New Times For 1031

How to combine a partial reverse/partial forward like-kind exchange under the new revenue procedure issued by the Internal Revenue Service on September 15, 2000.

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The Internal Revenue Service's Revenue Procedure 2000-37, issued on September 15, 2000, provides a safe harbor for structuring "reverse" like-kind exchanges if certain technical requirements are satisfied. The Deferred Exchange Regulations established useful safe harbors for structuring forward exchanges, i.e. where the taxpayer first transfers relinquished property and subsequently acquires replacement property, by creating a somewhat unique tax entity called a qualified intermediary.

The regulations provide that rights conferred upon a taxpayer under state agency law to dismiss a qualified intermediary, and thus obtain the benefits of money or other property held by the intermediary, will be disregarded in determining whether the transaction satisfied the exchange requirement of section 1031. However, those regulations did not extend the federal income tax status of the qualified intermediary to reverse exchanges. Therefore, any attempt to structure a reverse exchange necessarily required a delicate balancing act of the client's tax objectives and its business objectives: How much risk was the taxpayer willing to transfer to a "friendly" third party — and how much risk was the "friendly" third party willing to undertake — in order to establish that the third party was not acting as the taxpayer's agent, thereby disqualifying the exchange?

Revenue Procedure 2000-37 provides an opportunity to accommodate a taxpayer's business objectives while at the same time eliminating the tax risk that a reverse exchange will be disqualified as a result of agency. Revenue Procedure 2000-37 provides generally that the IRS will not challenge the qualification of property as either "relinquished property" or "replacement property" if the property is held in a "Qualified Exchange Accommodation Arrangement" (QEAA). The QEAA may own property for up to 180 days and the list of permissible agreements between the taxpayer and the Exchange Accommodation Titleholder (EAT) is extensive, including taxpayer guarantees of indebtedness, puts and calls, and make whole agreements.

Mechanical Structure Under Revenue Procedure 2000-37

"Qualified indicia of ownership" must be held by the EAT at all times from the date of its acquisition of either the replacement property or the relinquished property until either the replacement property is transferred to the taxpayer, or the relinquished property is transferred to the purchaser.

For purposes of the revenue procedure, "qualified indicia of ownership" means legal title to the property, 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), or 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, or an Illinois type land trust), and that holds either legal title to the property or such other indicia of ownership.

The taxpayer must have a bona fide intent that the property held by the EAT is either the replacement property or the relinquished property in an exchange that is intended to qualify for nonrecognition of gain or loss under section 1031. The taxpayer and the EAT must enter into a Qualified Exchange Accommodation Agreement providing that the EAT is (1) holding the property for the benefit of the taxpayer in order to facilitate and exchange under section 1031 and the revenue procedure and (2) the taxpayer and the EAT agree that the EAT is the beneficial owner of the property for all federal income tax reporting purposes. The taxpayer must identify either relinquished property or replacement property within 45 days of the acquisition of property by the EAT. The same rules with respect to an identification under the Deferred Exchange Regulations apply to multiple and alternative identifications under the revenue procedure.

The EAT must transfer the property it owns either to the taxpayer, in the case of replacement property, or to the purchaser, in the case of relinquished property, not later than 180 days following its acquisition by the EAT.

Permissible Agreements Between EAT And Taxpayer

This is the key to avoiding the balancing act described earlier. The QEAA may contain any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain non arms-length terms:

1. The EAT can also act as the qualified intermediary.

2. The taxpayer may guarantee some or all the obligations of the EAT, including the debt incurred to acquire the property, and indemnify the EAT against all costs and expenses.

3. The taxpayer or a related party can loan or advance funds directly to the EAT or guarantee a loan or advance to the EAT.

4. The EAT can lease the property to the taxpayer or a related party rent-free.

5. The taxpayer or a related party can manage the property, supervise the construction of improvements to the property, act as a contractor or provide other services to the EAT.

6. The taxpayer and the EAT can have puts and calls at fixed or formula prices.

7. The taxpayer and the EAT can agree that any variation in the value of the relinquished property can be taken into account when the relinquished property is transferred to the purchaser through the taxpayer's advance of funds to, or receipt of funds from the EAT.

Perhaps most importantly, property will not fail to be treated as being held subject to a QEAA even though the accounting, regulatory, or state or local tax treatment of the agreement between the taxpayer and the EAT is different from the treatment required by the revenue procedure. For example, even though the EAT must be treated as the owner of the property for federal income tax purposes, the taxpayer may presumably be treated as the owner for GAAP purposes.

Planning Opportunities

The most significant planning opportunity presented by the revenue procedure is perhaps in combining a partial reverse exchange with a partial forward exchange. This technique offers taxpayers a total of up to 360 days to acquire sufficient replacement property in order to fully defer recognized gain. A sample "timeline" may be helpful in visualizing this structure.

A timeline for combining reverse/forward tax deferred exchange utilizing Revenue Procedure 2000-37 requires a few assumptions:

- Relinquished property FMV $100
- Replacement property #1 ("parked property") FMV $60
- Replacement property #2 FMV $40

PLAYERS IN THE NNN MARKET

• THE BOULDER GROUP is a Northbrook, Illinois-based brokerage for NNN properties. The company maintains a comprehensive inventory of free-standing properties nationwide leased to investment-grade tenants.

• CAPITAL LEASE FUNDING is a discount lender that makes permanent financing loans to owners and developers of NNN properties. The company is based in New York City, but is active nationwide.

• CARDINAL CAPITAL is a Dallas-based company that is an owner and buyer of triple-net leased retail, office and industrial properties.

• CB RICHARD ELLIS maintains a real estate services unit for NNN properties.

• COMMERCIAL NET LEASE REALTY is an Orlando, Florida-based equity REIT that owns and develops NNN properties. The company specializes in free-standing stores ranging between 7,500 and 100,000 square feet. It also provides property management and asset management services to retailers.

• MARCUS & MILLICHAP has several brokers nationwide who specialize in the sale of NNN properties. They primarily work with developers of these properties to list and sell them to individual and institutional owners.

• SILVER WILLIS INVESTMENT REAL ESTATE is a Larkspur, California-based brokerage that is associated with Radius Retail Advisors. The company's two partners, Barry Silver and Dan Willis, have been selling net-lease properties as a team for 10 years.

• STAUBACH RETAIL SERVICES maintains a brokerage that sells NNN properties.

• SYNDICATED EQUITIES is a Chicago-based brokerage that specializes in 1031 Exchanges to NNN properties. Syndicated Equities does a number of new Walgreens deals each year.

• TRAMMELL CROW COMPANY maintains a brokerage for NNN properties in several of its offices.

• U.S. REALTY ADVISORS is a New York-based company that specializes in sale-leaseback transactions and net leases. The company is diversified in the field, arranging not only sale-leasebacks on retail properties, but also on movie theaters, hotels and restaurants.

• UNITED TRUST FUND is in the business two ways. The company is an owner-landlord of sale-leasebacks where it buys the property from a tenant and leases it back to them under a long-term lease. In the past three years, the Miami-based company has also become an active player in the build-to-suit business for tenants like Eckerd. The company operates mainly in the Southeast and Midwest.

• UPLAND REAL ESTATE GROUP, based in Minneapolis, specializes in the sale of triple-net leased properties. The company is one of the largest brokerages of NNN properties in the country. It has sold over $185 million of triple-net lease properties with over $50 million in sales in 2000. The company has recently redesigned its Web site to add a searchable database for net leased properties at www.nnnsales.com.

Qualified indicia of ownership will be accomplished by establishing a special purpose entity (Delaware LLC) to acquire and hold legal title to replacement property #1 as EAT.

The steps are as follows (note: underlined dates critical, *italicized dates non-critical*):

• Taxpayer executes contract for purchase of replacement property #1.

• Prior to closing, the taxpayer executes a QEAA with the EAT.

• The EAT forms a special purpose entity Delaware single member LLC to acquire title to replacement property #1.

• Subsequently, the taxpayer assigns rights under contract for purchase of replacement property 1 the LLC.

• Day 0 – Closing on replacement property #1:

(a) The taxpayer arranges for funds to be made available to the LLC to consummate the purchase of the replacement property – either though a direct loan from the taxpayer to LLC, or through conventional financing. The loan is, in all events, non-recourse to the LLC and its originating member.

(b) LLC pays the purchase price to the seller of replacement property #1.

(c) The seller conveys title to replacement property #1 to the LLC.

(d) LLC gives note to the taxpayer or lender that is secured by a mortgage on replacement property #1.

(e) LLC then leases replacement property #1 to the taxpayer in order to give operating rights to taxpayer. The lease rate can be set at any amount. If conventional financing is used to acquire replacement property #1, the lease rate is commonly set at an amount equal to the monthly debt service.

• Day 45 – Taxpayer identifies relinquished property to LLC:

Relinquished property has a FMV of $100. Multiple relinquished properties may be identified in accordance with the Deferred Exchange Regulations Identification requirements.

• *Day 100* – The taxpayer executes contract to sell relinquished property to the purchaser.

• *Day 175* – Taxpayer executes an exchange agreement with a qualified intermediary and qualified exchange trust agreement with a trustee. The taxpayer also assigns his rights under the relinquished property contract to the qualified intermediary and gives writ-

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ten notice of that assignment to the purchaser.

• Day 180 – Closing on the relinquished property:

(a) The qualified intermediary instructs the taxpayer to convey the relinquished property directly to the purchaser.

(b) The purchaser pays $100 purchase price for the relinquished property to the qualified intermediary.

(c) The taxpayer and the LLC enter into a purchase and sale agreement for replacement property #1 ($60).

(d) Taxpayer assigns rights under the purchase agreement for replacement property #1 to the qualified intermediary.

(e) The qualified intermediary pays $60 to the taxpayer/lender in satisfaction of the note given by the EAT/LLC to the taxpayer/lender.

(f) The qualified intermediary instructs the EAT/LLC to either (1) convey title to replacement property #1 to the taxpayer, or (2) transfer 100 percent of membership interest in the EAT/LLC to the taxpayer.

• Day *225/45* – Taxpayer identifies additional replacement property to the qualified intermediary.

• *Day 300/120* – Taxpayer executes contract for purchase of replacement property #2 (FMV $40).

• *Day 355/175* – Taxpayer assigns contract for purchase of replacement property #2 to the qualified intermediary.

• Day 360/180 Closing of acquisition of replacement property #2:

(a) The qualified intermediary pays $40 purchase price to seller of replacement property 2.

(b) The qualified intermediary instructs seller of replacement property #2 to convey title to the taxpayer.

Why shouldn't we structure all acquisitions utilizing the arrangement sanctioned by the new revenue procedure?

• Potential duplication of transfer taxes, title insurance and other transaction expenses.

• Increased financing costs assuming funds required for acquisition of replacement property are borrowed from lender.

• Loss of depreciation benefits during the period replacement property is held by EAT/LLC.

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