1031 Exchange: The Myth of the Cooperation Clause

In this post, we will take a brief look into the evolution of Section 1031 to show why it was critical along the way to make use of an "Exchange Cooperation Clause" and why, as the rules changed over time, such use is no longer necessary.

The IRS, through various revenue rulings has provided guidelines for allowable and unallowable closing and settlement costs based on common geographical practices and standards.

The Starker case

Section 1031 made its way into the Tax Code in 1921, nearly a hundred years ago. At that time, until the mid-1980s, the sale and purchase were thought to need to take place "simultaneously", after all, isn't that the commonsense definition of a trade between two people? Apparently not. Beginning in the late 1970s and continuing into the mid-1980s, in the landmark case of Starker vs. U.S., it was determined by a Federal District Court in California that there did not appear to be any requirement in the plain language of Section 1031 of simultaneity.

"No gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment".

This seemingly innocuous ruling opened up a Pandora's Box of opportunity, not to mention confusion. The period of time for completing the trade with his buyer in the Starker case was five years. In 1986, shortly after the decision came out, Congress chose a legislative fix. It agreed that Section 1031 did not require the exchange of the properties to take place at the same time but decided to limit the open ended duration to complete the trade of the one for the other to 180 days. Essentially that limited time period still allowed the two transactions to be close enough in time to be considered to be tied to one another. But anything of a longer period simply broke the link between the sale and the purchase into unrelated (for tax purposes) transactions.

Identification and purchase period to qualify for 1031 exchange

As for the opportunity presented, taxpayers had 45 days to identify potential properties and 180 days to close on one or more of the properties designated. This was much easier than trying to pull together a sale and a purchase at the same time. Instead of being a somewhat little used provision to defer tax, exchanges began to flourish as a result of the extended window to complete the exchange.

But practical problems abounded. One of the biggest problems was what to do with the buyer's funds during the interim period between the sale and purchase? Section 1031 still required an actual exchange between the taxpayer and the buyer. If the seller took the funds and applied them within 180 days, that was not sufficient. The moment the taxpayer received the funds, the matter became a taxable sale whether or not new property was acquired within the time limits. It was not akin to the old rules where you could get deferral on the sale of a personal residence if you bought a new one within two years. One solution was to allow the buyer to retain the funds with the contractual obligation to use them to buy the new property once the seller was ready to do so. That has so much obvious risk that it doesn't have to be explained.

Creative lawyers at the time came up with an effective solution. Keep the exchange relationship open between the taxpayer and buyer but place the buyer's purchase price into a trust account with a third party to keep it out of the taxpayer's receipt. This also had the benefit of keeping it out of the buyer's possession or control. A name quickly followed for this procedure and it was affectionately called a Starker Trust!

Now we are getting close to the point of this blog. Starker Trusts could be fifteen pages long and filled with legalese. From the buyer's standpoint, he or she saw the property listed for sale and negotiated a deal. The buyer came to closing with the applicable funds. However, in the case of a seller doing an exchange, at closing the seller (or seller's lawyer) would ask the buyer to enter into the Starker Trust for the seller's benefit. But the buyer would often balk. Sometimes there was simply bad blood between the parties by the time of closing. Other times buyers were reluctant generally to get involved in a tax matter that did not otherwise involve them. It was not unusual for the buyer to agree only if the buyer's lawyer read and approved it and the seller agreed to pay the attorney fees.

What is an Exchange Cooperation Clause?

The only way the seller could obligate the buyer to sign the necessary agreement was to provide for that buyer's obligation in the body of the purchase/sale agreement. Hence a clause began appearing in contracts for this purpose requiring the buyer to execute the Starker Trust agreement. That became know as the Exchange Cooperation Clause and it was good policy at the time.

In regard to the Pandora's Box mentioned above, many unresolved issues arose pertaining what could, and could not, be done for a seller to attain exchange status. These included such issues as:

- Who could retain the benefit of the interest accrued on the Starker Trust deposit
- Who was eligible to hold the funds in the Starker Trust
- Were there other ways to secure the buyer's obligation to provide replacement property to the taxpayer
- If the taxpayer picked out new property for the buyer to acquire to trade back to the taxpayer, did the buyer have to come into the chain of title

Where does the Qualified Intermediary come in?

In response to these questions and many more, in 1991, the 1031 Treasury Regulations were issued to provide some guidance. At the heart of the Regulations was the introduction of a new player within the exchange, namely the Intermediary. Certain persons in an agency relationship with the taxpayer were "disqualified" from acting as the intermediary but anyone else was deemed "qualified". Hence the term Qualified Intermediary (QI) came into being. This is what gave rise to the many exchange companies, such as Realogy 1031, that exist today.

The main function of the QI was to stand in the shoes of the buyer as a party with whom the taxpayer could effectuate an exchange. Through a series of steps set forth in the regulations, for tax purposes, the taxpayer was selling to the QI (who caused the property to go the buyer) and the QI acquired replacement property from the seller and transferred it to the taxpayer. As a result, an exchange was

deemed to have taken place between the taxpayer
and the QI. So, the buyer was not a party to the seller's exchange transaction and had no need to cooperate. The regulations also set up several options in regard to holding the funds during the transaction including letting the QI hold them. This is what is typically done in an exchange today.

Is an Exchange Cooperation Clause necessary?

So, for nearly thirty years, there has been no requirement for the buyer to cooperate in the seller's tax transaction, but old habits die hard. In today's world, due to the series of steps referred to above, the seller does have to assign the rights under the sale contract to the QI and notify the fact of this limited assignment to the parties to the contract. The parties receiving the written notice (mainly the buyer and later the seller) are not required to agree, cooperate or even to sign acknowledging receipt. They often sign receipt as a courtesy, but it is not required by the regulations. The same thing must be done with regard to the replacement property contract. This assignment in not tantamount to an outright assignment of the whole contract to a third party, rather it is just the assignment of the seller's rights (but not the obligations) in the contract for purpose of getting tax deferral. As a matter of general law, if a contract has no restriction against assignment, and most don't, the person has the legal right to make an assignment. However, if a contract, or state law, included a restriction on assignment, even just of the "rights" to treat it as an exchange, a counterparty in the sale or purchase agreement might be able to thwart this as a technicality. As a result, in today's contracts, even when there is no restriction against assignment, just to be safe, a clause is usually found in the preprinted contracts or added, along the lines as follows:

"Each of the parties hereto may assign its rights (but not its obligations) to a Qualified Intermediary as defined in the IRC Code Section 1031 Treasury Regulations. Said exchange will be closed without cost, liability or delay to the non-exchange party."

In summary, as the rules evolved under IRC Section 1031 since its inception, at one time it was very important to have a clause in the sale contract requiring the buyer to "cooperate" in the seller's exchange transaction. One of the primary changes to the need for the buyer to participate was in the heart of the 1991 Treasury Regulations substituting in a third party, namely the Qualified Intermediary to remove the buyer from any need to cooperate. As a result, an "exchange cooperation clause" because irrelevant. To this day people tend to put emphasis on this clause because it was necessary so many years ago. In the modern era, post-1991, the only requirement for a taxpayer in this regard is to assign the rights under the contract and provide written notice of the fact. There is no requirement for the buyer to cooperate in any way.