Reverse Exchanges After Rev. Proc. 2000-37

By Mary B. Foster

Mary Foster analyses reverse like-kind exchanges as affected by the safe harbor created by Rev. Proc. 2000-37.

The IRS published Rev. Proc. 2000-37 on September 15, 2000.[1] It creates a safe harbor for "reverse" exchanges, allowing taxpayers to acquire a replacement property up to 180 days prior to the disposition of the relinquished property. It will undoubtedly increase the volume of reverse exchanges and make the benefits of Code Sec. 1031 available to more taxpayers.

While the safe harbor is good for short-term reverse exchanges, a recent case[2] points out the difficulties in structuring a reverse exchange beyond the safe harbor and the 180-day limit.

A taxpayer may want to acquire a replacement property before the disposition of the relinquished property for many reasons. The contingencies in the sale agreement of the relinquished property may not have been removed prior to the date of the closing of the replacement property. Or perhaps the taxpayer has not found a buyer for the relinquished property. The taxpayer may lose an earnest money deposit or favorable financing rates if it fails to close on the replacement property on the specified closing date. Improvements to the replacement property may require more than 180 days to complete, so the replacement property must be acquired by an accommodator/developer and construction of the improvements begun prior to the sale of the relinquished property.

A Brief History of Reverse Exchanges

An actual reverse-Starker exchange, one in which the taxpayer acquires the replacement property prior to disposing of the relinquished property, is not authorized by Code Sec. 1031(a)(3). That subsection of the Internal Revenue Code (the Code) only authorizes deferred exchanges. There are several cases on failed reverse exchanges in which there was no connection between the purchase of the replacement property and the sale of the relinquished property.[3] The regulations on deferred exchanges (the "Deferred Exchange Regulations") specifically do not apply to reverse-Starker exchanges.[4] The preamble to those

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1991 Deferred Exchange Regulations indicated that the Treasury and the IRS would continue to study whether such exchanges were authorized under Code Sec. 1031. Plans for an IRS study were apparently tabled for several years. The IRS did issue a private letter ruling in 1998 approving a two-party reverse exchange in which a utility company acquired the replacement property before it granted the relinquished property easement to the same party, and tax advisors considered this ruling as a sign that the current personnel at the IRS were not opposed to reverse exchanges. No further guidance was issued until Rev. Proc. 2000-37.[5]

In the meantime, taxpayers finding themselves in a reverse exchange situation had typically structured the transaction as a simultaneous exchange with either the relinquished property or the replacement property being "parked" with an accommodator until the relinquished property was sold. A taxpayer risked that the accommodator would be considered the taxpayer's agent and the exchange disallowed. Nevertheless, many of these parking style exchanges were being done.

Rev. Proc. 2000-37 was apparently issued in response to Technical Advice Memorandum 200039005. In that memorandum, the taxpayer had structured a simultaneous exchange, but the relinquished property failed to close on time. The taxpayer elected to have an accommodator take title to the replacement property. When the relinquished property finally closed, the taxpayer effected a simultaneous exchange for the parked replacement property. The IRS ruled that the accommodator was the taxpayer's agent and the exchange failed. According to an IRS official in informal remarks, the Revenue Procedure was issued to help taxpayers in situations like the taxpayer in the TAM, where there has been a short delay in the sale of the relinquished property. The Revenue Procedure provides a safe harbor so the taxpayer can still make the exchange work.

The Revenue Procedure is not designed to help all taxpayers having trouble selling relinquished property or requiring more than 180 days to complete improvements on the replacement property. It does not allow a taxpayer to create a long term "bank" of replacement properties with an accommodator for future exchanges. Taxpayers desiring to accomplish these goals need to look outside the safe harbor. The Revenue Procedure's goal is "to provide taxpayers with a workable means of qualifying their transactions in situations where the taxpayer has a genuine intent to accomplish an exchange at the time it arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter."[6]

An Overview of Rev. Proc. 2000-37

The Revenue Procedure creates a safe harbor for a parking style exchange and allows an exchange accommodation titleholder (AT) to acquire either the replacement property or the relinquished property in an exchange and hold it for up to 180 days, while the taxpayer attempts to sell the relinquished property. The IRS will not challenge (a) the qualification of property as either replacement property or relinquished property in an exchange or (b) the treatment of an AT as the beneficial owner of such property if property is held in a "qualified exchange accommodation arrangement" (QEAA).[7]

Without the safe harbor, the taxpayer could not be sure whether the AT was the owner of property for federal income tax purposes or the taxpayer's agent. As a general rule, the party that bears the benefits and burdens of ownership is considered the owner for federal income tax purposes.[8] If all the facts and circumstances must be examined, then there is uncertainty as to whether the exchange works. The Revenue Procedure removes this uncertainty.

The Revenue Procedure is applicable to properties acquired by an AT on or after September 15, 2000.[9] The principles set forth in the Revenue Procedure have no application to any other federal tax determinations.[10] No inference is intended with respect to parking arrangements entered into before September 15, 2000.

Alternate Parking Structures

The Revenue Procedure provides two forms of a QEAA. In the first structure, the exchange occurs with the taxpayer acquiring the replacement property and conveying the relinquished property to the AT using an exchange intermediary. This type of transaction may be diagramed as shown in Figure 1.

This structure is typically used when the lender requires that the taxpayer, rather than the AT, acquire title to the replacement property. Most single family residential lenders require that the taxpayer be in title to the replacement property at the time the loan is made.

In the second structure, the AT acquires the replacement property. When the taxpayer's relinquished property is ready to close, then the taxpayer will exchange the relinquished property for the replacement property through an exchange intermediary. This type of transaction may be diagramed as shown in Figure 2.

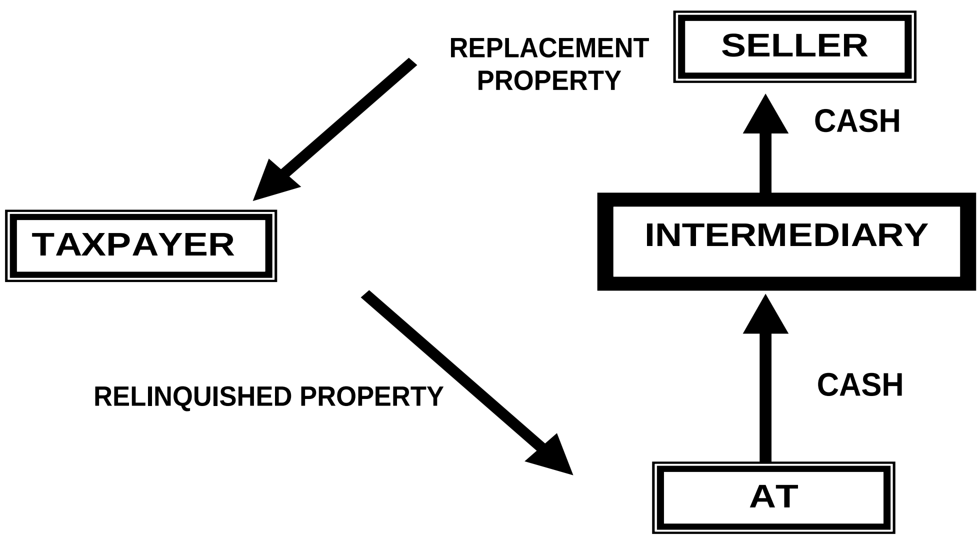
This structure works well when the taxpayer is not certain what relinquished property will be exchanged or if a due on sale clause on the relinquished property would be triggered by the transfer of the relinquished property in the first structure. It is also the only structure that allows for improvements to be constructed by the AT on the replacement property.

Exchange Accommodation Titleholder Requirements

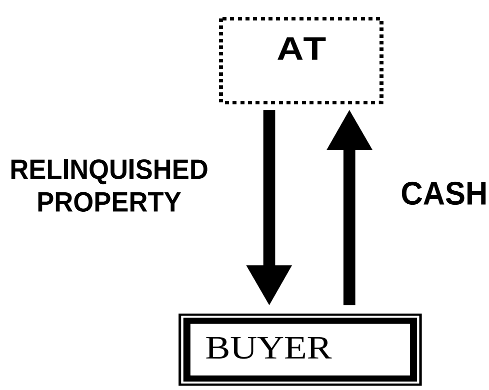
The AT cannot be the taxpayer or a "disqualified person," as defined in the Deferred Exchange Regulations.[11] A disqualified person is generally a related party to the taxpayer or a person who has acted as the taxpayer's attorney, accountant, real estate agent or broker, employee or investment banker on non-exchange matters within the two-year period ending on the date the AT acquires the parked property. In some situations, it may be useful for the taxpayer to maintain a 10-percent or lesser ownership interest in an AT (perhaps as a one-percent owner/manager of a limited liability company) in order to facilitate financing or management of the parked property.

Figure 1

Restructured as a Simultaneous Exchange at the Front Leg (Relinquished Property Parked):



Delay on selling relinquished property, but not in excess of 180 days



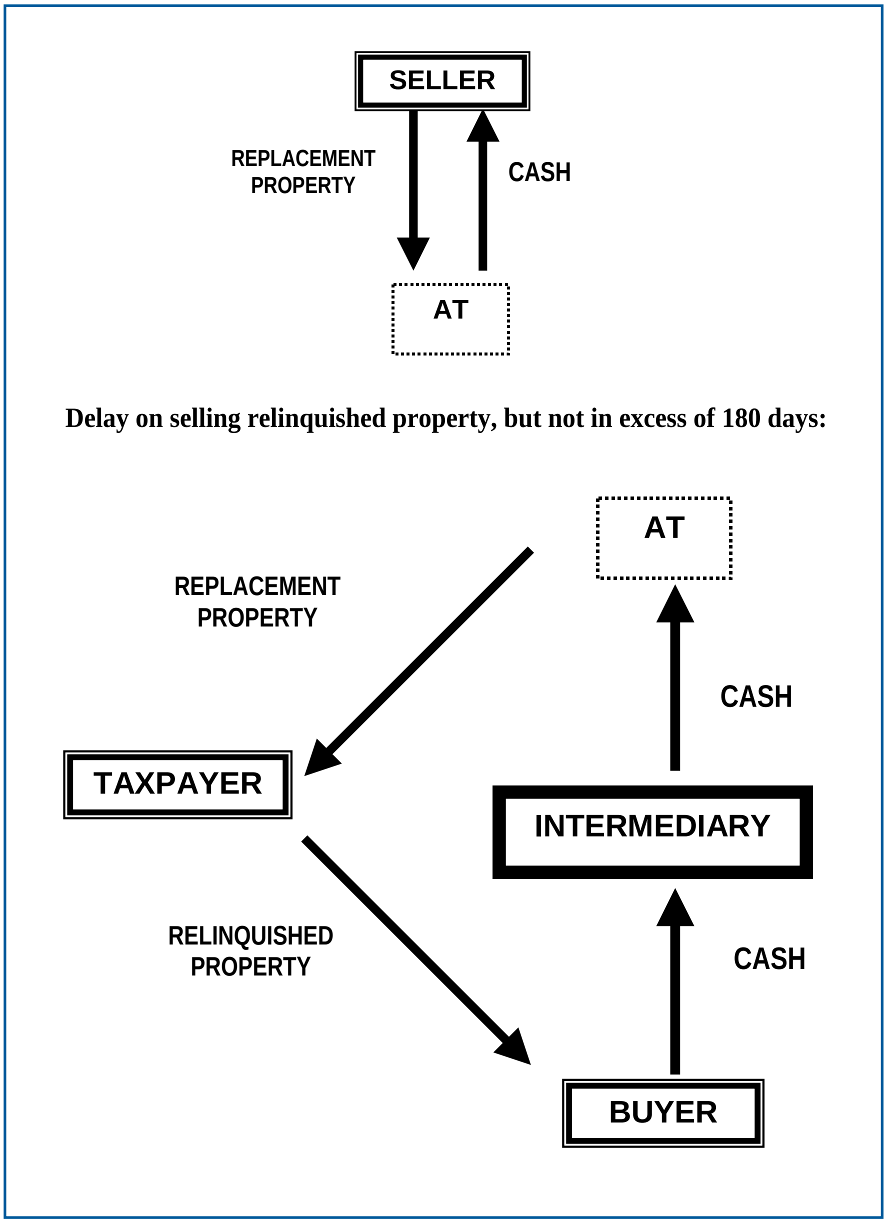
The AT must be a person subject to federal income tax. If the AT is treated as a partnership or S corporation for federal income tax purposes, then more than 90 percent of its interests or stock must be owned by partners or shareholders who are subject to federal income tax.[12]

The AT must hold "qualified indicia of ownership" at all times from the date of acquisition by the AT until the parked property is transferred to the taxpayer if the parked property is replacement property, or to the buyer if the parked property is relinquished property. "Qualified indicia of ownership" means legal title to the parked property, such as real property. It can mean other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (*e.g.*, a contract for deed). Qualified indicia of ownership also include interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (*e.g.*, a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership.[13]

A taxpayer engaging in a safe harbor exchange should insist that the AT be a sole purpose entity, holding only the taxpayer's property. The liability risks of combining different taxpayers' properties are simply too great. If a suit is filed against the AT on one property, it will affect the other properties held by the AT. In addition, a third party lender may require that the AT be a sole purpose entity. The taxpayer will have to bear the additional cost to the AT of setting up the entity, including state filing fees and taxes. The taxpayer may also be able to acquire 100-percent ownership of the parking entity as the replacement property, rather than the title to the parked property, and avoid a second real estate transfer tax in some jurisdictions.[14]

The Revenue Procedure does not preclude the QEAA from specifically stating that the AT is the taxpayer's agent. This declaration may be helpful in avoiding transfer taxes in some jurisdictions. It may also be helpful when parked replacement property is undergoing construction. Nevertheless, it should be declared cautiously because it will disallow the exchange if the parking period exceeds the 180-day limit.

Figure 2



Qualified Exchange Accommodation Agreement

No later than five business days after the transfer of the parked property to the AT, the taxpayer and the AT must enter into a written agreement (the qualified exchange accommodation agreement or "QEA Agreement") that provides certain specific language:

> The exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Code Sec. 1031 and this revenue procedure and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in this revenue procedure. The agreement must specify that the exchange accommodation titleholder 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 this agreement.[15]

The Revenue Procedure gives the taxpayer five business days to enter into a QEA after the AT has acquired the parked property. "Business day" is not defined, but the term "business day" is used in the Code and regulations to mean "a day which is not a Saturday, Sunday, or legal holiday."[16]

Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with the QEA Agreement. This means that the AT will have to do more than just report its AT fee on its federal tax return. It must report the acquisition, holding and disposition of the parked property. An IRS representative, in informal comments, stated that the AT must make a good faith effort to report correctly, although a taxpayer will not be "foot faulted" if the AT does not report the transaction perfectly.

It is unclear if the AT must take or is entitled to depreciation deductions under Code Sec. 167. The Revenue Procedure states that other federal income tax issues implicated, but not addressed, include the treatment for federal income tax purposes "of whether an AT may be precluded from claiming depreciation deductions (e.g., as a dealer) with respect to the relinquished property or the replacement property."[17] The AT will typically rent the parked property to the taxpayer and that raises the issue of whether the property is inventory or not. From the AT's perspective, if it does not take depreciation which is otherwise allowable, the basis in the parked property will be reduced without any corresponding tax benefit to the AT, thus causing gain on the sale of the parked property.[18] Alternatively, depreciation deductions taken might be disallowed by the IRS on the basis that the parked property is the AT's inventory. The issue is limited to those QEAA arrangements involving depreciable parked properties that are parked over a year end.

The Revenue Procedure does provide that the parked property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local or foreign tax treatment of the arrangement between the taxpayer and the AT is different from the treatment required by the Revenue Procedure.[19] Some states may choose not to follow the Revenue Procedure because it is not law but just a procedure followed by the IRS and Treasury. Therefore, a parking exchange that is not taxable at the federal level may be taxable at the state level.

Bona Fide Intent

At the time 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 under Code Sec. 1031.[20] This requirement seems easy to satisfy because the taxpayer presumably would not be going to the trouble and cost of entering into a QEAA for some other purpose. However, taxpayers are endlessly creative and the QEAA could be used to avoid temporary ownership for some other purpose.

Identification of Relinquished Property

If the exchange is structured so that the AT parks the replacement property, the taxpayer has some flexibility in deciding what relinquished property to exchange for the parked replacement property. Some taxpayers may have several potential relinquished properties that are on the market at the time the replacement property is acquired by the AT.

The Revenue Procedure requires that the relinquished property be identified no later than 45 days after the transfer of title of the replacement property to the AT.[21] The identification must be made in a manner consistent with the principles described in the Deferred Exchange Regulations for identifying replacement property.[22] The Revenue Procedure does not contain any further details on how to apply the identification principles of a deferred exchange to a parking exchange. Presumably, the taxpayer may identify up to three alternative relinquished properties or any number so long as the aggregate value of the identified properties does not exceed 200 percent of the value of the replacement property being parked with the AT.

180-Day Limit

The parked property must be transferred no later than 180 days after the transfer of qualified indicia of title to the AT. If the parked property is replacement property, then the transfer must be to the taxpayer. If the parked property is relinquished property, then the transfer must be to a person who is not the taxpayer or a disqualified person.[23] The 180-day limit restricts the applicability of the Revenue Procedure to short delays. Taxpayers desiring to come within the safe harbor may have to reduce the price of the relinquished property to sell it quicker. A buyer of relinquished property should be careful to limit its damages to the earnest money in the event of default and to avoid a claim for the taxpayer's damages for failure to meet the safe harbor.

Parked relinquished property cannot be transferred to a related party to come within the 180-day period. There does not appear to be a prohibition of transferring the relinquished property to a related party if the parked property is replacement property. Thus, a taxpayer could transfer the relinquished property to a related party if the 180 days is almost up on the parked replacement property. The related party rules of Code Sec. 1031(f) would apply, and the related party would have to hold the relinquished property for two years.

The combined time period that the relinquished property and the replacement property are held in a QEAA cannot exceed 180 days.[24] The AT can acquire the replacement property for a period of time, make improvements to it if required, and then exchange it with the taxpayer for the relinquished property. However, the AT cannot hold the replacement property for 180 days and then transfer it to the qualified intermediary (QI) to hold for another 180 days. The Revenue Procedure provides that the replacement property must be transferred by the AT to the taxpayer.[25]

Permissible Agreements

The main risk in a parking exchange is that the AT will be deemed the taxpayer's agent because of the AT's lack of benefits and burdens of ownership and the lack of arms' length provisions in their agreement. The Revenue Procedure lets the taxpayer off the hook on the agency issue by providing that the QEAA may contain several legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arms' length bargaining between unrelated parties with respect to such arrangements.[26] The permissible agreements are as follows:

(1) The AT may also act as QI and enter into an exchange agreement to serve as QI in a simultaneous or deferred exchange.

(2) The taxpayer or a disqualified person may guarantee some or all of the obligations of the AT, including secured or unsecured debt incurred to acquire the parked property or may indemnify the AT against costs and expenses.

(3) The taxpayer or disqualified person may loan or advance funds to the AT or guarantee a loan or advance to the AT.

(4) The parked property may be leased by the AT to the taxpayer or a disqualified person.

(5) The taxpayer or a disqualified person may manage the parked property, supervise improvement of the parked property, act as a contractor or otherwise provide services to the AT with respect to the parked property.

(6) The taxpayer and the AT may enter into agreements relating to the purchase or sale of the parked property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the parked property is acquired by the AT.

(7) The taxpayer and the AT may enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the AT's receipt of the property may be taken into account upon the AT's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the AT.

Practical Mechanics of a QEAA

How does a QEAA work in practice? First, the taxpayer must decide whether the AT will park the relinquished property or the replacement property. Then, the following will typically occur:

(1) The taxpayer will enter into a QEA agreement with the AT, which provides that the AT will

purchase the parked property. The QEA Agreement must contain the language required for a QEAA, as stated above.

(2) The AT will not actually pay any cash for the parked property. If the parked property is relinquished property, then the purchase price will be estimated and paid by the assumption of the existing mortgage on the relinquished property on a nonrecourse basis and/or a new seller carryback loan from the taxpayer. If the parked property is the replacement property, then the AT can borrow the funds from a third party lender or the taxpayer. The taxpayer may make loans to the AT, and the AT loans apparently need not bear interest. The Revenue Procedure permits non-arms' length terms in financing arrangements,[27] and the original issue discount rules of Code Sec.1272 provide that no interest will be imputed on a debt instrument which has a fixed maturity date not more than one year from the date of issue.[28]

(3) If the parked property is the relinquished property, then the taxpayer enters into a simultaneous exchange agreement with a QI. At the closing, the taxpayer conveys the relinquished property to the AT by a direct deed for the purchase price. Theoretically, the funds loaned to the AT to purchase the relinquished property are used by the QI to purchase the replacement property. Actually, the taxpayer deposits funds in the replacement property escrow and receives a note from the AT from the relinquished property escrow. The cash and the note offset each other as cash boot paid and cash boot received in the form of the AT note. The seller deeds the replacement property directly to the taxpayer.

> Despite the favorable "no inference" language, parking exchanges outside the safe harbor will need to be structured differently ... to increase the probability that the AT will not be considered the taxpayer's agent.

(4) The AT holds parked property until the relinquished property is sold, but not for a period in excess of 180 days. The parked property is leased back to the taxpayer under a triple net lease with the taxpayer responsible for all taxes, insurance and operating expenses. If mortgage payments are due on the parked property debt, then the taxpayer can pay these as additional rent to the AT. The AT reports these amounts as rental income on its tax return with the offsetting deductions. The taxpayer deducts these amounts as rent paid to the AT. The taxpayer may also manage the parked property. The AT is not required to make a profit on the rent as the Revenue Procedure permits non-arms' length terms in lease arrangements.[29]

(5) If the replacement property is parked, then when the relinquished property is ready to be sold, the taxpayer enters into a simultaneous exchange agreement with a QI. At the closing, the taxpayer conveys the relinquished property to the buyer by a direct deed for the purchase price. The QI then uses the exchange proceeds to pay the AT the fixed price for the replacement property. The AT then pays off the AT note to the taxpayer and any other financing on the replacement property and deeds the replacement property directly to the taxpayer. The taxpayer does not have taxable boot from the receipt of the repayment of the AT note because the taxpayer has paid cash boot into the exchange in the form of the original down payment on the replacement property.

(6) If the relinquished property is parked, then when the relinquished property is sold by the AT, all loans to the AT are paid off with the sale funds. If the relinquished property sells to the buyer for less than the AT's purchase price from the taxpayer, the AT will not owe the taxpayer the difference. Likewise, if the relinquished property sells to the buyer for more than the AT's purchase price, the AT may agree to pay the taxpayer the excess. The AT thus bears no benefit of increased value or burden of decreased value of the relinquished property.[30]

(7) If the relinquished property does not sell within the 180-day period, the taxpayer has the right to call the parked property back from the AT for the amount of the loans assumed by the AT. This call is effective for a period not in excess of 185 days after the

AT acquired title. Likewise, the AT has the right to put the parked property back to the taxpayer for only the amount of the debt assumed by the AT. A fixed or formula price put or call longer than 185 days will knock the AT arrangement out of the safe harbor.[31] It is unclear if the transaction must be closed within the 185-day period or the put or call simply must be exercised. The conservative interpretation is that it must be closed by the 180th day, especially considering the consequence of being wrong and falling out of the safe harbor.

Replacement Property Improvements

Improvements may also be made to the parked replacement property in a QEAA. The Revenue Procedure provides that the taxpayer or a disqualified person may supervise the improvement of the parked property or act as a contractor for the improvements.[32] The taxpayer will need to arrange a construction loan for the taxpayer or otherwise provide funding for the improvements.

Combination Reverse/Deferred Exchanges

A safe harbor reverse exchange can be combined with a deferred exchange. A taxpayer exchanging into more than one replacement property may want to park the first replacement property with an AT. The parking period cannot exceed 180 days. When the relinquished property sells, the QI acquires the replacement property from the AT as one replacement property and uses the balance of the exchange proceeds in a deferred exchange for additional replacement property.

A taxpayer that has begun a deferred exchange with one relinquished property may want to acquire a portion of a replacement property in the deferred exchange and have an AT acquire the balance of the replacement property to use as replacement property for another relinquished property that has not *yet* sold! The parked portion should be treated as a separate property and transferred to the taxpayer in the subsequent exchange within 180 days of the AT's acquisition of the portion of the parked property.

Failed Reverse Exchanges Under Rev. Proc. 2000-37

What if the taxpayer is unable to dispose of the relinquished property within the 180-day period and wants to cancel the exchange? If the replacement property has been parked, then the AT will deed the parked replacement property to the taxpayer, and the taxpayer will be treated as purchasing the parked property on that date. The taxpayer may want to ignore the whole failed QEAA arrangement and treat itself as owning the parked property from the start.

What if the relinquished property has been parked by the AT? The taxpayer might have filed a tax return reporting the exchange and a carryover basis in the replacement property. The reacquisition of the relinquished property would seem to give the taxpayer a new, fair market value basis in the relinquished property. Or is the correct treatment to ignore the parking arrangement and treat the replacement property as a purchase? The Revenue Procedure does not answer these questions.

If the taxpayer elects to continue the parking arrangement beyond the 180 days, then the Revenue Procedure does not apply. The determination of whether the AT is the owner of the property for federal tax purposes, and the proper treatment of any transactions entered into between the parties will be made without regard to the Revenue Procedure.[33] This should not give the taxpayer much comfort in a typical QEAA because the AT would probably be considered the taxpayer's agent, as discussed below.

Reverse Exchanges Outside the Safe Harbor of Rev. Proc. 2000-37

Rev. Proc. 2000-37 only provides a safe harbor for reverse exchanges that meet its requirements. Many reverse exchanges will fail to meet the requirements, principally the 180-day limit. The Revenue Procedure states that the IRS recognizes that parking arrangements can be accomplished outside of the safe harbor and no inference is intended with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the safe harbor, whether entered into prior to or after the effective date of the Revenue Procedure.[34]

Despite the favorable "no inference" language, parking exchanges outside the safe harbor will need to be structured differently than those within the safe harbor to increase the probability that the AT will not be considered the taxpayer's agent. This will be more costly for the taxpayer and will entail more tax risk, because there is no assurance that the AT is not the taxpayer's agent. A taxpayer entering into a reverse parking exchange must decide up front whether to structure the transaction within the safe harbor or to go to the added time and expense of structuring the exchange outside the safe harbor. The following sections address the authorities dealing with reverse exchanges, before and after the issuance of Rev. Proc. 2000-37.

Case Law

A recent court decision analyzes a modern "parking" style reverse exchange.[35] The decision was entered after the issuance of Rev. Proc. 2000-37. In *DeCleene*, the taxpayer operated a business on the relinquished property. The taxpayer purchased raw land in September 1992 and proceeded to obtain a permit to build a new building for his business on the land. In September 1993, the taxpayer entered into an exchange agreement with the buyer. Under the agreement, the taxpayer quitclaimed the raw land to the buyer and the buyer constructed improvements on the land. Then, in December 1993, three months later, the taxpayer transferred the relinquished property to the buyer in exchange for the land and improvements as replacement property. The court concluded that the taxpayer had merely sold the relinquished property in a taxable sale to the buyer, because the taxpayer never divested himself of beneficial title to the replacement property land and thus could not acquire it in an exchange. The court noted Rev. Proc. 2000-37 but held that it did not apply to the case because it is only effective for exchanges after September 15, 2000. The court ruled that the taxpayer had retained beneficial title to the land, focusing on the putative buyer's lack of economic risk for the land and the construction of the improvements. Although the taxpayer transferred legal title to the buyer, the consideration was a non-recourse, non-interest bearing note from the buyer. The taxpayer was contractually obligated to reacquire the land with the improvements from the buyer. The taxpayer paid all the real estate property taxes. The construction of the improvements was financed by a non-recourse construction loan to the buyer, guaranteed by the taxpayer. The buyer had no potential risk or exposure with respect to the additional outlay of funds required to finance construction of the building, and no potential for or exposure to any economic gain or loss on its acquisition and disposition of title to the replacement property land and improvements. The court concluded that the taxpayer, like the taxpayer in *Bloomington Coca-Cola*,[36] had a building built according to his specifications on land he owned and the taxpayer was obligated to pay for that building. The taxpayer did avoid a negligence penalty because he reasonably relied on his CPA and attorney in structuring the failed exchange.

According to an IRS official in informal remarks, the Revenue Procedure was issued to help taxpayers in situations ... where there has been a short delay in the sale of the relinquished property.

DeCleene appears to contain a typical QEAA structure, except for the fact that the taxpayer owned the raw land prior to the exchange. The decision, however, is based more on the lack of the buyer's benefits and burdens of ownership than the taxpayer's prior ownership of the land.

Taxpayers in other cases have prevailed on the agency issue. Contrast *DeCleene* with *Coastal Terminals, Inc.*[37] In *Coastal Terminals*, the buyer of the relinquished property was required to acquire the replacement property and construct a facility on it. The exchange did not occur until the new facility had been constructed by the buyer. The court emphasized that the buyer used its own funds to buy the property, construction materials and construct the facilities and incurred obligations to the contractor. The buyer thus had risk, while the buyer in *DeCleene* did not.

The IRS has raised and lost the argument that the entity parking replacement property is the agent of the taxpayer in other cases. In *J.H. Baird Publishing Co.*,[38] the developer was a real estate agent who acted both as developer and intermediary in the exchange. The real estate agent acquired the relinquished property from the taxpayer and sold it to the buyer for cash. The real estate agent then purchased a lot with the proceeds and deposited the net cash after closing costs, including a payment to himself, into an escrow account, as escrow agent for the taxpayer. The funds in the escrow account were used by the real estate agent to construct improvements on the lot to the specifications of the taxpayer. The taxpayer approved all contractors, plans and invoices. The real estate agent was found not to be the taxpayer's agent, because it was not acting in its capacity as real estate agent and earned a profit for its role as developer.

In *F.L. Fredericks*,[39] the taxpayer's wholly-owned construction company acquired the relinquished property from the taxpayer and sold it to the buyer. It then acquired the replacement property land, constructed improvements and transferred the land and improvements to the taxpayer as replacement property. The court found that the construction company was not the taxpayer's agent, because it was an active corporation carrying on business as a licensed contractor and real estate developer. The company also acquired construction financing and was paid a fee of $750,000 by the taxpayer. The transaction occurred before the enactment of the related party rules of Code Sec.1031(f).

Despite these favorable cases on the agency issue, *DeCleene* proves that the accommodating entity must have burdens as well as benefits, and the typical QEAA arrangement would probably not past muster under an agency analysis.

IRS Rulings Relevant to Non-Safe Harbor Exchanges

A reverse parking exchange was disallowed due to the accommodator's agency in Technical Advice Memorandum 200039005, as discussed above.

In a private letter ruling favorable to the taxpayer, the IRS listed the following risks of ownership assumed by the accommodating party in a reverse build to suit exchange: (i.) the obligation to construct a building according to the taxpayer's plans, (ii) obligations under a construction loan from the taxpayer, (iii) an obligation to spend a minimum amount before disbursement under the construction loan, (iv) claims that may be asserted with respect to construction, (v) liability on the construction contracts, and (vi) obligations under the lease (the land was leased under a long term lease).[40] The ruling allowed the taxpayer to advance money for the acquisition of the replacement property, citing the case of *124 Front Street, Inc.*,[41] and mentioned the "great latitude" courts have permitted taxpayers in structuring exchanges. The ruling did not disclose the "minimum amount" invested by the accommodator.

Suggestions to Avoid Agency in Non-Safe Harbor Exchanges

The cases and rulings point out the importance of the accommodating party having some risk of loss and obligations.[42] The following ideas may help mitigate the agency risk in a non-safe harbor exchange.

(1) The accommodator might obtain some of the funds for the parked property from a third party other than the taxpayer or someone related to the taxpayer. The funds should either be the accommodator's own funds or borrowed on an arms' length basis, including interest at a market rate.

(2) Avoid taxpayer guarantees of financing and other obligations related to the parked property. This is often easier said than done.

(3) The accommodator should receive the appreciation in the parked property if the parking period lasts beyond a fixed period, such as one year. The taxpayer can have an option to purchase the parked property at the fixed price until that date; thereafter, the price is determined by appraisal.

(4) It appears less likely that the accommodator will be considered the taxpayer's agent if the AT is an ongoing business, rather than a special purpose entity. This helped the taxpayer in *Fredericks* but was not enough to overcome the bad facts in *DeCleene*.

(5) The accommodator should charge a fair market rent to the taxpayer if the parked property is leased to the taxpayer. The rental profit can be part of the accommodator's fee.

(6) It may be better to park the replacement property with the accommodator than to park the relinquished property. When the relinquished property is parked, the taxpayer must overcome the argument that it has never relinquished the benefits and burdens of ownership and has a prior operating history with the relinquished property. The taxpayer in *DeCleene* could not overcome the burden of proof that it had given up the benefits and burdens on its property. There is little risk of an IRS assertion that the transaction is a sale-leaseback characterized as a like-kind exchange, under the authority of cases like *Century Electric Co.*[43]

"Pure" Reverse Exchanges

A pure reverse exchange would allow the taxpayer to receive the replacement property before actually disposing of the relinquished property. The taxpayer would own both the relinquished property and the replacement property at once, rather than using a third party entity to park one of the properties.

There is little judicial authority for such an exchange. In one case, an exchange was allowed when the taxpayer received heifers in exchange for his promise to deliver calves in the future, which did not exist at the time of the exchange.[44] Presumably, such an exchange could be structured with an exchange agreement in which the taxpayer contracts to receive the replacement property in return for the later transfer of the relinquished property. The pure reverse exchange raises issues about who receives the income and loss and appreciation and depreciation from the relinquished property during the exchange period.

The American Bar Association (ABA) submitted a report to the IRS advocating the validity of a "pure reverse exchange" and urging the IRS to issue a regulation allowing a taxpayer to structure a reverse exchange through an intermediary. The IRS apparently considered issuing a revenue procedure creating a safe harbor for a pure reverse exchange based on the ABA's report, but the IRS instead opted for the parking arrangements set forth in Rev. Proc. 2000-37. The IRS official who worked on the project stated informally that a pure reverse exchange raised too many issues to deal with in a revenue procedure, but the official's belief was that a pure reverse exchange can be structured in some fashion.

The IRS did approve a "pure" two party reverse exchange in which a utility company acquired the replacement property utility easement before it granted the relinquished property utility easement to the same party.[45] There were no issues of depreciation or income during the exchange period because the properties were utility easements. The IRS specifically identified the exchange as a "reverse exchange transaction" and approved the exchange without further analysis as to its reverse nature.

Conclusion

The safe harbor created by Rev. Proc. 2000-37 will aid many taxpayers and create certainty for short-term reverse exchanges. Non-safe harbor exchanges will require careful planning and shifting of some burdens and benefits of the parked property to the accommodator. The taxpayer must decide which approach to take at the beginning of the reverse exchange and structure accordingly.

ENDNOTES

1 IRB 2000-40, 308.
2 *D. DeCleene*, 115 TC —, No. 34, Dec. 54,128.
3 *See, e.g., G.S. Bezdjian*, CA-9, 88-1 USTC ¶9306, 845 F2d 217; *E.C. Lee*, 51 TCM 1438, Dec. 43,180(M), TC Memo. 1986-294; *J. Dibsy*, 70 TCM 918, Dec. 50,930(M), TC Memo. 1995-477; and *C.A. Lincoln*, 76 TCM 926, Dec. 52,970(M), TC Memo. 1998-421.
4 Reg. §1.1031(k); T.D. 8346, 1991-1 CB 150, 151.
5 LTR 9814019 (Dec. 23, 1997).
6 *Supra* note 1, § 2.06.
7 *Id.*, §1.
8 Rev. Rul. 82-144, 1982-2 CB 34.
9 *Supra* note 1, §5.
10 *Id.*, §3.01.
11 Reg. §1.1031(k)-1(k); *Id.*, §3.03.
12 *Supra* note 1, §4.02(1).
13 *Id.*, §4.02(1).
14 Rev. Rul. 99-6, 1999-1 CB 432.
15 *Supra* note 1, §4.02(3).
16 Code Sec. 7503.
17 *Supra* note 1, §3.03.
18 Code Secs. 1016(a), 1245 and 1250.
19 *Supra* note 1, §4.04.
20 *Id.*, §4.02(2).
21 *Id.*, §4.02(4).
22 Reg. §1.1031(k)-1(c).
23 *Supra* note 1, §4.02(5).
24 *Id.*, §4.02(6).
25 *Id.*, §4.02(5).
26 *Id.*, §4.03.
27 *Id.*, §4.03(3).
28 Code Sec. 1272(a)(2).
29 *Supra* note 1, §4.03(4).
30 *Id.*, §4.03(7).
31 *Id.*, § 4.03(7).
32 *Id.*, §4.03(5).
33 *Id.*, §3.02.
34 *Id.*, §3.02.
35 *Supra* note 2.
36 *Bloomington Coca-Cola Bottling Co.*, CA-7, 51-1 USTC ¶9320, 189 F2d 14.
37 *Coastal Terminals, Inc.*, CA-4, 63-2 USTC ¶9623, 320 F2d 333.
38 39 TC 608, Dec. 25,816 (1962), *acq.*, 1963-2 CB 4.
39 67 TCM 2005, Dec. 49,629(M), TC Memo. 1994-27.
40 LTR 9149018 (Sept. 4, 1991).
41 *124 Front Street, Inc.*, 65 TC 6, Dec. 33,448 (1975).
42 *See also* LTR 9413006 (Dec. 20, 1993), LTR 9209010 (Nov. 22, 1991), LTR 8701015 (Oct. 2, 1986), LTR 8304022 (Oct. 22, 1982), LTR 8217106 (Jan. 28, 1982), LTR 8035049 (June 5, 1980), LTR 7929091 (Apr. 23, 1979) and LTR 7823035 (Mar. 9, 1978).
43 CA-8, 51-2 USTC ¶9482, 192 F2d 155.
44 *B.D. Rutherford*, 37 TCM 1851-77, Dec. 35,594(M), TC Memo. 1978-505.
45 *Supra* note 5.