SAFE HARBOR FOR REVERSE LIKE-KIND EXCHANGES

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The Internal Revenue Service (the "IRS") recently announced Revenue Procedure 2000-37, which provides a safe harbor for reverse like-kind exchanges under section 1031 of the Internal Revenue Code. The Revenue Procedure is effective for reverse exchange arrangements entered into on or after September 15, 2000. In general, the Revenue Procedure is very helpful for taxpayers engaging in reverse like-kind exchanges. However, one significant drawback to the Revenue Procedure is that it does not allow property to be "parked" with an accommodation party for more than 180 days. This article summarizes the requirements of the reverse like-kind exchange safe harbor set forth in the Revenue Procedure.

Definition of a Reverse Like-Kind Exchange

An exchange of real property, like a sale, generally is a taxable transaction. Code section 1031, however, exempts certain exchange transactions from the recognition of gain or loss. Specifically, section 1031 provides that no gain or loss will be recognized upon the exchange of property held for productive use in a trade or business or for investment solely for property of "like kind" which is to be held for productive use in a trade or business or for investment. Any kind of real estate generally is treated as of a "like kind" with other real property.

In a typical like-kind exchange, the taxpayer simultaneously exchanges the "relinquished property" (i.e., the property that the taxpayer gives up in the exchange) for the "replacement property" (i.e., the like-kind property the taxpayer acquires in the exchange). Alternatively, if the taxpayer has not identified replacement property, it may direct the proceeds from the sale of the relinquished property to an intermediary, identify the replacement property within 45 days of transferring the relinquished property, and have the intermediary apply the sale proceeds to the acquisition of the replacement property by the earlier of 180 days after transferring the relinquished property or the due date (with extensions) for the taxpayer’s income tax return for the taxable year in which the transfer of the relinquished property occurs. Prior to the Revenue Procedure, such deferred exchanges were authorized if they occurred in the order described in the preceding sentence, but were not authorized if a taxpayer first purchased replacement property and later disposed of the relinquished property.

The Revenue Procedure enables taxpayers to engage in "reverse" like-kind exchanges, in which an exchange accommodation titleholder (an "Exchange Accommodator") acquires the replacement property on behalf of the taxpayer before the taxpayer transfers the relinquished property. In a reverse like-kind exchange, the desired replacement property generally is "parked" with the Exchange Accommodator, who is treated as the tax owner of the replacement property until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee. A reverse like-kind exchange could be useful if a taxpayer has identified property that it wishes to acquire, or if the seller of such property insists upon closing the sale quickly, but the taxpayer must wait before it can transfer the relinquished property.

Safe Harbor Requirements

The Revenue Procedure provides that the IRS will not challenge the qualification of property as relinquished property or replacement property and will not challenge the status of the Exchange Accommodator as the beneficial owner of property transferred to the accommodator if the property is held in a "qualified exchange accommodation arrangement" (an "Exchange Arrangement"). All of the following requirements must be met in order to hold property in an Exchange Arrangement:

- The Exchange Accommodator is not the transferor or a "disqualified person" (i.e., an agent of the transferor or a related person) and either is subject to federal income tax or, if it is a partnership or S corporation, more than 90% of its interests or stock is owned by partners or shareholders who are subject to federal income tax.

- The Exchange Accommodator holds "qualified indicia of ownership" (i.e., legal title, other indicia of ownership that are treated as beneficial ownership under commercial law (e.g., a contract for deed), or an interest in an entity that is disregarded for tax purposes (e.g., a single member LLC) that owns legal title to the property or has such other indicia of ownership) for the replacement property at all times from the date it acquires the property to the date it transfers the property.

- When the Exchange Accommodator acquires the property, it is the taxpayer's bona-fide intent that such property represents either replacement property or relinquished property in a like-kind exchange under Code section 1031.

- No later than five business days after the transfer of replacement property to the Exchange Accommodator, the taxpayer and the Exchange Accommodator enter into a written agreement specifying that the property is being held for the benefit of the taxpayer to facilitate an exchange under Code section 1031. The agreement must specify that the Exchange Accommodator will be treated as the beneficial owner of the property for all federal income tax purposes.

- No later than 45 days after the transfer of replacement property to the Exchange Accommodator, the taxpayer properly identifies the relinquished property. Under the deferred exchange rules, the taxpayer may identify alternative and multiple properties.

- No later than 180 days after the transfer of title of property to the Exchange Accommodator, the property is transferred either to the transferor as replacement property or to a person other than the transferor or a "disqualified person" as relinquished property.

- The combined time period that the relinquished property and the replacement property are held in an Exchange Arrangement does not exceed 180 days.

The Revenue Procedure also lists certain legal and contractual relationships between the taxpayer and the Exchange Accommodator that will not prevent an exchange transaction from qualifying for the safe harbor. Listed below are a few of the permissible relationships.

- The taxpayer or a disqualified person may guarantee some or all of the obligations of the Exchange Accommodator, including secured or unsecured debt incurred to acquire the property, or may indemnify the Exchange Accommodator against costs and expenses.

- The taxpayer or a disqualified person may loan or advance funds to the Exchange Accommodator or may guarantee a loan or advance to the Exchange Accommodator.

- The Exchange Accommodator may lease the property to the taxpayer or a disqualified person.

- The taxpayer or a disqualified person may manage the property, supervise improvement of the property, act as a contractor, or otherwise provide services to the Exchange Accommodator with respect to the property.

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