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Safe harbor provisions for failed deferred like-kind exchanges

June 30, 2010 - Front Section

The existing economic conditions have presented challenges and circumstances that were not considered being risks of doing business daily. To have an unexpected event result in a taxable event could prove disastrous to your enterprise. One such area of growing concern is the failure of deferred like-kind exchanges that involve a Qualified Intermediary (QI).

To recap, a deferred like-kind exchange under IRC Section 1031 requires a written agreement between the taxpayer and a QI, where the QI acquires relinquished property from the taxpayer, transfers the relinquished property, acquires replacement property, and transfers the replacement property to the taxpayer. The taxpayer has 45 and 180 days from the transfer of the relinquished property to identify and acquire the replacement property.

The default of the QI on its obligation to acquire replacement property and transfer it to the taxpayer within the prescribed time limits causes the transaction to be treated as a sale of the relinquished property, requiring the taxpayer to recognize taxable gain in the year the replacement property was to be transferred by the QI.

For occurrences such as these, the Internal Revenue Service has provided guidance for the treatment for failed deferred like-kind exchanges where a QI has filed for bankruptcy protection or receivership.

Rev. Proc. 2010-14 provides for a safe harbor method for taxpayers under certain conditions. The taxpayer cannot attempt to enforce its agreement with the QI or access the proceeds from the sale of the relinquished property. In exchange, the IRS will not require the taxpayer to recognize any taxable gain until payments are actually received by the taxpayer. A safe harbor gross profit ratio method is provided to determine how much gain has to be recognized in the year the payments are received.

Note that any recapture income under Section 1245 and 1250 is included in income in the taxable year which gain is recognized under the safe harbor provision, to the extent of the gain recognized in that taxable year.

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New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540