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Bankrupt qualified intermediaries: Congress considers 1031 assistance

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Section 1031 of the Internal Revenue Code permits a taxpayer to defer the recognition of gain or loss on the like-kind exchange of property. To qualify, a taxpayer must obtain like-kind replacement property by the earlier of 180 days after the date the taxpayer transfers the relinquished property or the due date (with extensions) of the taxpayer's federal income tax return for the year in which the transfer of the relinquished property occurred.

A taxpayer is allowed to exchange like-kind property using a third-party facilitator called a qualified intermediary. The taxpayer transfers the relinquished property to the qualified intermediary, who then sells the property and uses the sale proceeds to purchase replacement property for the taxpayer. If the replacement property is received by the taxpayer within the prescribed time period, then the taxpayer is not required to recognize the gain or loss on the exchange.

Unfortunately, several qualified intermediaries have filed for bankruptcy protection in the past year. In some instances those intermediaries failed to complete the Section 1031 transactions that they had been engaged to complete, leaving the taxpayers without a replacement property and, in some cases, limited or no sales proceeds from the relinquished property. By statute, deferral of the gain on the relinquished property could not be deferred because the requirements of Section 1031 had not been satisfied.

In several recently issued informational letters, the IRS stated that these taxpayers must recognize and report the gain under the provisions of the statute. Consequently, the taxpayers were whipsawed - they were required to recognize gain on the original sale transaction, despite not having benefitted from sale proceeds or having received any replacement property. However, the IRS did note that the taxpayers may be able to deduct any unreimbursed loss resulting from the qualified intermediary's actions from gross income in the year in which the loss is fixed.

The House of Representatives' Committee on Ways and Means is currently considering a bill which would suspend the 180 day period in the case of bankrupt qualified intermediaries, thereby permitting the exchange to be completed at some later date. This column will track the bill's progress.

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