Sale Guaranty Corporation. 11/

Subsequent to this article and the above-referenced cases, I raised the same issue in another article. 12/ In the more recent article, I mentioned a recent case and concerns for taxpayers and property owners in general when attempting to work with a third party where the funds held by the third party were lost, or possibly lost, because of creditors and claims in bankruptcy. This more recent case is Deer Creek, Inc. v. Section 1031 Services, Inc., et. al. 13/

Using Yogi Berra's famous line: "De Ja Vu All Over Again," one might address the same issue as a result of a recently issued case on this same topic, In Re Nation-wide Exchange Services, Inc. 14/ In this case, the intermediary, who acted for the exchange transaction, was forced into a bankruptcy position. He had improperly utilized funds of the taxpayer.

The Trustee in bankruptcy, similar to the other cases cited, asserted the position that the bankruptcy trustee was entitled to the funds and the property in question, both of which were owned by the taxpayer/plaintiff in the case, Miller & Holmes, Inc.

This case was quite involved as to the real estate and the funds. However, for purposes of this Note, the focus is on the question as to who is entitled to the funds when the qualified intermediary is forced into bankruptcy and there were funds and property that were the taxpayer's funds, but were being held by the qualified intermediary (and, eventually, by the trustee in bankruptcy).

The amounts in question were fairly substantial, in the many hundreds of thousands of dollars. The wrongdoer was clearly the qualified intermediary. Because of the criminal actions and the action to abscond with the funds, the qualified intermediary was eventually charged with Federal criminal charges, faced a plea, conviction, sentencing and was imprisoned. Notwithstanding the very adverse result to the qualified intermediary who had improperly acted, this did not return the funds to the taxpayer, nor address the taxpayer's concern with the funds, the property and the potential of deferring tax.

The Opinion by the Court in this Nation-wide case supported the trustees' position that the trustees were entitled to be paid some \$306,000. However, in turn, the trustee was required to transfer the property, then held by the qualified intermediary, and, therefore, held by the trustee, to the plaintiff, Miller & Holmes. This would not have been a very satisfying "win" by the plaintiff, Miller & Holmes. Although they would receive the property, they had fully paid for it. Of course, they also incurred attorney fees and court costs, along with a great deal of delay and the risk of adverse tax implications from the loss of use of Code §1031.

However, fortunately for the taxpayer in this Nation-wide case, as I learned from the attorney who handled the case, Mr. Kass Weil, of the firm of Moss & Barnett in Minneapolis, the taxpayer was successful in obtaining the property without the requirement of paying the \$306,000. 15/

Although the result, considering the possible options, was eventually very satisfactory to the taxpayer, the delay in the potential tax deferral, potential loss of the real estate, and the requirement to pay additional funds, all addressed the concerns with a setting in which a qualified intermediary acts improperly with funds that were those of the taxpayer.

III. CONCLUSION: Intentionally I have left out some of the detail on the very extensive case of Nation-wide, cited earlier. The focus was on the direct Code §1031 issues, the default by the intermediary, and concerns when the intermediary is in bankruptcy. Many other issues were involved, including the fact that the property in question was actually one that would have qualified by the taxpayer for condemnation treatment under Code §1033. 16/ Because of this special condemnation rule, the taxpayer was able to qualify for a deferral of the tax liability, receive the real estate bargained for, and avoid paying additional monies to the trustee in bankruptcy.

Although this result may seem to be favorable under the circumstances, avoiding the entire exposure of loss of funds, such risk factors and adverse tax implications certainly should be addressed by taxpayers. "Addressing" these issues means to consider whether the real estate exchange is the better route, or whether there are alternatives to be considered that might produce better tax results. And, with the tax issue aside, where a Code §1031 transaction is anticipated, taxpayers would be very well advised to be certain that the taxpayer's qualified intermediary is in fact qualified in every aspect, including integrity. The potential loss of hundreds of thousands of dollars, delay caused by the bankruptcy, and potentially adverse tax implications, should convince taxpayers and their counsel to carefully consider the use of intermediaries that are capable, able, trustworthy, and bona fide to undertake the position as a qualified intermediary. 17/

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FOOTNOTES

1. See Levine, Mark Lee, Exchanging Real Estate, Chapter 1, Volume 1, PP&E, (2004 Edition) for a detailed discussion of the history of Code §1031 as it now exists. Code §1031 was formulated in the early 1920's and has been modified a number of times, up to the current position in 26 U.S.C.A. Code §1031, herein sometimes referred to as "Code Section 1031" or "Code §1031."
2. Note that state law may or may not apply the rules under Federal Code §1031.
3. See Code §1031(a)(1) and the exceptions listed for exchanges that will not qualify for deferral, as denoted under Code §1031(a)(2). These exceptions include such items as stock in trade or other property held primarily for sale; stocks, bonds or notes; other securities or evidence of indebtedness or interest; interest in a partnership; certificates of trust or beneficial interest; and choses in action.
4. See Code §1031(a)(3). This "timely" reference refers to a requirement that the exchange be completed, generally speaking, within 180 days from the transfer of the relinquished property. The relinquished property is the property given up by the taxpayer to receive other like-kind, qualified property labeled as "replacement property." (This 180 days is changed to an earlier date, the date that the return of the taxpayer is due, including any extensions, where applicable. However, generally speaking taxpayers will fall within the 180-day time frame for measuring their timely performance.)
5. See Treasury Reg. §1.1031(k).
6. See Treas. Regs. §1.1031(k).
7. See the Levine text, cited supra, Note 1. See Levine, Mark Lee, Real Estate Transactions, Tax Planning, Chapter 29, Thomson West, St. Paul, Minnesota (2004 edition).
8. See Treasury Reg. §1.1031(k).
9. Levine, Mark Lee, "The Impact On A Tax-Deferred Exchange Under Code §1031 When the Intermediary Enters Bankruptcy." That article was printed under a similar title in the Journal of Property Management, Institute of Real Estate Management (IREM) (November/December 1998).
10. See In Re San Diego Realty Exchange, Inc., Debtor, and Taxel, Trustee, Plaintiff-Appellee, v. Surnow, Appellant-Defendant, 24 F.3d 249 (9th Cir., 1994).
11. See In Re Exchanged Titles, Inc., a California corporation, Debtor, DeGroot, et. al., Plaintiffs, v. Exchanged Titles, Inc., a California corporation and Charles W. Daff, Chapter 7 Trustee, Defendants, 159 B.R. 303 (September 15, 1993). See also In Re Sale Guaranty Corporation, Debtor, Siegel, Trustee, Appellant, v. Boston, et. al., v. Ward, et. al., v. Newman, et. al., 2 Cal. Bankr. Ct. Rep. 80 (1998), B.A.P. (9th Cir., April 1998) and 199 F.3d 1375 (12/99).
12. Levine, Mark Lee, "Caveat Exchanger: 'De Ja Vu' All Over Again," Real Estate Issues, Counselors of Real Estate (Summer, 2000). These cases can also be found within the Levine text, cited supra, Note 1, in Chapter 10.

13. See Deer Creek, Inc. v. Section 1031 Services, Inc., et. al., 510 S.E. 2d 853, 235 Ga. App. 891 (1999).

14. See In Re Nation-wide Exchange Services, Inc. v. Miller & Holmes, Inc., 91 A.F.T.R. 2d (2003-1850), 49 Collier Bankr. 2d 1557 (2003).

15. Through the kind comments by Mr. Weil to me, I learned that a settlement was reached on the Nation-wide case while it was on appeal. Apparently all attorneys felt that the judge's position of requiring the payment was improper. In any event, the taxpayer was fortunate to have good counsel that was able to negotiate a settlement, prior to the appeal. The settlement resulted in the taxpayer receiving not only the property under a specific performance position, but also avoiding the \$306,000 payment. The taxpayer also had a somewhat serendipitous result in that the settlement allowed sufficient position to negotiate, through the strong actions of counsel, for the deferral of the tax on the transaction.

16. See Code §1033 and the discussion of "involuntary conversions." It appears that Code §1033 could have applied in the case in question, because the property was subject to condemnation; the taxpayer chose to undertake an exchange.

A better choice probably would have been the "involuntary conversion," which would have avoided many of the steps that were necessary in this given case, with an exchange setting. For more on this, see the Levine text, cited supra in Note 7, Chapter 30.

17. For more in the area of exchanges involving the potential of an improperly acting qualified intermediary, see the above-noted authorities, cited supra, Note 1.