Like-Kind Exchanges and Qualified Intermediaries

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The economic downturn has depressed the real estate market, a significant component of the section 1031 industry. In its wake, the industry witnessed three major qualified intermediary failures. QI failures deprive exchangers of exchange proceeds and also create potential tax and legal liabilities for the exchangers. This report analyzes those potential liabilities and also discusses the cause of QI failures and actions that exchangers and QIs may consider to help safeguard exchange proceeds.

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I. Introduction

A. Overview of Qualified Intermediaries

In 1991 Treasury promulgated final regulations that approved the use of so-called qualified intermediaries to facilitate multiparty deferred like-kind exchanges under section 1031.[1] The regulations permit a QI to hold funds (exchange funds) received from a transfer of an exchanger's relinquished property pending the acquisition of one or more replacement properties. The regulations also provide detailed rules for ensuring that the taxpayer will not be deemed to be in constructive receipt of exchange funds held by a QI.

For years, some commentators expressed concern that the large sums of exchange funds available to QIs could attract the attention of schemers or criminals who might not have their clients' best interests at heart.[2] Although there had been some smaller QI defalcations or bankruptcies since 1991, in the last two years, we have seen three major QI failures. In two cases, criminal charges were brought against the individual owners of the QI company. In the third case, an institutional QI invested exchange funds in assets that were thought to be highly liquid but turned out not to be so.

In most jurisdictions, QIs are not subject to specific regulation. To date, only California, Colorado, Idaho, Nevada, and Washington have enacted laws regulating QIs and establishing operating requirements. Given the recent QI meltdowns discussed below, more state regulation is expected. It will be welcomed by many in the industry. The authors find it ironic that for many years the greatest fear in the QI industry was a potential external threat — that Congress might restrict the types of qualifying replacement property and thus shrink the industry. Instead, the QI industry now faces a legitimate fear among potential exchangers about the security of deposited exchange funds.

B. The Three Major Meltdowns

The first major QI failure occurred in January 2007 when Southwest Exchange Inc., a regional company, ceased operating. About $97.5 million of exchange funds went missing. Nikki Pomeroy, the daughter of Southwest's principal, Don McGhan, himself a veteran of failed

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[1]*See* T.D. 8346, *Doc 91-3361*, *91 TNT 92-3*. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended. The term "exchanger" refers to a taxpayer who intends to exchange property in a deferred like-kind exchange under section 1031.

[2]*See, e.g.*, Terence F. Cuff, "Structuring a Simple Forward Real Estate Exchange," *J. Real Est. Tax'n* (1st Quarter 2007), p. 77 ("It is hard to imagine an industry that could prove more attractive to aspiring criminal talent than the intermediary business").

businesses and Securities and Exchange Commission investigations, was indicted under Nevada law on March 30, 2009, for 11 felony counts of embezzlement and 11 counts of unlawful intermediary conduct. McGhan was named but not charged in the indictment. Approximately $91.7 million was ultimately recovered (before attorney fees and expenses) for distribution to Southwest's exchange customers and other creditors — an amount termed "amazing" by the court-appointed receiver.[3] The recoveries were primarily from financial institutions, insurance companies, and other deep pockets that dealt with Southwest and allegedly aided the scheme. The central allegation was that McGhan bought Southwest for about $3 million and immediately started using much of its approximately $100 million of cash to fund other McGhan businesses and lavish personal expenses.[4]

Later in 2007, the 1031 Tax Group collapsed amid scandal. That entity was created by entrepreneur Ed Okun as a rollup of formerly reputable regional QIs.[5] With nine figures' worth of exchange funds missing, the Okun 1031 empire filed for bankruptcy protection and was unable to close like-kind exchanges. Okun was indicted in federal district court in Richmond, Va., on March 18, 2008. On March 19, 2009, he was convicted of 23 counts, including mail fraud, wire fraud, money laundering, and perjury, relating to the use of exchange funds to finance his extravagant lifestyle.

The third major, and likely most expensive, QI failure occurred in November 2008. LandAmerica 1031 Exchange Services (LES), a QI subsidiary of LandAmerica's holding company, ceased operations because it did not have the liquidity to close on exchanges. A chapter 11 filing by LandAmerica's parent holding company and the QI subsidiary followed. The holding company had guaranteed the payment of exchange funds that should have been on hand at LES. The title companies owned by the holding company did not file for chapter 11 protection and were sold to Fidelity Title.

The bankruptcy court in LandAmerica's hometown of Richmond began sorting through about $416 million in claims by approximately 450 exchangers. Those claims represent exchange funds deposited with LES, as well as claims for federal and other taxes that would not have been incurred had LES timely honored its obligations under its exchange agreements regarding replacement property acquisitions.

C. The LES Bankruptcy

Publicly available information suggests that LES's demise was triggered by the collapse of the auction rate securities market on February 13, 2008. LES had invested the majority of its exchange funds in those securities, which typically mature in 30 years. When the auction rate market froze, LES lost its main source of cash to satisfy its obligations to the 450 exchangers who had deposited exchange funds but had not yet completed their replacement property acquisitions.

It has been suggested that LES was far from alone in its practice of investing exchange funds in auction rate securities and that other QIs, like LES, kept the spread on the return produced by auction rate securities over the growth factor promised to exchangers, often without disclosing that practice to their customers. LES did not have a one-size-fits-all exchange agreement; rather, it used various forms of exchange agreements containing different provisions regarding investment of the exchange funds, security devices, and payment of growth factors. Some were silent on depositing and investing exchange funds and merely promised an agreed-on growth factor. Others required the deposit of exchange funds in a segregated account at a specific bank. And a smaller number of agreements, typically involving transactions with far larger dollars, provided for specific escrow arrangements. The segregated account and escrow arrangements generally provided for exchangers to receive all income earned on the investment of exchange funds.[6]

In the LandAmerica-LES bankruptcy, various exchangers asserted that the precise language in their exchange agreements caused their exchange funds to be held in trust for their benefit and were therefore outside the bankruptcy estate. Of course, the creditors who lacked those arrangements vigorously contested that position. The court agreed to hear and promptly decide test cases on each of the different categories of exchange agreements to determine how claims would be classified and paid. The largest exchanger/creditor, Health Care REIT Inc., reached a settlement for the release of its $137 million of exchange proceeds held in a specific escrow account established for its benefit.[7] In consideration of the settlement, the company paid $2 million to the debtor's estate and $500,000 in costs.

On April 15, 2009, the bankruptcy court ruled that the so-called segregated accounts did not constitute a trust

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[3]*See* Jeff German, "Southwest Exchange Settlement: $91.7 Million," *Las Vegas Sun*, Jan. 27, 2009.

[4]One such business was engaged in the manufacturing of silicone implants, thereby adding "breast implants" to "bankruptcy" and "Brazil" as the third "Killer B" about which advisers caution taxpayers in dealing with QIs.

[5]Wags have suggested why buy just one QI and loot it? Instead, use a portion of the cash from the first one to buy more.

[6]Reg. section 1.1031(k)-1(g)(5) permits a QI to pay exchangers interest or a growth factor on exchange funds without giving rise to constructive receipt. There is no requirement that a QI disburse all or any specific portion of actual investment earnings to an exchanger, and many QI business models call for a split of such earnings. The regulations do not impose any limitation on how a QI invests exchange funds. The few states that regulate QIs generally adopt some investment standards. When a QI does not pay all income earned on investment of exchange funds to the exchanger, regulations under sections 468B and 7872 treat the transaction as a deemed loan from the exchanger to the QI, subject to a $2 million de minimis exception. *See* reg. section 1.468B-6. This treatment may give rise to imputed interest to the exchanger.

[7]*In Re LandAmerica Financial Group*, No. 08-35994-KRH (Bankr. E.D. Va., Apr. 15, 2009), Joint Motion Pursuant to Rule 9019, APN 08-03149.

for purposes of exclusion from the bankrupt estate.[8] Concluding that the existence of a trust was a matter of state law, the court applied Virginia principles. It noted that the relevant exchange agreements never used the word "trust" and that the parties, had they intended to create a trust arrangement under the safe harbor of reg. section 1.1031(k)-1(g)(3), could have done so. The court also quoted what it considered a key provision in the exchange agreement:

> LES shall have sole and exclusive possession, dominion, control and use of all Exchange Funds, including interest, if any, earned on the Exchange Funds. . . . [Exchanger] shall have no right, title or earnings in and to any of the Exchange Funds or any earnings thereon and [exchanger] shall have no right, power or option to demand, call for, receive, pledge, borrow or otherwise obtain the benefits of any of the Exchange Funds.[9]

This ruling, unless overturned on appeal, means that exchangers with segregated accounts will join exchangers with commingled accounts and other unsecured creditors in dividing up LES's remaining bankruptcy estate. The largest nonexchanger, unsecured creditor happens to be LandAmerica Financial Group Inc., LES's parent company. The parent company advanced $65 million in loans to LES to help LES cover operating costs after the auction rate securities market froze. On May 15, 2009, Judge Huenneker agreed to a mediation plan to resolve the intercompany claim.[10]

D. Issues Addressed

This article, through a hypothetical, will review the problems associated with a "disappearing" QI from a legal, tax, and economic perspective, and it will suggest strategies for maximizing the security of exchange funds. The article will focus on rulings in the LES bankruptcy case to see how the court has dealt with the various structures used by LES in its exchange agreements. Lastly, the article will explore the tax consequences for those whose planned exchanges have failed and whose exchange funds may be partially or completely gone as the result of a QI bankruptcy. The issues analyzed will include whether the constructive receipt doctrine requires that exchangers report all their gain on their relinquished property sales and, if so, the amount, character, and timing of any losses to which exchangers may be entitled on any shortfall on their ultimate recoveries.

II. Hypothetical and QI Economics 101

A. The Planned Exchange

Consider a hypothetical situation, albeit one that has recently become all too real, involving Despair Ing. Despair purchased real property (RQ Prop) many years ago for $500,000 and leased it to her wholly owned S corporation, Despair Co., for use in the company's gardening tools and nursery business. Despair's adjusted basis for RQ Prop was $200,000 when she found an unrelated purchaser who agreed to pay $2 million cash for RQ Prop. Thus, if there had been a taxable sale, Despair would have had $300,000 of unrecaptured section 1250 gain and $1.5 million of long-term capital gain. Despair Co. needed more space for expansion of its business, so Despair did the only logical thing: She pursued a section 1031 exchange to acquire a more suitable property to lease to Despair Co. In late July 2008, Despair closed on the sale of RQ Prop for $2 million cash and entered into a plain vanilla exchange agreement with Appeared Stable QI Inc. (ASQI) as the QI. A mortgage of $500,000 on RQ Prop held by XYZ Bank was paid off at closing. Ignoring closing costs, that left $1.5 million cash (Despair's exchange funds) going to ASQI. Despair and her advisers then began work on identifying qualified replacement property (RP Prop).

In return for acting as a QI, ASQI received a fee of $1,000. The exchange agreement provided that Despair's exchange funds were to be deposited into an account at a designated financial institution, ABC Bank, and that Despair would receive a growth factor (effectively interest) for the exchange period at a rate equal to that paid by ABC Bank on a specified type of account. ASQI then deposited the exchange funds in a commingled account maintained by ASQI at ABC Bank, consisting of exchange funds from many other exchanges ASQI was facilitating. ASQI invested those proceeds in auction rate securities.

What economic inducement would entice ASQI to do this? Assume the auction rate securities then paid an effective interest rate of about 0.5 percent per annum (or 50 basis points) above the specified growth factor. One-half percent for the 180-day exchange period on $1.5 million equals about $3,750, or a significant multiple of the stated exchange fee. ASQI had as its in-house motto, "What the exchangers don't know won't hurt them."

B. The Auction Rate Market Freezes

The market for auction rate securities froze on February 13, 2008. Note that Despair's sale and deposit with ASQI occurred in July 2008, or well after the market collapsed. As a "temporary" measure, ASQI began using exchange funds later deposited by new exchangers, including Despair, to satisfy its then-existing obligations to prior exchangers who were purchasing replacement properties to close out their exchanges. In November 2008, the day before Despair notified ASQI to close out her exchange via a timely purchase of RP Prop, ASQI ceased operating and filed a chapter 11 bankruptcy petition. That filing froze all the assets held by ASQI. Thus, when Despair went to close on RP Prop, her $1.5 million deposit was not forthcoming from ASQI.

Despair (realizing her parents' prescience in naming her) cogitated on the situation and soon became aware of

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[8] *Id.*; *Millard Refrigerated Services v. LandAmerica 1031 Exchange Services*, APN 08-03147-KRH (Bankr. E.D. Va. Apr. 15, 2009). Millard has announced that it plans to appeal this ruling.

[9] The last clause of the last sentence of this provision is required under reg. section 1.1031(k)-1(g)(6). The first sentence clearly is not. Reg. section 1.1031(k)-1(g)(3) specifically permits a QI to establish a qualified escrow account or a qualified trust to secure its obligations and limit its "dominion and control" over exchange funds.

[10] *See* Emily C. Dooley, "Judge Agrees to LandAmerica Mediation Plan," *Richmond Times Dispatch*, May 15, 2009.

other substantial and expensive problems that would arise if ASQI did not quickly disburse her exchange funds. First, the 180-day exchange period would expire; thus, Despair's exchange would not qualify for section 1031 nonrecognition. Second, Despair had contracted with Impatient to purchase RP Prop for $3.5 million. She was going to use her $1.5 million of exchange funds as the down payment and had secured a $2 million loan commitment from XYZ Bank for the balance of the purchase price. Without the required down payment, XYZ Bank will not issue the loan. Despair does not have the financial strength to replace the missing $1.5 million. Now Despair cannot close on RP Prop, and Impatient is threatening a specific performance action against her. Further, Despair Co. needs a new, larger facility for its nursery business. Despair Co. had leased RQ Prop from the new owner for a term of nine months (the 180-day exchange period plus three months to complete any renovations to the new facility) because it planned to move its business to RP Prop by the end of that time frame. The new owner will try to evict Despair Co. unless Despair agrees to a substantially higher rent.

With some adaptation of these hypothetical facts, several plaintiffs are alleging that LES's demise had similar causes and effects. LES was accepting new exchanges — and substantial exchange funds from new clients — until just days before its bankruptcy filing. In addition to the voluminous litigation in the LandAmerica-LES bankruptcy, there is also a class action case in Los Angeles against LandAmerica's primary bank (SunTrust), the bank's brokerage affiliate, and two individuals. The complaint asserts that after the auction rate securities market froze, LES, with SunTrust's knowledge and assistance, became a giant Ponzi scheme until it collapsed under its own weight.[11] The outcome of that litigation will undoubtedly affect the amounts ultimately recovered by LES's exchange customers. Perhaps Despair will consider filing or joining a class action against ABC Bank and other parties who worked with ASQI.

III. QI Bankruptcy and Lessons to Be Learned

A. Finding Out

Despair learned that ASQI had financial problems when she contacted it to distribute her exchange funds on the eve of her closing on RP Prop. That is one of several ways in which exchangers may learn about QI problems. The timing of the revelation can affect the ultimate harm incurred by the exchanger. Because Despair did not learn about ASQI's problems until right before her scheduled closing for RP Prop, she had incurred legal obligations based on the understanding that her exchange funds would be available for closing. Others may not be that far along in the exchange process and can avoid further damages.

Some exchangers may first learn of their QI's problems in the news media. Imagine the surprise of an exchanger who learns of his QI's demise over Sunday morning coffee while reading the local paper. Indeed, many of Okun's clients may have been unaware that Okun had acquired the regional QI they had previously used to facilitate exchanges. They may have read about Okun's bankruptcy filing and not immediately realized that their exchanges were at risk. Word of mouth may carry a similar message to exchangers. It is not unusual for tax professionals or real estate brokers to refer multiple clients to a single QI. They may learn from one client that a QI is illiquid and inform other clients of the QI's financial troubles. Regardless of the mode of communication, an exchanger who is not too far along in the exchange process should halt efforts to acquire any replacement property. Terminating the exchange process as early as possible will help an exchanger avoid the situation in which Despair found herself when she could not close on the acquisition of RP Prop. An exchanger who can terminate the process earlier may be able to limit potential damages.[12]

B. A Failed Investment Strategy

Several factors can contribute to the demise of an established QI. Unwise use of exchange funds is a common feature of the recently failed QIs. The use of new exchange funds to satisfy obligations to prior exchangers may be successful from a cashflow standpoint in a vibrant economy. Assuming ASQI was a moderately successful QI, it would have completed as many as 350 exchanges annually in a normal market. On average, it might hold as much as $150 million in exchange funds. Based on ASQI's performance over the past few years, ASQI's managers may have realized that the balance of exchange proceeds never fell below $90 million. That balance is commonly known as the QI's "float." To obtain additional profit from the float, ASQI decided to invest $90 million in auction rate securities. Those securities provided a better return than a demand deposit, and they had been liquid over the past several years. ASQI's managers believed they could improve ASQI's profitability through that investment strategy, and, if the balance of the exchange funds ever dipped below $90 million, they could liquidate some of the auction rate securities. Alternatively, they could use exchange funds from incoming transactions to cover obligations to distribute exchange funds for the benefit of existing clients.

The investment strategy ASQI adopted was based on some assumptions. The model would assume that the auction rate securities will remain liquid. After the market froze, ASQI assumed that the exchange market would remain active enough to provide new exchange funds sufficient to cover demands from old exchanges without having to access the float. It was the failure of this

[11] *See Arthur v. SunTrust Banks*, No. 09-cv-0054 (S.D. Cal. Jan. 14, 2009).

[12] The IRS is reportedly considering guidance that would permit an exchanger to substitute one QI for another midstream in the exchange process if there is a risk of a QI default. Without this guidance, it appears that a midstream change of QIs would violate the exchange requirement under section 1031, which mandates that the same party both transfer the exchanger's relinquished property and acquire its replacement property. This guidance may also explicitly permit the use of joint signature accounts to hold exchange funds.

strategy that ultimately caused the collapse of ASQI. The bulk of ASQI's business came from real estate transactions. As the real estate market softened, the number and size of new exchanges began to shrink. And as that happened, ASQI could no longer use new exchange funds to satisfy its obligations to existing clients.

Although the investment strategy used by ASQI is not without potential legal problems, most observers would agree that it is not as bad as the models adopted by Southwest and Okun. Instead of investing the float in more aggressive investments, Southwest and Okun used the float to fund unrelated businesses or for personal purposes. Even with such a scheme, those QIs could remain viable as long as new exchange funds exceeded the obligations to distribute proceeds from old exchanges. However, that possibility does not exist in a declining market. Once the market softens or the QI loses market share, it must access the float to meet its obligations. A QI that has mismanaged the float will not have that option.

Once ASQI realized it was unable to meet its obligations to existing clients, it filed for bankruptcy. Bankruptcy filing stops the disbursement of assets from the bankrupt entity and creates an estate that generally consists of the property of the debtor (ASQI in this hypothetical) at the time of the filing. The bankruptcy court must determine what constitutes the property of a bankrupt QI and how it will be distributed. A bankrupt QI's obligations should consist primarily of obligations to distribute exchange funds to close on acquisitions of replacement properties or obligations to distribute cash if no replacement property acquisitions occur in a timely manner. What constitutes the property of a bankrupt QI is the primary issue in the LES bankruptcy.

C. Accounting for One's Account

Despair's rights to exchange funds may depend on the type of account in which she requested ASQI hold her proceeds. Assume that ASQI offered four different types of accounts. First, Despair could have requested that ASQI hold her exchange proceeds in a commingled account. As the name implies, a comingled account would hold the proceeds of several exchangers in a single account. ASQI would make no attempt to trace Despair's proceeds within the account. It would merely notify Despair of the deposit and assume the obligation to make one or more required distributions for Despair's benefit under the terms of the exchange agreement. Often, these types of exchange agreements grant the QI complete dominion and control over the exchange funds during the exchange period. If the value of the assets in a commingled account decreased, ASQI could not attribute that decrease in value to investments made with specific exchangers' funds. Every exchanger who had exchange funds in the commingled account originally could bear a portion of the lost value. Commingled account structures require minimal administrative resources and large potential returns for the QI. Therefore, QIs generally charge the least for this option. As discussed below, this may be a perfect example of getting what one has paid for.

Second, Despair could have chosen a segregated account. A segregated account may be a single account in ASQI's name with a subaccount established for each exchanger. The subaccount may be nothing more than a book entry showing that ASQI is holding a specified amount of exchange funds for a specific exchanger, identified with a taxpayer identification number. For example, an exchange agreement might provide that ASQI would invest exchange funds in the subaccount in a specific manner, such as in a money market account. A virtue of segregated accounts is that ASQI can track the performance of investments in any subaccount. If the value of assets purchased in one subaccount decreases, ASQI should limit its distribution from that subaccount to the value of the assets at the time of distribution. Maintaining segregated accounts through subaccounts requires greater administrative resources, and QIs often charge more for these accounts. However, as discussed below, these types of accounts may not provide any greater security than a commingled account in a QI bankruptcy.

Third, Despair may have been able to direct that ASQI deposit her exchange funds in a separate account that ASQI establishes specifically for her. The account might be in ASQI's name, but ASQI would maintain the account on Despair's behalf and invest the exchange funds as directed by her. Despair may have requested that ASQI establish the account at a specific financial institution. This structure requires even more administrative resources and likely even greater costs because banks prefer not to open and close separate accounts for each exchange. Further, no legal authorities suggest that these types of separate accounts provide greater security for exchange funds.

Fourth, Despair could have directed the purchaser of the RQ Prop to transfer her exchange funds to a qualified trust or qualified escrow account[13] to secure ASQI's obligation to acquire and transfer RP Prop. The qualified escrow holder or the qualified trustee would hold Despair's exchange funds. Properly drafted exchange documents would ensure that Despair's exchange funds go directly into the qualified escrow account or qualified trust. ASQI would never take possession of the exchange funds and would not have access to them. The trustee or escrow holder would distribute the exchange funds only if Despair and ASQI approve the distribution and only in accordance with the requirements of reg. section 1.1031(k)-1(g)(6). As discussed below, this appears to be the most secure structure to protect exchange funds and prevent them from being treated as the debtor's property in a QI bankruptcy. Not surprisingly, it is also the most expensive option.[14]

The type of account Despair chose could affect the ultimate security of her exchange funds, but even the most secure structure may not enable her to obtain those funds to close on RP Prop in a timely manner. The bankruptcy filing by ASQI automatically stays all creditors' claims against it. During the first several bankruptcy hearings, which could take place during the several

[13]*See* reg. section 1.1031(k)-1(g)(3) (describing the requirements for qualified trusts and qualified escrow accounts).

[14]In the authors' experience, banks may charge between $1,000 and $3,000 to establish a separate escrow or trust account.

months after the filing, a judge is not very likely to lift the stay to allow distributions from any of the four types of accounts. Before allowing any distributions, the judge must determine the amount of the bankrupt estate's property. That determination will be difficult because exchangers with exchange funds in one type of account will argue that the judge should lift the stay only for their accounts. That will undoubtedly prolong the stay. Exchangers who have exchange funds in a qualified escrow account or qualified trust will argue that their proceeds should not be property of the bankrupt estate. Regardless of the merits of that argument, the judge is unlikely to lift the stay for distribution from those accounts, at least until specific facts are developed.

The exchangers who have exchange funds in a qualified trust or qualified escrow account will most likely have to demonstrate that ASQI never had possession of the funds, that the documents created an escrow or trust with a party other than ASQI, and that ASQI does not unilaterally control the disposition of the funds. Until the exchanger establishes those facts, the judge is unlikely to lift the stay. Thus, even if Despair's exchange funds were held in a qualified escrow account or qualified trust, she would likely lack access to them when needed to timely close the acquisition of RP Prop. By the time Despair does obtain access to her exchange funds, the 180-day exchange period may have expired and she may be in material breach of the contract to acquire RP Prop.

D. Lessons From the LES Bankruptcy

At the time of this writing, the bankruptcy court in the LES case has ruled definitively on only one of the four types of accounts. As noted above, the court held that funds in segregated accounts are part of the bankruptcy estate.[15] As also noted above, one of the major exchangers who used a qualified escrow account settled its adversarial proceeding for disbursement from the escrow account. The court therefore did not rule on whether the proceeds held in the escrow account were property of the bankrupt estate. However, given that the exchanger received more than 98 percent of its escrow account funds in the settlement, one may infer that the parties believed the outcome would have been in the exchanger's favor. Of course, a settlement, unlike a court opinion, does not definitively establish the extent to which proceeds held in a qualified trust or qualified escrow account are safe.

In the LES bankruptcy, one exchanger requested and was granted permission to lend money to LES in an amount equal to the balance of the exchanger's exchange funds. LES then distributed the loan proceeds to the seller of the replacement property so the exchanger could complete the exchange. Before making the loan, the exchanger had cash and an unsecured right to receive replacement property or exchange funds from LES. After making the loan, the exchanger received its replacement property and had an unsecured note from LES equal to the amount of the loan. Thus, the exchanger's economic position did not change as a result of the lending transaction. Although the exchanger cannot determine its share of the bankruptcy estate until the bankruptcy proceedings have concluded, the loan structure allows it to avoid contractual damages, and perhaps tax liability, by completing its exchange. This lending mechanism appears to be a solution to the time-sensitive nature of section 1031 exchanges, but it is not without potential problems, and, of course, it requires that the exchanger have available cash to make the loan.

An exchanger who contemplates using the lending mechanism must consider the tax and legal consequences of the structure. No tax law authority provides that distributed loan proceeds will be treated in the same manner as exchange funds. Perhaps the IRS could challenge the structure, claiming the exchanger received taxable boot when the QI issued its note. If that were the case, the structure would not help defer gain recognition. In the LES bankruptcy case, the judge, debtor, and creditors' committee all accepted a single exchanger's proposed lending arrangement. They all agreed that the exchanger could lend the money to LES and that LES could distribute that money to complete the exchanger's replacement property acquisition. That does not mean that every bankruptcy judge, debtor, and creditors' committee would approve similar proposals or that the same judge and committee would approve the same type of structure for a different exchanger. If an exchanger acts without the judge's and committee's blessing, the exchanger may end up throwing good money after bad. For example, the court could determine that the distribution was inappropriate and require that the exchanger return the value of the replacement property to the QI. Exchangers must analyze both the tax and legal issues before proceeding with the lending mechanism.

E. Avoiding the Problem

The LES case provides insight into the workings of a QI bankruptcy. It also provides some instruction about how to protect exchange funds and about practices QIs and their exchangers should avoid. The main problems in the LES bankruptcy derive from LES's commingled account and from LES's investment in auction rate securities with exchange funds held in that account. When those securities became illiquid, LES was unable to meet its obligations to its exchangers and filed for bankruptcy. The bankruptcy filing froze LES's assets and stalled the distribution of all exchange funds held by LES, including those held in escrow accounts. The freezing of the assets caused many exchangers to miss time-sensitive deadlines and incur tax liabilities and contractual damages that they could otherwise have avoided.

The most secure arrangement for exchange proceeds is the qualified escrow account or qualified trust.[16] Exchangers must ensure that those arrangements are carefully documented and structured so that the escrow

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[15]Given this ruling, it seems to follow that exchange funds held in a commingled account almost certainly are part of the bankruptcy estate.

[16]Some commentators believe that a qualified trust provides more security than a qualified escrow account. It may also be possible for an exchanger to perfect a security interest in the

(Footnote continued on next page.)

holder or trustee holds the exchange proceeds to secure the obligation of the QI. The QI should not be able to unilaterally direct the distribution of the exchange proceeds. The escrow holder or trustee should make distributions only for the purpose of acquiring the replacement property or to the exchanger after the so-called (g)(6) restrictions lapse.[17] Finally, exchange funds should flow directly to and from the trustee or escrow holder and never come into the QI's possession.

The solvency of a QI depends in large part on its practices. If the QI maintains a commingled account, all exchangers are at risk because the value of assets held in the commingled account may decline in value or become illiquid. Because the commingled account can cause problems (even the most secure depository institutions could fail), exchangers may consider hiring only those QIs that do not maintain a commingled account and are amenable to using qualified trusts or qualified escrow accounts. That will raise the cost of transacting business with the QI because it will need to create a separate account for each exchanger. That strategy will, however, increase the security of the exchange funds. The exchange documents should expressly provide how the exchanger would like the QI to invest the exchange funds held in the segregated account established for the exchanger. The exchanger should also receive the benefit of all income earned on the investment of exchange funds, so there is no hidden fee being paid to the QI.[18]

If the QI establishes a qualified trust or qualified escrow account, and if funds in that account are invested according to the instructions in the exchange documents, the QI should not be liable for any diminution in the value of the assets in the account. The QI could incur liability, however, if it fails to follow the exchanger's instructions. Such a failure could in turn trigger a chain reaction leading to a bankruptcy proceeding, and it could tie up assets in other segregated accounts. Thus, a QI with only segregated accounts is not immune from financial difficulty if it violates the terms of its exchange agreements. The use of a qualified trust or qualified escrow account should minimize those risks and keep exchange funds out of the reach of a rogue QI with bad motives or risky investment practices. However, even those structures cannot ensure "absolute security" of exchange funds if a trustee or escrow holder is corrupt or mismanaged.[19] Exchangers must perform due diligence as to all parties participating in an exchange transaction.

IV. Exchanging With a Bankrupt QI

A. Extension of Exchange Period?

In our example, Despair transferred RQ Prop (through ASQI) in late July 2008. If all had gone well, Despair would have received either RP Prop or, at the very least, a return of her exchange funds (plus her promised growth factor) in or before late January 2009 when her 180-day exchange period expired. Because Despair would still like to acquire RP Prop (assuming her exchange funds are ever freed up by ASQI's bankruptcy trustee), her initial thought might be to seek an extension of her exchange period. After all, section 1033(a)(2)(B) allows for an extension of the applicable period for replacing involuntarily converted property if there are extenuating circumstances, and section 17 of Rev. Proc. 2007-56[20] allows for an extension of the exchange period on account of an applicable "presidentially declared disaster" under section 7508A. Despair certainly believes her circumstances constitute a disaster.

Unfortunately, the IRS has clearly stated in informal guidance that it cannot extend the statutorily created 180-day exchange period absent the type of natural disaster (for example, a hurricane, major storm, wildfire, or earthquake) or terrorist attack described in section 7508A.[21] Despair is simply out of luck in terms of obtaining nonrecognition treatment under section 1031 for the transfer of RQ Prop and the later acquisition of RP Prop.

B. Debt Relief in 2008

Because Despair's 180-day exchange period spans two years, she finds herself squarely within the purview of the rules combining like-kind exchanges with installment sales under reg. section 1.1031(k)-1(j) as a result of her failed exchange. Despair's first issue under those rules is whether she must report any gain in 2008 because of the

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escrow or trust account. Reg. section 1.1031(k)-1(g)(3)(i) permits an exchanger to perfect a security interest in a qualified escrow account or qualified trust that holds the exchange proceeds. Exchangers should consult their local law to determine the method for perfecting such a security interest. Note that this security interest must be in the account itself rather than directly in cash or a cash equivalent held in the account. A direct security interest in cash or securities would result in constructive receipt of exchange funds under reg. section 1.1031(k)-1(g)(2)(i) because the exchanger must take possession of the cash or securities to perfect a security interest in it.

[17] *See* reg. section 1.1031(k)-1(g)(6).

[18] In today's low-interest environment, exchangers seeking the maximum protection for exchange funds might consider taking advantage of the unlimited FDIC insurance coverage available through 2009 for non-interest-bearing transaction accounts at institutions participating in the FDIC's Temporary Liquidity Guarantee Program. More information on this program, and FDIC coverage in general, is *available at* http://www.fdic.gov/deposit.

[19] Interestingly, LES's Web site promised "absolute security" of exchange funds because of its "parent guaranty" structure. Both LES and its parent company have now filed for bankruptcy.

[20] 2007-34 IRB 388, *Doc 2007-19104, 2007 TNT 161-6.*

[21] *See, e.g.,* LTR 200211016 (Dec. 10, 2001), *Doc 2002-6466, 2002 TNT 52-49* (refusing to postpone exchange period despite QI's receivership and freezing of accounts); INFO 2008-0021 Letter of William A. Jackson (chief, Branch 5, Office of Chief Counsel) to Rep. William D. Delahunt, D-Mass. (June 27, 2008); INFO 2009-0017 Letter of Michael Mantemurro (branch chief, Office of Associate Chief Counsel) to Rep. Jerry F. Costello, D-Ill. (Feb. 4, 2009). The Mantemurro letter declines to address the request of Costello's constituent for "bailout money from TARP" or "FDIC funds" to recover his losses on the grounds that those issues do not involve tax administration. The constituent expressed that the IRS and the federal government were partly responsible for his losses because their regulations created the QI regime for exchanges.

$500,000 payoff of her mortgage at the RQ Prop closing. That issue was addressed in the partnership context by Rev. Rul. 2003-56,[22] which provides that excess liability relief on relinquished property in an exchange is treated as taxable boot received in the year of the relinquished property closing. Because Despair will not timely receive any replacement property, she must calculate her 2008 gain using the installment sale rules under section 453.[23] Under those rules, Despair must recognize a portion of her gain in 2008 under the installment method because buyer funds were used to pay off her mortgage to XYZ Bank.

C. Consequence of End of Exchange Period

If Despair in fact receives her exchange funds back from ASQI's bankruptcy trustee in 2009, she would again apply the general installment sale rules to report a portion of the gain on her sale of RQ Prop. What happens, however, if no distribution is received in 2009? Must Despair still report installment sale gain in 2009 based on the constructive receipt of her exchange funds?

Unfortunately for Despair, reg. section 1.1031(k)-1(j)(2)(ii) suggests that she may have had constructive receipt of her exchange funds once her exchange period expired in January 2009. In particular, that regulation provides that a QI is not treated as the agent of an exchanger for section 453 purposes; however, that non-agency treatment ceases to apply at the end of the 180-day exchange period. Accordingly, on day 181, the IRS may view Despair as being in constructive receipt of exchange funds previously held by ASQI now that ASQI no longer can qualify for nonagency status.[24]

Given the bankrupt status of ASQI on day 181, perhaps Despair can argue that the open transaction doctrine should apply to treat her installment sale as open unless and until it can be determined with reasonable certainty whether she stands a chance of recovery from ASQI's bankruptcy trustee. This may indeed look like the type of "rare and extraordinary case" to which the open transaction doctrine might apply.[25] Still, without specific IRS guidance on QI defaults, it appears that Despair may be stuck with constructive receipt of her exchange funds on day 181 once ASQI loses its nonagent status.[26]

D. Loss on Ultimate Recovery

Assume that ASQI's bankruptcy trustee is ultimately able to dispose of the auction rate securities held by ASQI, albeit at a substantial discount. Further assume that in 2010 Despair receives $750,000 (half of her $1.5 million of exchange funds) in a final distribution from the bankruptcy estate and that she has no claims against third parties to recover her remaining loss. Finally, assume Despair's tax return preparer concluded that Despair needed to report all her installment sale gain in 2008 and 2009 for the reasons discussed above. What are the tax consequences to Despair in 2010 when her loss of $750,000 is ultimately determined? Does Despair qualify only for a capital loss under the nonbusiness bad debt rules of section 166(d), or may she obtain the more favorable ordinary loss treatment available for a business bad debt under section 166 or for a theft loss under section 165(c)?

Although a QI is deemed to be an independent party for section 1031 purposes during its exchanger's exchange period, this tax fiction does not extend to other code provisions. For other tax purposes, a taxpayer is treated as if he received exchange funds and then lent those funds to his QI.[27] If the loan construct applies, Despair will assert that she is entitled to a bad debt deduction in 2010 for the $750,000 she cannot collect on her "loan" to ASQI. She will also try to characterize her bad debt deduction as a more favorable business bad debt rather than a nonbusiness bad debt under section 166(d).[28] A business bad debt is fully deductible as an

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[22]2003-1 C.B. 985, *Doc 2003-11702*, *2003 TNT 91-44*. The reasoning of this ruling should apply to taxpayers other than partnerships.

[23]*See generally* reg. section 1.1031(k)-1(j)(2)(iv) (applying installment sale rules to failed exchanges spanning two tax years if there was a "bona fide intent" to complete an exchange with a QI).

[24]Despair may consider arguing that as long as the bankruptcy judge prohibits distributions of funds, it is not in constructive receipt of those funds, even after the expiration of the exchange period.

[25]*See* reg. section 1.1001-1(a); reg. section 15A.453-1(d)(2)(iii); and *Burnet v. Logan*, 283 U.S. 404 (1931) (holding that a property sale transaction is not regarded as closed for tax purposes if a contractual promise is too contingent and speculative to have any ascertainable value, and that "open transaction" is limited to "rare and extraordinary cases"). To succeed under the open transaction doctrine, Despair must make the case that her sale of RP Prop is, for purposes of section 453, a sale to ASQI and that, given ASQI's bankruptcy, ASQI's promise to return Despair's exchange funds is too speculative to have an ascertainable value on day 181. The combined like-kind exchange/installment sale rules under reg. section 1.1031(k)-1(i) lend some support to this construct.

[26]Under the installment method, a taxpayer must determine the amount of gain attributable to payments received or deemed to be received each tax year. *See* section 453(c). For this purpose, the term "payment" includes "amounts actually or constructively received during the taxable year." *See* reg. section 15A.453-1(c)(3)(i). When a QI has absconded with exchange funds before the end of the exchange period, arguably there is nothing for a taxpayer to constructively receive when the QI's nonagency status terminates.

[27]Reg. section 1.468B-6(c) provides (subject to some exceptions) that for purposes of section 7872, exchange funds held by a QI are treated as a loan by the exchanger to the QI. One of the exceptions is when all the earnings attributable to the investment of exchange funds is paid to the exchanger. That was not Despair's arrangement with ASQI. If that were the arrangement (i.e., Despair was entitled to all the income or loss on the auction rate securities acquired by ASQI), the IRS might argue that ASQI acquired those securities as Despair's agent (or at least held them in an agency capacity once Despair's exchange period expired) and that Despair is entitled only to a capital loss if and when the bankruptcy trustee disposes of those securities.

[28]For individual taxpayers, a business bad debt qualifies for ordinary loss treatment equal to the taxpayer's basis in the debt. Here, assuming Despair reported all her gain on the sale of RQ Prop in 2008 and 2009 under the installment method, her basis should equal the remaining $750,000 face amount of ASQI's "debt" (i.e., her basis in RQ Prop, plus gain recognized minus

(Footnote continued on next page.)

ordinary loss and can give rise to a net operating loss deduction, while a nonbusiness bad debt is deductible as a short-term capital loss and will not give rise to an NOL deduction. Under sections 1211 and 1212, a short-term capital loss may be used only to offset current-year capital gains plus up to $3,000 of ordinary income, and it will then be available in future years to offset future capital gains plus up to $3,000 of ordinary income annually.

To qualify for business bad debt treatment under section 166, the worthless debt must have been "created or acquired in connection with the taxpayer creditor's trade or business" or, at the time of worthlessness, must be proximately related to the taxpayer's trade or business.[29] It is unclear how Despair will fare under that test. Despair will argue that she was engaged in the real estate business as an individual (that is, she leased RQ Prop to Despair Co. and then sold RQ Prop). Depending on the nature of Despair's lease terms with Despair Co., the IRS might argue that her real estate activities resemble an investment rather than a trade or business.[30] Moreover, assuming Despair has not acquired RP Prop by 2010, the IRS may well argue that Despair was not engaged in real estate activities at all, both when the loan to ASQI was created and when that loan became worthless. Despair Co.'s operation of its nursery business will not be attributed to Despair, even though she is the sole shareholder.[31] It follows that Despair may qualify only for a nonbusiness bad debt deduction on her $750,000 loss, either because her real estate activities do not rise to the level of a trade or business or because she was not engaged in any real estate activities when ASQI incurred its "debt" or when that debt became worthless.[32] The short-term capital loss available to Despair under section 166(d) may be of limited use to her because it cannot be carried back for use against her 2008 or 2009 capital gains and because she is not anticipating substantial capital gains in the future.

Finding little cause for joy under the bad debt deduction rules of section 166, Despair may want to argue that her loss is more akin to a theft loss described in section 165(c)(2). A theft loss gives rise to an ordinary deduction and (if it exceeds one's income for the loss year) can give rise to an NOL under section 172(d)(4)(C). Theft loss treatment might not eliminate Despair's despair, but it would certainly cheer her up some and perhaps allow her to claim substantial tax refunds. It is also not necessary for Despair to be engaged in a trade or business to claim a section 165(c)(2) theft loss; she must merely satisfy the less stringent test of being engaged in a "transaction entered into for profit."[33]

To demonstrate that she is entitled to a theft loss deduction, Despair must prove that her "loan" to ASQI did not create a bona fide debt because ASQI had no intention of repaying her funds and intended to use those funds to further a criminal Ponzi scheme in which exchange funds from new exchangers would be used to pay off obligations to old exchangers.[34] If she can make that case, Despair might even try to accelerate her theft loss deduction into 2008 or 2009 by taking advantage of the recently promulgated safe harbor in Rev. Proc. 2009-20 for Ponzi scheme victims.[35]

The facts may not indicate that ASQI intended to cheat Despair out of her money when it received and deposited her exchange funds. ASQI will argue that it was hoping to ride out the collapse of the auction rate securities market and fulfill its obligations to all its exchangers. ASQI's managers did not divert exchange funds for personal purposes. Although ASQI may be guilty of poor management and breach of its exchange agreements, it may not have committed a crime. Accordingly, Despair may again find herself out of luck in terms of qualifying for more favorable theft loss treatment on her $750,000 loss of exchange funds. Despair may be stuck with a nonbusiness bad-debt deduction for 2010 and less favorable short-term capital loss treatment. Under the tax laws, it is sometimes better to have your money stolen

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cash received.) *See American Offshore, Inc. v. Commissioner*, 97 T.C. 579 (1991) (holding that section 453B does not bar a bad-debt deduction when the remaining balance of an installment obligation becomes worthless).

[29]*See* section 166(d)(2) and reg. section 1.166-5(b).

[30]Taxpayers holding real estate for rental are ordinarily viewed as engaged in a trade or business even if their activities are modest in scale. *See, e.g., Coors v. Commissioner*, 60 T.C. 368 (1973), *aff'd*, 519 F.2d 1280 (10th Cir. 1975). *But see Nicholson v. Commissioner*, T.C. Memo. 1993-183, *Doc 93-4977, 93 TNT 91-23* (holding that when debt arose from taxpayer's "net leasing" activity and taxpayer did little more than cash rent checks, activity did not rise to the level of a "business").

[31]*See, e.g., Burnet v. Clark*, 287 U.S. 410 (1932).

[32]Nonbusiness bad debts, unlike business bad debts, are deductible only when wholly worthless. However, Despair is not precluded from a deduction merely because she is receiving $750,000 from the ASQI's bankruptcy trustee. *See, e.g., Nash v. Commissioner*, 31 T.C. 569 (1958) (deduction allowed for unpaid balance of nonbusiness bad debt in year when it becomes certain that only part of the debt will be collected).

[33]*See* Rev. Rul. 2009-9, 2009-14 IRB 735, *Doc 2009-5872, 2009 TNT 50-6*. This ruling also clarifies that a section 165(c)(2) theft loss is not subject to the deduction floors under section 165(h) or to the limitations on itemized deductions under sections 67 and 68.

[34]*See* ILM 200811016 (June 22, 2007), *Doc 2008-5655, 2008 TNT 52-20*, and cases discussed therein on the "bona fide" debt versus theft issue. To claim a theft loss, Despair must demonstrate that ASQI engaged in illegal conduct under state law. *See* reg. section 1.165-8(d). A mere breach of an exchange agreement does not amount to criminal conduct. To date, no criminal charges have been filed in the LES matter. Despair would perhaps fare better in claiming a theft loss if she were a victim of Okun or Southwest, against whom criminal charges were filed.

[35]2009-14 IRB 749, *Doc 2009-5873, 2009 TNT 50-5*. Under the safe harbor of Rev. Proc. 2009-20, a Ponzi scheme victim may deduct as a theft loss in the "year of discovery" either 95 percent or 75 percent of the amount invested with the schemer. The safe harbor appears to be directed mainly to victims of the giant ($60 billion-plus) Ponzi scheme conducted by Bernard Madoff over a 20-year period, although Madoff is not mentioned by name in the revenue procedure. It is unclear whether a victim of even a criminally fraudulent QI can qualify for the safe harbor, because the type of scheme involved must include a fictitious purchase of securities.

than to have it mismanaged. Unfortunately, that insight provides little in the way of tax planning ideas. Without increased due diligence by exchangers and their advisers, exchangers will continue to risk not only the safety of their exchange funds, but also the adverse tax consequences associated with failed exchanges.

V. Conclusion

QI meltdowns are good for no one. They may cause exchangers to lose money, incur significant tax liabilities, and breach contracts. They engender costly litigation and potential criminal prosecution of QI owners and managers. With all of that, exchangers and QIs should take steps to prevent future losses from QI meltdowns. Exchangers and their advisers can help by directing their exchange funds to a qualified trust or qualified escrow and by performing due diligence regarding all parties involved in facilitating the exchange. QIs can help by using fee arrangements that do not encourage aggressive investments, by eliminating commingled accounts, and by encouraging exchangers to use qualified escrow accounts or qualified trusts.

QI meltdowns also create tax compliance challenges. Without either a willingness to take positions for which clear authority does not exist (and the luck to avoid or succeed on an IRS challenge) or subsequent helpful guidance from the IRS, Despair will find that the tax law only adds insult to the injury of her $750,000 economic loss.[36] That is, she will need to report taxable gain under the installment method in 2008 and 2009 on her transfer of RQ Prop because she cannot extend her 180-day exchange period, and she will be treated as actually receiving the cash used to pay off her mortgage in 2008 and as constructively receiving her exchange funds on day 181 in January 2009. Further, although Despair may claim a $750,000 loss in 2010 when her claim against ASQI's bankruptcy estate is finally resolved, she may qualify only for a nonbusiness bad debt deduction of limited use. The tax law appears to have provided Despair only with more reasons to despair and provided future exchangers with more reasons to plan ahead to avoid the myriad financial and tax disasters arising from a disappearing QI.

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[36]In a letter to Sen. Christopher J. Dodd, D-Conn., dated June 12, 2009, *Doc 2009-13682, 2009 TNT 114-17*, David P. Vandivier, Treasury acting assistant secretary for legislative affairs, stated that Treasury is "aware of and sympathetic to the difficult tax consequences" faced by exchangers unable to complete transactions due to a QI bankruptcy and is "evaluating the scope of our authority in this area to issue administrative guidance."