Office of Chief Counsel
Internal Revenue Service

Memorandum

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to: Revenue Agent – Team 1361 (Atlanta)
CTM Territory 10
(Large Business & International)

from: Associate Area Counsel (Atlanta)
(Large Business & International)

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subject: ("Taxpayer")
Tax Year:
Like-Kind Exchange

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ISSUE

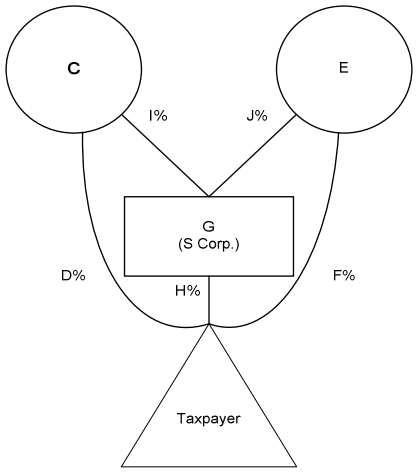
Whether Taxpayer had actual or constructive receipt of the proceeds from the sale of relinquished property that, as a result, disqualifies Taxpayer from deferred taxation under I.R.C. § 1031?

CONCLUSION

Yes. As explained herein, Taxpayer had actual and/or constructive receipt of the proceeds from the sale of relinquished property. Therefore, Taxpayer may not defer taxation under section 1031 pursuant to the like-kind exchange program, described below.

STATEMENT OF FACTS

Taxpayer is a limited liability company that is treated as a partnership for tax purposes. Taxpayer is subject to the unified audit procedures in sections 6621-6234 (*i.e.,* TEFRA procedures). Taxpayer is owned by: (%), (%), and (%). is owned by (%) and (%). The ownership structure is in the following schematic.



Taxpayer purchases cars that it leases to , a car rental company.[1] Taxpayer and are two of several entities owned by and as part of their franchise enterprise. Taxpayer was established to facilitate a low-cost fleet financing agreement.

Taxpayer entered into an exchange agreement with (" ") whereby would act as a qualified intermediary ("QI") facilitating a like-kind exchange program ("LKE Program").[2] was later succeeded by , which was the QI during the year under examination.

Taxpayer sold almost all of its vehicles (relinquished property) in wholesale automobile auctions, either to automobile manufacturers or automobile dealers.[3] Taxpayer sold the remainder through wholesale automobile brokers.[4] The proceeds from sale of the relinquished property moved through three accounts.

(1) Exchange Funds Collection Account (QI collection account). Taxpayer assigned its rights under the sales contracts to the QI.[5] The proceeds were deposited to the QI's collection account, called the Exchange Funds Collection Account, which is a restricted account maintained by the QI.[6] The Exchange Funds Collection Account is defined as "a single, segregated 'lockbox' collection account with Intermediary for all Participant Exchangors, governed by the terms of this Agreement [the Amended Master Exchange Agreement] and into which proceeds from the sale of Relinquished Property are deposited."[7] Regarding restrictions, the Amended Master Exchange Agreement states:[8]

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[1] Amended Master Exchange Agreement, dated , by , Taxpayer, , , , and (herein "Amended Master Exchange Agreement") at recital B.
[2] Amended Master Exchange Agreement.
[3] Response to IDR 8, LKE Funds Flow.
[4] Response to IDR 8, LKE Funds Flow.
[5] Amended Master Exchange Agreement at § 3.1.
[6] Response to IDR 8, LKE Funds Flow; Amended Master Exchange Agreement, Art. 1.5.
[7] Amended Master Exchange Agreement at § 1.5.

(c) The Exchange Funds Collection Account shall be a restricted account, and no Participant Exchangor shall have any right to pledge, borrow, or otherwise obtain the benefits of Exchange Funds held in the Exchange Funds Collection Account, except as provided in Article 7 below and to the extent not inconsistent with Reg. § 1.1031(k)-1(g)(6). All remaining funds, if any, contained in an Exchange Funds Collection Account from each assigned Sale Contract shall be disbursed to the relevant assigning Participant Exchangor upon the first to occur for the relevant Exchange: (i) the expiration of the Exchange Period, (ii) the receipt by a Participant Exchangor of all Identified Property with respect to such assigned Sale Contract following expiration of the Identification Period, or (iii) the expiration of the Identification Period, if no Identified Properties are identified pursuant to Article 5 hereof. It is intended that the foregoing restrictions be interpreted and imposed in a manner consistent with the limitations contained in Reg. § 1.1031(k)-1(g)(6) which Regulations shall govern.

(d) Intermediary shall disburse by daily automatic wire any and all available amounts deposited in the Exchange Funds Collection Account to the Qualified Escrow Account. Although it is intended that the disbursement of funds pursuant to this Section 4(d) shall not result in Exchangor's constructive receipt of Exchange Funds for purposes of Code § 1031 and the Regulations thereunder, nothing herein shall constitute a representation by Intermediary to that effect.

(2) Master Collateral Account (Qualified Escrow Account).[9] The proceeds in the QI's collection account were transferred, by an automatic, nightly sweep, to a Master Collateral Account at ("Bank"), which is an account that receives and hold funds for the benefit of a consortium of lenders[10] that has liens on all rights to the automobiles, including those owned by Taxpayer.[11] The rules in the Master Collateral Agency and Security Agreement govern the Master Collateral Account.

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[8] Amended Master Exchange Agreement at § 4.1(c).

[9] Taxpayer refers to the Master Collateral Account as a "Qualified Escrow Account." Taxpayer's use of this phrase should not be construed as the IRS's agreement that the Master Collateral Account satisfies the requirements of a qualified escrow account under section 1031 or the regulations thereunder.

[10] The "lenders" are a consortium of institutional lenders: , , , , , and . The Amended Master Exchange Agreement refers to "Affiliate Credit Agreement Lenders," two of whom are and . The Affiliate Credit Agreement Lenders provided no funds under the Master Exchange Agreement; they were included in the agreement solely for the purpose of being pre-approved by the consortium of lender banks if necessary (which has not been necessary). Response to IDR #22. Taxpayer is among the lessors/borrowers. Taxpayer purchases vehicles, then leases them to , which is a "lessee" under the Master Collateral Agency and Security Agreement. See Master Collateral Agency and Security Agreement at the preamble.

[11] Response to IDR 8, LKE Funds Flow; Amended Master Exchange Agreement, Art. 4.1(d).

Under that agreement, Taxpayer has control of the funds, as follows: "The Servicer, the Lessees and **the Lessors [including Taxpayer] shall direct all payments representing Liquidation Proceeds with respect to Master Collateral Vehicles included in the Like-Kind Exchange Program** to the Qualified Intermediary in accordance with the Exchange Agreement [the Amended and Restated Master Vehicle Exchange Agreement, dated [12]]." (Emphasis added.)

(3) Repayment Account. After the sales proceeds were deposited in the Master Collateral Account, Taxpayer would send a transfer request to Bank, which transferred the sales proceeds to a Repayment Account.[13] The Repayment Account is maintained at Bank and, according to Taxpayer, the deposits are used for either "notational loan repayments" or the deposits are transferred back to the QI to acquire replacement vehicles.[14] Proceeds from the sales of vehicles in the LKE program are supposed to be directed to the QI.[15]

The following officers and employees of have signatory authority over the Repayment Account: (1) , President; (2) , Vice President – Finance; (3) , Chief Financial Officer; and (4) , Controller.[16]

In , Taxpayer used $ of the funds in the Repayment Account to purchase vehicles outside of the LKE program.[17] These amounts, listed on the following table, were transferred to accounts for entities that sold newly purchased vehicles to Taxpayer.[18] These amounts were neither transferred to the QI nor used to repay the consortium loan; rather, the funds were transferred to the sellers from the Repayment Account (and not through the QI) at the direction of the signatories:

	Date	Amount	Seller
1		$	
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[12] The reference to the date of , and to the agreement being restated are typographical errors; the correct date of the agreement is , and the agreement was not restated. Response to IDR #21.
[13] Response to IDR 8, LKE Funds Flow. The repayment account is not governed by a separate document. Rather, Taxpayer views the repayment account as an account governed by the Master Collateral Agency and Security Agreement.
[14] Response to IDR 8, LKE Funds Flow.
[15] Master Collateral Agency and Security Agreement, § 2.5(b).
[16] Response to IDR 7, Bank Loan Accounts Signature Authority.
[17] Bank statement period through , Repayment Account – Bank as Collateral Agent/Re: Taxpayer, Account ; Taxpayer's response (e-mail dated) at item 3.
[18] Bank statement period through , Repayment Account – Bank as Collateral Agent/Re: Taxpayer, Account .

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In year ending , as reported on Form 8824, Like-Kind Exchanges, Taxpayer deferred $ of gain relating to the LKE Program. You propose to disallow this deferred gain because Taxpayer's LKE Program did not meet the requirements of section 1031.

LAW AND ANALYSIS

Generally, no gain or loss is recognized on the exchange of property held for productive use in a trade or business ("relinquished property") if the property is exchanged solely for property of like-kind that is to be held either for productive use in a trade or business or for investment ("replacement property").[19] In order to qualify for nonrecognition treatment of the gain or loss on the exchange, the replacement property must be identified as property to be received in the exchange on or before 45 days after the date on which the taxpayer transfers the relinquished property and the property must be received after the earlier of 180 days after the date on which the taxpayer transfers the relinquished property, or the due date for the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.[20]

An exchange may still qualify for like-kind treatment if the replacement property is received after the relinquished property has been transferred, provided that the requirements of Treas. Reg. section 1.1031(k)-1 are met.[21] This exchange is called a deferred exchange and is pursuant to an agreement to exchange property.[22] The deferred exchange must actually be an exchange, not a sale of property followed by a purchase of property of a like kind.[23] The exchange will also not qualify for favorable treatment under section 1031 if the taxpayer actually or constructively receives money or property that does not meet the requirements of section 1031, in the full amount of the consideration for the relinquished property before the replacement property is received.[24]

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[19] I.R.C. § 1031(a)(1).
[20] I.R.C. § 1031(a)(3).
[21] Treas. Reg. § 1.1031(k)-1(a).
[22] Treas. Reg. § 1.1031(k)-1(a).
[23] Treas. Reg. § 1.1031(k)-1(a).
[24] Treas. Reg. § 1.1031(k)-1(a).

Revenue Procedure 2003-39, 2003-1 C.B. 971, provides safe harbor rules with respect to programs involving ongoing exchanges of tangible personal property using a single intermediary. It appears that Taxpayer is engaged in ongoing exchanges of tangible personal property using a single intermediary, but Taxpayer does not claim that its transactions satisfy Revenue Procedure 2003-39. Generally, like-kind programs that do not meet the safe harbor rules of Revenue Procedure 2003-39 may qualify for nonrecognition treatment if they otherwise meet the requirements of section 1031 and the regulations thereunder.

Regarding receipt of money or other property, section 1.1031(k)-1(f)(1), states:

> in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive the like-kind replacement property.

The Regulation further describes when a taxpayer would be in constructive receipt of money. Specifically, section 1.1031(k)-1(f)(2) provides:

> **(2) Actual and constructive receipt.** Except as provided in paragraph (g) of this section (relating to safe harbors), for purposes of section 1031 and this section, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived….

The safe harbors in section 1.1031(k)-1(g) prevent actual or constructive receipt by a

taxpayer of money or other property. The safe harbors include use of escrow accounts and qualified intermediaries.

A "qualified escrow account" is an escrow account wherein the escrow holder is not the taxpayer (or a disqualified person) and the escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account.[25] A "disqualified person" includes a person owning more than 10% of the capital interest or profits interest in a partnership, as stated in section 707(b)(1)(A).[26] This safe harbor ceases to apply when the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the qualified escrow account or qualified trust.[27]

A "qualified intermediary" is a person who is not the taxpayer (or a disqualified person) and enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.[28] An intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property;[29] an intermediary is treated as acquiring and transferring the relinquished property if the intermediary enters into an agreement with a person (other than the taxpayer) for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person;[30] and an intermediary is treated as acquiring and transferring replacement property if the intermediary enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.[31] An intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property.[32] The qualified intermediary safe harbor ceases to apply when the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by the qualified intermediary.[33] The qualified intermediary safe harbor applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary.[34]

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[25] Treas. Reg. § 1.1031(k)-1(g)(3)(ii).
[26] Treas. Reg. § 1.1031(k)-1(k)(3).
[27] Treas. Reg. § 1.1031(k)-1(g)(3)(iv).
[28] Treas. Reg. § 1.1031(k)-1(g)(4)(iii).
[29] Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(A).
[30] Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(B).
[31] Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(C).
[32] Treas. Reg. § 1.1031(k)-1(g)(4)(v).
[33] Treas. Reg. § 1.1031(k)-1(g)(4)(vi).
[34] Treas. Reg. § 1.1031(k)-1(g)(4)(ii).

Taxpayer's LKE Program fails to qualify for tax-deferred treatment under section 1031 for several reasons. First, Taxpayer can direct payments representing liquidation proceeds of vehicles in the LKE Program.[35] This control by Taxpayer reflects Taxpayer's actual or constructive receipt of the funds, which precludes deferred tax-treatment under section 1031.[36]

Second, the qualified intermediary has no rights over the Repayment Account and cannot authorize transfers from the account nor effectively limit Taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits from the proceeds held in this account, as required by section 1.1031(k)-1(g)(6). Through the series of transfers of the funds from the sale of relinquished properties, the limitation in the Amended Master Exchange Agreement became ineffective.

Similarly, the Repayment Account is not a qualified escrow account under section 1.1031(k)-1(g)(3)(ii) because the account does not limit Taxpayer's ability to use the funds in the account. Further, is a signatory and escrow holder, but he also owns % of Taxpayer. As a result, he owns more than 10% of Taxpayer, a partnership, and is therefore a disqualified person.[37] An escrow account is not a qualified escrow account if held by a disqualified person.[38]

Taxpayer received proceeds in the Repayment Account when the proceeds were deposited into the account. This is apparent by Taxpayer's actual use of the funds in to acquire vehicles outside of the LKE program. Under section 1.1031(k)-1(a), Taxpayer engaged in a sale, followed by a purchase of property of like-kind, not a deferred exchange. Taxpayer's unrestricted right to the funds in the Repayment Account excludes Taxpayer from the deferral of the gain from the exchange of like-kind properties allowed under section 1031 and, consequently, the gains from the exchanges must be currently recognized.

Taxpayer's position is that the Repayment Account is essentially an escrow account. As stated previously, however, to be an escrow account, the account holder must not be the taxpayer and the escrow agreement must expressly limit the taxpayer's ability to obtain the cash in the escrow account. Once a taxpayer obtains the rights to the cash, then the escrow account safe harbor ceases to apply. In the present case, officers of an entity related to Taxpayer control the account and the agreements governing the LKE Program do not expressly limit Taxpayer's ability to obtain the cash in the Repayment Account. Therefore, Taxpayer's position is without merit.

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[35] See Master Collateral Agreement at § 2.5(b).
[36] See Treas. Reg. § 1.1031(k)-1(f)(1) (requiring that gain or loss be recognized if a taxpayer actually or constructively receives money or other property before receiving the like-kind replacement property); Treas. Reg. § 1.1031(k)-1(f)(2) (defining actual and constructive receipt).
[37] Treas. Reg. § 1.1031(k)-1(k)(3).
[38] Treas. Reg. § 1.1031(k)-1(g)(3)(ii).

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

Based on the bank statements you provided, the deposits to the Repayment Account with the notation “funds transfer credit” are clearly traceable to withdrawals from the Master Collateral Account. [redacted] Similarly, based on the information you provided, withdrawals and debits from the Repayment Account naming a beneficiary are clearly payments outside of the LKE Program, a point also confirmed by Taxpayer. [redacted]

This advice was reviewed prior to issuance by the Associate Office of Chief Counsel (Income Tax & Accounting).

If you have any questions, please contact the undersigned.

GWENDOLYN C. WALKER
Associate Area Counsel
(Large Business & International)

By: _____
Kimberly B. Tyson
Senior Attorney (Greensboro)
(Large Business & International)