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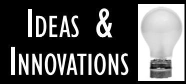
Using the Reverse Exchange: A Solution for Timing Problems

By Thomas J. Moylan

A reverse exchange is the "flip side" of a deferred exchange, where a taxpayer directly or indirectly acquires a like kind replacement property before disposing of a relinquished property. In a fast-paced real estate market, owners of real property often face the prospect of losing the opportunity to acquire a desirable replacement property.



Beginning with the Internal Revenue Service's acceptance of deferred like-kind exchanges, taxpayers have engaged in a wide variety of transactions, including so-called "parking" or "warehousing" transactions, to facilitate reverse like-kind exchanges. Parking transactions typically are designed to "park" the desired replacement property with a qualified intermediary until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate buyer in a simultaneous or deferred exchange. Once such a 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 buyer. In other situations, a qualified intermediary may acquire the desired replacement property on behalf of the taxpayer and immediately exchange such property with the taxpayer for the relinquished property, thereafter holding the relinquished property until the taxpayer arranges for a transfer of such property to the ultimate buyer. In parking arrangements, taxpayers attempt to arrange the transaction so that the qualified intermediary has enough of the benefits and burdens relating to the property so that the qualified intermediary will be treated as the owner for federal income tax purposes.

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The Requirements of a QEAA

On Oct. 2, 2000, the IRS issued Revenue Procedure 2000-37, providing long awaited guidance on structuring reverse exchanges to avoid IRS challenge. The Revenue Procedure describes a safe harbor for reverse exchanges if certain requirements are met.

Rev. Proc. 2000-37 provides that a reverse exchange will not be challenged if the taxpayer, who will be the ultimate owner of the parked property, satisfies two requirements: (i) the taxpayer enters a written Qualified Exchange Accommodation Arrangement (QEAA), and (ii) the taxpayer engages the services of an exchange accommodation titleholder (EAT).

Property will be considered to be held in a QEAA if all of the following requirements are met:

(a) The Rev. Proc. requires that "qualified indicia of ownership" of the property is held by the EAT. This requirement is met by either (i) deeding the property directly to a qualified intermediary or (ii) deeding the property to a single-member limited liability company owned by the EAT;

(b) The taxpayer must have a bona fide intent that the property held by the EAT represent either replacement property or relinquished property in an exchange that is intended to qualify for non-recognition of gain (in whole or in part) or loss under section 1031;

(c) No later than five business days after the transfer of qualified indicia of ownership of the property to the EAT, the taxpayer and the EAT enter into a written QEAA that provides that the EAT is holding the property for the benefit of the taxpayer in order to facilitate an exchange under section 1031 and the Rev. Proc. and that the taxpayer and the EAT agree to report the acquisition, holding and disposition of the property as provided in the Rev. Proc. The agreement must specify that the EAT will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with the QEAA;

(d) The relinquished property must be identified within 45 days. Similar to forward deferred exchanges, the taxpayer may properly identify alternative and multiple properties;

(e) The exchange must close within 180 days after the transfer of qualified indicia of ownership of the property to the EAT; and

(f) The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days.

The Requirements of an EAT

(a) The EAT cannot be a disqualified person. The Rev. Proc. cross references the regulations applicable to deferred exchanges, which eliminates the usual suspects of the taxpayer's attorney, accountant, investment banker, broker, etc. as a potential EAT.

(b) The EAT must be subject to federal income tax or, if the EAT is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax.

Permissible Arrangements

In addition to setting forth the requirements necessary to fall within the safe harbor, the Rev. Proc. listed permissible agree-

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ments that should provide most taxpayers and qualified intermediaries with the level of comfort necessary to effectuate a reverse exchange. A few of the more important types of permissible agreements are:

(a) The taxpayer may loan funds to the EAT or guarantee a loan to the EAT on non arm's length terms.

(b) The parked property may be leased to the taxpayer at non fair market rates. For example, the lease amount might be set at an amount equal to any loan payments against the parked property plus all other costs of holding the parked property.

(c) The taxpayer can manage or act as general contractor to improve the parked property, though the taxpayer should avoid realizing a profit from his role as general contractor as that may violate the exchange regulations.

Exchange First or Exchange Last

Under an exchange first structure, the taxpayer (i) enters into an agreement to sell the relinquished property to the EAT, (ii) engages the services of a qualified intermediary to facilitate an exchange (as though it was entering into a forward deferred exchange), (iii) sells the relinquished property to the EAT (loaning the acquisition funds to the EAT), and (iv) purchases and takes title to the replacement property. The EAT then has 180 days to sell the relinquished property. Once the sale occurs, the EAT will payoff the loans made to it by the taxpayer. The QEAA will contain provisions concerning any gain or loss realized by the EAT on the sale. This structure may be utilized when the replacement property is environmentally sensitive or difficult to finance with an EAT.

Under an exchange last structure, the EAT acquires the replacement property with funds borrowed from the taxpayer or a commercial lender. Upon the sale of the relinquished property, the taxpayer (i) enters into an exchange agreement with the qualified intermediary, (ii) enters into a purchase and sale agreement with EAT, (iii) assigns the P&S to the QI, and (iv) purchases the replacement property from the EAT. The EAT utilized the sale proceeds to pay back any loans. ■