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Qualified Intermediaries and the Taxpayers Who Trust Them: The Case of the Like-Kind Exchanger with Nothing to Exchange

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I. INTRODUCTION

On May 26, 2007, the *Wall Street Journal* reported that a popular and historically entrenched tax deferral tool is in trouble.[1] The tool—a section 1031 exchange—allows taxpayers to defer taxation on the capital gains received from selling investment property as long as the proceeds from the sale are reinvested in like-kind property within a certain time period. In many instances, the taxpayer employs a qualified intermediary, who plays the important role of key middleman in the exchange. Recently, more than one of these key middlemen has run into financial trouble, leaving the taxpayer it served with nothing to exchange.[2]

The qualified intermediary ("QI" or "qualified intermediary") plays the role of cash-holder in deferred multiparty section 1031 exchanges, because to qualify for section 1031 treatment, the "seller can't touch the money from the sale."[3] In essence the QI holds onto the seller's cash until it can be used to purchase new investment property.[4]

Qualified intermediaries are generally banks or title insurance companies. However, the business is largely unregulated under

1. Peter Lattman & Kemba Dunham, *Tax Strategy For Real Estate Hits Rocky Turf*, WALL ST. J., May 26, 2007, at B1.
2. *Id.*
3. *Id.*
4. *Id.*

the tax code.[5] Light regulation means that when the intermediary has his hands on the money, he can do almost whatever he wants with it, within the bounds of his agreement with the taxpayer, of course.[6]

Out of this framework flows the sad story of the taxpayer whose intermediary lost or stole his funds. According to the *Wall Street Journal*, recent months have seen "at least two big cases of independent QIs running into trouble."[7] One case involved the alleged misappropriation of over $95 million of customers' exchange funds to fund other business and personal activities.[8] Another highly publicized case involved "1031 Tax Group LLC," which filed for bankruptcy protection on May 14, 2007, owing an estimated $151 million in exchange funds to over 300 investors.[9] To put a face on the problem, the *Wall Street Journal* told the story of Ms. Graham:

> Candace Graham, a real-estate investor from Portola Valley, Calif., is owed roughly $3.3 million by 1031 Tax Group, according to a bankruptcy court filing. In February, Ms. Graham, 58 years old, sold an office building and, to defer taxes, placed the proceeds with a subsidiary of the 1031 Tax Group but hasn't been able to gain access to the funds to buy another property. Because her deferral strategy fell apart, she faces the prospect of a capital-gains bill. "I have no idea how I will pay the government now," said Ms. Graham.[10]

Ms. Graham's story raises legal issues that go beyond the question of increased regulation of qualified intermediaries.[11] If Ms. Graham's funds (the money from the sale of the relinquished property) are not restored in time for her to make a legitimate sec-

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5. *Id.*

6. Lattman & Dunham, *supra* note 1, at B1. For example, the Code does not impose any licensing requirements on the Qualified Intermediary. *Id.*

7. *Id.*

8. *Id.* Donald McGhan allegedly took exchange funds belonging to over 130 clients of his qualified intermediary businesses, partly to finance his investment in a company that manufactures silicone breast implants. *Id.*

9. *Id.* The company's owner allegedly borrowed money from the company to fund real estate investments made by another company he controlled. *Id.*

10. Lattman & Dunham, *supra* note 1.

11. *Id.* The IRS has taken note of the obvious issue (i.e., the 1031 taxpayer whose QI lost his money probably cannot satisfy the 180-day exchange requirement). *Id.* Clarissa Potter, Deputy Chief Counsel of the IRS, reported to the *Wall Street Journal* that the agency is following the trouble, and that it has taken due notice that "taxpayers may face disruptions when an intermediary cannot meet its obligations." *Id.*

tion 1031 exchange, will she be taxed on the sale of the relinquished property? The issue is one of first impression in the context of like-kind exchanges, a Code section where taxpayers must adhere to strict rules in order to get a deferral. Further, if Ms. Graham is taxed, to what extent is she taxed, and when? This comment will answer these questions.

The answer lies in a synchronization of the Internal Revenue Code's rules governing section 1031 exchanges and case law regarding a principal's realization of income where his agent misappropriates his funds. The comment begins with an exploration of section 1031, its evolution, and the role of the qualified intermediary within its framework. Next, it focuses on the rules regarding a principal's realization of misappropriated funds. In the analysis section, the writer synchronizes the two aforementioned areas into a rule to be applied to Ms. Graham. Finally, in the conclusion, the rule is applied to Ms. Graham's situation.

II. INTERNAL REVENUE CODE SECTION 1031

Under the Internal Revenue Code, "gross income means all income from whatever source derived," including gains from "dealings in property."[12] Generally, one's taxable income is calculated by subtracting his adjustments and deductions from his gross income.[13] The gain or loss from any dealing in property is the amount realized[14] from the sale or disposition of the property, less the adjusted basis[15] provided by the Code for computing gain or loss.[16]

There are exceptions to the aforementioned framework. A taxpayer can sell property in two different ways under the Code without having to realize a gain, which in turn means he does not

12. I.R.C. § 61(a) (2000).

13. Id. § 63. Knowledge of the rules regarding adjustments and deductions are not necessary for the reader of this comment.

14. The amount realized is generally equal to the amount of money received from the sale or disposition of property, plus the fair market value of other property received. *Id.* § 1001(b).

15. The adjusted basis for the purposes of this comment is generally equal to the property's basis—which is its cost—adjusted for depreciation and/or improvements. *See, e.g., id.* §§ 1011(a), 1012. The Code has special rules for computing the basis of specific things like gifts and property received from a decedent, but these rules are not relevant to this comment.

16. *Id.* § 1001(a).

have to pay taxes on the gross income he received from the sale.[17] One such exclusion is Code section 121[18], which allows a taxpayer to exclude from gross income the gain he derived from the sale of his principal residence.[19]

Another exclusion is provided in section 1031(a) of the Code, which states that "no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment 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."[20] Under this framework, a taxpayer can avoid realizing a gain on the property he is giving up (the "relinquished property") if he exchanges it for like-kind[21] property (the "replacement property"), as long as he complies with certain timing parameters[22] and both properties are held for the productive use in a trade or business or for investment.[23]

It is important to understand that the like-kind exchange is a tax deferral device, not a tax elimination device.[24] The taxpayer's basis in the replacement property is equal to his basis in the relinquished property, reduced by any cash received and any loss recognized and increased by any gain recognized.[25] In other words, section 1031 lets the taxpayer delay taxation on the gain

17. *See* Robert L. Cherry, Jr., *Use of a Qualified Intermediary for 1031 Tax Free Exchanges; Sell Real Estate and Pay No Tax*, 33 REAL EST. L.J. 239 (2004). This comment deals only with gains from the sale of property; losses are beyond its scope.

18. I.R.C. § 121 (2000).

19. Cherry, *supra* note 17, at 239.

20. I.R.C. § 1031(a)(1) (2000). However, the rule does not apply to gains derived from the exchange of stocks, bonds, notes, other securities, partnership interests, certificates of trust or beneficial interests, or choses in action. *Id.* § 1031(a)(2).

21. *See id.* § 1031(a)(1). The "like-kind" requirement is interpreted liberally. According to the Treasury Regulations, the words "like-kind" reference the nature or character of the property, not its grade or quality. Treas. Reg. § 1.1031(a)-1(b) (1991). The Regulation goes on to state alternatively that one kind or class of property is not considered of "like-kind" to property of a different kind or class. *Id.* As such, improved and unimproved real estate are considered like in kind, because their difference lies not in kind or class, but in grade or quality. *Id.* Generally, it is safe to assume that "[v]irtually all real property is like-kind property." Cherry, *supra* note 17, at 241. That said, for the purposes of this comment, it is assumed that all property exchanged is real estate and thus fulfills the "like-kind" requirement.

22. *See* I.R.C. § 1031(a)(3) (2000). The replacement property must be identified within forty-five days of the transfer of the relinquished property, and it must be received by taxpayer at the earlier of 180 days from the transfer of the relinquished property, or the date—inclusive of an extension—of the taxpayer's return for the tax year in which the transfer of the relinquished property took place. *Id.*

23. *See id.* at § 1031(a)(1).

24. *See* Richard M. Lipton, *The 'State of the Art' in Like-Kind Exchanges*, 91 J. TAX'N 78, (1999).

25. *See* I.R.C. § 1031(d) (2000).

realized from exchanging Property X until he eventually sells his investment property for something that is not of like kind—generally cash—but his gain on cashing out is calculated using his basis in Property X.

A. *The Evolution of Section 1031*

Congress' intention behind section 1031 was to permit taxpayers to avoid present tax liability when exchanging one property for another of like kind, because taxes should not be imposed on a gain realized where the taxpayer maintains a continuous investment in like-kind property.[26] Originally, Congress assumed that like-kind exchanges would only apply where Taxpayer 1 and Taxpayer 2 exchanged properties simultaneously,[27] but the law has evolved to allow multiparty transactions and deferred transactions.[28] Ms. Graham's is a multiparty deferred transaction.

In a multiparty transaction, the Taxpayer sells the relinquished property to the Buyer, who acquires the replacement property that the Taxpayer desired from Seller, and the Seller conveys the replacement property to the Taxpayer on behalf of the Buyer.[29] The IRS originally contended that these three-party exchanges did not satisfy section 1031, but eventually surrendered after losing in *Barker v. Commissioner*.[30]

In *Barker*, the Buyer wanted to buy Blackacre from the Taxpayer and the Taxpayer wanted to buy Whiteacre from a third-party Seller.[31] To accomplish the exchange, a fourth party simultaneously acquired both properties, transferred Whiteacre to the Taxpayer in return for Blackacre, and transferred Blackacre to the Buyer in exchange for cash.[32] The IRS contended that the transaction did not amount to a successful section 1031 exchange because the Taxpayer in essence sold Blackacre and reinvested the proceeds.[33]

The Tax Court analyzed the transaction in *Barker* against a backdrop of precedential support for three-party exchanges in general, and specific judicial approval under section 1031 in situa-

26. Ravenswood Group v. Fairmont Associates, 736 F. Supp. 1285 (S.D.N.Y. 1990).
27. Cherry, *supra* note 17, at 241.
28. Lipton, *supra* note 24, at 79.
29. *Id.*
30. *Id.* (citing Barker v. Comm'r, 74 T.C. 555 (1980)).
31. *Barker*, 74 T.C. at 561-62.
32. *Id.*
33. *Id.* at 562.

tions where the Buyer immediately sold the property that Taxpayer transferred to him.[34] The *Barker* deal had several factors characteristic to section 1031 exchanges, including the intent to exchange two properties, the actual transfer of legal title, the simultaneous completion and interdependence of contractual arrangements, and most importantly, the fact that "[the Taxpayer] did not, or could not, obtain actual or constructive receipt of the cash proceeds of the sale of [Blackacre] to [Buyer]."[35] However, the court, in interpreting section 1031, deemed suspect the transitory nature of the transaction and the possibility that the Taxpayer "could have received cash rather than real estate."[36] These weaknesses were not enough to overcome the Taxpayer's argument, mainly because the IRS had already acquiesced to transitory ownership in the context of three-party transactions, and because the interdependence of the transactions made the receipt of cash by the Taxpayer impossible to accomplish.[37] Thus, multiparty exchanges are presently an accepted form of section 1031 gain deferral.

Section 1031 evolved a second way when deferred transactions became permissible. These exchanges grew out of the Ninth Circuit decision in *Starker v. United States*,[38] where the issue was whether section 1031 required a simultaneous exchange of deeds.[39] In *Starker*, the United States argued that all exceptions to the general rule (that gains and losses are recognized) must be construed narrowly; they must satisfy both the Code's specific requirements for the exception and the underlying purpose for having the exception.[40]

However, the *Starker* court had difficulty determining what the underlying purpose for section 1031 really was.[41] Plus, section

34. *Id.* at 562-64.

35. *Id.* at 564-65.

36. *Barker*, 74 T.C. at 565.

37. *Id.* at 566-68.

38. Lipton, *supra* note 24, at 79 (citing Starker v. United States, 602 F.2d 1341 (9th Cir. 1979)).

39. *Starker*, 602 F.2d at 1350.

40. *Id.* at 1352 (citing Treas. Reg. § 1.1002-1(b) (1957), which states that nonrecognition of an exchange under the Code is only permissible where the exchange satisfies both (1) the Code's specific requirements for the exception, and (2) the underlying purpose for which the exchange is excepted from the general rule).

41. *Starker*, 602 F.2d at 1352. Legislative history showed that Congress wanted to eliminate taxing those who did not "cash in on their investments in trade or business property" because liquidity problems would ensue for some taxpayers. *Id.* However, the Court noted that the liquidity rationale must be limited because those taxpayers who sell and reinvest could not defer recognition under § 1031, yet may experience the same liquidity

1031 had a history of being interpreted liberally.[42] After discounting the government's narrow construction argument, the *Starker* court turned to the features that made the taxpayer's transaction most likely to trigger a gain, including the fact that there had been a substantial time gap separating the exchange of the deeds.[43] After citing a single Fifth Circuit case and employing minimal analysis, the *Starker* court flatly rejected the IRS requirement that the section 1031 exchange be simultaneous.[44] Congress acquiesced in 1984 by enacting section 1031(a)(3), which gives the taxpayer forty-five days to identify the replacement property and 180 days to close on it.[45]

As such, section 1031 evolved from a device for two-party simultaneous exchanges into a device that permits the nonrecognition of deferred multiparty transactions, and the Treasury Regulations now provide guidance to taxpayers wishing to complete such transactions. In fact, the multiparty exchange rules found in the Regulations have resulted in the creation of an entire industry—qualified intermediaries— that "stand ready, willing, and able to assist taxpayers in completing deferred exchanges that are nontaxable under section 1031."[46]

B. *The Role of the Qualified Intermediary Under Section 1031*

Under the Regulations, a multiparty exchange is given section 1031 treatment—despite the lack of a two-person "exchange"—as long as the taxpayer adheres to the rules regarding the identification and receipt of the replacement property.[47] However, a gain may be recognized if the taxpayer actually or constructively receives money or property before he receives the like-kind replacement property.[48]

Generally, a taxpayer has actual receipt when he receives the money or property or its benefit.[49] A taxpayer has constructive

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problems. *Id.* Another § 1031 aim of Congress was apparently to address the difficulty of valuing property that was exchanged. *Id.* However, the recognition of even $1 in boot would necessitate a valuation, so the valuation rationale could not have been the main reason for the enactment of § 1031. *Id.*

42. *Id.*

43. *Id.* at 1353.

44. *Id.* at 1354-55 (citing Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968)).

45. *See* Lipton, *supra* note 24, at 79.

46. *Id.*

47. Treas. Reg § 1.1031(k)-1(a) (2002).

48. *Id.*

49. Treas. Reg § 1.1031(k)-1(f)(2) (2002).

receipt when the money or property is credited to his account, set aside for him, or made available so that he could draw on it with notice.[50] Even where the taxpayer has no actual or constructive receipt of money or property himself, actual or constructive receipt *by his agent* is imputed to him.[51] In other words, for a transaction to be legitimate under section 1031, the taxpayer cannot touch the money paid for the sale of the relinquished property, nor can he have his agent touch the money for him.

Enter the section 1031 swap through a qualified intermediary, permitted under the Treasury Regulations, where the typical exchange involves: (1) the taxpayer; (2) the buyer of the relinquished property; (3) the seller of the replacement property; and (4) the now-infamous qualified intermediary.[52] In essence, the QI holds onto the taxpayer's money from the sale of the relinquished property and pays it to the seller of the replacement property.

Here, the astute reader perceives a discrepancy. He thinks to himself, "Isn't the intermediary's receipt of the taxpayer's money the constructive receipt of funds to the taxpayer?" The Regulations state that it is not. The IRS created a safe harbor to shield section 1031 exchangers from the dreaded constructive receipt of funds—and inadvertently created a whole industry—by authorizing multiparty exchanges made through qualified intermediaries.[53]

Under the safe harbor, a qualified intermediary can touch the money for the taxpayer without the taxpayer having to realize actual or constructive receipt of the funds.[54] How? The IRS states that the qualified intermediary *is not considered the agent* of the taxpayer.[55] But the safe harbor vanishes at the moment the tax-

50. *Id.*

51. *Id.*

52. *See* Cherry, *supra* note 17, at 242

53. *See* Lipton, *supra* note 24, at 79.

54. *See* Treas. Reg § 1.1031(k)-1(g)(4) (2002). Qualified intermediaries are typically companies that are in business to make money by handling tax deferred exchanges. *See* Cherry, *supra* note 17, at 242.

55. Treas. Reg § 1.1031(k)-1(g)(4)(i) (2002). The Regulation states:

> In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is *not considered the agent* of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer receives like-kind replacement property *is made as if the qualified intermediary is not an agent* of the taxpayer.

Id. (emphasis added).

payer has the "immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money . . . held by the qualified intermediary."[56]

Regulation of the qualified intermediary industry is almost nonexistent. Under the Regulations, to be a valid QI, one must: (1) enter into a written "exchange" agreement with the taxpayer; (2) acquire the relinquished property from the taxpayer as required in the agreement; (3) transfer the relinquished property; (4) acquire the replacement property; and (5) transfer the replacement property to the taxpayer.[57] If he fulfills the aforementioned requirements, anyone can become a qualified intermediary; the industry is not licensed or audited by any regulatory body.[58] Further, qualified intermediaries currently face no bonding, insurance, or minimum equity capitalization constraints.[59]

In sum, the QI is a powerful tool that allows the taxpayer to complete a multiparty swap with replacement property it has not yet identified at the time the relinquished property is given up. The regulations that created the QI industry allow for easy access into the sector and provide no industry oversight. In the end, it is taxpayers like Ms. Graham who suffer when the QI misappropriates the proceeds from the relinquished property. The issue is whether Graham is taxed on the gain received—which was held by her qualified intermediary—when she cannot complete the exchange because the QI misappropriated the proceeds needed to buy the replacement property. Here, the tax jurisprudence that flows from principal-agent misappropriation provides guidance.

III. THE RULES GOVERNING AN AGENT'S MISAPPROPRIATION OF THE PRINCIPAL'S PROPERTY

As previously stated, gross income means all income from whatever source derived, including gains from dealings in property.[60] The Supreme Court has defined income as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[61] In cases dealing with an agent's misappropriation of his

56. Treas. Reg. § 1.1031(k)-1(g)(4)(vi) (2002).
57. *Id.* § 1.1031(k)-1(g)(4)(iii).
58. *Choosing a SAFE 1031 Exchange Qualified Intermediary (QI)*, http://www.exeterco.com/Selecting_SAFE_Qualified_Intermediary.aspx (last visited August 13, 2007).
59. *Id.*
60. I.R.C. § 61(a) (2000).
61. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

principal's funds, the tax treatment of the principal depends on whether he had constructive receipt of the funds, and whether the principal-agent relationship existed at the time of the misappropriation.

Generally, the receipt of funds by an agent is constructive receipt by his principal.[62] An exception to the general rule exists if there is an unauthorized use of funds from which the principal derives no benefit.[63] However, if the principal derives an economic benefit from the agent's actions, the principal constructively receives the income even though the agent took unauthorized action to his detriment.[64] Even if a corporate principal does not derive an economic benefit from the unauthorized use of funds, it will have gross income to the extent that the transaction consisted of the normal activities of the corporation.[65]

The timing of the misappropriation is also a factor. The issue is whether the agent is considered an agent at the moment he mis-

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62. *See* Md. Cas. Co. v. United States, 251 U.S. 342, 346-47 (1920).

63. *See* Alsop v. Comm'r, 290 F.2d 726, 728 (2d Cir. 1961), *aff'g* 34 T.C. 606 (1960). In *Alsop*, the taxpayer discovered that her literary agent had been embezzling her royalties for the past ten years. *Alsop*, 290 F.2d at 727. The taxpayer had not reported the royalties as income because she was unaware that they existed. *Id.* After learning of foul play, the taxpayer obtained judgments against the agent and she deducted embezzlement losses in the amount of the judgments. *Id.* However, she did recover a portion of the money from her agent, but did not report it as income. *Id.* The court determined that the taxpayer was not able to take the deductions for the embezzlement losses because she never received the income, and that the subsequent recovery of money from the agent was income in the year received. *Id.* at 728-29.

64. *See* Donohue v. Comm'r, 323 F.2d 651 (7th Cir. 1963). In *Donohue*, an accountant embezzled money from his client—a tavern owner—who was unaware of the embezzlement until a later year. *Donohue*, 323 F.2d at 652. The Seventh Circuit noted that the embezzled money had been deposited in the cash register, used in the taxpayer's business, and later embezzled. *Id.* The taxpayer argued that the money was income to the accountant in the year of its receipt. *Id.* The court disagreed; it distinguished *Donohue* from *Alsop* because the taxpayer had an economic benefit from the receipt of the money in the cash register prior to the embezzlement. *Id.* Accordingly, the court ruled that the employer had income in the year of receipt. *Id.* at 652-53. *See also* Sowell v. Comm'r, 302 F.2d 177, 179-80 (5th Cir. 1962). In *Sowell*, the partial owner of an oil and gas lease pledged the lease and assigned the income from it to obtain a loan, all without the knowledge or consent of the co-owners. *Sowell*, 302 F.2d. at 178-79. All income that would have been paid to the other owners was remitted to the bank in payment of the loan. *Id.* at 179. The other owners reported the income and corresponding depletion deductions, as well as a bad debt deduction for the amounts remitted to the bank but not repaid to them on their returns. *Id.* at 179. The IRS claimed that the owners did not have constructive receipt of the income and as such were not entitled to report the income or the deductions. *Id.* The court determined that the owners did derive an economic benefit from the payment to the bank on the loan because each payment increased the owner's equity in the lease and lessened the bank's interest. *Id.* at 180.

65. *See* Asphalt Indus., Inc. v. Comm'r., 384 F.2d 229, 232 (3d Cir. 1967) (holding that the corporate principal must include the funds embezzled by its president in gross income because the transactions consisted of the normal activities of the corporation).

appropriates the funds. If the purpose behind the principal-agent relationship had been fulfilled, a subsequent misappropriation by the so-called agent will not be attributed as income to the principal because the relationship had already ended.[66]

Theoretically, the principal-agent relationship may also be terminated prior to its fulfillment if the agent breaches his fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship. Whether such a breach would be seen as a termination of the agency relationship is unknown.[67]

IV. THE ISSUE

Back to Ms. Graham. She had tax-deferred funds from the sale of relinquished property that were held by a qualified intermediary, who misappropriated the funds before Graham could identify and close on like-kind replacement property. The issue is whether Ms. Graham has taxable income from the sale of the relinquished property, and if so, to what extent and when.

66. *See* Rossi v. Comm'r, 41 B.T.A. 734 (1940). In *Rossi*, the taxpayer was a member of a partnership that became insolvent. *Rossi*, 41 B.T.A. at 735. It assigned all of its assets to an agent, who sold them and used the funds to settle with the partnership's creditors. *Id.* However, in the subsequent year, the agent received a check payable to the partnership for a tax refund. *Id.* at 736. The agent endorsed the check, deposited the money into the bank, and used the funds for his own personal expenses. *Id.* The taxpayer had no knowledge of the money and no additional payments were made to the partnership's creditors from the funds. *Id.* The IRS argued that although the taxpayer had no knowledge of the money, the funds were received by taxpayer's agent, so the income was taxable to taxpayer in the year of agent's receipt. *Rossi*, 41 B.T.A at 737. The Board determined that the agency agreement between the partnership and the agent ended when the agent made final payments to all of the partnership's creditors, because an agency agreement terminates when its purpose has been completed. *Id.* at 738. Thus, the taxpayer had no income. *Id.*

67. *See* Grant v. Comm'r, T.C. Memo 1995-29. In *Grant*, the taxpayers sought debt consolidation due to financial troubles that followed their relocation from Alaska to Alabama. *Grant*, T.C. Memo at *1. Under the guise of debt consolidation, and without the knowledge of the taxpayers, the agent cashed in the one of the taxpayers' retirement accounts and misappropriated the proceeds. *Id.* at *2. The Service notified the taxpayers of a tax deficiency resulting from the nonpayment of income tax on the liquidation of one of the accounts. *Id.* at *4. The issue was whether the unauthorized distribution of taxpayers' pension fund to the agent—who misappropriated the funds—constituted gross income to the taxpayers under § 61(a). The court expounded the general rule that the taxpayer has no gross income where an agent receives and misappropriates funds for his own use, the principal had no knowledge of the misappropriation, and the principal received no economic benefit from the misappropriated funds. *Id.* at *4. However, a taxpayer will have gross income where he had no knowledge of the misappropriated funds, but nevertheless, received some economic benefit from the funds. *Grant*, T.C. Memo at *4. Here, the court was satisfied that the taxpayers had no knowledge of the agent's misappropriation, nor had they received an economic benefit from it, so the taxpayers were not required to report income from the agent's receipt of the retirement account proceeds. *Id.*

Before plunging into the law, consider the theory behind taxation in general. Taxes are mainly used to pay for public services.[68] However, the imposition of a tax on an activity encourages people engaged in Activity X to substitute Activity Y, which is less heavily taxed.[69] Inefficiency results because those people were more productively employed in Activity X, otherwise no tax would have been needed to induce them to switch from X to Y.[70] Thus, taxes result in a necessary reduction in the efficiency with which resources are employed.[71]

V. ANALYSIS

Ms. Graham sold property. The selling price—or the amount realized—was $3.5 million. Under sections 61(a)[72] and 1001[73] of the Code, Ms. Graham must pay income tax on the amount realized minus the price she paid—or the basis—which is adjusted upward for improvements made and downward for depreciation expenses deducted.

There is an exception. Ms. Graham held her property solely for investment. As long as she exchanges it for like-kind property under the rules of section 1031, Graham can delay paying taxes on the gain. Note that she cannot avoid paying taxes altogether, because eventually she will not *exchange* the property; she will sell it for property that is not of like kind, and when she does, the basis she uses to compute her gain will be the basis of the first property she exchanged. This brief illustration shows that the purpose of section 1031 is all about liquidity. It allows Ms. Graham to productively exchange like-kind investment or business properties and defer the taxable gain until the time comes when she has the cash to pay the tax. In fact, section 1031 increases the efficiency with which resources are employed because it keeps taxation of the gain from interfering in the decision to reinvest.

Although it may not have been Congress' intent when it drafted section 1031, the deferred multiparty exchange that Ms. Graham has set in motion is permitted. Graham's transaction is multi-

68. RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 223 (2nd prtg. 1974). Taxation is also used by some as a device to change resource use and/or as a means to distribute wealth. *Id.*

69. *Id.*

70. *Id.*

71. *Id.* at 223-24.

72. I.R.C. § 61(a) (2000) (defining what is gross income).

73. *Id.* § 1001 (determining the amount of gain or loss, generally).

party because there are more than two parties involved; she sold the relinquished property to Buyer for $3.5 million and will buy the replacement property from a to-be-determined Seller.[74] Graham's transaction is *deferred* because she did not simultaneously exchange properties.[75] Perhaps the most important factor behind the courts' consent of multiparty and deferred like-kind exchanges was the idea that the taxpayer could not obtain actual or constructive receipt of the cash from the sale of the relinquished property.[76] So far so good for Ms. Graham; she is well on the way to a tax-deferred exchange.

Remember, the IRS issued specific regulations that must be fulfilled in order to make a deferred exchange legitimate. Generally, the QI must: (1) enter into a written exchange agreement with the taxpayer; (2) acquire the relinquished property from the taxpayer as required in the agreement; (3) transfer the relinquished property; (4) acquire the replacement property; and (5) transfer the replacement property to the taxpayer.[77] In Ms. Graham's case, the QI completed steps (1) – (3) and collected the proceeds from the sale of the relinquished property, but lost Graham's money before acquiring the replacement property.

For now, disregard whether Ms. Graham may still complete a valid section 1031 exchange; she has bigger problems. The IRS may argue that she must recognize as income the difference between her adjusted basis in the relinquished property and the $3.5 million that her QI received for it. The IRS could argue that Ms. Graham had constructive receipt of the funds from the relinquished property even though her QI eventually misappropriated them. Admittedly, the Treasury Regulations state that the taxpayer must treat a section 1031 exchange as a sale if he has constructive receipt of the replacement property funds,[78] and gener-

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74. The Tax Court deemed that multiparty exchanges were legitimate under § 1031 in Barker v. Comm'r, 74 T.C. 555 (1980). *See supra*, section II.

75. The Ninth Circuit deemed that deferred exchanges were legitimate under § 1031 in Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). Congress acquiesced in 1984 by enacting I.R.C. § 1031(a)(3), which gives the taxpayer forty-five days to identify the replacement and sixty days to close on it. *See* I.R.C. § 1031(a)(3) (2000).

76. *Barker*, 74 T.C. at 564-65.

77. Treas. Reg. § 1.1031(k)-1(g)(4)(iii) (2002).

78. *See* Treas. Reg. § 1.1031(k)-1(f)(1) (2002):

> [I]n 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

ally, actual or constructive receipt of funds by the taxpayer's agent is imputed to the taxpayer himself.[79]

However—and this is a big however—the Regulations state that a QI is not considered the taxpayer's agent *in the context of a section 1031 exchange*.[80] There was no "exchange" in the case of Ms. Graham, which opens the door for treating her as a normal seller with an agent who collected $3.5 million in her name. Nevertheless, the plain language of the regulations does not require a *consummated exchange* in order to treat the QI as not being an agent: "[i]n the case of a taxpayer's *transfer of relinquished property* involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a)."[81]

However, the IRS could still argue that it is not trying to tax Graham based on section 1031(a); it is taxing her under section 1001(a).[82] Admittedly, Graham has not completed a like-kind exchange, and under any Code section other than section 1031, the QI would be considered Graham's agent.

Under the *Alsop* and *Donohue* cases, the IRS could argue that the intermediary's receipt of funds from the sale of Graham's property is imputed to Graham and that she must pay income tax on the difference between the sale price and the adjusted basis as a result.[83]

Generally, the receipt of funds by an agent is constructive receipt by his principal,[84] unless the principal derives no benefit from the agent's use of his funds; but if the principal derives an economic benefit from the agent's actions, he has constructively received the income even though the agent took unauthorized action to the principal's detriment.[85] Thus, whether or not Graham

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> property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange.

Id.

79. *See id.* § 1.1031(k)-1(f)(2).
80. *See id.* § 1.1031(k)-1(g)(4)(i).
81. *Id.* (emphasis added).
82. *See* I.R.C. § 1001(a) (2000):

> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

I.R.C. § 1001(a).

83. *See supra* Part III for a discussion of the *Alsop, Donohue*, and *Asphalt Indust.* line of cases.
84. *Alsop*, 290 F.2d at 728.
85. *Donohue*, 323 F.2d 651.

is taxed will depend on how persuasive the IRS is in arguing that she received an "economic benefit" when the QI accepted the funds for the relinquished property. For example, if the intermediary paid off an outstanding mortgage on the relinquished property or made an investment gain on Graham's funds before losing them, Graham could have to recognize ordinary income in the amount of her economic benefit.[86]

VI. CONCLUSION

Would the IRS go after Ms. Graham, arguing that she should be taxed under the economic benefit theory? It might, because the IRS has public policy considerations for not adopting a favorable position.

Currently, there is no oversight of qualified intermediaries. They are not licensed, required to be bonded, insured, or meet minimum capitalization requirements. Conversely, the majority of states require real estate agents and contractors to be bonded and insured as a condition of licensure. Arguably, similar requirements should be imposed on qualified intermediaries.

If the IRS were favorable in Ms. Graham's case, it would provide an incentive to maintain the status quo. Qualified intermediaries wishing to avoid bonding, insurance, and minimum capitalization costs could point to the favorable treatment given to taxpayers like Graham as a factor that lessens the impact of such losses. Thus, by requiring a taxpayer like Graham to report the sale of the relinquished property and claim a loss for the QI's theft or misappropriation of the proceeds, the IRS would arguably be providing a service to the participants of like-kind exchanges.

However, the IRS had a chance to regulate the QI industry and it chose not to.[87] By pushing the entire QI industry into stricter regulation, the acts of a few deadbeat intermediaries will drive up like-kind exchange costs for all taxpayers.

It also seems far-fetched to believe that a QI could cite the favorable treatment of Ms. Graham to convince a potential client that the exchange is less risky than it appears. Graham still lost

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86. Also note that if Graham were imputed the income that her intermediary collected, she would be unsuccessful arguing that the principal-agent relationship had already ended. Generally, if the purpose behind the principal-agent relationship had been fulfilled, a subsequent misappropriation would not be attributed to Graham because the principal-agent relationship had already ended. *See Rossi*, 41 B.T.A. 734.

87. As stated in Part II, *supra*, the qualified intermediary industry was created by the IRS Treasury Regulations.

the proceeds from the sale of her $3.5 million dollar property; the only issue before the IRS is whether or not to tax her as if she sold it. And don't forget that taxpayers are free to negotiate the terms of their QI agreement, including a provision that the QI shall not invest the proceeds, etc.

In short, the plight of Ms. Graham is a lesson to all like-kind exchangers to use due diligence in choosing an intermediary and in negotiating the terms of the exchange agreement. To tax Graham as a seller would be an inefficient way to spur the costly regulation of an industry; it would create inefficient barriers to taxpayers seeking to exchange via section 1031 all because of a few deadbeat intermediaries.

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