

REVERSE EXCHANGES

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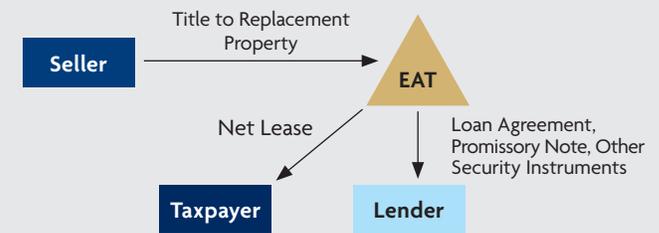
Reverse Exchange/Replacement Property Parking Steps

Use this step-by-step guide to execute your Reverse Exchange with success.

1. Taxpayer determines that Replacement Property needs to be acquired prior to transferring Relinquished Property and desires to enter into a Replacement Property Parking Arrangement with an Exchange Accommodation Titleholder (EAT).
2. Typically, at this time, Taxpayer has a signed Purchase Agreement to acquire replacement property. If not, Taxpayer adds language to the contract reserving its right to assign the contract to either a Qualified Intermediary (QI) or an EAT. If this cannot be done (for negotiation purposes), Taxpayer should at least provide Seller with a direction (at closing) to transfer the property to the EAT as its agent.
3. Taxpayer engages the EAT to acquire Replacement Property.
4. Taxpayer and EAT execute a Qualified Exchange Accommodation Agreement (QEAA). This agreement provides that the EAT will acquire “qualified indicia of ownership” in the Replacement Property for a period of up to 180 days and that Taxpayer intends that the property to be parked is Replacement Property, as defined in the 1031 Regulations.
5. Taxpayer and EAT execute a Net Lease between the Taxpayer (or Taxpayer’s affiliate) and the EAT at a rental rate of \$1/year. The Lease transfers all operating responsibilities and all income from the property back to Taxpayer.
6. Taxpayer and EAT may also execute various loan documents prior to closing including a Non-recourse Promissory Note, Mortgage/Deed of Trust, Assignment of Leases and Rents, etc. In the event a third party lender is providing all or a portion of the funds to complete the purchase, the Taxpayer can guarantee or co-sign any loan documents the EAT is required to execute. If a third party lender is providing financing, the rent under the Net Lease is set to exactly offset the monthly debt service. If the Taxpayer adds equity to complete the purchase, this will be evidenced by a non-interest bearing, non-recourse Promissory Note. The terms of the Note will be such that the debt is extinguished when the EAT transfer the property to the Taxpayer.

7. At the closing of the Replacement Property, The EAT, through a single purpose entity, takes legal title to the property.

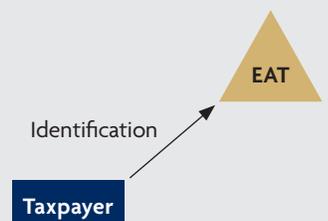
Acquisition of Replacement Property by EAT



8. Within 45 days from the date the EAT acquires the Replacement Property, Taxpayer submits a formal Identification of Relinquished Property to the EAT. Taxpayer can identify:
 - a. Up to 3 potential Relinquished Properties without regard to value, or
 - b. Any number of Relinquished Properties provided the combined FMVs of all of the identified properties doesn't exceed 200% of the value of the parked Replacement Property.

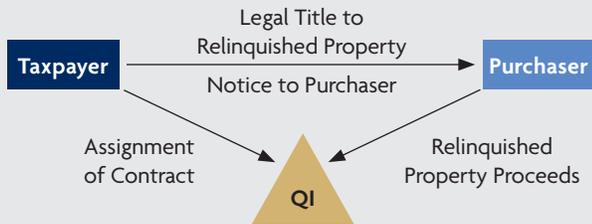
Identification of Relinquished Property

The Identification Notice must be made in a written document that is signed by the Taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the Identification Period.



9. When Taxpayer has a signed contract to sell the Relinquished Property, Taxpayer assigns its rights, but not its obligations in the contract to the QI.
10. Written notice of the assignment is given to the third party Purchaser on or before the date of transfer. The Exchange Agreement and the Qualified Exchange Trust Agreement are executed at this time.
11. Relinquished Property is transferred to Purchaser, and sale proceeds are deposited into a Qualified Exchange Trust Account.

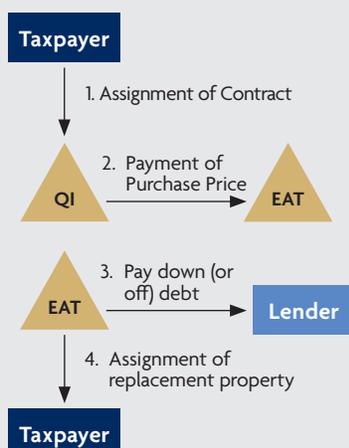
Sale of Relinquished Property



12. Taxpayer identifies the parked Replacement Property in a written Identification document signed by Taxpayer and delivered to the QI.
13. Taxpayer and EAT sign a Purchase and Sale Agreement for the transfer of the parked Replacement Property. The purchase price is set at the price at which the EAT acquired the property, plus improvements, if any.
14. Taxpayer assigns the Purchase and Sale Agreement to the QI in order to meet the requirement that the QI has “acquired and transferred” the property. Written notice of the Assignment is given to the EAT, as Seller.
15. Taxpayer then directs the QI to purchase the Replacement Property from the EAT. The funds in the Qualified Exchange Trust Account are used to:
 - a. Reimburse Taxpayer for funds advanced to complete the purchase; or...
 - b. Pay off or pay down the third party loan.

Transfer of Replacement Property from EAT and Close out Reverse Exchange

1. Taxpayer assigns its rights under the contract for purchase of the Replacement Property to the QI.
2. Taxpayer then instructs the QI to pay the purchase price to the EAT as Seller of the Replacement Property.
3. EAT uses the proceeds from the Relinquished Property sale to pay down (or pay off) the debt.
4. EAT then transfers the replacement property to the Taxpayer by Assignment of LLC Interests.



16. As illustrated in the graphic at the bottom of the page, the Replacement Property is transferred by special warranty deed or by assignment of the membership interest in the SPE that owns the property. The transfer of the Replacement Property from the EAT to the Taxpayer must occur within 180 days from the date the EAT acquires “indicia of ownership” of the Replacement Property.

Revenue Procedure 2000-37

This Revenue Procedure provides a safe harbor under which the Service will not challenge reverse exchange transactions if they are structured within the parameters of the Revenue Procedure.

Qualified Exchange Accommodation Agreement (QEAA)

The Taxpayer must enter into a written QEAA with the EAT within five (5) business days of the date either Relinquished or Replacement Property is parked with the EAT. Property is deemed to be held in a QEAA if the following requirements are met:

Qualified Indicia of Ownership

Qualified Indicia of Ownership is held by someone other than the Taxpayer or a disqualified person (i.e. the EAT) who is subject to federal income tax.

Qualified Indicia of Ownership can be demonstrated by:

1. Legal title held by the EAT;
2. Other indicia of ownership such that the EAT is treated as the beneficial owner of the property, as in a contract for deed; or
3. A single member LLC that holds legal title to the property (or some other entity that is disregarded for federal income tax purposes), the membership interest of which is owned by the EAT.

At the time the property is transferred to the EAT, the Taxpayer must have bona fide intent that the property represents either Replacement Property or Relinquished Property that is intended to qualify for non-recognition of gain under Section 1031.

The QEAA must specify:

1. The EAT is holding the property for the benefit of the Taxpayer to facilitate a 1031 exchange; and
2. The EAT is the beneficial owner of the property; and
3. The parties must report ownership of the property as such for federal income tax purposes.

Identification Requirements

Within 45 days after the Replacement Property is parked with the

EAT, the Taxpayer must identify the Relinquished Property to be transferred in the forward exchange. The identification must be made in a manner consistent with the Treasury Regulations (i.e., the “three-property rule or the “200% rule”).

Parking Period

Within 180 days after Property is parked with the EAT, Parked Replacement Property must be transferred to the Taxpayer as Replacement Property or Parked Relinquished Property must be transferred to a third party purchaser. If the Taxpayer is unable to sell the Relinquished Property within 180 days of parking Property, the Parked Property is returned to the Taxpayer and the exchange will fail to qualify under Code Section 1031.

Non-Arm’s Length Agreements

The Revenue Procedure allows the Taxpayer and EAT to enter into a number of non-arms length agreements during the time that the property is parked with the EAT. These agreements allow the Taxpayer to manage and control the property during the parking period and relieve the EAT of liabilities associated with property acquisition, ownership and disposition. The Revenue Procedure provides the following:

- a. Taxpayer can loan funds to the EAT to acquire Replacement Property or guarantee third party financing.
- b. Taxpayer can indemnify the EAT against costs and expenses.
- c. Taxpayer can lease the parked property from the EAT.
- d. Taxpayer can manage the property, oversee improvements, act as contractor, and provide services to the EAT.
- e. Taxpayer and the EAT can enter into agreements arranging for the purchase or sale of the property, including puts and calls, effective for a period not to exceed 185 days from the date the EAT acquires the property.
- f. Taxpayer and the EAT can enter into an agreement to deal with fluctuations in the price of the property during the period of time the property is parked with the EAT.

Revenue Procedure 2004-51

Background—Rev. Proc. 2000-37

In September of 2000, the IRS issued formal guidance on structuring reverse like-kind exchanges under IRC Section 1031 (Revenue Procedure 2000-37; 2000-40 IRB 1 September 15, 2000). The Revenue Procedure was the culmination of many years of study and consideration of the best way to address the situation where a Taxpayer has located and needs to close on its Replacement Property before transferring its Relinquished Property while structuring the transaction as a tax-deferred exchange under the provisions Section 1031.

The Service created a safe harbor “parking arrangement” that allows

the Taxpayer to arrange for either Relinquished Property or Replacement Property to be acquired by a third party Exchange Accommodation Titleholder (EAT) for a period of up to 180 days. During that time the EAT, while not bearing any economic benefits or burdens of ownership, must nevertheless be the owner for federal (and as appropriate state) income tax purposes.

The Revenue Procedure specifies that the IRS will not challenge the qualification of property as either Replacement Property or Relinquished Property, as defined in the Treasury Regulations, or the treatment of an EAT as the beneficial owner of such property for federal income tax purposes, if the property is held in a “Qualified Exchange Accommodation Arrangement” (QEAA). Property is deemed to be held in a QEAA if the following requirements are met:

1. Qualified indicia of ownership is held by someone other than the Taxpayer (i.e.: the Exchange Accommodation Titleholder) who is subject to federal income tax.
2. Qualified indicia of ownership can be demonstrated by: (a) legal title held by the EAT, (b) other indicia of ownership such that the EAT is treated as the beneficial owner of the property, as in a contract for deed, or (c) a single member LLC that holds legal title to the property (or some other entity that is disregarded for Federal income tax purposes), the membership interest of which is owned by the EAT.

At the time the property is transferred to the EAT, the Taxpayer must have bona fide intent that the property represents either Replacement Property or Relinquished Property that is intended to qualify for non-recognition of gain under Section 1031.

This language in the Rev. Proc. was interpreted by some practitioners and Taxpayers as permitting a transaction where a Taxpayer owns property, transfers it to an EAT who constructs improvements on the property, and transfers it back to the Taxpayer as replacement property in a 1031 exchange. As a result, the Service issued Rev. Proc. 2004-51 with the following modification to the language re: qualifying replacement property:

“ ***The Service will treat an exchange accommodation titleholder as the beneficial owner of property for federal income tax purposes if the property is held in a QEAA. Property held in a QEAA may, therefore, qualify as either “replacement property” or “relinquished property” (as defined in §1.1031(k)-1(a)) in a tax-deferred like-kind exchange if the exchange otherwise meets the requirements for deferral of gain or loss under §1031 and the Regulations thereunder.*** ”

Additionally, new Section 4.05 was added to Rev. Proc. 2000-37 which provides the following:

“ This revenue procedure does not apply to replacement property held in a QEAA if the property is owned by the Taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an Exchange Accommodation Titleholder.

Thus, the new section provides for a 180-day look-back at the ownership of the intended Replacement Property.

Rev. Proc. 2004-51 was aimed, in part, at the “disappearing lease” transaction. Assume Taxpayer owns Property A and would like to construct improvements with proceeds from the sale of Property B [low basis property also owned by Taxpayer]. In order to avoid recognizing gain on the sale of Property B, Taxpayer transfers a 30+-year leasehold interest in Property A to an EAT who constructs improvements on Property A. Taxpayer then sells Property B through a qualified intermediary, who acquires the leasehold interest and improvements from the EAT and transfers them to Taxpayer.

Presumably Taxpayer would assert that under Section 4.01 of Rev. Proc. 2000-37, as originally issued, the Service has agreed not to challenge the qualification of Property A with the constructed improvements as “Replacement Property”, or the treatment of the EAT as the beneficial owner of the property since it was held in a Qualified Exchange Accommodation Arrangement. However, based on the DeCleene case and the step transaction doctrine, it is doubtful that a court would respect either a lease to an EAT or a transfer of the property to the EAT where the EAT is obligated to construct improvements on the property, funded solely by the Taxpayer with no economic risk to the EAT and with the Taxpayer managing and directing the construction.

In *DeCleene v. Commissioner*, 115 T.C. No. 34 (November 17, 2000). Taxpayer transferred property it previously owned (Lawrence Drive) to WLC, in exchange for which WLC was to construct improve-

ments on Lawrence Drive and transfer it back to Taxpayer. At the time of the transfer back to Taxpayer, Taxpayer would transfer McDonald Street property to WLC to complete the two party exchange. Taxpayer proceeded to quit claim the Lawrence Drive property to WLC. WLC gave Taxpayer a non-recourse note and mortgage on the property which was assigned to a bank who provided construction financing. When WLC completed the construction three months later, WLC transferred Lawrence Drive to Taxpayer, Taxpayer transferred McDonald Street to WLC. The Tax Court held that Taxpayer never disposed of Lawrence Drive and remained its owner during the construction period. Because Taxpayer 1. previously owned the property, 2. was obligated to pay for the construction of the improvements and 3. was obligated to re-acquire the property on the completion of the improvements, the Taxpayer remained the beneficial owner of the property.

The likely IRS position is that the changes made by Rev. Proc. 2004-51 expressly reject these types of transactions because (a) the “property” was owned by the Taxpayer within the prior 180 day period and (b) an exchange of real estate owned by the Taxpayer for land owned by the same Taxpayer “does not otherwise meet the requirements of Section 1031”; presumably because of Rev. Rul. 67-255 [which holds that a building constructed on land owned by a Taxpayer is not of like-kind to involuntarily converted land of the same Taxpayer]. In addition, the IRS’s position set forth at Reg. 1.1031(k)-1(e)(4) states that relinquished property cannot be exchanged for production services.

While a Taxpayer might argue that if the lease is a fair rental value lease—there is no premium value due to lease payments that are less than market value—the property that is being transferred back to the Taxpayer is the improvements, which the Taxpayer never owned. This argument is probably irrelevant in light of the conclusion in the DeCleene case, Rev. Proc. 2004-51, and the step transaction doctrine.

In public statements at various forums, IRS representatives have explained that the IRS is not implying that a transfer by the Taxpayer to an EAT could never be accomplished outside the safe harbor. This might occur where the EAT actually acquires beneficial ownership of the property in contrast to limited ownership for tax purposes only.