

Escrow Agent Erroneously Releases Funds to Taxpayer

Peter Morton v. US, No. 08-804C (Ct. Claims, April 27, 2011)

In the decision on a motion for summary judgment, the Court held that taxpayer did not constructively receive exchange funds mistakenly placed in the taxpayer's bank account by the escrow agent, and returned by the taxpayer the next day.

Peter Morton is one of the co-founders of the Hard Rock Café chain. He has several wholly owned S corporations, including Red, White and Blue Pictures, Inc. (RWB). RWB owned the aircraft in the exchange, but Mr. Morton is the plaintiff in the case because RWB was a passthrough entity. Mr. Morton paid the taxes assessed by the IRS and sued for a refund in the Court of Claims.

In 1999, Mr. Morton (presumably through RWB) structured an exchange of a Gulfstream G-III for a Gulfstream G-IV aircraft. RWB entered into an exchange agreement with a QI and an escrow agreement with an escrow agent. RWB met all the requirements of the QI safe harbor, but the escrow agent accidentally placed the funds into RWB's account. RWB returned the funds the following day.

The government argued that RWB constructively received all the funds when the escrow accidentally and in contravention of the escrow agreement transferred funds from the escrow account to RWB. The Court disagreed that an accidental transfer followed by an immediate return of funds would constitute actual or constructive receipt. The Court noted that significantly, Mr. Morton was bound by contract not to "receive, pledge, borrow or otherwise obtain the benefits of the Exchange Value" for at least 45 days. "Legally, he could not do anything but return the funds to the proper account. If he had done anything other than return the funds, he would have been liable for conversion, or even theft." Additionally, the court held that Mr. Morton should not be penalized for another's mistake when he took every step to validly effect an exchange. The Court stated that he complied with all the requirements of the QI safe harbor over which he had control; he did not have control over the mistaken actions of a third party. Therefore, he validly effected the exchange.

The Court nevertheless deferred judgment on the exchange until Mr. Morton presented more evidence on whether the aircraft were actually used for "productive use in a trade or business", as required for Section 1031. He had not sufficiently substantiated the business or personal nature of the individual trips made in the aircraft.