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Parking Transactions —Developments Regarding "Reverse" Like-Kind Exchanges

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The Internal Revenue Service recently issued guidance relating to quasi-"reverse" like-kind exchanges where the replacement property is acquired by an accommodation party before the relinquished property is transferred. This guidance takes the form of a Revenue Procedure (Rev. Proc. 2000-37) providing a safe harbor under Internal Revenue Code ("IRC") Search7RH1031 if certain technical requirements are met.

Almost simultaneously with the issuance of the Revenue Procedure, the IRS released a technical advice memorandum (TAM 200039005, May 31, 2000) regarding an attempted like-kind exchange involving a parking transaction of a similar nature to those intended to be addressed by the Revenue Procedure. The TAM concluded that the parking transaction and related transactions did *not* qualify as a nontaxable like-kind exchange under the existing safe harbors in the IRC Search7RH1031 regulations regarding deferred exchanges (the "deferred exchange regulations"), or otherwise.

Background

IRC Search7RH1031(a)(1) provides, generally, that no gain or loss is recognized if property held for use in a trade or business or for investment is exchanged solely for other property of like kind to be held for use in a trade or business or for investment. Prior to amendments made in 1984, IRC Search7RH1031(a) did not expressly address situations where the exchange is not simultaneous, for example, where property is relinquished in exchange for a promise to deliver replacement property at a later date (by far the more common form of exchange for real property).

To resolve certain issues regarding the treatment of deferred exchanges following the seminal decision of *Starker v. United States* (602 F.2d 1341 (9th Cir. 1979)), IRC Search7RH1031(a) was amended and regulations were issued to clarify the treatment of like-kind exchanges where the relinquished property is transferred prior to the acquisition of the replacement property. The statute requires that the replacement property be (i) identified as property to be received in the exchange by the 45th day after the transfer of the relinquished property, and (ii) acquired by the taxpayer within 180 days after such transfer (or prior to the due date, including extensions, of the taxpayer's return for the year of such transfer, if earlier).

A deferred exchange in which the replacement property is acquired before the relinquished property is transferred by the taxpayer might qualify as a nontaxable exchange under the general rule of IRC Search7RH1031(a), even though not described in the safe harbors provided by the deferred exchange regulations. In the preamble to those regulations, however, the Service reserved judgment as to whether IRC

Search7RH1031(a) may apply if the replacement property is acquired before the relinquished property is transferred.

Taking into account uncertainties as to the applicability of IRC Search7RH1031(a) to transactions where, by reason of business exigencies, the replacement property must be acquired before the replacement property is sold, taxpayers have engaged in numerous variations of what are commonly called "parking" transactions in order to claim the benefit of IRC Search7RH1031(a).

Parking transactions commonly take one of the following forms:

1. accommodation party acquires the replacement property and retains it until the taxpayer is ready to dispose of the relinquished property, at which point the accommodation party transfers the replacement property to the taxpayer in exchange for the relinquished property.
2. An accommodation party acquires the replacement property, immediately exchanges it with the taxpayer for the relinquished property, and then retains the relinquished property until the taxpayer arranges for its sale to a true third party.

In either case, the objective of protecting the accommodation party from any risk of loss raises various issues regarding the substance of the parking transaction and whether its form should be respected.

Revenue Procedure 2000-37

Revenue Procedure 2000-37 sets forth a safe harbor under which, if a taxpayer engages in either of these parking transactions in connection with a like-kind exchange, the Service will not challenge the qualification of property as "replacement property" or "relinquished property" for purposes of IRC Search7RH1031 and the regulations thereunder, or the treatment of the accommodation party as the beneficial owner of such property for federal income tax purposes. The Revenue Procedure refers to the accommodation party as the "exchange accommodation titleholder"; that party is referred to hereinbelow as the "AT".

The Revenue Procedure applies to any "qualified exchange accommodation arrangement," or QEAA, which is entered into with respect to an AT that acquires property on or after September 15, 2000.

Safe harbor requirements. The Revenue Procedure requires that an AT be a person, other than the taxpayer or a "disqualified person" (a term defined in the deferred exchange regulations as including certain persons related to the taxpayer, e.g., the taxpayer's employee or attorney), who is subject to Federal income tax. An S corporation or an entity treated as a partnership for Federal income tax purposes may qualify as an AT if more than 90% of its stock or interests are owned by partners or shareholders subject to Federal income tax.

The AT must hold "qualified indicia of ownership" of the property. This may be legal title or other indicia of beneficial ownership, and the necessary indicia of ownership may be held directly or through an entity that is disregarded as an entity separate from its owner for income tax purposes—such as a limited liability company wholly owned by the AT.

The taxpayer and the AT must also enter into a "qualified exchange accommodation agreement," incorporating various required provisions, within five business days after the acquisition of qualified indicia of ownership by the AT.

Other key requirements for qualification under the safe harbor include: (i) that the relinquished property be identified no later than 45 days after the replacement property is transferred to the AT, in a manner consistent with the identification requirements in the deferred exchange regulations; and (ii) that, no later than 180 days after the transfer of property to the AT, such property be either transferred to the taxpayer as replacement property, or transferred to a person other than the taxpayer (or a disqualified person) as relinquished property.

The AT will typically insist on arrangements with the taxpayer that minimize the AT's exposure to loss. The Revenue Procedure states that property may be treated as held in a QEAA, and therefore qualify for the safe harbor, notwithstanding the existence of one or more arrangements between the AT and the taxpayer or a disqualified person that are specified in the Revenue Procedure. Thus:

a. the AT may act as the "qualified intermediary" for a like-kind exchange of the property;
b. the taxpayer or a disqualified person may guarantee the obligations of the AT, including debt incurred to acquire the property, or indemnify the AT against costs and expenses;
c. the taxpayer or a disqualified person may lend funds to the AT or guarantee a loan to the AT;
d. the AT may lease the property to the taxpayer or a disqualified person;
e. the taxpayer or a disqualified person may manage the property, supervise the improvement of the property, or otherwise provide services to the AT with respect to the property;
f. the taxpayer and the AT may enter into agreements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, that are effective for a period of not more than 185 days from the date the property is acquired by the AT; and
g. the taxpayer and the AT may enter into agreements providing that any variation in the value of the relinquished property from the estimated value on the date of the AT's receipt of the property will be accounted for through a cash payment upon the disposition by the AT of the relinquished property.

The Revenue Procedure notes that parking transactions may be accomplished outside of the safe harbor provided by the Revenue Procedure, and states that no inference is intended as to the tax treatment of parking transactions not within the safe harbor.

Technical Advice

In contrast to Revenue Procedure 2000-37, TAM 200039005 describes a series of transactions incorporating a parking transaction that, in the view of the IRS, did not constitute an exchange within the scope of IRC Search7RH1031.

A property owner ("O") intended to effect a deferred like-kind exchange through which it would dispose of property it owned (the "relinquished property") in exchange for replacement property, which was to be acquired by an intermediary with the proceeds from the sale of the relinquished property and then transferred to O.

The sale of the relinquished property failed to close as anticipated, but the seller of the replacement property nonetheless insisted that the replacement property be purchased immediately. Therefore, O caused the replacement property to be acquired by an accommodator ("A") with funds provided by O and a secured purchase money obligation for which O was liable.

Thereafter, O obtained a contract to sell the relinquished property, entered into an exchange agreement with A, and assigned the contract of sale to A. A then completed the sale of the relinquished property, and thereafter transferred the replacement property to O.

The TAM concludes that the acquisition of the replacement property by the accommodator on behalf of O was not a transaction within the scope of the qualified intermediary safe harbor under the deferred exchange regulations, observing that this was a "reverse-*Starker*" transaction to which those regulations were not intended to apply. The TAM also states that A could not be a qualified intermediary as defined in the deferred exchange regulations, because there was no "exchange agreement" (as defined in those regulations) at the time of the acquisition by A of the replacement property.

The TAM further concludes that A acquired the property as O's nominee or agent, and therefore that O became the owner of the replacement property for tax purposes before the relinquished property was transferred by O. After reiteration that the safe harbor for deferred exchanges involving qualified intermediaries did not apply to such a series of transactions, the TAM concluded that the steps did not otherwise qualify as an exchange under IRC Search7RH1031, because the circumstances did not demonstrate the requisite interdependence of steps and mutuality of intent between the parties to effect an exchange.

Observations

The transactions described in the TAM were clearly, as a technical matter, outside the scope of Rev. Proc. 2000-37. The brief statement of facts in the TAM does not, however, indicate any substantial difference between the actual circumstances and a series of transactions that, with appropriate documentation, could constitute a like-kind exchange within the scope of the safe harbor defined by the Revenue Procedure.

Thus, the TAM underscores the possibility that the IRS may attack transactions intended to qualify under IRC Search7RH1031 that generally follow one of the forms of parking transactions described above, but fail to meet all the requirements of the Revenue Procedure. However, the IRS position on such parking transactions is not yet clearly established, and it is easy to read too much into a solitary technical advice memorandum which may not be cited as precedent.

Also, it remains to be seen how the courts will rule, after the clarification of the IRS position through the Revenue Procedure, with respect to the applicability of IRC Search7RH1031 to quasi-reverse like-kind exchanges that are effected through parking transactions similar but not identical to those within the scope of the Revenue Procedure. The Revenue Procedure might undercut the ability of the IRS to challenge certain such transactions. It would be foolhardy to assume for planning purposes, however, that highly aggressive parking transactions which do not come within the safe harbor will be respected as exchanges.

Setting aside such concerns, the Revenue Procedure, by providing a safe harbor in an area of the law that was previously unsettled, is likely to open the door for many who would otherwise be precluded from engaging in like-kind exchanges.

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