# *1031 Exchanges: The Basics and Beyond*

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Disclaimer: The views expressed herein are not a legal opinion. Every fact situation is different, and the reader is encouraged to seek legal advice for their particular situation.

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# *About the Presenter*

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Managing Director & General Counsel, Accruit, LLC

Marty joined Accruit, LLC as a result of the merger into Accruit of North Star Deferred Exchange LLC, which Marty founded in 1998. Marty brings over 35 years' experience in the field tax deferred exchange administration.  A 1977 graduate of the American University Washington College of Law in Washington, D.C., Marty has written and spoken extensively on the subject of tax deferred exchanges.

Marty's publications include "Tax-Free Exchange of Real Estate" (*Real Estate Financing.* Matthew Bender & Company, 2004), *Land Trust Administration* (IICLE, 1999) and *Kenoe on Land Trusts* (IICLE, 1999). His articles have appeared in professional publications including the American Bar Association's *The Compleat Lawyer*, Women's Council of Realtors' *Communiqué*, Illinois State Bar Association's *ISBA Real Property Newsletter*, Chicago Bar Association's *Real Property Law Communicator*, and DuPage County Bar's *DCBA Brief*. Marty's articles have also appeared in various journals including the *Real Estate Finance Journal*, *World Leasing News, Vehicle Leasing Today*, *Fleet Financials*, *Franchise Handbook*, *Franchise Opportunities Journal* and *Equipment Leasing Today*. Marty has lectured at events sponsored by the National Business Institute, Business Enterprise Institute, the national McDonald's CPA Conference, Illinois State Bar Association, Illinois Banker Association, Office of the Illinois Commissioner of Banks and Real Estate, Illinois Institute for Continuing Legal Education, Community Investment Corporation, PricewaterhouseCoopers, BDO Seidman, Chicago Bar Association, Cantor Fitzgerald, Realogy and others.

Marty is a Certified Exchange Specialist through the Federation of Exchange Accommodators. Marty is a member of the Illinois Real Estate Lawyers Association and the Northern Illinois Commercial Association of Realtors.

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# Course Description

## *Course Presentation*

This course provides an in-depth examination of the process and procedure of 1031 Exchanges, the rationale behind the continuity of investment, and tax deferral.

This course provides a fundamental overview of the process and procedure of managing 1031 Exchanges, nonrecognition of gain or loss from exchanges in kind, exceptions and requirements, gains and losses from exchanges not in kind, exchanges of livestock, and special rules.

This course provides practical guidance and a discussion on best practices regarding 1031 Exchanges, the most basic transaction of a two-party simultaneous exchange, the three-party simultaneous exchange, and the commonly encountered delayed or deferred exchanges.

This course explores the complex issues and presents potential solutions to the legal and factual situations that arise, such as the property identification rules, the necessity to identify replacement property, understanding of the identification and receipt rules, the parking exchanges and determining which property to park, and using exchanges to build on vacant property or improving existing property.

This course will provide a comprehensive overview of the laws and strategic considerations when managing 1031 Exchanges, such as reverse exchanges on occasion the facts are such that a taxpayer must acquire the new property prior to the sale or risk losing the desired new property, or the build-to-suit or improvement exchange, which refers to a type of exchange done where some of the proceeds of the relinquished property will be used to cause improvements to be added to the existing property or to the vacant land.

This course provides a base of skills, knowledge and perspectives regarding 1031 Exchanges, the non-safe harbor reverse exchanges and their requirements, the current exchange regulations involving safe harbor provisions, the qualified escrow and qualified trust accounts, the qualified intermediary safe harbor, and the interest and growth factor safe harbor.

This course provides an intellectual foundation and introduces a set of learning skills essential for success in the legal profession and for life beyond. The course will provide opportunities for careful reading, for creative and critical thinking, for oral and written communication, and for engaging with others in a shared conversation about stimulating material.

## *Course Material*

This material is intended to be a guide in general and is not legal advice. If you have any specific question regarding the state of the law in any particular jurisdiction, we recommend that you seek legal guidance relating to your particular fact situation.

The course materials will provide the attendee with the knowledge and tools necessary to identify the current legal trends with respect to these issues. The course materials are designed to provide the attendee with current law, impending issues and future trends that can be applied in practical situations.

## Course Learning Objectives and Outcomes

This course is designed to provide the following learning objectives:

The ability to understand the relevant state and federal law related to 1031 Exchanges.

The ability to understand the duties, roles and responsibilities of counsel in situations involving real estate exchange such as trade, investment, or use in a business to defer capital gains tax, depreciation recapture, state tax, and Net Investment Income Tax on the sale.

The ability to recognize and describe the variety and terminology associated with the 1031 Exchange transactions not specifically covered by the Internal Revenue Code, the exceptions and requirements that apply to exchanges, certain dispositions not taken into account, special rules for exchanges such as those between related persons or where a substantial diminution of risk is present, and foreign real and personal property.

The ability to identify and distinguish between the two-party simultaneous exchange involving two taxpayers who swap property with one another, the three-party simultaneous exchange where only one of the parties wishes to do an exchange and the second party has no property to transfer to the exchanger, and delayed or deferred exchanges where the taxpayer sells to the party of choice and has to identify in writing the potential replacement properties to acquire one or more of the properties identified.

The ability to understand, discuss and implement practice tips to improve an attorney's practice and provide improved representation to clients related to 1031 Exchanges.

Participants will develop an understanding of reverse exchanges, where the exchanges must be done in the proper sequence and embark on a more complicated task than a properly sequenced forward transaction, and build-to-suit or improvement exchanges, where some of the proceeds of the sale of the relinquished property will be used to cause improvements to be added to the existing property or adding improvements to the vacant land.

Participants will learn to critically evaluate and analyze non-safe harbor reverse exchanges where the deals are required to wrap up within 180 days from the inception, which may not always be practical to complete within that limited time frame in the real world, especially in the case of significant new constructions.

Participants will practical gain skills in the area of current exchange regulations, such as the safe harbor provisions and why they are needed, the qualified escrow and qualified trust accounts that ensure availability of funds while not putting the taxpayer in any sort of receipt of them, the qualified intermediary safe harbor which is the most substantive safe harbor and constitutes one of the most significant portions of the 1991 treasury regulations, and the interest and growth factor safe harbor that provides for the taxpayer's receipt of interest or some other type of yield (growth factor) on the deposit.

Participants will gain understanding of property identification and other rules, why it is necessary to identify the replacement property as a direct result of the *Starker* case, and the various identification and receipt rules and requirements, as well as the parking exchanges such as the 1031 Reverse Exchange.

Upon completion of the course, participants should be able to apply the course material; improve their ability to research, plan, synthesize a variety of sources from authentic materials, draw conclusions; and demonstrate an understanding of the theme and concepts of the course by applying them in their professional lives.

## Timed Agenda:

**Presenter Name: Martin S. Edwards**

**CLE Course Title: 1031 Exchanges: The Basics and Beyond**

| **Time Format (00:00:00 - Hours: Minutes: Seconds)** | **Description** |
|---|---|
| 00:00:00 | ApexCLE Company Credit Introduction |
| 00:00:20 | 1031 Exchanges: The Basics and Beyond |
| 00:00:32 | CLE Presenter Introduction |
| 00:01:10 | Rationale for Tax Deferral for Sale of Real Estate |
| 00:03:40 | Benefits of Exchanging |
| 00:08:02 | Historical Structures/Evolution of Concept |
| 00:09:28 | Two Party Simultaneous Exchanges |
| 00:12:13 | Starker v. U.S., 602 F.2d 1341 (9th Cir. 1979) |
| 00:19:01 | Safe Harbors Provisions |
| 00:22:33 | The Qualified Escrow and Qualified Trust Account |
| 00:24:44 | The Interest and Growth Factor Safe Harbor |
| 00:26:54 | The Qualified Intermediary Safe Harbor |
| 00:33:37 | Property Identification Rules and Other Rules |
| 00:36:33 | The 200 Percent Rule |
| 00:41:58 | Drop and Swap |
| 00:46:10 | Parking Exchanges |
| 00:47:51 | Determining which Property to Park |
| 01:02:40 | Presenter Closing |
| 01:03:02 | ApexCLE Company Closing Credits |
| 01:03:07 | End of Video |

# 1031 Exchanges: The Basics and Beyond

## Part One – Introduction of the Subject

### Rationale for Tax Deferral for Sale of Real Estate

Many people are surprised to learn that Section 1031 first made its way into the tax code in 1921. This was based on a belief by Congress that when someone swaps property with someone else and takes no cash out of the deal, there is no basis for assessing or collecting a tax. So, if a farmer traded some farmland with another for equal value, at the end of the day, each ended up with essentially what he had before. This was, and is, considered a continuity of investment. It wasn't relevant what each paid originally for the property (the property basis). Since the properties were not usually of equal value, some cash was usually necessary to equalize values. Then, as well as now, the receipt of the cash did not constitute the receipt of "like-kind property" and therefore was subject to tax. These exchanges took place directly between two persons, and the property exchanges were simultaneous. Below is the simple language from the IRS Code providing for such tax deferral:

> "In general, no gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment". (IRC Code § 1031)

### Benefits of Exchanging

Owners of real estate that is held for trade, investment purposes or use in a business are generally able to defer capital gains tax, depreciation recapture, state tax, (in most states), and Net Investment Income Tax (NIIT) also known as Medicare Surtax, if applicable, on the sale if they perform an exchange and adhere to the applicable Treasury Regulations. (https://www.accruit.com/sites/default/files/Internal%20Revenue%20Service%20Regulations%20IRC%20Section.pdf)

By utilizing a 1031 exchange, taxpayers use that portion of the sales proceeds that they would otherwise pay to the government to potentially acquire more valuable property. Taxpayers may consolidate or diversify their real estate holdings through an exchange by going from one property to many or many to one. Estate planning advantages are also available in an exchange because a property owner's heirs receive a stepped-up basis in the real estate upon death with the way the law is currently drafted. Some persons use exchanges due to their own relocation; to use appreciation to exchange into something with more cash flow and may also exchange into something using more leverage to produce more cash flow and; to convert non-depreciable property to depreciable. Taxpayers may use exchange funds toward construction of improvements that are incorporated and made a part of the real estate during the 180-day exchange period window in an improvement/build-to-suit exchange as set forth in Rev. Proc. 2000-37. (https://www.irs.gov/pub/irs-drop/rp-00-37.pdf)

For persons who might be wishing to stop dealing with management headaches, there are even popular passive investments in real estate that generate a rate of return without the management obligations associated with owning investment property. (https://www.accruit.com/blog/delaware-statutory-trusts-1031-exchange-investments).

## Historical Structures/Evolution of Concept

There are many types of conventional 1031 exchanges. There are also a lot of exchange-related transactions not specifically covered by Internal Revenue Code. The variety and the terminology associated with the transactions can be confusing to taxpayers.

### I. Title 26, Subtitle A, Chapter 1, Subchapter, O, Part III, Section 1031

(a) **Nonrecognition of gain or loss from exchanges solely in kind** (1) **In general**

No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

(2) **Exception**

This subsection shall not apply to any exchange of—

(A) stock in trade or other property held primarily for sale

(B) stocks, bonds, or notes

(C) other securities or evidences of indebtedness or interest

(D) interests in a partnership

(E) certificates of trust or beneficial interests, or

(F) choses in action

For purposes of this section, an interest in a partnership which has in effect a valid election under section 761 (a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

(3) **Requirement that property be identified, and that exchange be completed not more than 180 days after transfer of exchanged property**

For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if—

(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(B) such property is received after the earlier of—

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

(b) **Gain from exchanges not solely in kind**

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) **Loss from exchanges not solely in kind**

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) **Basis**

If property was acquired on an exchange described in this section, section 1035 (a), section 1036(a), or section 1037 (a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035 (a), section 1036(a), or section 1037 (a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035 (a), and section 1036 (a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357 (d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.

(e) **Exchanges of livestock of different sexes**

For purposes of this section, livestock of different sexes are not property of a like kind.

(f) **Special rules for exchanges between related persons**

(1) **In general**

If—

(A) a taxpayer exchanges property with a related person,

(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

(C) before the date 2 years after the date of the last transfer which was part of such exchange—

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer,

there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

(2) **Certain dispositions not taken into account**

For purposes of paragraph (1)(C), there shall not be taken into account any disposition—

(A) after the earlier of the death of the taxpayer or the death of the related person,

(B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or

(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

(3) **Related person**

For purposes of this subsection, the term "related person" means any person bearing a relationship to the taxpayer described in section 267 (b) or 707 (b)(1).

(4) **Treatment of certain transactions**

This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

(g) **Special rule where substantial diminution of risk**

(1) **In general**

If paragraph (2) applies to any property for any period, the running of the period set forth in subsection (f)(1)(C) with respect to such property shall be suspended during such period.

(2) **Property to which subsection applies**

This paragraph shall apply to any property for any period during which the holder’s risk of loss with respect to the property is substantially diminished by—

(A) the holding of a put with respect to such property

(B) the holding by another person of a right to acquire such property or

(C) a short sale or any other transaction

(h) **Special rules for foreign real and personal property**

For purposes of this section—

(1) **Real property**

Real property located in the United States and real property located outside the United States are not property of a like kind.

(2) **Personal property**

(A) **In general**

Personal property used predominantly within the United States and personal property used predominantly outside the United States are not property of a like kind.

(B) **Predominant use**

Except as provided in subparagraphs (C) and (D), the predominant use of any property shall be determined based on—

(i) in the case of the property relinquished in the exchange, the 2-year period ending on the date of such relinquishment, and
(ii) in the case of the property acquired in the exchange, the 2-year period beginning on the date of such acquisition.

(C) **Property held for less than 2 years**

Except in the case of an exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection—

(i) only the periods the property was held by the person relinquishing the property (or any related person) shall be taken into account under subparagraph (B)(i), and

(ii) only the periods the property was held by the person acquiring the property (or any related person) shall be taken into account under subparagraph (B)(ii).

(D) **Special rule for certain property**

Property described in any subparagraph of section 168 (g)(4) shall be treated as used predominantly in the United States

## II. Two Party Simultaneous Exchanges

The most basic of all 1031 transactions, the two-party simultaneous exchange involves two taxpayers who swap property with one another. To the extent one must add cash to make up for a difference in value, the receipt of the cash by the other party is non "like-kind" property and therefore taxable to the recipient. In exchange vernacular the receipt of property which is not like-kind, in this example cash, and therefore taxable is referred to as "boot".

Taxpayers doing a direct two-party simultaneous exchange do not necessarily need to use an exchange company facilitator provided the contracts are prepared properly and the transaction is closed as an exchange rather than simply a sale and a purchase. Some persons elect to close these deals using an exchange company and to follow the rules for delayed (non-simultaneous) exchanges in order to benefit from the "safe harbor" as to structure that is set forth in the rules. In fact, recognizing that persons may wish to apply these rules to simultaneous exchanges, the preamble to the exchange Regulations provide:

> *"The rules in the proposed Regulations, including safe harbors, apply only to deferred (delayed) exchanges. Commentators noted that the concerns relating to actual or constructive receipt and agency also exist in the case of simultaneous exchanges. They requested that the safe harbors be made available for simultaneous exchanges. Upon review, the Service has determined it necessary to make only the qualified intermediary safe harbor available for simultaneous exchanges. The final Regulations provide, therefore, that in the case of simultaneous transfers of like-kind properties involving a qualified intermediary, the qualified intermediary will not be considered is the agent of the taxpayer for purposes of section 1031 (a). Thus, in such a case the transfer and receipt of property by the taxpayer will be treated as an exchange".*

## Three Party Simultaneous Exchanges

Most of the points related to a two-party simultaneous exchange apply to this type of exchange as well. The primary difference with this type of exchange is that only one of the parties wishes to do an exchange and the second party has no property to transfer to the exchanger. However, the parties arrange so a third-party seller of a target property is identified. The second party buyer acquires the target property from the third party and exchanges that property with the taxpayer to enable the taxpayer to complete their exchange. This type of transaction also closes simultaneously with all parties at the closing table. As a practical matter this is how exchanges were done until the decision in the Starker Case (*Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979)) changed everything.

## Delayed or Deferred Exchange

These types of exchanges are by far the most common. Here the taxpayer sells to the party of choice and has 45 days to identify in writing potential replacement property(ies) and 180 days (sometimes earlier based on the due date for tax return filing) to acquire one or more of the properties identified. This type of transaction is covered by the exchange Regulations and requires the use of a "qualified intermediary." This party, usually an exchange company, acts as a middleman (hence the term intermediary) between the taxpayer, the buyer, and the third-party seller. For tax purposes, if the taxpayer sold to the buyer through the intermediary and bought from the seller through the intermediary an exchange occurred between the taxpayer and the intermediary. Essentially the qualified intermediary took the place of the buyer as the party with whom the taxpayer exchange properties. Unlike the prior types of exchanges, the sale of the old property and the acquisition of the new property are not simultaneous. (See: https://www.accruit.com/blog/what-1031-exchange-infographic).

In addition, the exchange Regulations require that during the period between the sale and the purchase, the proceeds of the sale, i.e., the exchange funds, be held outside the actual or constructive receipt of the taxpayer. This can be accomplished in several ways, however the most common and simplest is to have the qualified intermediary hold the funds for the benefit of the client. If replacement property is not identified or is identified but not all funds are used for acquisition, all or a portion of the exchange funds are returned to the taxpayer. There are some restrictions on the ability of the qualified intermediary to return funds prior to the 45-day identification period, or if property is actually identified, the 180-day exchange period. (See Private Letter Ruling PLR200027028).

One way to receive funds early is based on the failure to acquire the property based on a contingency built into the Purchase Agreement, more specifically:

(B) The occurrence after the end of the identification period of a material and substantial contingency that - (1) Relates to the deferred exchange, (2) Is provided for in writing, and (3) Is beyond the control of the taxpayer and of any disqualified person (as defined in paragraph (k) of this section), other than the person obligated to transfer the replacement property to the taxpayer. (Reg § 1.1031(k)-1(g)(6)(iii)).

Typical examples are having a contract contingent on a zoning variance or obtaining a liquor license.

## III. Reverse Exchanges

Under the exchange Regulations, exchanges must be completed in the proper sequence. This means the sale of the relinquished property must take place prior to the acquisition of the new or replacement property. However, on occasion the facts are such that a taxpayer must acquire the new property prior to the sale or risk losing the desired new property. This reverse sequence is often referred to as a “reverse exchange.” The acquisition of the replacement property is reverse from that of a conventional exchange. Since exchanges must be done in the proper sequence, embarking on this type of transaction is more complicated than a properly sequenced forward transaction.

In September 2000 the IRS issued a Revenue Procedure providing a means of effectively tying up the new property without running afoul of the 1031 exchange Regulations. The reverse exchange technique, which is really a title “parking” arrangement, essentially consists of the exchange company affiliate, referred to in the Rev. Proc. as an Exchange Accommodation Titleholder (“EAT”) taking title to the new property on behalf of the taxpayer to avoid the taxpayer acquiring that property prior to selling the old property. Immediately after the sale of the old property through a conventional forward exchange (but no later than 180 days), the exchange company affiliate transfers the new property to the taxpayer. This technically creates the proper sequence.

The second similar technique is also available under the revenue procedure. This entails a sale on paper of the old property to the exchange company affiliate. Immediately after the sale the taxpayer acquires the replacement property. Again, this creates the proper sequence. The taxpayer and exchange company affiliate have 180 days to find a true buyer of the old property and the buyer’s funds make everyone whole.

## IV. Build-to-Suit or Improvement Exchange

This refers to a type of exchange done where some of the proceeds of the sale of the relinquished property will be used to cause improvements to be added to existing property or adding improvement to vacant land. In either case, the taxpayer can complete the trade where both the value of the land and of the enhanced improvements will count for the amount the taxpayer traded for. For example, a taxpayer may put in new heating, ventilating, air conditioning, roof, and windows on the property. These types of exchanges are structured pursuant to IRS Rev. Proc. 2000-37, Revenue Procedure, and are sometimes known as "property parking exchanges" and require the exchange facilitator to take on an additional role as a Qualified Exchange Accommodation Titleholder (an "EAT"), similar to a reverse exchange for replacement property, except here the accommodator is improving property while holding it.

Since exchanges must be "like-kind" exchanges of real estate, once the taxpayer takes ownership of the new property, any value of improvements completed is considered payment for labor and materials which is not real property and therefore not considered like-kind. This problem can be overcome with a technique which is essentially a reverse exchange.

More specifically, the exchange company affiliate can take title to the replacement property on behalf of the taxpayer and cause the desired improvements to be made while under ownership of the exchange company affiliate. Upon the earlier of 180 days or the completion of the improvements the entire value of the real property and improvements is conveyed directly to the taxpayer to complete their exchange.

# Non-Safe Harbor Reverse Exchanges

The types of reverse and construction exchanges referenced to this point are creatures of the Revenue Procedure which outlines the safe harbor requirements for such transactions. Among other requirements of the safe harbor as to structure, the deals are required to wrap up within 180 days from the inception. However, in the real world it is not always practical to complete such transactions within that limited time frame. Especially in the case of significant new construction there are many reasons why the improvements cannot be in place in time to adhere to that short period of time.

However, dependent on circumstances, there may be a window of opportunity to do reverse or construction type exchanges for a longer period. While there are no IRS rules explicitly allowing this longer structure, there are various cases and rulings which provide a basis for these transactions. Further the safe harbor Revenue Procedure tacitly acknowledges that these deals may take place even though not explicitly covered in the Revenue Procedure.

Section 3.02 of the Revenue Procedure states:

> "Further, the Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in this revenue procedure. Accordingly, no inference is intended with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the safe harbor provided in this revenue procedure…".

These are generally significant sized properties, and the transactions are usually quite complicated. The taxpayer is best served if he/she has knowledgeable professional advisers and can find an exchange company experienced in all the nuances of structuring such transactions to provide the best chance to pass muster if ever scrutinized by the IRS.

# II. Part Two - Current Exchange Regulations

## Safe Harbors Provisions

Purchases of real estate are often among the biggest financial decisions a person makes during his or her lifetime. It would be foolhardy to make such an investment without title insurance. Likewise, selling a property and buying a new one as part of a like-kind exchange is a significant investment. The IRS offers taxpayers some "exchange insurance" via the safe harbors. Although the regulations state that an exchange does not necessarily need to adhere to the safe harbors to be valid, by staying within the safe harbors the IRS is providing to the taxpayer the assurance that the transaction will not be challenged in any way regarding the structure.

## What are safe harbors and why are they needed?

The 1991 tax deferred exchange regulations provided for various "safe harbors" to allow certain specific actions set forth in the regulations to be utilized by parties without otherwise running afoul of the rules. Without the safe harbors, these actions would disqualify an exchange. These safe harbors were put into the regulations as solutions for problems in the mechanics of an exchange prior to the 1991 regulations and to make a delayed exchange easier to accomplish. Some of these safe harbors have come to be used in almost every single transaction, while others are seldom used.

## The Security or Guaranty Arrangement Safe Harbor

Most exchanges are done on a delayed basis. In other words, the relinquished property is sold on a certain date and the replacement property is acquired up to 180 days later. A taxpayer is not allowed to exercise any actual receipt or constructive receipt of the exchange funds paid by the buyer at the time of the sale. If the taxpayer did have any control, then the transaction would be deemed to be a sale followed by an unrelated purchase, but not an exchange of one for the other. The idea here is that the buyer does not pay the seller/taxpayer, rather the buyer is promising once the seller is ready to purchase a replacement property that the buyer will come up at that time with the funds to be applied towards the purchase of the selected property.

So, the safe harbor that was meant to deal with this problem allows a taxpayer to secure the buyer's obligation to acquire and transfer the replacement property at the time the taxpayer has picked it out and is ready to receive it. More specifically, the taxpayer is allowed to receive security for that contractual obligation in the form of a mortgage/deed of trust or a standby letter of credit in favor of the taxpayer. The regulations further allow for the buyer's legal promise to be secured by a guarantee of a third party. In the event a mortgage/deed of trust is utilized, the secured property can be the taxpayer's relinquished property that is being sold to the buyer or an unrelated property that is owned by the buyer.

## The Qualified Escrow and Qualified Trust Account

Ensuring that a taxpayer is not in actual or constructive receipt of sale proceeds while also making sure that funds will be readily available when needed can be a delicate dance. The second safe harbor provides a way to ensure availability of funds while not putting the taxpayer in any sort of receipt of them. The difference between this approach and that of the first safe harbor is that, in this case, the buyer is out of the picture as soon as the closing on the relinquished property sale is finished.

The use of an escrow or a trust for this purpose is very similar to one another. Both disallow an escrowee or a trustee if that party is an agent of the taxpayer or is a related party to the taxpayer. Further, the escrow or trust agreement must affirmatively state that it “expressly limits a taxpayer’s rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash… held by” the party holding it.

> “(ii) Paragraph (g)(4)(i) of this section applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in paragraph (g)(6) of this section.” (Reg § 1.1031(k)-1(g)(3)(iii)).

The party acting as the escrowee or trustee can be the same or a related entity acting as the qualified intermediary (QI) for the transaction. For instance, a bank may be acting as a qualified intermediary but hold the funds in a trust capacity in the bank’s trust department.

An escrow agreement provides for the placement of money or other assets in the control of an independent third party in order to protect the parties involved in a transaction. The funds or assets are held by the escrow agent until it receives the appropriate instructions or until predetermined contractual obligations contained in the escrow agreement have been fulfilled.

This safe harbor offers benefits additional to making the buyer’s involvement in the taxpayer’s transaction unnecessary after the initial closing. To avoid constructive receipt by the taxpayer, the funds are held away from the buyer but not deemed received by the taxpayer. Further, an unscrupulous qualified intermediary could not unilaterally withdraw the funds without the acquiescence of the taxpayer. This can be achieved with or without an escrow or trust if the QI has dual controls in place internally when transferring money out of an account. This should not be a concern when due diligence allows for choosing a well-regarded qualified intermediary. There have been past instances in which a qualified intermediary failed to clearly segregate individuals’ exchange proceeds in the unlikely event of a bankruptcy of the QI, holding the funds in an escrow or trust is one way to make the clear case that they belong to the exchanger and are not subject to creditor claims against the QI.  Another way to accomplish this important degree of separation is by clearly holding each clients' funds in separately marked accounts for the benefit of the client and tying the client's Tax Identification Number to the account.

## The Qualified Intermediary Safe Harbor

The Qualified Intermediary is person or entity acting to facilitate an exchange under section 1031 and the regulations. Section 1.1031(k)-1(g)(4)(iii) requires that, for an intermediary to be a qualified intermediary, the intermediary must enter into a written "exchange" agreement with the taxpayer and as required by the exchange agreement, acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer. The Qualified Intermediary Safe Harbor is the most substantive safe harbor and constitutes one of the most significant portions of the 1991 treasury regulations.

The Treasury Department came up with the idea of a qualified intermediary providing logical underpinnings to a delayed exchange between a taxpayer, a buyer, and a third-party seller. It is worth noting that "qualified intermediary" can really just be thought of as "intermediary." Certain individuals or businesses are disqualified from acting as intermediary (such as family member, agent, accountant etc.) so anyone not disqualified is, in fact, qualified. So, by inserting an *intermediary* into the mix when selling to one party and buying from another, the taxpayer is deemed to have completed an exchange with the intermediary rather than with the buyer and/or seller.

The nexus between the taxpayer and the Qualified Intermediary can be accomplished in several ways under the Regulations.  These include simply having the Qualified Intermediary as a seller or buyer under the sale and purchase contracts, or by deeding the properties to and through the Intermediary.  In day-to- day practice it is almost always done by the taxpayer transferring rights in the sale contract to the Intermediary who, for tax purposes, who is then deemed to transfer the old property to the buyer, notwithstanding the actual deed being issued from the taxpayer to the buyer. Later, the taxpayer transfers certain rights in the purchase contract to the QI, who for tax purposes, acquires the new property and transfers it to the taxpayer. The actual title can be directed deeded from the taxpayer to the buyer and from the seller to the taxpayer. (See Rev. Rul. 57-244). The QI Regulations read specifically as follows:

iv) Regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of paragraph (g)(4)(iii)(B) of this section –

(A) An intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property,

(B) An intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person, and

(C) An Intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

(v) *Solely for purposes of paragraphs (g)(4)(iii) and (g)(4)(iv) of this section, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. (Italics added).* For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

## The Interest and Growth Factor Safe Harbor

Prior to the issuance of the 1991 Treasury Regulations, the accrual of interest on exchange funds deposited into a bank account was a vexing problem. The legal fiction taking place was for the taxpayer to sell to a buyer and for the buyer's funds to be held back for up to 180 days before being applied toward the purchase of the taxpayer's replacement property. If interest was accrued for, and ultimately received by, the seller, then the funds must have belonged to the taxpayer all along. This conundrum resulted in some special measures that took place when negotiating the sale contract with the buyer. One option was to let the buyer receive the interest on the funds put into the escrow by the buyer. This often resulted in a windfall for a buyer in an exchange. Another option was to let the buyer receive the interest, but require the buyer turn it over to the taxpayer after the exchange was completed. Last, the parties might try and anticipate how much interest was expected to be received by the buyer and then "goose up" the contract sale price by an equal amount.

Since these measures were so problematical, the Treasury Department decided to clean this up by providing a safe harbor for the taxpayer's receipt of interest or some other type of yield (growth factor) on the deposit. The safe harbor essentially states that even though the accrual and payment of interest on the funds is inconsistent with the fact that they are not considered the taxpayer's funds while on deposit, it was still permissible to allow the taxpayer to receive the benefit of interest on the funds. The interest is reportable as income whether the taxpayer includes those funds with the balance of the purchase price for replacement property, or simply receives a check for the interest upon closing of the transaction.

Pertaining to the taxpayer's receipt of interest on deposited exchange funds, the Regulations provide:

> "In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives the like-kind replacement property will be made without regard to the fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange".
> (Reg § 1.1031(k)-1(h).

## Property Identification Rules and Other Rules

In a typical Internal Revenue Code §1031 deferred exchange a taxpayer has 45 days from the date of sale of the relinquished property to identify potential replacement property. This 45-day window is known as the identification period. The taxpayer has 180 days (shorter in some circumstances) to acquire one or more of the identified properties, which is known as the exchange period. Property(ies) acquired within the 45-day identification period do not have to be specifically identified, however they do count toward the 3-property and 200 percent rules discussed below.

## Why is it Necessary to Identify Replacement Property?

These rules are a direct result of the Starker case where for the first time a taxpayer was found to be able to sell relinquished property on one day and acquire replacement property at a different point in time. In fact, the Starker case involved a five-year gap between the sale and purchase. Prior to the decision in the Starker case, it was believed that an exchange had to be simultaneous. As a result of the open-endedness of this decision, as part of the Tax Reform Act of 1984, Congress added the 45/180 day limitation to the delayed exchange. These time limitations were a compromise between allowing an exchange to be non-simultaneous while at the same time having some temporal continuity between the sale and the purchase.

## Understanding the Identification and Receipt Rules

The identification rules in a 1031 exchange include the following:

- The 45-day requirement to designate replacement property
- The 3-property rule
- The 200-percent rule
- The 95-percent rule
- The incidental property rule
- Manner of Description of Real Property
- Property to be produced

### *The 45-Day ID Requirement*

The Regulations, provide:

> "The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter." The identification must (i) appear in a written document, (ii) signed by the taxpayer and (iii) be delivered to the replacement property seller or any other person that is not a disqualified person who is involved in the exchange". (Reg § 1.1031(k)-1 (c)).

The custom and practice is for the identification to be delivered to the qualified intermediary, however, for example, a written statement in a contract to purchase the replacement property stating that the buyer is identifying the subject property as his replacement would meet the requirements of the identification. The restriction against providing the notice to a disqualified person is that such a person may be likely to bend the rules a bit based upon the person's close relation to the taxpayer. Pursuant to 1.1031(k)-1(k), disqualified persons generally are those who have an agency relationship with the taxpayer. They include the taxpayer's employee, attorney, accountant, investment banker and real estate agent if any of those parties provided services during the two-year period prior to the transfer of the relinquished property. Property identifications made within the 45-day period can be revoked and replaced with new identifications, but only if done so within that the identification period.

## *The 3-Property Rule*

This rule simply states that the replacement property identification can be made for up to "three properties without regard to the fair market values of the properties." At one time in the history of §1031 exchanges, there was a requirement to prioritize identified properties. At those times, if a taxpayer wished to acquire a second identified property, they could not do so unless the first identified property fell through due to circumstances beyond the taxpayer's control. Presumably this harsh requirement played a role in the 1991 Treasury Regulations where the 3-Property Rule is found. By far and away, most taxpayers utilize this rule.

## *The 200% Percent Rule*

The 200-percent rule states the taxpayer may identify:

> *"Any number of properties as long as their aggregate fair market value as of the* end of the identification period doesn't exceed 200% of the aggregate fair market value of all relinquished properties as of the date the relinquished properties were transferred by the taxpayer." (Reg § 1.1031(k)-1 (c)(4)(i)(B)).

Another way to state this is that the taxpayer can identify any number of properties and close on any number of them if the sum of the market value of all of them does not exceed twice the market value of the relinquished property. There is some uncertainty of how the market value of these properties is determined such as the listing price, amount the seller is willing to accept, and amount the taxpayer agrees to pay. The answer is unclear but using the listing price would surely be a safe choice. However, should the market value of all of them is more than double, the client needs to be aware of the 95% rule as discussed below.

## *The 95 Rule*

The 95-percent rule is defined as follows:

> "Any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified replacement properties." (Reg § 1.1031(k)-1 (c)(4)(ii)(B)).

As a practical matter, this rule is very hard to adhere to. Basically, it provides that should the taxpayer have over identified for purpose of the first two rules, the identification can still be considered valid if the taxpayer receives at least 95% in value of what was identified. For example, if a taxpayer identified four properties or more whose market value exceeds 200% of the value of the relinquished property, to the extent that the taxpayer received 95% of what was "over" identified then the identification is deemed proper. In the real world it is difficult to imagine a fact pattern where this rule can be utilized by a taxpayer.

## Description of Replacement Property in IRS 1031 Exchange

The description of replacement property must be unambiguous and specific. For instance, the identification of "a condominium unit at 123 Main Street, Chicago, IL" would fail due to the specific unit not having been identified. The actual rules are as follows:

- Replacement property is identified only if it is unambiguously described in the written document or agreement.
- Real property generally is unambiguously described if described by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building).
- and either: (a) received by the taxpayer within
- the designation period in accordance with Treasury Regulations Section 1.1031(k)-1(c)(1) or (b) identified in a written designation notice signed
- by the taxpayer and hand delivered, mailed, telecopied or otherwise sent
- to the qualified intermediary before the end of the designation period in accordance with Treasury Regulations Sections 1.1031(k)-1(b) and (c)".

Delaware Statutory Trust ("DST") investments are very common with persons selling or buying exchange property. In the event of the identification of such a fractional interest in real estate, care must be taken to identify the exact percentage being acquired, not simply reference to a particular DST.

At time the receipt of the replacement property might differ slightly from what was identified. So, for instance if a taxpayer identifies a 47% interest in a property but ultimately receives a 46% or 48% interest, in most case that is considered a match to the identification. The examples on this issue that appear after the identification section in the Regulations provide an example where the actual deviation was 25% in value compared to what was identified. The example indicated it was still a valid identification, so most persons take from this that a variation, at least no more than 25% higher or lower is still a match to what was identified. (Reg § 1.1031(k)-1(d), Example 4).

## 1031 Exchange Property to Be Improved or Produced

Oftentimes, the property intended to be acquired by the taxpayer will be in a different physical state at the time it is identified compared to the state it will be upon receipt by the taxpayer.  The regulations account for this by requiring the identification for real estate to include the address or legal description of the property plus as much detail as practical about the intended improvements.  In connection with the receipt of property to be improved, even if the described improvements are not completed at the time it is received by the taxpayer, the exchange is valid so long as the actual property received does not differ from what was identified by the taxpayer except for the extent of improvements that have been completed.

# Part Three – Parking Exchanges

## Reverse Exchanges Using the Replacement Property; Exchange Last

Real estate owners often receive conflicting advice about whether reverse tax deferred exchanges are legitimate tax strategies pre-approved as to structure by the IRS.  In fact, reverse tax deferred exchanges have a long history and continue to be a valuable tool for owners of real estate who hold property for investment or business purposes.

## What is a 1031 Reverse Exchange?

A reverse exchange refers to the sequence of a taxpayer's sale of relinquished property and the purchase of replacement property.  When circumstances require a taxpayer to acquire replacement property prior to the sale of relinquished property, that situation is known generally as a "reverse exchange" fact pattern.  Without further planning, the taxpayer's direct purchase of the replacement property prior to the sale of the relinquished property, sometimes referred to as a "pure reverse" exchange is not approved by the IRS.  The ability to do a reverse exchange requires a taxpayer to structure the transaction in a manner providing for the taxpayer to sell the relinquished property before acquiring the replacement property.  In fact, the use of the term "reverse exchange" is a bit of a misnomer since the solution to deal with a reverse exchange fact pattern requires the sequence of sale and purchase to be accomplished with non-reverse timing.  There are a couple of ways that his can be accomplished.

## Do the Internal Revenue Service Regulations: IRC§1031 Allow for Reverse Exchanges?

Not specifically. After the landmark legal decision in the Starker case (which was discussed in "Are Tax Deferred Exchanges of Real Estate Approved by the IRS?") and the 1991 Treasury Regulations that followed, exchanges became a lot easier to complete and therefore much more popular than before. For the same reasons, the desire for taxpayers to complete reverse exchanges became much more popular at the same time. In fact, during the comment period between May of 1990 and April of 1991 regarding the proposed regulations governing conventional forward exchanges (see Internal Revenue Service Regulations: IRC§1031), many persons requested the IRS to include guidelines for completing a reverse exchange at the same time. In the preamble to those final regulations, however, the Treasury Department declined to do so stating:

> "After reviewing the comments and the applicable law, the Service has determined that the deferred exchange rules of Section 1031(a)(3) do not apply to reverse-Starker transactions… however the Service will continue to study the applicability of the general rule of 1031(a)(1) to these transactions."

## Does the IRS Revenue Procedure 2000-37 Allow for Reverse Exchanges?

Yes. During the period from 1991 through 2000, many professional advisors structured reverse exchanges without the benefit of a "safe harbor" set forth by the IRS. Fortunately, this uncertainty became clarified in September of 2000 with the issuance of Revenue Procedure 2000-37. Basically, the Rev. Proc. suggested that an accommodating party could acquire the replacement property on behalf of the taxpayer and hold it for up to 180 days allowing the taxpayer time to sell the relinquished property and immediately acquire the replacement property from the accommodating party. Alternatively, the taxpayer could arrange for an accommodating party to acquire the relinquished property from the taxpayer, allowing the taxpayer to immediately acquire the replacement property...provided however, that the taxpayer found a bona fide buyer to acquire the property from the accommodator within 180 days. Either of these steps would allow the taxpayer to effectively acquire the new property prior to the sale of the old property through an IRS approved reverse exchange structure.

## What is an EAT in a Reverse Exchange?

The Rev. Proc. referred to the accommodating party as an Exchange Accommodation Titleholder, commonly referred to as an “EAT”. For the mutual benefit of the taxpayer and the EAT, it is customary for the EAT to take title to the property using a special purpose entity, usually a limited liability company (“LLC”). This insulates each separate client’s reverse exchange that is being facilitated by the EAT from other clients’ transactions and from the affairs of the exchange company acting as the member of the EAT.

An Exchange Accommodation Titleholder may not be a disqualified person as defined in the Regulations. There are many companies that provide conventional forward exchange services (as a qualified intermediary) but a more limited number of those companies are also set up to provide EAT services. The practice of holding title to a property on behalf of a taxpayer is often referred to as “parking” title to the property with the EAT.

## Today's IRS Approved Reverse Exchange Structures

### 1. Parking the Replacement Property

The reverse exchange Rev. Proc. requires the taxpayer and EAT to enter an overarching document referred to as a Qualified Exchange Accommodation Agreement (“QEAA”). This is a term that the IRS coined in the “reverse exchange” Rev. Proc. 2000-37. The Rev. Proc. contains certain provisions which are mandatory to be in the agreement for these parking arrangements to be in the safe harbor set forth in the Rev. Proc. This applies to reverse exchanges of relinquished or replacement property as well as build-to-suit and property improvement exchanges.

Usually, the taxpayer will already be under contract with the buyer prior to contacting the EAT regarding the reverse exchange. To shift the purchase over to the EAT, there is a simple assignment document assigning the purchase contract from the taxpayer to the EAT. Note that this assignment should not be confused with the assignment of rights to the Qualified Intermediary acting under a forward exchange.

The property acquisition financing on behalf of the EAT is either provided by the taxpayer or the taxpayer’s relationship lender, or a combination of both. It is customary for the EAT to issue a Note and some kind of security interest such as a mortgage or a pledge of the membership interest in the limited liability company to the lender(s).

In the context of reverse exchange administration, a Master Lease between the Exchange Accommodation Titleholder as Lessor and the taxpayer as Lessee, is often used in order for taxpayer to be able to sublease the property to the actual property tenants. This removes the need for the Exchange Accommodation Titleholder from having any interaction with the property tenants. If also puts responsibility on the taxpayer to pay for utilities, taxes, and insurance. Master Lease with the taxpayer so that the taxpayer can act as lessor in relation to the tenants. This also puts the rental income into the taxpayer's hand and not in the hands of the EAT. The EAT simply wants to receive its fee. The Rev. Proc. does not require the lease or taxpayer loan to be arm's length.

In addition to the QEAA, the parties typically enter into some kind of contract providing for the transfer of the property by deed, or the membership in the LLC, to the taxpayer. This takes place immediately after the taxpayer's sale of the relinquished property.

Last, depending upon the type of property being parked, there is typically a Phase One environmental report or simply an environmental indemnification agreement between the parties.

To recap, the applicable documents generally are as follows:

- This is a term that the IRS coined in the "reverse exchange" Rev. Proc. 2000-39 pertaining to the overarching agreement which must be put in place between the Exchange Accommodation Titleholder and the taxpayer. The Rev. Proc. contains certain provisions which are mandatory to be in the agreement in order for these parking arrangements to be in the safe harbor set forth in the Rev. Proc. This applies to reverse exchanges of relinquished or replacement property as well as build-to-suit and property improvement exchanges. Qualified Exchange Accommodation Agreement
- Assignment of Purchase Contract
- Non-Recourse Promissory Note
- Mortgage, Deed of Trust or Pledge Agreement of Membership Interest to secure EAT's obligation to pay back funds borrowed

- Master Lease effectively allowing the taxpayer to deal directly with property tenants and to assume the responsibility to pay property expenses.
- Sale Agreement requiring the EAT to transfer the parked property back to the taxpayer
- Environmental Indemnity Agreement

Entering into a reverse exchange with an EAT does not remove the necessity of doing a conventional forward exchange of the relinquished property for the replacement property. Rather, it buys the taxpayer time to sell the relinquished property by arranging for the EAT to acquire the replacement property from the seller and to park it. The proceeds from the sale of the relinquished property are used to acquire the property from the EAT and the EAT uses those funds to pay back any prior loans made to the EAT for the original acquisition of the replacement property.

## 2. Parking the Relinquished Property

Parking the relinquished property entails similar documentation to that of a replacement property parking arrangement. Conceptually, this arrangement is no different than a white knight showing up on the taxpayer's doorstep to buy her property on the eve of the replacement property acquisition.

- Per the Rev. Proc. an overarching agreement must be entered into between the taxpayer and the EAT known as the QEAA
- There will be a contract between the taxpayer and the EAT providing for the EAT's purchase of the relinquished property
- Generally, if that property has debt on it, the EAT can acquire the property subject to the debt allowing for the property to be purchased for the amount of the taxpayer's expected net equity at the time of a later sale to a third party. That equity amount can be acquired through a bank loan or a direct loan from the taxpayer to the EAT. Any amount lent to the EAT will be used immediately by the EAT to acquire the property and the amount of equity paid goes into the taxpayer's forward exchange account
- There is a Note and a security instrument reflecting the amount lent to the EAT
- Master Lease allows for the taxpayer to deal directly with the tenants.
- There may be a requirement for the "Phase One Environmental Audit "or "Environment Indemnity Agreement" depending on the type of

property. Some EATs can waive this and simply rely on the taxpayer's indemnification of the EAT.

- Last, there may be some type of surety document which will provide for the taxpayer to be responsible for the representations and warranties made to the ultimate buyer of the relinquished property upon sale to that party by the EAT
- When the relinquished property is sold by the EAT to a permanent buyer, the funds received by the EAT are used to pay back any loans originally made to the EAT as well as any debt that the EAT acquired the property subject to

## Determining which Property to Park

When parking the replacement property, the amount needed to acquire that property is a sum certain. However, when parking the relinquished property, it is often sold by the taxpayer to the EAT for a best guess of value. Inevitably, the actual amount later received by a permanent buyer will deviate up or down. So, when parking the relinquished property adjustments must be made to deal with these deviations. So, all things being equal, usually the replacement property gets parked. There are some factors which, when present, may suggest parking the relinquished property to be advantageous:

- The value of the relinquished property is much less than the replacement property so that the loan to the EAT is easy to attain
- The replacement property may involve special financing such as a Tax Increment Financing (TIF) or a Small Business Administration (SBA) loan which requires the taxpayer to be the borrower
- The replacement property may have some environmental issues which might involve some remediation of the issue

## Using Exchanges to Build on Vacant Property or Improve Existing Property

The purpose of a 1031 exchange is to trade up in value of your real estate, otherwise, there is no gain from which to defer taxes. What happens if you purchase a property that is of lesser value than your relinquished property, but it needs significant improvements?

## What is a build-to-suit or 1031 improvement exchange?

Often a taxpayer will sell his old property (the relinquished property) for a greater value than the cost of purchasing the new property (the replacement property). If nothing further is done, the excess value that is not reinvested is taxable and referred to as "boot". However, if the new property is land to be constructed upon (a build-to-suit exchange) or consists of land with a structure on it that needs further improvements (a property improvement exchange), it is possible for the improvement costs to be incurred prior to the exchange. As is the case with many IRC §1031 procedures, there are safe harbor provisions which must be closely adhered to.

Many people assume that so long as the taxpayer uses exchange proceeds to acquire the new property and makes the improvements within the 180-day window for an exchange, the taxpayer can include the cost of the improvements into the value of the new property. However, IRC §1031 regulations require a valid exchange to consist of like-kind properties being exchanged. Hiring a contractor or other service provider and paying for labor and materials is not like-kind to the sale of real estate. As expressed by the IRS the problem is as follows:

> "The transfer of relinquished property is not within the provisions of Section 1031(a) if the relinquished property is transferred in exchange for services. Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind." (Reg § 1.1031(k)-1(e)(4)).

The exchange regulations became effective in 1991. Approximately ten years later, in 2001, the IRS issued Revenue Procedure 2000-37 part of which dealt with this situation. The IRS came up with the idea of a Qualified Also referred to as an "EAT", is typically a special purpose, limited-liability company that is used to own the legal title to property that is being parked as part of a reverse exchange. An exchange accommodation titleholder may not be a disqualified person. Exchange Accommodation Titleholder enables the use of this structure to work around the issue of improvements not being like-kind to the taxpayer's old property.

## How does the use of an EAT help in an exchange involving improvements?

The EAT can acquire title to the new property on behalf of the taxpayer and to "park" it until the improvements are in place (but in no event beyond 180 days). Once the EAT transfers ownership of the property to the taxpayer, the taxpayer has acquired improved real estate, which then includes the value of the improvements that were made during the parking period. For the mutual benefit of the taxpayer and the EAT, it is customary for the EAT to take title to the property using a special purpose entity, usually a limited liability company (LLC). This insulates the client's exchange transaction from other clients' transactions as well as from the affairs of the exchange company acting as the EAT.

## What's the difference between how forward and reverse build-to-suit or improvement exchanges are structured?

A build-to-suit or improvement exchange can take two different forms. The first occurs when the taxpayer has sold property and funded the exchange account prior to the acquisition date of the new property. The exchange funds can pass to the EAT to cover the purchase price of the new property. The balance of the funds is given to the EAT as necessary to cover the costs associated with making the improvements. This is known as a forward build-to-suit or property improvement exchange

If the taxpayer wants to begin the improvements before the sale of the old property, a reverse build-to-suit or property improvement exchange is necessary, since the sequence of buying (by the EAT) and selling is "reverse" from a normal exchange. In the case of a reverse transaction, since the exchange account it not yet funded, funding of the purchase price and improvements needs to be provided to the EAT from a bank or taxpayer loan or sometimes both. These loans get paid back at the conclusion of the transaction when the exchange funds are used by the taxpayer to acquire the property from the EAT. This structure is known as a reverse build-to-suit or improvement exchange.

## Do all improvements need to be made during the 180-day parking period?

It is not necessary for the improvements to be completed during the parking period; however, the taxpayer only gets credit for the value of the land and improvements that are in place at the time the taxpayer takes direct ownership. Prepayment to a contractor for labor and material will not qualify. The taxpayer can make additional improvements after the exchange has taken place.

## What flexibility does Revenue Procedure 2000-37 allow in a build-to-suit or property improvement exchange?

Revenue Procedure 2000-37 contains some very taxpayer friendly provisions including:

- The terms of any build-to-suit/property improvement contract between the taxpayer and EAT do not have to be at arm's length
- The taxpayer may loan funds directly to the EAT
- The taxpayer is permitted to guaranty any bank loan made to the EAT
- The taxpayer may indemnify the EAT for costs and expenses incurred
- The taxpayer or a "disqualified person" (generally an agent of the taxpayer) may advance funds to the EAT
- The property may be leased by the EAT to the taxpayer during the parking period
- The taxpayer may act as the contractor (and receive a fee) or supervise the making of the improvements

In a reverse build-to-suit/property improvement exchange, at some time during the parking transaction (but no later than 180 days) the old property gets sold and the net proceeds go into the taxpayer's exchange account.  No later than 180 days from the inception of the parking transaction, the exchange funds are sent to the EAT as the nominal seller and the EAT uses these funds to repay the original bank and/or taxpayer loan.

The procedure is much the same for a forward build-to-suit/property improvement exchange where the exchange account has been funded prior to the parking transaction.  In this case, although the funds may have been paid out to the EAT, the taxpayer still needs to complete the conventional exchange by acquiring the improved property from the EAT.

Whether it is a forward or reverse build-to-suit exchange, completing the transaction is the same.  The taxpayer's rights under the contract to acquire the improved property from the EAT are assigned to the qualified intermediary, and the transfer to the improved property is accomplished by either assigning the membership interest in the EAT to the taxpayer or by the EAT issuing a deed to the taxpayer.

Customary agreements that would be used to document this type of exchange include:

- Qualified Exchange Accommodation Agreement (required under Revenue Procedure 2000-37)
- Assignment by the taxpayer to the EAT of the purchase contract for the new property
- Loan documents between the EAT as borrower and the lender
- Use of a Master Lease, particularly if the property has a tenant is helpful. This removes the need for the EAT from having any interaction with the property tenants. If also puts responsibility on the taxpayer to pay for utilities, taxes, and insurance. Master Lease if the property has a tenant or tenants
- Sale Contract for the sale of the property from the EAT back to the taxpayer
- Environmental Indemnity Agreement

## Non-Safe Harbor Parking Transactions

The safe harbor transactions fit within the parameters of the safe harbor created in September 2000 by Revenue Procedure 2000-37 and governs those transactions in which the property is parked no longer than 180 days. However, there are instances in which, for a number of reasons, the replacement property must be parked for longer than 180 days. Common examples are those in which the relinquished property will take longer to market and sell than 180 days or in which construction of improvements are required on the replacement property.

While the Revenue Procedure does not cover so-called non-safe harbor transactions, it takes the position of no negative inference merely because certain structures are pre-approved due to the safe harbor:

> Further, the Service recognizes that 'parking' transactions can be accomplished outside of the safe harbor provided in this revenue procedure. Accordingly, no inference is intended with respect to the federal income tax treatment of 'parking' transactions that do not satisfy the terms of the safe harbor provided in this revenue procedure, whether entered into prior to or after the effective date of this revenue procedure. (Rev. Proc. 2000-37 Section 3.02).

Some exchangers mistakenly believe that if a parking period extends past the 180-day deadline they can somehow allow the transaction to keep running and simply conclude their exchange without any adverse consequences. This approach to "blown" safe harbor deals has apparently found some support in a 2016 court case, Bartell v. Commissioner, 147 T.C. No. 5. In Bartell, the U.S. Tax Court ruled, among other things, that even though the taxpayer entered into what was essentially a safe harbor transaction on August 1, 2000 and the parking period lasted until December 31, 2001, the taxpayer's 1031 exchange should not have been disallowed by the IRS.

In Bartell, the court overlooked the 17-month timeline even though the property was purchased by an exchange facilitator with loan funds secured by the taxpayer, the taxpayer managed the construction portion of the deal, and the taxpayer was in possession of the property during the parking period. It is clear the parking entity did not really have any true benefits and burdens of ownership. Accruit believes the Bartell case should not be relied on in current similar situations for a number of reasons including the facts that the parking transaction was commenced prior to the issuance of Rev. Proc. 2000-37, it originated in the taxpayer friendly 9th Circuit and, most importantly, although the IRS did not appeal the decision, it did make it clear they will not acquiesce to the decision as precedent in other cases.

When, for any number of reasons, more than 180 days is required, the best approach may be to utilize what is referred to as a non-safe harbor reverse exchange which is specifically structured to last longer than 180 days and create true benefits and burdens of ownership in the parking entity. Since these are not typical parking arrangements, each transaction must be structured differently based upon the facts presented. The taxpayer's CPA's, attorneys and other advisors working for the taxpayer need to be involved in the process.

# Resources

## Resources Specific to this Course

In addition, please see the resources cited within the material.

## Resources for the Legal Professional

ABA Center for Professional Responsibility - www.abanet.org/cpr

Chicago Bar Association - www.chicagobar.org

Commission on Professionalism - www.2civility.org

Judicial Inquiry Board - http://www.illinois.gov/jib

Illinois Board of Admissions to the Bar - www.ilbaradmissions.org

Illinois Department of Financial and Professional Regulation - www.idfpr.com/default.asp

Illinois Lawyers' Assistance Program, Inc - www.illinoislap.org

Illinois State Bar Association - www.isba.org

Illinois Supreme Court - www.state.il.us/court

Lawyers Trust Fund of Illinois - www.ltf.org

MCLE Program - www.mcleboard.org