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Park At Your Own Risk
(The Pitfalls of Reverse Like-Kind Exchanges)

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In today's overheated real estate market, like-kind exchanges under Internal Revenue Code section 1031 are a vital way to defer income tax on gain from the sale of appreciated real estate. Under section 1031, gain or loss is not generally recognized with respect to the disposition of property to the extent that such property is exchanged for "like-kind" property. All real estate, whether unimproved land or skyscraper, is generally considered "like-kind" with respect to all other real estate for purposes of section 1031, making a like-kind exchange an attractive option.

In a like-kind exchange, timing is crucial. Section 1031 and the regulations thereunder expressly permit both simultaneous and deferred like-kind exchanges. In a deferred exchange, the property sold by the taxpayer (the "relinquished property") is transferred by the taxpayer *prior to* the taxpayer's acquisition of new property (the "replacement property") in the exchange. Replacement property must be identified within 45 days of the transfer of the relinquished property and must be acquired within 180 days of such transfer (or prior to the due date of the taxpayer's return, including extensions, if earlier). To accomplish a multiple party exchange (where the buyer of the relinquished property is not the seller of the replacement property), the taxpayer assigns the purchase and sale contract on both the relinquished property and the replacement property to an unrelated third party engaged by the taxpayer (referred to as a qualified intermediary, or QI). The QI is the party who carries out the exchange, selling the relinquished property to a third party and holding the sales proceeds in an "exchange account" for up to 180 days. In a successful exchange, the taxpayer (through the QI) will acquire the replacement property during the 180-day period with funds from the exchange account, and (pursuant to the direction of the QI) title to the replacement property is transferred directly to the taxpayer.

A taxpayer is not always in control of the timing of the closings comprising the exchange, and might not be able to sell the relinquished property prior to his acquisition of the replacement property. The Code and regulations do not expressly permit a "reverse" exchange, where the replacement property is acquired first, but a safe harbor created in 2000 can rescue a taxpayer's exchange. Under the safe harbor set forth in Revenue Procedure 2000-37, the taxpayer can engage an unrelated third party (referred to as an exchange accommodation titleholder, or EAT) to acquire the replacement property for the taxpayer. The property remains "parked" with the EAT until the taxpayer disposes of the relinquished property (through the QI mechanism described above), at which time the EAT transfers the replacement property to the taxpayer. This is referred to as the "Exchange Last" parking format. Alternatively, under a second format sanctioned by the Revenue Procedure, the taxpayer sells the relinquished property to an EAT (through the QI), and shortly thereafter the QI uses the sales proceeds to acquire the replacement property from a third party seller. The replacement property is transferred directly to the taxpayer, and the EAT retains the relinquished property until the taxpayer arranges for its sale to a third party buyer. This is referred to as the "Exchange First" parking format. In either scenario, the EAT can hold the relevant property for a maximum of 180 days. During this period, the taxpayer is able to retain economic control of the parked property through a lease or management agreement with the EAT. For income tax purposes, the EAT is treated as the owner of the property, which is critical for like-kind exchange qualification, but the EAT is the taxpayer's agent for all purposes other than income tax purposes.

Although reverse exchanges may sound simple, there are many practical complications. Some challenges arise in connection with successfully meeting the requirements of the Revenue Procedure's safe harbor, while others involve lender issues and how to document and report the real estate transaction for state and local law purposes.

One common challenge comes up in the context of state and local transfer

tax. In a reverse exchange, there are *two* direct transfers of title to the property (or of controlling interests therein)—one transfer when the property is transferred to the EAT, and a second transfer when the property is transferred by the EAT. Two transfer tax returns potentially need to be filed. In an Exchange Last transaction, the transfer tax is paid on the first transfer of the replacement property (from a third party seller to the EAT). At some time between the date of the first transfer and 180 days from that date, the EAT transfers the property to the taxpayer, triggering a second transfer tax unless there is a relevant exception in the particular transfer tax statute. In New York City, for example, there is an exception for transfers between agents and their principals, potentially applicable to the second transfer described above. Additionally, the taxpayer should consider whether the EAT should acquire the property in a wholly owned limited liability company (and transfer 100 percent of the interests in the limited liability company to the taxpayer rather than the property itself), to take advantage of possible beneficial transfer tax rules regarding entity interest transfers in certain jurisdictions. Reverse exchanges must be structured with these and other transfer tax issues in mind.

The safe harbor of the Revenue Procedure allows the taxpayer to retain economic control of the property while the property is parked with the EAT, through the use of a lease or a management agreement. Which transaction form is chosen can have important consequences for certain kinds of taxpayers. For example, if the taxpayer is a Real Estate Investment Trust (REIT), the use of a lease will generate rental income, which is qualifying REIT income for purposes of the REIT income tests, while a management agreement will generate management fees that do not qualify as good REIT income. The taxpayer's particular concerns should be evaluated when structuring the relationship between the EAT and the taxpayer.

When a lender enters the reverse exchange picture, additional complexities arise. Since the EAT is acquiring title to property, the EAT will be the borrower on any new or existing loan associated with the replacement property acquisition. Obtaining lender's consent to the EAT as borrower, and to the eventual replacement of the taxpayer as borrower upon the second transfer of the property, can be difficult, and can cause delay. If the loan is in a mortgage pool, rating agency approval may also be needed. The loan documents will need to reflect this arrangement and will have to be approved by the lender. It is important to communicate with the lender as early as possible, to insure that necessary approvals are received in a timely fashion so as not to delay the closing.

If difficulties with the replacement property lender are delaying the closing beyond an acceptable time, a taxpayer might consider switching from an Exchange Last to an Exchange First format. In an Exchange First parking arrangement, the replacement property is transferred directly to the taxpayer and is never held by the EAT, so the loan financing the acquisition of the replacement property can be made directly to the taxpayer.

Although the Exchange First format can be very helpful in certain situations, one disadvantage is that under this format, a taxpayer has less flexibility in choosing the relinquished property. In an Exchange First transaction, the taxpayer must transfer the particular relinquished property to the EAT on the same day that the taxpayer acquires the replacement property. Therefore, the taxpayer must choose which relinquished property is to be sold before closing on the acquisition of the replacement property. In an Exchange Last transaction, the taxpayer has 45 days from the closing on the acquisition of the replacement property to identify *up to three* relinquished properties which he might potentially sell, and has until the 180th day after the closing on the acquisition of the replacement property to sell any of the three identified relinquished properties.

Revenue Procedure 2000-37's parking safe harbor offers taxpayers great flexibility, but requires a new level of sophistication and hands-on experience to navigate.