The Service Gives Taxpayers a Green Light on Certain Reverse Exchanges – Revenue Procedure 2000-37 (Part II)

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IRC § 1031 is one of the few remaining tax havens available to taxpayers. It provides an exception to the general rule requiring current recognition of gain or loss on the sale or exchange of property.[1] If the requirements of IRC § 1031 are met, the gain realized as a result of the transaction is deferred. Congress' rationale in part for this result is that a tax should not be imposed when the taxpayer continues its investment in like-kind property.

Historically, the Service took the position that IRC § 1031 required that an exchange, in order to qualify for tax deferral, had to be simultaneous. In other words, disposition of the relinquished property and acquisition of the replacement property had to occur at the same time.

In 1979, the 9th Circuit Court of Appeals, in *Starker v. U.S.*,[2] ruled that the Service's position was erroneous and concluded that nothing in the statute required that an exchange be simultaneous in order to qualify for tax deferral. The *Starker* decision judicially approved deferred exchanges, in that it acknowledged a taxpayer may dispose of the relinquished property before it acquires the replacement property. It did not, however, place any time limitations on how long the taxpayer has to acquire the replacement property after disposing of the relinquished property. The door was left wide open.

In 1984, as part of the Tax Reform Act of 1984, Congress closed the door when it enacted IRC § 1031(a)(3). This provision sets forth two basic requirements for deferred exchanges:

- The replacement property must be properly identified by the taxpayer within 45 days following the disposition of the relinquished property; and
- The replacement property must be received by the taxpayer by the earlier of 180 days following the disposition of the relinquished property or the due date (including extensions) of the taxpayer's federal income tax return for the year in which the relinquished property is transferred.[3]

The Service adopted the position that IRC § 1031, as amended, requires that the relinquished property be disposed of either simultaneously with (Simultaneous Exchange) or prior to (Deferred Forward Exchange) the acquisition of the replacement property. On April 25, 1991, Treasury promulgated final Treasury Regulations on deferred exchanges under IRC § 1031(a)(3). In the preamble of the regulations, Treasury stated that these deferred exchange rules apply only to Deferred Forward Exchanges; they do not apply to

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exchanges where the replacement property is required before the relinquished property is transferred ("Reverse Exchanges"). It did state, however, that the Service will study the applicability of IRC § 1031 to Reverse Exchanges.

In 1993, in order to encourage the Service to conduct its study on Reverse Exchanges, the Tax Section of the American Bar Association (ABA) submitted to the Service a report containing proposed guidelines favoring Reverse Exchanges. The Service ignored the tax bar's cry for guidance until it unexpectedly issued Private Letter Ruling 9814019, which recognized a Reverse Exchange of utility line easements.[4] The ruling, while it only binds the Service with regard to the taxpayer who obtained the ruling and the transaction set forth therein, provided the tax bar with renewed optimism that written guidelines favoring Reverse Exchanges would soon be forthcoming. In 1999, in order to facilitate the Service's efforts in this regard, the Tax Section of the ABA submitted another report to the Service favoring Reverse Exchanges.

On September 15, 2000, the Service finally issued long-awaited written guidance on Reverse Exchanges. Revenue Procedure 2000-37 provides tax practitioners with a safe harbor for Reverse Exchanges. Consequently, if a Reverse Exchange meets the requirements set forth in the revenue procedure, the Service will not challenge its tax deferred status.

Just when the tax bar thought life was terrific and exchange accommodators thought their industry had been revitalized, the Service released Technical Advice Memorandum 200039005.[5] In this memorandum, the Service disallowed a Reverse Exchange which appears to have clearly met the safe harbor set forth in Revenue Procedure 2000-37. Not to despair, most tax practitioners believe life is still rosy. This memorandum was decided four months before Revenue Procedure 2000-37 was issued, but was not released until September 29, 2000. Consequently, the consensus among most tax practitioners is that the Revenue Procedure supersedes the memorandum.

Reverse Exchanges

Taxpayers are generally faced with the prospect of a Reverse Exchange when either:

- The disposition of the relinquished property is delayed for numerous reasons, including the fact that the taxpayer has not found the ultimate acquirer of the relinquished property or the ultimate acquirer has not completed its financing or due diligence review of the property; and/or
- The acquisition of the replacement property is accelerated for numerous reasons, including the fact that the owner of the replacement property insists on promptly completing the disposition of such property due to its own deferred exchange time constraints or its own financing issues.

Revenue Procedure 2000-37 creates a methodology which allows taxpayers faced with either of these predicaments to side-step the timing problems and otherwise complete a qualifying tax deferred exchange. Failure to meet the safe harbor created by the revenue procedure, however, does not mean a transaction always fails to qualify for tax deferral under IRC § 1031. The Service specifically stated that no reference is intended with regard to the federal tax treatment of transactions that do not satisfy the

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requirements of the safe harbor.

Revenue Procedure 2000-37

Limited to Parking Transactions

Revenue Procedure 2000-37 is limited to Reverse Exchanges which constitute so-called “parking” transactions. There are generally two varieties of parking transactions.

The Replacement Property is Parked / The Exchange Occurs Last. In this scenario, the Qualified Intermediary (as defined in Treasury Regulation § 1.1031(k)-1(g)) first acquires the replacement property on behalf of the taxpayer. The replacement property is parked with a Qualified Intermediary until the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. When the transfer is arranged, the taxpayer transfers the relinquished property to the Qualified Intermediary in exchange for the replacement property, and the Qualified Intermediary then transfers the relinquished property to the ultimate transferee.

The Relinquished Property is Parked / The Exchange Occurs First. In this scenario, the Qualified Intermediary acquires the replacement property on behalf of the taxpayer and immediately exchanges such property with the taxpayer for the relinquished property. The relinquished property is parked with the Qualified Intermediary until the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee. The Qualified Intermediary then transfers the relinquished property to the ultimate transferee, completing the transaction.

New Terminology

Revenue Procedure 2000-37 introduces three new terms to the world of tax deferred exchanges, namely:

- Qualified Exchange Accommodation Arrangement (QEAA);
- Accommodation Titleholder (AT); &
- Qualified Indicia of Ownership (QIO).

Qualified Exchange Accommodation Arrangement

In order to satisfy the safe harbor, the taxpayer must enter into a QEAA. A QEAA exists if certain requirements are met:

QIO. QIO of the parked property must be with the AT. QIO means legal title to the parked property or other indicia of ownership of the parked property (e.g. contract for deed), or the ownership of all of the interests in a disregarded entity (for federal tax purposes) that holds legal title to the parked property or other indicia of ownership of the parked property (e.g. contract for deed).

AT. The AT is a person who is not the taxpayer or a “Disqualified Person.” In accordance with Treasury Regulation § 1.1031(k)-1(g)(4), a “Disqualified Person” is an agent of the taxpayer on the exchange date. An

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agent is expressly defined to include any employee, attorney, accountant, investment banker or broker, or real estate agent or broker, who has performed services for the taxpayer within two years from the earlier of the date either the replacement property or the relinquished property is transferred. Any financial institution, title insurance company or escrow company providing routine financial title insurance, escrow or trust services to the taxpayer will not be deemed the taxpayer's agent. *Id.* A "Disqualified Person" also includes family members; an individual and a corporation if the individual owns more than 10% of the corporation's stock value; two corporations in a control group; a grantor and fiduciary of a trust; a corporation and a partnership with more than 10% common ownership; two S corporations with more than 10% common ownership; an S corporation and a C corporation with more than 10% common ownership; a partnership and a partner if the partner owns more than 10% of partnership's capital or profits interests and two partnerships with more than 10% common ownership of the partnership's capital or profits interests.

The AT must be subject to federal income tax, or more than 90% of the ownership interests in the AT must be owned by persons subject to federal income tax.

The AT and the Qualified Intermediary (i.e. exchange accommodator) may be the same person. In addition, the AT and the Qualified Intermediary may be affiliates. Under the Deferred Forward Exchange regulations, the replacement property may be deeded directly from the seller to the taxpayer and the relinquished property may be transferred from the taxpayer directly to the buyer. Consequently, in most cases, the Qualified Intermediary will not be placed in the chain of title of either the relinquished or the replacement properties. T.Reg. § 1.1031(k)-1(g)(4). On the other hand, under the safe harbor, the AT must actually hold legal title or other indicia of ownership of the parked property. Consequently, it is expected that the AT and Qualified Intermediary will not in most cases be the same person. Rather, it is contemplated, as a method of insulating the risk associated with property ownership, most Qualified Intermediaries will form affiliate companies to act as the AT.

Taxpayer Intent. When the QIO of the parked property is transferred to the AT, the taxpayer must have the bona fide intent that the parked property represent either replacement property or relinquished property in an exchange qualifying for nonrecognition of gain (in whole or in part) or loss under IRC § 1031. While not required, it is strongly recommended that the taxpayer's intent be memorialized in the "Qualified Exchange Accommodation Agreement" (referred to immediately below) at or immediately before any property is parked with the AT.

Qualified Exchange Accommodation Agreement. Within five business days after the QIO of the parked property is transferred to the AT, the AT and the taxpayer must enter into a written agreement ("Qualified Exchange Accommodation Agreement"). Again, for the purpose of meeting the taxpayer intent requirement (referred to immediately above), this agreement should be entered immediately at (rather than within five business days after) the time the QIO of the parked property is transferred to the AT.

The written agreement must expressly provide:

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- The AT is holding the parked property for the benefit of the taxpayer in order to facilitate a qualifying tax deferred exchange under IRC § 1031 and Revenue Procedure 2000-37.
- The AT and the taxpayer agree to report the acquisition, holding and disposition of the parked property in accordance with Revenue Procedure 2000-37.
- The AT is the beneficial owner of the parked property for all federal income tax purposes.
- Both the AT and the taxpayer must report the federal income tax attributes of the parked property on their respective federal income tax returns in a manner consistent with the agreement. Consequently, the AT must file federal income tax returns reflecting its ownership of the parked property and reflect income or loss from the property thereon. *Caveat: Taxpayers should insist that the AT indemnify it from losses resulting from the AT not properly reporting the tax consequences of holding the parked property and causing it to fail the safe harbor.*[6]

The written agreement is not a replacement for the exchange agreement between the taxpayer and the Qualified Intermediary. These agreements serve different purposes. The exchange agreement generally serves to memorialize the interdependent steps necessary for the transaction in its totality to constitute an exchange and to create the barriers necessary to avoid the taxpayer's constructive receipt of the exchange proceeds held by the Qualified Intermediary. The written agreement required by the revenue procedure, on the other hand, does not have to bar the taxpayer from indirectly benefiting from the parked property during the period it is parked with the AT. In fact, the taxpayer, under the written agreement, may be expressly allowed to lease or manage the parked property.

Identification of Relinquished Property. Within 45 days following the transfer by the taxpayer of the QIO of the replacement property to the AT, the taxpayer must properly identify the relinquished property or properties in accordance with the identification rules set forth in the Deferred Forward Exchange Treasury Regulations. T.Reg. § 1.1031(k)-1(c)(4). No extensions are available.

Reverse Exchange Period. The Reverse Exchange must be completed within 180 days following the QIO of the parked property to the AT (Reverse Exchange Period). Immediately following the publication of Revenue Procedure 2000-37, many tax practitioners publicly criticized the Service, asserting that the Reverse Exchange Period is much too short in duration. The Tax Section of the ABA recommended (in its last written proposal to the Service) that the Reverse Exchange Period be two years. One-hundred-eighty days is insufficient to allow most taxpayers to complete an improvement Reverse Exchange (e.g. the replacement property is to be improved while it is parked with the AT). Despite the outcry of the ABA, the Service recently stated that it does not intend to change the duration of the Reverse Exchange Period. James Sewell, Associate Legislative Counsel of the Treasury Department, recently stated that the target beneficiary for the safe harbor was the small, less sophisticated property owner; not the large investor and/or developer who would likely be undertaking large improvement exchanges. Consequently, Sewell concluded the revenue procedure, as drafted, is adequate for its intended purpose.

Flexibility

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The revenue procedure gives taxpayers great flexibility.

- The AT, if the requirements of T.Reg. § 1.1031(k)-1(g)(4) are met, may also act as the Qualified Intermediary.
- The taxpayer or a Disqualified Person (i.e. the taxpayer's agent) may guaranty some or all of the obligations of the AT associated with the parking transaction, including debt used to acquire or improve the replacement property.
- The taxpayer or a Disqualified Person (i.e. the taxpayer's agent) may indemnify the AT against costs and expenses associated with the parking transaction.
- The taxpayer or a Disqualified Person (i.e. the taxpayer's agent) may loan or advance money to the AT, or guaranty loans or advances to the AT.
- The AT may lease the parked property to the taxpayer or a Disqualified Person (i.e. the taxpayer's agent).
- The taxpayer or a Disqualified Person (i.e. the taxpayer's agent) may manage the parked property, supervise improvements to the parked property, act as the contractor, or otherwise provide services to the AT with regard to the parked property.
- The taxpayer and the AT may have agreements relating to the purchase or sale of the parked property, including puts and calls at fixed or formula based prices, but such agreements may only be effective for 185 days or less from the date the QIO of the parked property is transferred to the AT.
- The taxpayer and the AT may enter into agreements providing the taxpayer will advance funds to the AT if the relinquished property is disposed of at less than the expected disposition price, thereby necessitating additional funds to complete the acquisition or improvement of the replacement property, or that the AT will give the taxpayer any funds in excess of those funds needed to complete the parking transaction upon conclusion of the Reverse Exchange.
- The AT is not required to manage the parked property.
- The AT is not required to bear the risk of loss relative to the parked property.

Revenue Procedure 2000-37 allows the taxpayer to deal with the AT at less than arms length. As stated above, the taxpayer may lease, manage or operate the parked property on terms and conditions which allow the taxpayer the economic benefits of owning the parked property even though the QIO is held by the AT during the Reverse Exchange Period. The taxpayer may lend money directly to the AT on an unsecured basis or guaranty other loans obtained by the AT to acquire or improve the parked property.

Step by Step Summary of the Typical Reverse Exchange Under Revenue Procedure 2000-37

The following are the steps a typical taxpayer will take in order to consummate a Reverse Exchange under the safe harbor:

Step 1
The taxpayer enters into an earnest money agreement to acquire the replacement property.

Step 2

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The taxpayer enters into a Qualified Exchange Accommodation Agreement with an AT.

Step 3

The taxpayer assigns the earnest money agreement for the replacement property to the AT.

Step 4

The AT acquires the replacement property with funds arranged by the taxpayer in accordance with the broad parameters set forth in Revenue Procedure 2000-37. The replacement property is parked with the AT.

Step 5

In the Qualified Exchange Accommodation Agreement or in a separate written identification document, the taxpayer property identifies the relinquished property and such notice is delivered to the AT within 45 days following the day in which the AT obtained QIO of the parked property.

Step 6

The AT may lease or otherwise allow the taxpayer to use the parked property on beneficial terms and conditions. The taxpayer may cause the property to be improved during the period it is parked with the AT.

Step 7

The taxpayer locates a buyer for the relinquished property and enters into an earnest money agreement with such person for the sale of the relinquished property.

Step 8

The taxpayer enters into an exchange agreement with a Qualified Intermediary and assigns the earnest money agreement for the relinquished property to the Qualified Intermediary. The taxpayer also assigns to the Qualified Intermediary its right to acquire to acquire the parked property from the AT under the Qualified Exchange Accommodation Agreement.

Step 9

The Qualified Intermediary causes the taxpayer to directly deed the relinquished property to the buyer. The Qualified Intermediary receives the proceeds from the buyer for the relinquished property.

Step 10

The Qualified Intermediary uses the proceeds from the relinquished property to buy the parked property from the AT.

Step 11

Pursuant to the exchange agreement, the Qualified Intermediary causes the AT to directly deed the parked

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replacement property to the taxpayer, completing the Reverse Exchange.

Remaining Issues

While Revenue Procedure 2000-37 is a good initial effort by the Service to provide taxpayers with guidance on Reverse Exchanges, it leaves several questions unanswered, including:

- Is the Reverse Exchange Period really 180 days, or is it the earlier of 180 days from the date the AT obtains QIO of the parked property or the due date (including extensions) of the taxpayer's federal income tax return or the AT's federal income tax return for the year in which the QIO is transferred to the AT?
- Can the taxpayer lend the AT money or lease the parked property at less than fair market value rates without the Service imputing additional interest or rent?
- Will the Service entertain requests for private letter rulings on non-safe harbor parking reverse exchanges (e.g. when the Reverse Exchange Period is longer than 180 days)?
- Can the taxpayer terminate the AT and engage a new AT during the Reverse Exchange Period without the risk of failing the safe harbor?
- Can the taxpayer assign its rights under the Qualified Exchange Accommodation Agreement to another taxpayer under the safe harbor?

Conclusion

While the questions unanswered by Revenue Procedure 2000-37 need the Service's attention, the safe harbor is truly a monumental advance in the arena of Reverse Exchanges. Most tax practitioners are optimistic that further advances will be made in the future. With this renewed optimism and the fairly clear guidelines set forth in the safe harbor, Reverse Exchanges will undoubtedly become more prevalent than ever before. Consequently, tax practitioners must have a good understanding of IRC § 1031 and Revenue Procedure 2000-37.

[1] Unless indicated otherwise, all references to the Internal Revenue Code are made to the Internal Revenue Code of 1986, as amended. The Internal Revenue Code is referred to herein as the "IRC" or the "Code."
[2] 602 F2d 1341 (1979).
[3] If the last day of the identification period or the exchange period falls on a holiday or a weekend, there is no extension to the next business day. TD 8346 (Preamble).
[4] PLR 9814019 (December 23, 1997). *See also*, PLR 9823045 (March 10, 1998).
[5] TAM 200039005 was decided on May 31, 2000, but was not released until September 29, 2000.
[6] The safe harbor requirement of consistent reporting of the parking transaction by the AT and the taxpayer does not go beyond federal taxation. The financial accounting and regulatory accounting treatment of the parking transaction need not be consistent for purposes of satisfying the safe harbor. Likewise, the state, local and foreign tax treatment of the parking transaction need not be consistent for

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purposes of satisfying the safe harbor.

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