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Reverse Exchanges Come of Age

The IRS approves a parking exchange technique.

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EXECUTIVE SUMMARY

- **PAST PROBLEMS WITH CERTAIN SECTION 1031** exchanges had led to the development of the reverse or "parking" exchange in which a third-party "warehouses" the new property until the taxpayer sells the existing property. Although the IRS didn't attack parking exchanges, questions about their validity remained unanswered until revenue procedure 2000-37.

- **WITH ITS ISSUANCE OF REVENUE PROCEDURE 2000-37 ,** the IRS ended a long debate and endorsed "reverse" exchanges on real estate and other investment assets. The rules established a safe harbor for these types of IRC section 1031 exchanges and offered guidance to CPAs on how to execute them.

- **THERE ARE TWO WAYS TO STRUCTURE A PARKING** exchange. The most common is the "exchange last" technique in which the parking entity buys the desired replacement property first and sells it to the taxpayer later. Under the less common "exchange first" technique, the taxpayer temporarily parks the property to be relinquished with the warehousing entity and then buys the replacement property.

- **THE IRS GUIDANCE CREATED NEW TERMINOLOGY,** offered specific requirements and approved a number of steps in a successful parking exchange. To be covered under the safe harbor, an exchange must include a number of written elements and be completed within 180 days to receive automatic protection.

- **REVENUE PROCEDURE 2000-37 ALSO ANSWERED SOME** lingering questions about the burdens and benefits of ownership and settled agency issues that had long troubled CPAs. The IRS specifically said the entity performing the parking service may be the same entity that performs the qualified intermediary function.

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he long-standing debate is over. With the advent of revenue procedure 2000-37, the IRS has finally endorsed what are commonly called "reverse" exchanges on real estate and other investment property. Effective September 15, 2000, this pronouncement established a safe harbor for these types of IRC section 1031 tax-deferred exchanges and provided a relatively clear road map for CPAs to help clients execute them safely.

Recent Developments

- Revenue procedure 2000-46.
- Revenue procedure 2000-37.
- Private letter ruling 200111025.
- Private letter ruling 200109022.
- Private letter ruling 200027028.

- *Donald DeCleen* v. *Commissioner,* 115 T.C. no. 34.
- *J. Clark Bundren* v. *Commissioner,* T.C. Memo 2001-2.
- Technical advice memorandum 200039005.

Real estate investors have long recognized the benefits of section 1031 exchanges, which include postponing the tax due on the transfer until the taxpayer sells the replacement property. Most exchanges today are done on a delayed basis, meaning the sale of the existing property and the acquisition of a new one take place at different times. Under a reverse or “parking” exchange, an unrelated third party (sometimes called a parking entity or qualified intermediary) acquires and “warehouses” the replacement property until the investor sells the original property and is free to purchase the parked property from the third party. Reverse exchanges have no special tax benefits; they simply offer taxpayers a transaction option they might otherwise lose because of timing. (For a primer on deferred exchanges, see “Beyond Section 1031,” *JofA* , Jul.00, page 61.) With the IRS signaling its desire that parking exchanges be clearly documented, executed and reported, it’s important that CPAs understand the new rules found in revenue procedure 2000-37.

A HISTORY OF PARKING EXCHANGES

Although delayed exchanges are more popular, simultaneous exchanges are still done on rare occasions if all the steps fall into place. With the delayed method, a taxpayer first sells the so-called relinquished property and then acquires a replacement property within 180 days. A qualified intermediary does the required paperwork and holds the sale proceeds. Although the IRC does not specifically mention this forward order, it certainly is implied. The expanded section 1.1031 regulations the Treasury Department issued in 1991 neither endorsed nor condemned reverse exchanges; rather, the prelude simply stated the regulations did not apply to reverse exchanges, with no further comment.

In the past, some taxpayers attempting section 1031 exchanges abandoned the process when unforeseen events made a forward exchange (where the relinquished property is sold first) impossible. This was mostly because CPAs saw few safe options for completing the transaction if the taxpayer acquired the replacement property before selling the relinquished property. This dearth of options led to the development of reverse or parking exchanges. See exhibit 1, below, for an example.

Exhibit 1: Reverse or Parking Exchange

Tom and Mary Fitzgerald have put their investment property on the market with a broker who expects to find a buyer within 6 months. Two weeks after listing the property, the Fitzgeralds find a unique replacement property that matches their future goals and objectives. They contact the seller, submit a full price offer with a 150-day closing date contingent on the sale of their current property. The seller agrees to the price, but counters with a 60-day closing. Although the Fitzgeralds really like the property, the timing doesn’t meet the requirements of the easier-to-complete normal delayed exchange.

The Fitzgeralds turn to their CPA for help. She recommends a reverse or parking exchange technique that uses a separate parking entity to acquire and hold the replacement property. Once the Fitzgeralds close the sale of their current property, they will buy the replacement property from the parking entity. Their accountant counsels that using a parking exchange will allow them to capture the desired property and still complete the exchange in the correct order, deferring any tax due indefinitely under the section 1031 rules for like-kind exchanges.

Historically, the concerns some CPAs had about parking arrangements were twofold:

- A lack of direct IRS approval.
- Doubts about whether the parking entity really had the full “burdens and benefits” of property ownership that make for a real-world transaction.

Although the IRS showed no interest in attacking these exchanges, some CPAs initially felt uncomfortable giving assurance about their validity. Because the taxpayers involved in parking exchanges often lent money directly to the third-party parking the property or offered personally guaranteed loans to fund the acquisition, some CPAs were concerned about whether the transactions were truly arms-length. If the exchange lacked true substance, the IRS might have a good reason to consider it a tax avoidance scheme or could argue the parking entity was really the taxpayer’s agent, invalidating the exchange.

Over time, when the IRS didn’t question parking exchanges, more CPAs became comfortable with the approach. Yet despite their increased use and popularity, parking exchanges remained questionable. In an attempt to give some direction, the IRS published revenue procedure 2000-37 in September 2000. The ruling outlines appropriate steps and requirements taxpayers must follow to complete a parking exchange.

WHY A PARKING EXCHANGE?

Parking exchanges have become popular for a number of reasons. (See exhibit 2, below, for a detailed list.) Most involve the timing of the transaction. Typically, either the current owner of the targeted replacement property wants to close before the client can sell the relinquished property or a planned closing is delayed. Investor preference also makes this type of exchange popular. By using a parking exchange, a taxpayer who is uncertain of whether to sell an attractive property can take more time to look for and secure a desirable replacement. This added flexibility appeals to investors in today's fast-paced real estate market.

Exhibit 2: Reasons for Executing Parking Exchanges

■ **An investor wants to find the perfect replacement property before agreeing to sell his or her existing property.**

A taxpayer receives an unsolicited offer on a property. Although the offer is attractive, the taxpayer fears it will be difficult to find suitable replacement property in a relatively short time. If the taxpayer cannot locate an ideal replacement quickly, he or she may not be able to comply with the 45-day identification rule necessary to complete a tax-deferred exchange. Before accepting the offer, the taxpayer can decide to search for the perfect replacement property and "capture" it using a parking exchange.

■ **A taxpayer actively marketing his or her relinquished property discovers the ideal replacement property. The seller insists on a quick closing, but the taxpayer's existing property is not yet under contract.**

Many times the seller of the perfect replacement property wants an immediate closing date that falls before the relinquished property can reasonably be sold. To complete a standard delayed exchange, the taxpayer may have to accept a lower price than if more time was allowed. If the seller won't extend the closing date, a parking exchange may be the best solution.

■ **The closing on the relinquished property is delayed past the planned replacement property closing or the sale falls apart.**

A taxpayer is executing a delayed exchange. The date of the replacement property acquisition is scheduled for several weeks after the relinquished property sale. At the last minute, that sale is cancelled. If the taxpayer is contractually compelled or still wants to close and use the new property as the future replacement property, a parking exchange may be the perfect option.

■ **Construction of the replacement property will take longer than the 180-day acquisition period.**

The taxpayer wants to build the replacement property, but the timeline from lot acquisition to having improvements in place that equal the desired replacement value exceeds 180 days. The lot needs to be acquired and construction started on the replacement property well before the sale of the relinquished property. A taxpayer can use what is commonly called a non-safe-harbor "reverse construction" exchange to complete the transaction.

Parking exchange methods. There are two ways to structure a parking exchange. The first and most common is the "exchange last" technique. It addresses the need to gain possession of the desired replacement property first and sell it to the taxpayer later. The second and less common method is the "exchange first" technique whereby the taxpayer temporarily parks the relinquished property. Although this technique is more difficult, it can sometimes be used to satisfy lender concerns.

Example. Susan Andrews has scheduled her replacement property closing for one week after closing on the property she is giving up. Due to a financing problem, the sale of the relinquished property cannot be completed as planned. Andrews has spent considerable time and money in due diligence and has nonrefundable earnest money at risk on her replacement property. Her bank loan on the new property is not subject to selling the old property. What can Susan do to protect her investment? The exchange last technique, in which a parking entity acquires and warehouses her targeted replacement property would be one option, but a new problem arises when the bank refuses to substitute the parking entity for the original borrower, given the short time until closing.

With her replacement property financing in question, Andrews opts to try the exchange first technique. Almost simultaneously, she conveys the relinquished property to the parking entity and then acquires the replacement property, completing the exchange. The parking entity then has 180 days to sell the relinquished property to complete the transaction. Because of the additional market and valuation risk, this is usually not the preferred way to structure a parking exchange.

REVENUE PROCEDURE 2000-37

With this guidance, the IRS created a safe harbor for parking transactions. The revenue procedure added new terminology (see exhibit 3, below), offered specific requirements and approved a number of steps on the road to a successful parking exchange.

Exhibit 3: New Vernacular–Revenue Procedure 2000-37

AT. Exchange accommodation title holder. Often referred to in practice as a parking entity, special purpose entity or single purpose entity.

QEAA. Qualified exchange accommodation agreement. The written exchange agreement between the taxpayer and the AT.

QIO. Qualified indicia of ownership. The AT must actually have title to the property and have the burdens and benefits of ownership commonly associated with land contracts or contracts for deed or own 100% of the membership interest in an entity whose sole asset is the property.

Mandatory written elements. To be covered under the safe harbor protections, the taxpayer must enter into a written agreement—referred to as the qualified exchange accommodation agreement or QEAA—within five business days of the date the exchange accommodation title holder (AT) first acquires the parked property. This agreement must state that the

■ Taxpayer has a bona fide intent to use the parked property to complete a section 1031 tax-deferred exchange.

■ AT holds title or qualified indicia of ownership (QIO) to the property to facilitate a section 1031 tax-deferred exchange and to comply with revenue procedure 2000-37.

■ AT will be treated as the beneficial owner of the parked property for all federal income tax purposes.

Other requirements. The IRS guidance also requires that

■ The exchange must be completed *within 180 days* to receive the automatic safe-harbor protection. The clock begins either when the AT receives the target replacement property (in the exchange last technique) or when the taxpayer transfers the relinquished property to the AT (in an exchange first scenario).

■ An identification letter is due within 45 days of the initial closing. If the replacement property is being warehoused, the taxpayer must identify the relinquished property to be sold within 45 days of the date the AT took title to the parked property.

■ A tax return must be filed. Although most professional service providers have taken the position the entity providing the parking function must file the returns, the revenue procedure makes this step mandatory. In addition, the AT may have to depreciate certain parked properties even if it acquired and transferred the properties in the same tax year.

■ The AT cannot be the taxpayer or a "disqualified person" as defined in Treasury regulations section 1.1031. (See the sidebar at the end of this article for guidance on selecting an AT.)

OTHER APPROVED ACTIONS

With revenue procedure 2000-37, the IRS took a rather liberal approach in answering some lingering questions about the "burdens and benefits" of ownership and the "agency" issues that had long troubled CPAs (see exhibit 4, below, for a list.) The IRS specifically said the entity performing the parking service may be the same as the entity performing the qualified intermediary function. With this measure, the IRS effectively dispelled any remaining concerns about agency —whether the qualified intermediary is acting as the taxpayer's agent.

Exhibit 4: Approved Actions in a Parking Exchange

In revenue procedure 2000-37, the IRS cleared up many of the concerns CPAs had about agency and the burdens and benefits of property ownership.

■ The AT does not have to have an equity investment in the transaction.

■ The AT does not have to guarantee any debt incurred in the exchange; the taxpayer may guarantee any loans.

■ The taxpayer may loan required funds to the AT.

■ The taxpayer can indemnify the AT against any costs or expenses associated with the exchange transaction.

■ The AT can delegate the operation or management of the parked property (either replacement or relinquished) to the taxpayer under a management or lease agreement.

■ The AT does not have to profit from the transfer of the parked property to the taxpayer, nor does it have to bear any significant risk of loss.

■ The AT may hire the taxpayer to supervise the construction of improvements to the property.

■ The AT can sell the parked property to the taxpayer based on a fixed-price formula.

Previously, certain qualified intermediary companies set up a separate entity (either an LLC or a corporation) to perform the parking function. This newly formed company acted as the warehousing entity, while the established company performed the QI function independently. Besides answering the agency concern, this technique protected the taxpayer from any unrelated litigation or other actions that might affect the intermediary. (For the same reason, it's still important for the professional service provider not to use the same entity to hold property for different exchanges or even to recycle a holding entity once a parking exchange is complete.)

Parking exchanges outside the safe harbor. While the new pronouncement expanded exchange possibilities by providing a safe harbor for a specific parking technique, it also limited the time frame for completion to 180 days. This limitation is particularly important for hybrid non-safe-harbor "reverse construction" exchanges. In this type of transaction, the parking entity acquires a lot on which the taxpayer makes improvements. Typically the time necessary to build the needed improvements (particularly in large commercial transactions) easily exceeds 180 days and falls outside the safe harbor. The IRS addressed this concern clearly in revenue procedure 2000-37, stating that it "recognizes that parking transactions can be accomplished outside the safe harbor provided in this revenue procedure." While the IRS underscored this fact, it did not list specific standards. If the parking exchange is not complete in 180 days (and consequently falls outside the safe harbor), what might lead the IRS to conclude the parking entity is actually the taxpayer's agent, invalidating the exchange? Lacking a clear answer, the troubling issues of agency and the burdens and benefits of ownership arise again and CPAs should consider them for transactions that fall outside the safe harbor.

STEP BY STEP

Although the safe-harbor guidelines for parking exchanges are more liberal than expected, the IRS is clear in its desire to have the steps in such exchanges documented, executed and reported. By blessing certain steps in these types of exchanges, the IRS has quelled the uncertainty and given taxpayers more flexibility when executing a tax-deferred exchange. Despite the 180-day time limit to complete the transaction from start to finish, the fact that the IRS now sanctions reverse exchanges should increase their popularity. ■

Choosing an AT

A taxpayer who must arrange to have a property parked might consider a number of individuals or entities to provide the service. However, not all parties are eligible—or appropriate. For instance, the taxpayer cannot use an entity he or she controls [as defined in IRC sections 267(b) and 707(b)] because it will be considered a related party. Revenue procedure 2000-37 specifically prohibits the use of a disqualified party, as defined in Treasury regulations section 1.1031. Generally speaking, this includes a taxpayer's CPA, attorney, investment banker, real estate broker, family member or an entity the taxpayer controls. Although a trusted friend is a possibility, this choice may lead to a different set of problems. A friend's assets might be frozen because of divorce or bankruptcy. Or a friend could have an IRS lien that would attach to the property, be sued for other reasons or die unexpectedly. Although these events may appear unlikely, the possibilities must be considered.

Because of these limitations, a professional service provider is usually the best choice to perform this function. The most common sources for parking services are real estate or tax attorneys, certain CPAs and qualified intermediary companies. The Federation of Exchange Accomodators (www.1031.org) is a good source of independent referrals.

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