

Reverse Exchange Questions and Answers

This is a discussion of questions frequently asked regarding reverse exchange transactions.

Safe Harbor Rules

Rev.Proc. 2000-37, issued in 2000, sets up a "safe harbor" rule so that the IRS will not challenge "reverse" exchanges done within its framework. The safe harbor rules apply only to transactions in which the replacement property is conveyed into the parking arrangement on or after September 15, 2000.

The Rev.Proc. says specifically that "the Service recognizes that 'parking' transactions can be accomplished outside of the safe harbor provided in this revenue procedure." There is no inference created that, if the safe harbor is not met in a certain transaction, the transaction will not pass muster. § 3.02. However, a November, 2000 Tax Court decision [DeCleene v. Commissioner, 115 T.C. No. 34 (2000)] rejected a construction reverse exchange just two months after the safe harbor rules were announced. The key factors in that case were that there was no independent Accommodation Party appointed, and the taxpayer was considered the real owner of the replacement property during the time the other party held title.

Time Limits

The taxpayer has 45 days from the date the Accommodation Party takes title to identify the relinquished property to the Intermediary. § 4.02(4). Within 180 days of the date the Accommodation Party takes title, it must convey the replacement property and improvements to the taxpayer. § 4.02(5). Within the same time period, the taxpayer must also sell the relinquished property and put the sale proceeds in the hands of the Intermediary. If the building on the replacement property is not completed at the time of conveyance, the Accommodation Party also assigns the building contract to the taxpayer. The IRS requires that both legs of the exchange be reported on the same year's tax return. The taxpayer may need to file for an extension in order to file after closing the second leg.

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Accommodation Arrangement

The Rev.Proc. says that the Accommodation Party must be "a person...who is not the taxpayer or a disqualified person." § 4.02(1). Disqualified people are defined in IRC § 1031(k)-1(k). A person is disqualified if he, she or it is the agent of the taxpayer, or the taxpayer owns more than 10% of the entity. The 1031 rules say that the taxpayer may not receive or constructively receive the exchange funds or property. If a disqualified person takes title or gets the money, the taxpayer has constructive receipt of it. The Rev.Proc. refers to the agreement with this independent entity as a "qualified exchange accommodation arrangement," or QEAA. The person who serves in this capacity is commonly termed the Accommodation Party.

There are several agreements necessary to this arrangement. They include the agreement with the Accommodation Party, a modified Intermediary exchange agreement, the building contract, indemnities of the Accommodation Party for environmental and other risks in holding title to the property, a lease, the loan documents, and a put and call agreement with the Accommodation Party requiring it to sell the replacement property to the taxpayer. The Rev.Proc. says that the QEAA agreement must be signed not later than five days after the Accommodation Party takes title to the replacement property. § 4.02(3). The QEAA must provide:

1. That the Accommodation Party is holding the property for the taxpayer to facilitate a section 1031 exchange under the Revenue Procedure 2000- 37.
2. That the Accommodation Party and the taxpayer will report the transaction as the Revenue Procedure requires.
3. That the Accommodation Party will be treated as the beneficial owner for federal income tax purposes.
4. That the parties will report the transactions in a manner consistent with the QEAA.

Parking

The Rev.Proc. approves a "parking" arrangement. This requires that a qualified Accommodation Party take title to the parked property. The Accommodation Party is not necessarily the qualified intermediary (Intermediary) appointed to hold the exchange funds and act as the taxpayer's agent for buying and selling the real estate. In most cases the Intermediary is a title insurance company. A title

insurer may also act as the Accommodation Party. In other cases, the seller of the replacement property or the builder act as Accommodation Party.

There are two kinds of parking arrangements. The replacement-leg arrangement is usually used when the taxpayer wants to build on the replacement property and get the as-built value in the exchange. The Accommodation Party takes title to the replacement property and builds the building, then deeds it to the taxpayer. The relinquished-leg arrangement is usually used when the taxpayer has to buy the replacement property before a buyer is found for the relinquished property. The Accommodation Party takes title to the taxpayer's relinquished property before the replacement property is purchased, and holds it until a buyer is found for the relinquished property.

Benefits and Burdens

A key factor is that the Accommodation Party must have genuine benefits and burdens associated with the ownership of real estate. However, Rev.Proc. 2000-37 says that the following services or arrangements between a taxpayer and the Accommodation Party are permitted, consistent with the Accommodation Party holding the benefits and burdens of ownership:

1. The taxpayer or disqualified person may guarantee the obligations of the Accommodation Party.
2. The taxpayer or disqualified person may loan or advance or guarantee a loan or advance to the Accommodation Party.
3. The Accommodation Party may lease the property to the taxpayer or a disqualified person.
4. The taxpayer or a disqualified person may manage the property, supervise improvements, act as contractor or provide other services to the Accommodation Party with respect to the property.
5. Agreements for purchase or sale may include puts and calls at fixed or formula prices effective not in excess of 185 days after the Accommodation Party's acquisition of the property.
6. The Arrangement may include an agreement that the taxpayer either reimburse an Accommodation Party for any deficiency in value received upon a sale of the property, or the receipt by the taxpayer of any excess value received by the Accommodation Party upon sale.

Exchange LLC

The common practice is to form a single member LLC to hold title to the parked property. Some arrangements call for the transfer of the parked property by the assignment of the member's interest in the LLC rather than by deed.

Notice in Offer of Intent to Do Exchange

The taxpayer should include a statement similar to the following in the offer to purchase the replacement property:

Seller acknowledges that Buyer intends to conduct a tax-deferred exchange of the Property for another parcel of real estate and agrees to cooperate in same to the extent described in this paragraph. In order to accomplish the exchange, Buyer shall have the right to assign this contract to a qualified accommodation title holder of Buyer's choice, and direct Seller to convey the Property to the accommodation party. Buyer shall give Seller notice of the assignment of contract and identity of the accommodation party at or before closing. Seller shall have no duty to execute the exchange agreement or to assume any greater liability due to Buyer's election to conduct an exchange.

Funding the Purchase of the Replacement Property

The Accommodation Party borrows the purchase price from a third party, or the taxpayer may lend or advance the money. The taxpayer may guarantee the debt if the Accommodation Party borrows from a third party. § 4.03(3).

Construction on Replacement Property

The Accommodation Party may contract to construct a building on the property. The taxpayer may supervise the construction work. § 4.03(5). The Accommodation Party may get a construction loan and give a mortgage to the construction lender. The taxpayer may guarantee the debt. § 4.03(2).

After the sale of the relinquished property, the taxpayer typically instructs the Intermediary to make construction advances from the exchange funds. This is permitted under § 4.03(3). At the time the replacement property is conveyed to

the taxpayer, the taxpayer also typically pays off the construction mortgage with exchange funds. The Intermediary returns any balance of funds to the taxpayer.

It is generally agreed that, if the building is not complete within six months, the taxpayer cannot increase the value of the replacement property by putting the balance of the building contract amount in escrow or by paying the Accommodation Party more than what the building is worth. The problem with either suggestion is that the additional consideration is not real estate but money, and is therefore treated as taxable boot. See IRC § 1031.(k)-1(m).

Valuing the Replacement Property

The IRS has set six months as the maximum time period for the Accommodation Party to hold the replacement property before conveying it to the taxpayer. Under § 1031, gain is deferred only to the matching value of the replacement property. If the value of the sold property is greater than the value of the replacement, there is taxable gain on either the difference between the two values or the realized gain, whichever is less.

Taxes and Insurance

The Accommodation Party may elect to maintain insurance on the parked property. It typically requires the taxpayer to maintain insurance on the property, with the Accommodation Party as an additional insured. Typically, the parked property is leased to the taxpayer under a triple net lease, making the taxpayer responsible for payment of taxes.

Environmental Risks

The Accommodation Party could become responsible for environmental cleanup costs because it comes into ownership of the real estate. The typical Accommodation Party agreement contains an environmental indemnity from the taxpayer to the Accommodation Party, and requires that the taxpayer give the same environmental information that a prudent buyer of the property would want. This may range from no evidence up to a Phase II environmental investigation and report.



Bank Loans

The Accommodation Party is typically required to sign a note and mortgage on the parked property. The note is non-recourse. It will contain the following paragraph, or one having the same effect:

Neither the undersigned, nor any of the members of the undersigned, shall be personally liable for the payment of the indebtedness evidenced by, or created or arising under, this Note; any judgment or decree in any action brought to enforce the obligation of the undersigned to pay such indebtedness shall be enforceable against the undersigned only to the extent of its interest in the property encumbered by the Mortgage and other security documents; and any such judgment or decree shall not be subject to execution upon or be a lien upon the assets of the undersigned other than its interest in such encumbered property.

The note is "backed up" by the personal guaranty of the taxpayer. Rev.Proc. 2000-37 permits the taxpayer to guaranty the accommodation party's note.

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