

## REVERSE EXCHANGE PLANNING

1. Reverse Exchange Safe Harbor Created by Revenue Procedure 2000-37 on September 15, 2000.
  - Reverse exchange is the “flip side” of a deferred exchange
  - Also known as “reverse starter”
  - IRS will not challenge the tax deferred status of any reverse exchange that is structured as a “qualified exchange accommodation arrangement” (“QEAA”)
  
2. Brief History of Reverse Exchanges. Code Section 1031 (a)(3) does not authorize reverse exchanges.
  - There are several cases disallowing reverse exchanges. The deferred exchange regulations specifically do not apply to reverse exchanges. IRS has informally indicated that reverse exchanges are possible. A 1998 private letter ruling approved a reverse exchange.
  - Prior to the new revenue procedure a taxpayer would “park” either the relinquished property or the replacement property with an accommodator. The taxpayer would risk that the accommodator would be considered the taxpayer’s agent and the exchange disallowed.
  
3. Overview of Revenue Procedure 2000-37
  - A. Definitions
    1. Relinquished Property. The Relinquished property is the property the taxpayer is selling.
    2. Replacement Property. The replacement property is the property the taxpayer is attempting to buy or exchange into.
    3. Exchange Accommodation Titleholder (“EAT”). An accommodator that takes title to either the replacement property or the relinquished property and can hold it for up to 180 days while the taxpayer attempts to sell the relinquished property. The EAT cannot be the taxpayer or a “disqualified person”. A disqualified person is generally a related party or someone who has acted as the taxpayer’s attorney, accountant, real estate agent, broker, employee, or banker on non-exchange matters within the previous two years. The taxpayer may want to be a ten percent (10%) or less owner in the EAT (perhaps as a 1% owner/manager of an LLC) in order to facilitate financing or the managing of the parked property. The taxpayer should insist that the EAT be a single purpose entity holding only the taxpayer’s property. The

EAT does not need to meet the benefits and burdens test. The taxpayer can fund the purchase, can manage construction and can lease the property at other than fair market value. The EAT, however, must report for federal income tax purposes, the “tax attributes” of owning the property. The EAT is not required to have equity and can be indemnified by the taxpayer. The EAT is not required to profit on the transfer or bear any significant risk of loss. Whether the EAT is required or allowed to depreciate the parked property is not addressed by the revenue procedure. Both the qualified intermediary (“QI”) and the EAT can be the same entity.

4. Qualified Exchange Accommodation Arrangement (“QEAA”). The taxpayer must enter into a QEAA pursuant to a qualified exchange accommodation agreement. There are six (6) requirements:
    - (1) Qualified Indicia of Ownership. The EAT must have qualified indicia of ownership, which means legal title to the parked property or other indicia of ownership such as a contract for deed or ownership of all the outstanding ownership interests in a disregarded entity.
    - (2) The QEA Agreement must state that the EAT agrees to report the acquisition, holding and disposition of the parked property as provided in the Rev. Proc. and that the EAT will be treated as the beneficial owner of the property for all federal income tax purposes.
    - (3) The QEA Agreement must be entered into within five (5) business days after the EAT first acquires qualified indicia of ownership of the parked property.
    - (4) The Agreement must express the taxpayers bona fide intent to use the parked property to complete an exchange.
    - (5) The relinquished property must be identified within 45 days after the exchange begins.
    - (6) The exchange must be totally complete within 180 days after the exchange begins.
  5. Qualified Exchange Accommodation Agreement (“QEA Agreement”). The QEA Agreement spells out the terms of the QEAA.
  6. Parked Property. This is the property held by the EAT.
2. The Rev. Proc. creates a safe harbor for a parking style exchange and allows an EAT to acquire either the replacement property or the relinquished property in an

exchange and hold it for up to 180 days while a taxpayer attempts to sell the relinquished property.

- If the Rev. Proc. is followed, the IRS will not challenge (a) qualification of the property as either replacement property or relinquished property in the exchange, or (b) the treatment of an EAT as the beneficial owner of such property.

4. Two basic types of reverse exchanges under the Rev. Proc.

1. Exchange first vs. exchange last.

1. Exchange first. The taxpayer acquires the replacement property in its own name and conveys the relinquished property to the EAT. This structure is typically used when the lender requires that the taxpayer, rather than the EAT, acquire title to the replacement property, which is the case with most single family residential lenders.

2. Exchange last. The EAT acquires the replacement property. The taxpayer has to facilitate the EAT's purchase of the property by providing the funds or guaranteeing their loan, etc. When the taxpayer's relinquished property is ready to close, then the taxpayer exchanges the relinquished property for the replacement property. This structure works well when the taxpayer is not certain what relinquished property will be exchanged or if the due-on-sale clause on the relinquished property would be triggered by the transfer of the relinquished property. It is also the only structure that allows for improvements to be constructed by the EAT on the replacement property.

2. Management. In both the exchange first and exchange last structures there will typically be mechanisms such as a lease or management agreement transferring operating control of the parked property to the taxpayer or his affiliate while the EAT holds title.

3. When an "exchange first" is better.

1. Lender requires standard type mortgage financing with the taxpayer actually holding title.

2. If the replacement property has particular management problems, it is usually better that the taxpayer immediately buy the replacement property.

3. It may be too late to change deeds already prepared and executed conveying the replacement property to the taxpayer.

4. There is no identification requirement in the exchange first structure. The only time constraint is the 180-day period in which the EAT must dispose of the parked property.
4. When an “exchange last” is better.
  1. If the taxpayer does not know which of several relinquished properties will be utilized in exchange. The decision can be made once one of them finally sells, but the flexibility is limited by the 45-day identification requirement.
  2. If the exchange turns into a non-safe harbor transaction, there is less risk that the EAT will be disregarded.
  3. This is the only option for build-to-suit arrangements. The work must be completed prior to taxpayer’s acquisition of the replacement property.
  4. The exchange takes place concurrently with the sale of the relinquished property. Market values, and thus equity values, being swapped are known, rather than based on assumptions in “exchange first” scenario.
5. Steps in a successful “exchange last” reverse exchange. A typical “exchange last” reverse exchange involving an income producing asset would be done as follows:

Step 1: Taxpayer enters into a contract to acquire potential replacement property and arranges acquisition financing or is prepared to advance the funds itself.

Step 2: Taxpayer enters into a written qualified exchange accommodation agreement with an EAT before the EAT acquires any qualified indicia of ownership. The QEA Agreement may permit the taxpayer to buy the parked property for a fixed price at the end of the safe harbor, or it may permit the taxpayer to buy the entire ownership interest in the EAT special purpose entity used by the EAT to buy the parked property.

Step 3: The EAT acquires title to the replacement property with financing arranged by the taxpayer and sometimes guaranteed by the taxpayer. Usually a single member special purpose single asset LLC will be used to acquire title. This will minimize exposure to EAT’s other assets and assures the taxpayer that liabilities of the EAT will not affect the asset.

Step 4: Either in the QEA Agreement or in a separate identification notice, the taxpayer identifies one or more relinquished properties to complete the exchange and delivers the identification notice to the EAT within 45 days after the EAT first acquires title to the parked property.

Step 5: The EAT triple net leases the parked property to the taxpayer for a period that does not exceed the safe harbor parking period with lease rates intended to meet debt service and operating expenses.

Step 6: While title to the parked property is held by the EAT, the taxpayer locates a buyer for the relinquished property and enters into a contract.

Step 7: The taxpayer enters into an exchange agreement with a qualified intermediary and assigns to the QI the taxpayer's rights to dispose of the relinquished property by the buyer. Taxpayer also assigns to QI the right to acquire the parked property held by the EAT.

Step 8: The QI causes the taxpayer to convey the relinquished property by direct deed to the buyer who transfers the exchange proceeds to the QI. In turn, the QI uses the exchange proceeds to buy the parked property from the AT, who uses the same sales proceeds to satisfy any closing costs and any acquisition debt not intended to be assumed.

Step 9: Under the exchange agreement, the QI directs the conveyance of the parked property from the EAT to the taxpayer by "direct deeding" the parked property to complete the exchange.

#### 6. Failed Reverse Exchanges Under the Revenue Procedure.

1. If the taxpayer is unable to dispose of the relinquished property within the 180-day period, it does not meet the revenue procedure.
2. Taxpayer must decide whether to continue as a non-safe harbor exchange or to cancel the exchange.
3. If the taxpayer wants to cancel the exchange and the replacement property has been parked, then the EAT will deed the parked replacement property and the taxpayer will be treated as purchasing the parked property on that date. The QEA Agreement may allow the taxpayer to ignore the whole failed arrangement and treat itself as owning the parked property from the start. If the relinquished property has been parked by the EAT, the taxpayer may have already filed a tax return reporting the exchange and a carryover basis in the replacement property. The revenue procedure does not answer whether the reacquisition of the relinquished property gives the taxpayer a new fair market value basis in the relinquished property or whether the arrangement should be ignored and treat the replacement property as a purchase.
4. If the taxpayer elects to continue the parking arrangement beyond the 180 days, then the revenue procedure does not apply. The determination becomes whether the EAT is the owner of the property - it is likely that the EAT will be considered the taxpayer's agent in such situations.

7. Reverse Exchanges Outside the Safe Harbor. Non-Safe Harbor Reverse changes will continue to be done because the 180-day period will not work in many situations. The revenue procedure states that the IRS recognizes that parking arrangements can be accomplished outside of the safe harbor. Non-safe harbor exchanges are going to have to be done differently than the typical safe harbor transaction in order to increase the probability that the EAT will not be considered the taxpayer's agent. This will be more costly for the taxpayer and will entail more tax risks. Thus, at the beginning of a reverse exchange, the taxpayer must consider what he will do if he cannot sell his relinquished property within the 180-day time period.
  
8. Conclusion. The new safe harbor under Rev. Proc. 2000-37 will provide tax certainty for a certain number of transactions. The requirement for the EAT to obtain legal title to the parked property will make these transactions more costly and more cumbersome. Thus, taxpayers should continue to strive to sell first and buy later under the standard deferred exchange format if at all possible. Most build-to-suit exchanges will not fit within the safe harbor limitations.

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**J. James Duggan, Esq.**  
**Nexsen Pruet Jacobs Pollard & Robinson**  
**200 Meeting Street, Suite 301**  
**Charleston, South Carolina 29401**  
**577-9440**