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ESTATE TAX MEMORANDUM

TO: **CPAs, Clients & Associates**

FROM: **David L. Silverman, Esq.**

DATE: **April 8, 2010**

RE: **Reverse Exchanges**

Although the deferred exchange regulations apply to simultaneous as well as deferred exchanges, they do not apply to reverse exchanges. See Preamble to final Regulations, 56 Red. Reg. 19933 (5/1/91). Reverse exchanges occur where the taxpayer acquires replacement property before transferring relinquished property. Perhaps because they are intuitively difficult to reconcile with the literal words of the statute, reverse exchanges were slow to gain juridical acceptance. An early case, Rutherford v. Com'r, TC Memo (1978) held that purchases followed by sales could not qualify under Section 1031. However, Bezdijian v. Com'r, 845 F.2d 217 (9th Cir. 1988) held that a good exchange occurred where the taxpayer received heifers in exchange for his promise to deliver calves in the future. Following Bezdijian, taxpayers began engaging in reverse exchanges in which either relinquished or replacement property was "parked" with an accommodator. Just as deferred exchanges were recognized by courts, so too, reverse exchanges soon received a judicial imprimatur.

Rev. Proc. 2000-37 Safe Harbor

Rev. Proc. 2000-37 was borne of an attempt by the IRS to provide a safe harbor that allows taxpayers intending to complete a like-kind exchange after acquiring replacement property to accomplish that result in a predictable fashion. Although the deferred exchange regulations do not govern reverse exchanges, many of its rules and time periods have been "borrowed" by Rev. Proc. 2000-37. Thus, the familiar 45-day identification and 180-day exchange periods which govern deferred exchanges also appear in Rev. Proc. 2000-37, albeit in a different context. The 45-day period limits the time in which the taxpayer may identify up to three properties to be relinquished in an "Exchange Last" reverse exchange. The 180-day period limits the time in which the taxpayer must relinquish one of those three identified properties. The 180-day period also applies with respect to the accommodator. The 180-day period limits the time in which an accommodator may hold and improve replacement property in an Exchange Last reverse exchange. The 180-day period also limits the time in which an accommodator may hold relinquished property for sale in an "Exchange First" reverse exchange.

Reverse exchanges under Rev. Proc. 2000-37 are effective with respect to an "Exchange Accommodation Titleholder" (EAT) that acquires beneficial title in either the relinquished or the replacement property. The IRS will not challenge the qualification of either replacement property or relinquished property, or the status of the EAT as owner for federal income tax purposes of such property, if the property is held in a "qualified exchange accommodation arrangement" (QEAA). The EAT in a QEAA may hold the exchange property for no more than 180 days. To be the tax owner, the EAT must possess "qualified indicia of ownership" (QIO) from the acquisition date until the date the property is transferred. While the taxpayer will want to profit while the property is held in a QEAA, if the EAT has actually acquired an ownership interest — which it must to engage in the exchange — the EAT must also profit from property appreciation during its period of ownership. The IRS states the EAT must have between three and seven percent of its equity at risk. The taxpayer may continue to lease or manage the property while it is parked with the EAT.

The EAT cannot be either the taxpayer or a "disqualified person." Disqualification is determined under rules similar to those found in deferred exchange Regs. § 1.1031(k)-1(g). The QEAA must explicitly provide that the EAT is not the taxpayer's agent for federal tax purposes since only the property owner can engage in a like-kind exchange. To avoid exposure to state and local taxes, the QEAA should also provide that the EAT is not taxpayer's agent for state or local tax purposes. [In contrast to the EAT in a QEAA, the QI in a safe harbor deferred exchange never has an equity stake in the transaction. The role of the QI is also distinguishable from that of the EAT in that the QI never acquires beneficial title in either the relinquished or the transferred property (and not even legal title if property is direct-deeded to the taxpayer) while the EAT must be the beneficial owner for tax purposes. Neither the QI nor the EAT is the taxpayer's agent for income tax purposes. However, the QI is the taxpayer's escrow agent for legal purposes. Since an escrow agent is bound by a fiduciary obligation, Regs. § 1.1031(k)-1(g)(3) provides that the taxpayer is not in constructive receipt of exchange funds held by the QI.]

"Exchange Last" and "Exchange First"

Rev. Proc. 2000-37 sanctions two types of reverse exchanges. The first is "Exchange Last." Here, an accommodator acquires and "parks" replacement property until the taxpayer arranges to dispose of the relinquished property through a QI. Financing for the acquisition may be arranged by the taxpayer. The QI transfers proceeds from the relinquished property sale to the EAT in exchange for the parked replacement property. The EAT then transfers the replacement property directly to the taxpayer, completing the exchange. The EAT uses the cash received from the QI to retire the debt. While parked with the EAT, the replacement property may be net-leased or managed by the taxpayer.

Since the parked property will have been initially acquired by the accommodator and will not have been previously owned by the taxpayer, there is little risk the accommodator will be disregarded for tax purposes. Another advantage of Exchange Last is that following acquisition by the accommodator of the replacement property, the taxpayer can consider several potential properties to be relinquished, and ultimately choose that which generates the least gain. However, if the taxpayer elects to proceed under the safe harbor provided by Rev. Proc. 2000-37, flexibility will be limited, since the taxpayer must identify three potential properties to be relinquished within the 45-day identification period.

In Exchange Last, although the taxpayer eventually acquires title to the replacement property, while the replacement property is parked with the EAT, the EAT is title owner of that property. Therefore, the EAT will be the borrower on a loan associated with the acquisition of the replacement property until the loan is satisfied by proceeds from the sale of the relinquished property. To avoid loan application problems, the taxpayer should apprise the lender at an early stage of the planned reverse exchange and the presence of the EAT. A build-to-suit exchange would typically employ the Exchange Last format, since the replacement property may be improved while parked with the accommodator.

Many “build-to-suit” arrangements will not be suitable for the Rev. Proc. 2000-37 safe harbor, since completion of improvements may not be possible within the 180-day period in which the property is held by the EAT. If it is necessary to go beyond 180 days (or if the EAT is a “disqualified person”) the taxpayer can still a pursue “non-safe-harbor” or “pure” reverse exchange. Rev. Proc. 2000-37 states that “the Service recognizes that parking transactions can be accomplished outside of the safe harbor.” PLR 200111025 explicitly recognized that non-safe-harbor reverse exchanges survive Rev. Proc. 2000-37. Pure reverse exchanges free the taxpayer of constraints imposed by the 45-day identification period and the 180-day period during which the accommodator may improve the replacement property. However, pure reverse exchanges pose more tax risk, as they are burdened with issues of agency, constructive receipt and beneficial ownership.

Therefore, if more than 180 days are required, and a planned safe harbor Exchange Last reverse exchange is converted into a non-safe-harbor reverse exchange, liberties taken when planning under the safe harbor may have doomed a non-safe-harbor reverse exchange unless these troublesome issues are considered from the start. The second type of reverse exchange is "Exchange First." Here, the taxpayer sells relinquished property to an EAT through a QI. Shortly thereafter, the QI uses the sale proceeds to purchase replacement property, which is transferred directly to the taxpayer, completing the exchange. Although the exchange is complete, the EAT may continue to retain the relinquished property for up to 180 days, until the taxpayer arranges for a buyer. Since the replacement property is transferred directly to the taxpayer, the EAT never acquires ownership. This eliminates the requirement that the EAT be involved in the loan process. It also eliminates the necessity of the EAT taking legal title, which may be advantageous from a transfer tax standpoint. Since the taxpayer is taking title to the replacement property immediately, it may be pledged as collateral for a loan. If management problems exist, it may also be preferable for the taxpayer to take immediate ownership in the replacement property.

An Exchange First reverse exchange might be desirable if the purchaser of the property to be relinquished has defaulted, leaving the taxpayer obligated to close on the replacement property or risk losing his downpayment. The taxpayer could acquire the replacement property before finding a new buyer for the relinquished property. By structuring an Exchange First reverse exchange under the Rev. Proc. 2000-37 safe harbor, the taxpayer sacrifices the luxury of time, since he may no longer wait 45 days to identify potential properties to be relinquished, nor wait 180 days to choose among those properties that property to be relinquished. Instead, the taxpayer must choose the property to be relinquished when the replacement property is acquired, and must actually relinquish it, since the QI must have the sales proceeds in hand to acquire the replacement property. The only applicable time constraint in a safe harbor Exchange First reverse exchange is the 180-period during which the EAT must dispose of parked relinquished property.

The requirement that the EAT obtain legal title to the parked property makes reverse exchanges relatively costly. Accordingly, their use should be reserved to situations where a deferred exchange is impossible, such as where the relinquished property buyer has defaulted, or where improvements must be commenced prior to disposition of the relinquished property. If improvements can be completed within the 180-day period in which the property may be parked with the EAT, Rev. Proc. 2000-37 provides a degree of certainty. However, if more time is required for construction, a non-safe-harbor reverse exchange may be the only option. The validity of a pure reverse exchange will depend upon whether the accommodator is respected as tax owner, or is merely deemed the taxpayer's agent. Just as pre-regulation case law remains relevant in resolving deferred exchange disputes, decisions predating Rev. Proc. 2000-37 are presumably still relevant in resolving disputes arising in reverse exchanges.