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Switching It Up: Reverse 1031 Exchanges

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The number of Internal Revenue Code Section 1031 tax-deferred exchanges has grown tremendously in the last few years. For example, the tenant in common industry has expanded from a marketplace of \$150 million in sales in 2001 to approximately \$2 billion in 2004.¹ A valid Section 1031 exchange allows a taxpayer to defer the recognition of gain on the sale of certain types of property held for productive use in trade or business or for investment purposes when exchanged for property of like-kind to be held either for productive use in trade or business or for investment.² In the most common type of Section 1031 tax-deferred exchange, a taxpayer will sell property he owns, referred to as the relinquished property, and purchase new property of a like kind, referred to as the replacement property. In a reverse exchange, the taxpayer acquires the replacement property first and then completes the sale of his relinquished property. In an environment in which real estate may be on the market for a matter of days, a taxpayer that wants to complete a Section 1031 tax-deferred exchange may not be able to sell his relinquished property prior to acquiring the replacement property and therefore may need to use a reverse exchange. A taxpayer may also use a reverse exchange if certain contingencies to the sale of the replacement property have not been met and that sale is delayed or if the taxpayer has more than one property for sale at a time and has not determined which property will constitute the relinquished property. Section 1031 and the associated regulations do not specifically allow for reverse exchanges. In fact, in 1991 when regulations were issued by the Treasury Department and the IRS concerning Section 1031, the regulations stated that they did not apply to "reverse exchanges" and therefore, taxpayers in the situations described above did not have any assurance that they could complete their real estate sale and purchase transactions and receive tax-deferred treatment. In 2000, the Internal Revenue Service issued Revenue Procedure 2000-37, 2002-2 C.B. 308, which clarified the IRS position by stating that if a taxpayer had a "genuine intent to accomplish a like-kind exchange at the time that it arranges for the acquisition of the replacement property" the taxpayer could complete a valid Section 1031 exchange and could be afforded the benefit of the safe harbor provisions. Rev. Proc. 2000-37 describes the criteria a taxpayer must meet to comply with the safe harbor provisions. A taxpayer may complete a valid reverse exchange outside of the safe harbor provisions described in Rev. Proc. 2000-37, but with an increased risk that the transaction will not be considered a valid tax-deferred exchange if challenged by the IRS.

In order to comply with the Rev. Proc. 2000-37, most taxpayers use a Qualified Exchange Accommodation Arrangement ("QEAA") as outlined by the IRS. The main requirements of a QEAA are as follows:

- An exchange accommodation titleholder ("EAT") (a person or entity other than the taxpayer or a disqualified entity)³ holds legal title to the replacement property or can prove other indicia of ownership with respect to the replacement property under applicable provisions of commercial law.⁴
- At the outset of the transaction, the taxpayer has a bona fide intent to complete a Section 1031 tax-deferred exchange.
- Not later than five business days after the EAT acquires the replacement property, the taxpayer and the EAT must enter into a written "qualified exchange accommodation agreement" that states the taxpayer intends to complete a Section 1031 exchange in accordance with Rev. Proc. 2000-37, that the EAT will be the owner of the replacement property for all federal tax purposes and will report its ownership as such and that the taxpayer will report the acquisition, ownership and disposition of the property in accordance with Rev. Proc. 2000-37 for federal income tax purposes.
- Not later than 45 days after the EAT acquires the replacement property, the taxpayer must properly identify the relinquished property.

- Not later than 180 days after the EAT acquires the replacement property, the replacement property must be transferred to the taxpayer to complete the exchange.
- The combined time period that the relinquished property and the replacement property are held in the QEAA does not exceed 180 days.⁵

There is substantially more documentation involved in completing a reverse exchange as compared to completing a regular deferred exchange. In addition to the qualified exchange accommodation agreement, the nature of the exchange and the taxpayer's plans for the investment may require a lease of the property from the EAT to the taxpayer, loan documentation and security agreements for loans from the taxpayer or third parties to the EAT enabling the EAT to purchase the property (and potentially vice versa if the relinquished property is acquired by the EAT rather than the replacement property) and a guaranty agreement with the EAT or a third party lender to ultimately make the taxpayer responsible for debt associated with the transactions. The EAT may also serve as the qualified intermediary ("QI") for the taxpayer and enter into a separate exchange agreement regarding those services. A QI is an entity that takes receipt of funds and receives an assignment of the purchase/sale contract during an exchange to ensure a taxpayer does not have receipt or constructive receipt of funds during the exchange process per the regulations promulgated under Section 1031. If the EAT and the QI are not the same entity, then there will be an exchange agreement between the taxpayer and the QI assigning to the QI the qualified exchange accommodation agreement with the EAT and the sale agreement for the relinquished property.

One additional planning opportunity afforded by the reverse exchange is the ability to make improvements to the replacement property before the taxpayer's acquisition. Once ownership of the replacement property is transferred to the EAT, the EAT may contract with a third party to complete certain improvements and the taxpayer may fund such improvements via a loan to the EAT. The taxpayer may supervise construction of the improvements or act as a contractor for the EAT to complete the improvements. The time to complete any improvements to the real property which will be afforded like-kind treatment is limited to the 180-day period outlined in the safe harbor guidelines above. If the property is improved with a building and 40% of the building is complete when the 180-day time period expires, then 40% of the building will be treated as like-kind property in the exchange and the remaining 60% of the building will not be considered like-kind property. In addition, the improvements need to be identified within the 45-day period mentioned above. The resulting cost of the replacement property to the taxpayer will be the cost of the property plus the cost of any improvements made by the EAT which are complete prior to the exchange date.

Reverse exchanges are not common because the costs involved are substantially greater than the costs involved in a normal Section 1031 exchange and can be avoided with careful planning. However, taxpayers may want the flexibility or the planning opportunity afforded by a reverse exchange and proceed despite the added costs. For more information, please contact Hirschler Fleischer.

¹ Pristin, Terry. Money Flowing New Way to Pool Buyers, New York Times, September 22, 2004.

² IRC § 1031(a).

³ An entity is regarded as a better choice because the death or incapacity of an individual can complicate completing the deferred exchange. The EAT must meet the requirements of the relevant Treasury Regulations.

⁴ The taxpayer may be required to hold title to the replacement property under certain loan terms. This type of reverse exchange is permitted so long as the relinquished property is transferred to the EAT prior to or simultaneous with the acquisition of the replacement property.

⁵ Rev. Proc. 2000-37, § 4.02, 2000-2 C.B. 308, October 2, 2000. 