# Exchanging Times

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## BUSTED SAFE HARBOR REVERSE EXCHANGES

A situation that we are seeing with more frequency is what we will refer to as the "busted" safe harbor reverse exchange—i.e., one that is not able to close within the 180 day period specified in Rev. Proc. 2000-37.

In the case of a "busted" safe harbor transaction, the 180 day requirement cannot be met because the relinquished property has not been sold. There is then the prospect that the EAT will hold the parked property for more than 180 days. This discussion will be limited to the most common scenario where the replacement property is being parked. In such situations, the following alternatives should be considered.

A. Terminate the Parking Arrangement; Possible Rescission. The Exchanger may conclude that he is unlikely to sell the relinquished property in the near future or he may have changed his mind about selling it. In this instance, he may simply have the EAT transfer the parked property to him. The tax consequences of this action are less clear than may at first seem evident.

The primary issue is who should be treated as the owner of the property during the parked period. Rev. Proc. 2000-37 stipulates as one of its conditions that the EAT be treated as the owner of the parked property and that the tax returns reflect that. However, if there is to be no exchange, the Exchanger probably will want to be treated as the owner and claim depreciation. In general, these issues are not addressed in Rev. Proc. 2000-37, and there are no clear answers.

If the 180 day period has taken place during the same taxable year, the parties might consider a rescission of their parking arrangement since the case law recognizes the effect of a rescission for tax purposes if it does occur in the same taxable year. See Penn v. Robertson, 115 F. 2d 167(4th Cir. 1940). On the other hand, if the period extends over two taxable years, this remedy may not be available.

B. Do Nothing and Proceed to Close outside Safe Harbor. The second alternative is to hold the replacement property until the relinquished property is sold and then consummate the exchange even though the safe harbor requirements are not met. One difficulty with this approach is that the EAT probably will have few or none of the burdens and benefits of ownership, which

Rev. Proc. 2000-37 referred to as a criteria of tax ownership applicable to exchanges outside the safe harbor.

Some cases (see, e.g. Biggs v. Commissioner, 69 T.C. 905 (1978)) suggest that an intermediary in a Section 1031 transaction does not need to have an economic interest in the property, and the IRS in PLR 200111025 seemed to require only a minimal amount. Nevertheless, the "do nothing" strategy would appear to be risky if the intent is to have a valid exchange.

C. Inject Some Economics. Another alternative is to amend the arrangement to provide some economic benefit to the EAT. For example, the lease of the parked property by the EAT to the exchanger might be amended to provide for rental payments representing a reasonable return to the EAT. Similarly, some economic risk could be added to the EAT's position. Thus, the argument would be that the relationship between the EAT and the exchanger in its entirety results in sufficient benefits to the EAT under applicable case law.

Some have taken the position that a non-safe harbor reverse transaction cannot be "added on" to a safe harbor transaction. While that is probably true under the provisions of Rev. Proc. 2000-37, the real issue is how such an amendment to the arrangement will be treated under the case law. The underlying issue is whether the EAT is to be treated as the agent of the exchanger. If the EAT meets the various requirements set forth by the IRS in LTR 200111035 to establish that the EAT is not the agent, for tax purposes, of the Exchanger, the additional economic attributes of the EAT could bolster the argument that the exchange is valid even though the safe harbor is not met.

D. "White Knight" Transaction. The final alternative is to have a "white knight" enter the picture and acquire either the parked replacement property from the EAT or the relinquished property from the Exchanger. The white knight would serve as interim owner of the property until a final buyer for the relinquished property were found, but its acquisition and ownership would be structured in a manner to have sufficient incidents of ownership of the property for tax purposes so that it would be deemed to be acting as a principal and not as the agent of the Exchanger. The best way to do this is for the white knight to have both upside and downside potential with respect to the property.

The "white knight" alternative presents the strongest case for tax purposes of the alternatives discussed here. However, as is frequently the case in tax matters, there is a trade-off in that it potentially is the most expensive to the exchanger through potential lost profits on the sale of the relinquished property or additional costs through a higher price for the replacement property that could accrue to the white knight.

E. Some Concluding Thoughts. As the foregoing indicates, the "busted" safe harbor transaction involves considerable navigation through uncharted

waters. We at RES collectively have considerable experience in the area of reverse exchanges and can provide you with the required resources if your parking arrangement is nearing the 180 day period. Even more importantly, if you are in the planning stage of a parking arrangement and think that you may have a 180 day issue, we can structure a non-safe harbor transaction for you.

## IS YOUR EAT CORRECTLY REPORTING ITS "PARKING ARRANGEMENT" TO THE IRS?

Under the IRS "safe harbor" Rev. Proc., the Exchange Accommodation Titleholder ("EAT") must report its acquisition, ownership and disposition of the "parked" property to the IRS on its own tax return. This means the EAT or its parent, if it is eligible to be included in a consolidated return, must file a tax return on which are reported the "tax attributes" of acquisition, ownership and disposition of the parked property. These tax attributes include certain income and expense items, including real property taxes, interest paid on loans, property insurance and Home-Owners' Association Dues. These items must be reported whether paid by the EAT or by another person, such as a lessee, on behalf of the EAT. The EAT must also report the gain or loss if it has "sold" the parked property within a tax year.

It is the responsibility the EAT to ensure that your reverse exchange qualifies for the "safe harbor". At Reverse Exchange Services, Inc. we have already delivered to our outside CPA firm the data for each individual EAT which held property last year. The CPA firm will be preparing the tax returns which are required in order to comply with the Rev. Proc., and RES will be filing the returns in a timely fashion. The next time you or a client are contemplating a reverse exchange, let RES put this attention to detail to work.

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