COMMENTS REGARDING NEED FOR GUIDANCE
ON REVERSE LIKE-KIND EXCHANGES

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These comments were prepared by individual members of the Committees on Real Estate and Sales, Exchanges & Basis. Primary responsibility was exercised by Louis S. Weller and Adam M. Handler, with substantial contributions from Mary Beth Foster, Ronold P. Platner, Robert D. Schachat and Fred T. Witt, Jr. The Comments were reviewed by Richard E. Levine of the Section’s Committee on Government Submissions and by Charles H. Egerton, Council Director for the Committee on Real Estate.

Although the members of the Section of Taxation who participated in preparing these comments may have clients who would be affected by the federal income tax principles addressed, or have advised clients on the application of these principles, no such member (or firm of which a member is a part) has been engaged by a client to make government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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I. **What is a "Reverse Exchange."**

A. **Receipt of Replacement Property before transfer of Relinquished Property.**

1. A and C agree to exchange properties. On September 1, 1999 C transfers property Y to A. On October 1, 1999 A transfers property X to C. The exchange is a deferred exchange for C and a reverse exchange for A.

2. A owns property X and intends to sell it to B. A wants to acquire property Y from owner C in a like-kind exchange for property X. Owner C of property Y requires a transfer date to A before X can be transferred to B. To accomplish this, C transfers Y to A, taking back a note to represent property Y’s purchase value. Later, A transfers property X to B, who pays off the note to C created when property Y was transferred. Neither B nor C have an exchange; A may have a reverse exchange.

B. **Concurrent Ownership of Both Properties.** In the exchanges described, the taxpayer owns both the relinquished and replacement properties concurrently during the “gap” period between receipt of the replacement property and transfer of the relinquished property.

II. **Taxpayers’ Need For Guidance.**

A. Taxpayers who hold property for trade or business or investment purposes sometimes find themselves in the position of holding property they intend to transfer in a like-kind exchange but find their planned transfer will not or cannot occur prior to the date they must acquire replacement property. This can apply to a large industrial concern, such as a utility company, or to the owner of a residential duplex. The problem is especially prevalent when the taxpayer in a like-kind exchange involving real estate wishes to have improvements constructed to replacement property as part of the exchange. Typically, land on which improvements are to be constructed must be purchased prior to commencement of construction and the 180 day period allowed for deferred exchanges by Section 1031(a)(3)(B) is frequently inadequate to permit completion of construction. The problem of exchanges involving property to be built to taxpayer specifications has been the subject of favorable court decisions, as illustrated by **Coastal Terminals vs. Commissioner**, 632 F.2d 1171 (5th Cir. 1980).

B. In general, the underlying philosophy of Section 1031 is to permit nonrecognition treatment where, in an integrated transaction, taxpayers shift their economic stakes from one like-kind property to another. This is just as true of the reverse exchange scenario as of the more familiar simultaneous or deferred exchange transactions. The issue is not one faced only by corporate or highly sophisticated taxpayers, but by all taxpayers who own assets qualifying under Section 1031 for like-kind exchange treatment.
III. Status of Law Applicable to Reverse Exchanges.


B. Regulations. Specifically omitted from coverage under deferred exchange Regulations §1.1031(k)-1.

C. Authority Approving Reverse Exchanges. Reverse exchanges have arguably been approved in Bennie D. Rutherford, T.C. Memo 1978-505 (relating to exchange of heifers) and Biggs vs. Commissioner, 632 F.2d 1171 (5th Cir. 1980) (real estate) and specifically approved in PLR 9814019 (exchange of power line easements). In PLR 9814019 the Service specifically identified the transaction in question as a reverse like-kind exchange and then ruled that this was a valid like-kind exchange and that the taxpayer’s basis in the new easements would be its basis in the old easements, increased by any gain recognized as a result of the boot.

D. Authority Denying Alleged Reverse Exchanges. Taxpayer attempts to convert purchase/sale transactions into reverse exchanges under section 1031 have failed. See, e.g., Bezdjian vs. Commissioner, 845 F.2d 217 (9th Cir. 1988), Edward C. Lee, T. C. Memo 1986-294, Julius Dibsy T.C. Memo 1995-477 and Chad Lincoln, T.C. Memo 1998-421. In each of these cases, there was a lack of contractual interdependence between property purchases and sales on which to base exchange treatment.

E. Authority Approving Construction Exchanges Equivalent to Reverse Exchanges. In Coastal Terminals and J.H. Baird Publishing Company vs. Commissioner, 39 T.C. 608 (1962), courts have approved the pre-exchange acquisition of property by a third party at a taxpayer’s direction so that facilities could be constructed to the taxpayer’s specifications and the completed, improved property acquired as replacement property in a like-kind exchange.

IV. 1993 Proposal.

A. Summary. In 1993 members of the American Bar Association Section of Taxation submitted a report on reverse exchanges to the Internal Revenue Service (the “1993 Report”) which contained a proposal for allowing reverse exchanges, but this has not resulted in any published guidance. The 1993 Report was published in the Fall 1993 edition of The Journal of Real Estate Taxation. In summary, the 1993 Report’s approach is to permit taxpayers to acquire replacement properties before disposing of relinquished properties by creating rules modeled on those applicable to deferred exchanges. The major elements of the 1993 Report proposal are:

1. Qualified intermediaries can be used to effect the exchange.
2. The gap period is limited to the period ending with the due date of the taxpayer’s income tax return (including allowable extensions) for the year in which a replacement property acquisition occurred. Thus, for a calendar year individual taxpayer the period could extend until October 15 of the year following the year of the replacement property acquisition. This creates a theoretical maximum 21.5 month gap period (*i.e.* January 1, Year 1 until October 15, Year 2).

3. Taxpayers could advance funds to the intermediary for purposes of acquiring replacement property and recover these advances from proceeds derived from sale of relinquished property without recharacterization of the recovery as receipt of boot.

4. All tax benefits (*i.e.*, depreciation and amortization) relating to the relinquished property would be frozen on acquisition of the replacement property and the basis and attribute shift to the replacement property which occurs under Section 1031(d) would occur as of the replacement property’s acquisition.

B. **Additional Items.** Guidance along the lines of the 1993 Report should make clear that income and expenses relating to a relinquished property which were not a function of basis (the subject of A.4, above), such as rental income, mortgage interest, operating expenses and property taxes, would continue to be reported during the gap period consistently with the taxpayer’s previous methods of reporting such items.

C. **Reason for Alternate Approach.** We recognize that some issues associated with the 1993 Report’s proposal may lead to consideration of alternate approaches to the permissible structuring of reverse exchanges. We also believe, as discussed below, that for valid business reasons a number of taxpayers may not be able to utilize the approach outlined in the 1993 Report and that an alternative approach is therefore desirable even if the proposal contained in the 1993 Report were to be adopted. In addition, we are unsure whether “freezing” depreciation and amortization deductions during the gap period is the economically correct result.

V. **Current Practice: Avoid the True Reverse Exchange by Adopting One of Two Substitute Approaches.**

A. **Purpose.** Because taxpayers are concerned that a “pure” reverse exchange may be challenged by the Service, substitute structures have been developed and are in current use which attempt to avoid having the taxpayer treated as owner of both the relinquished and replacement properties during the gap period.

B. **Third Party Acquires and Holds Replacement Property (“Exchange Last”).**
1. An independent party, *i.e.*, an “accommodator,” which is not a related party as defined in Section 1031(f) acquires and holds the replacement property until relinquished property can be transferred in a simultaneous or deferred exchange.

2. **Example:** Taxpayer A has property X, wants property Y, which must be acquired before X is ready to be sold. This may be due to the need to construct improvements on Y prior to completion of the exchange or to the demands of the seller. Accommodator D purchases Y, holds it until X is ready to close, then transfers Y to A in exchange for X, simultaneously selling X to a buyer B.

3. A modified form of this structure was the subject of analysis in the J.H. Baird case, where an accommodator acquired replacement property and began to construct improvements but during the course of construction received title to the relinquished property and transferred the relinquished property to the buyer. Because the taxpayer retained use of the relinquished property until the completion of construction and the transfer of the replacement property to it, the court held the taxpayer did not dispose of the relinquished property until that point, creating a simultaneous exchange.

4. In Coastal Terminals, a party who wanted to buy exchanger’s deep water port was directed to buy an inland site and construct a facility. The exchange occurred following completion of the new facility. The Court of Appeals upheld exchange treatment, emphasizing the buyer’s use of its own funds and undertaking of obligations to buy and build the facility for trade with the exchanger.

C. **Third Party Acquires Replacement Property, Exchanges and Holds Relinquished Property (“Exchange First”).**

1. This transaction starts with a simultaneous, three party exchange of the relinquished and replacement properties using an accommodator who acquires replacement property and trades it with taxpayer for relinquished property, then holds relinquished property until it can be sold.

2. **Example:** Taxpayer A has property X, wants property Y. Seller requires immediate transfer of Y and for business reasons A needs to own Y immediately. Accommodator D acquires Y by purchase from C and immediately exchanges Y with A, receiving X. D holds X until it can be sold to buyer B.

3. To illustrate the occurrence of these transactions outside the pure tax environment, it is instructive to note two reported bankruptcy cases describing use of the Exchange First structure.
a) In In Re Exchanged Titles, 159 Bank. Rptr. 303 (Bkrpt C.D.Cal. 1993), exchangers had structured an exchange with a professional accommodator. The exchangers provided funds to accommodator to purchase replacement property. The accommodator acquired title to the replacement property, immediately transferred it to the exchangers and the exchangers transferred title to the relinquished property to the accommodator. The parties intended that the accommodator would sell the relinquished property and pay proceeds to the exchangers. Following the closing, the exchangers maintained control over the relinquished property, collected rents, paid taxes, maintenance, insurance and mortgage payments and even refinanced the property. Before it could sell the relinquished property, the accommodator ceased doing business and was the subject of an involuntary Chapter 7 bankruptcy petition.

(1) The accommodator’s bankruptcy trustee claimed the relinquished property was an asset of the estate and any claim of the exchangers to proceeds from its sale was an unsecured claim. The exchangers asserted that only legal, not equitable title had been conveyed to the accommodator, that this was all that was required to complete a valid like-kind exchange under Section 1031 and that the exchangers’ equitable claim on the property survived any attempt by the trustee to cut off the interest under its "strong arm" powers.

(2) The Court held that the exchangers had retained equitable title to the relinquished property and that the trustee was not able to avoid the exchangers’ equitable claim because the trustee had constructive notice of the claim and therefore was not a bona fide purchaser.

b) In In Re Sale Guaranty Corporation, 220 B.R. 660 (9th Cir B.A.P. 1998) a fact pattern similar to Exchanged Titles was presented. Here, the bankrupt accommodator had received, but not recorded, a deed to the relinquished property in “exchange” for causing the replacement property to be transferred to the exchangers in two separate transactions. The Court held that the accommodator held the relinquished properties in a resulting trust for the exchangers, which could not be defeated by the claim of the bankruptcy trustee that the properties were part of the accommodator’s bankruptcy estate.

D. Business Reasons Why Taxpayers Might Prefer One Form of Reverse Exchange Substitute Transaction Over Another or Over the True Reverse Exchange.
1. Exchange Last Preferred to Exchange First:

a) Section 1031(a)(3) periods will expire later because the identification and exchange periods start with the transfer of the relinquished property. In an Exchange Last, this will occur on or after disposition of relinquished property. In an Exchange First, this occurs on purchase of replacement property. Where a replacement property acquired in an Exchange First reverse exchange has a value less than that of the relinquished property, there will be a maximum 180 days to acquire additional replacement property, although funds from the relinquished property disposition are not available. The 1993 Report’s proposal would not resolve this issue, since it assumes an exchange occurs with respect to the relinquished property upon acquisition of the replacement property.

b) A taxpayer may have more flexibility if the taxpayer is uncertain which of several potential relinquished properties will be transferred in the exchange for a specific replacement property. Where a portfolio of properties is being marketed for disposition, the decision as to which will be exchanged for a specific replacement property can be made when a contract to sell one of them is created, rather than at the time the replacement property is acquired. The 1993 Report’s proposal would not permit this, since the relinquished property must be known at the time of replacement property acquisition.

c) Since the exchange takes place concurrently with the sale of the relinquished property, reconciliation of equity values can occur with knowledge of the market value of the relinquished property, rather than based on a value assumed at the time of the replacement property's purchase. Thus, the problem of boot resulting from overestimating or underestimating the relinquished property’s value is eliminated.

2. Exchange First over Exchange Last:

a) When a lender providing outside purchase financing for acquisition of the replacement property requires the taxpayer to secure the loan with a mortgage to the property, only the Exchange First format allows the taxpayer to acquire title in order to deliver a mortgage encumbering the replacement property.

b) If the replacement property has particular management problems or particular land use entitlements requiring or conditioned upon
the taxpayer’s ownership, acquisition of title by the taxpayer may be necessary.

c) If the taxpayer decides to undertake the exchange immediately prior to a scheduled closing of the replacement property acquisition, it may be too late to change deeds and other conveyancing and financing documents already drawn and executed conveying title of replacement property to the taxpayer and representing purchase financing for the acquisition.

VI. Problems With Structuring the Exchange Last or Exchange First Substitute for the True Reverse Exchange.

A. The fundamental issue of concern to taxpayers and their advisors in arranging these transactions is whether, in the absence of a safe harbor or other published guidance, the accommodator will be respected as the owner of the property which it holds during the “gap” period.

B. Identity of the Accommodator. One source of concern is the line of cases led by Bollinger vs. Commissioner, 485 U.S. 340 (1988), dealing with corporate surrogate ownership, generally utilized to avoid usury limitations applicable to non-corporate owners in certain states. In Bollinger, a unanimous Court concluded that a series of corporations which held title to properties were agents of the real estate development partnerships which had caused the properties to be held in corporate form to avoid Kentucky’s usury law restrictions applicable to individuals and partnerships. This was the result sought by the partnerships, in order to permit their partners to report income and loss attributable to the properties. The Court rejected the Service’s assertion that the parties’ use of separate entities necessarily required that the entities be respected as separate, under the principles enunciated in Moline Properties vs. Commissioner, 319 U.S. 436 (1943). The tension between agent and independent owner status reflected in these cases is a major area of uncertainty for taxpayers planning reverse exchange substitute transactions.

1. The identity of the intermediary party receiving funds from a relinquished property buyer presented a problem for taxpayers following adoption of Section 1031(a)(3) in 1984.

2. Regulations §1.1031(k)-1(g)(4) addressed this issue by creating the qualified intermediary concept for deferred exchanges. This concept modified traditional agency relationship tests by incorporating specific safe harbor standards for qualified intermediaries, including the disqualified person concept and the limitations on use of cash proceeds from relinquished property sales set forth in Regulations §1.1031(k)-1(g)(6).
3. The qualified intermediary concept has met with wide acceptance and approval by taxpayers and eliminated much controversy which could have arisen in deferred exchanges relating to the constructive receipt issue.

4. A similar concept would be appropriate for reverse exchanges.

C. Financing the Acquisition of Replacement Property.

1. The taxpayer should be able to arrange for a third party loan to the accommodator on commercially reasonable terms and even guarantee the loan without having this fact convert the accommodator into an agent of the taxpayer. Since the taxpayer is most interested in the terms of financing for the replacement property purchase and will ultimately be the owner, the taxpayer should be able to establish this credit. As a practical matter, assuming that most accommodators will not have independent access to credit unless they are subsidiaries or affiliates of lending institutions, the guaranty of the taxpayer will often be a lender requirement.

2. In the Exchanged Titles case, the taxpayer provided funds for the accommodator to purchase the replacement property without utilizing loan documentation, but the court did not address the effect of this aspect of the structure on the exchange. Although there is no direct authority in the Section 1031 context, it is reasonable to argue that the taxpayer can make a loan to the accommodator on commercially reasonable terms and have that loan treated as a transaction separate from the exchange. The 1993 Report also endorses this approach.

D. Management of the Parked Property.

1. The taxpayer will generally want to manage and control the operation of the property held by the accommodator, since the accommodator’s ownership is fundamentally only to facilitate the exchange. This problem must be addressed in any guidance permitting accommodator ownership of properties in either the Exchange First or the Exchange Last structure.

   a) In the triple net lease format, the taxpayer/tenant takes on all responsibility for the property under terms of the lease. All tenants become the taxpayer's subtenants; risk of rent or other tenant defaults is shifted to the taxpayer. The taxpayer would prefer that rent be set at an amount necessary to pay mortgage and tax payments on the property (including debt service on loans provided by the taxpayer), letting the taxpayer bear the risk and have the reward of positive or negative cash flow.
b) An alternative is to make the taxpayer a manager of the parked property, with full authority to make operational decisions but without a direct landlord-tenant relationship to tenants of the parked property.

2. The structures using accommodators assume that the accommodator is prepared to report operating results of the property it owns on its income tax returns.

3. Taxpayers are concerned that the existence of net leases, particularly combined with options to purchase the lease property, give rise to potential characterization of the tenant as owner of the property. For analysis of the issues arising here, see Frank Lyon Co. vs. U.S., 435 U.S. 561 (1978) and its progeny.

E. Pricing Controls Affecting Accommodator. In either Exchange Last or Exchange First structure, the parties will generally want property value fluctuations to be wholly borne by the taxpayer. They will thus want the taxpayer to have a fixed price option to acquire the replacement property in the Exchange Last structure. In the Exchange First structure the parties will want to establish a fixed value for the relinquished property so that the taxpayer will bear the risk of any shortfall upon ultimate sale or obtain the benefit of a sale by the accommodator at a value which exceeds the value assigned to the property at the time of replacement property purchase. The effect of these price terms on whether the accommodator has benefits and burdens of ownership while it holds title to a property has troubled tax advisors structuring these transactions. Any effective solution in this area must permit taxpayers to hold options to acquire replacement property at the accommodator’s cost in the Exchange Last structure or to be allocated virtually all economic risk and reward in the Exchange First structure.

F. Special Problems Associated with Construction on the Replacement Property. Taxpayer control over character of construction has been challenged by the Service but Courts have not viewed this as a problem. See, J.H. Baird; Coastal Terminals; Fred L. Fredericks, T.C. Memo 1994-27. Since the taxpayer wants to be sure what is built is satisfactory, there must be a mechanism to permit taxpayer involvement in the construction process for reverse construction exchanges to be practical. In current practice, the vehicle is typically a construction management agreement or general contractor arrangement between the accommodator and the taxpayer or an agent of the taxpayer, such as a professional construction management firm.

VII. Proposed Revenue Procedure.

A. Taxpayers without access to sophisticated tax planning advice should be able to engage in the equivalent of reverse exchanges in a commercially reasonable manner. To facilitate this, we believe a simple revenue procedure can be utilized
to establish safe harbor provisions addressing the core issues associated with the Exchange Last and Exchange First reverse exchange substitute methods employing accommodation parties to hold property. Such a revenue procedure should contain the following elements:

1. The Internal Revenue Service (the “Service”) will not challenge either (a) the qualification of property as either “replacement property” or “relinquished property” (as defined in Reg. § 1.1031 (k)-1 (a)) for purposes of Section 1031 of the Internal Revenue Code and the regulations thereunder or (b) the treatment of the “accommodation titleholder” as the beneficial owner of such property for federal income tax purposes, if the property is held in a “qualified exchange accommodation arrangement.”

2. Property is held in a “qualified exchange accommodation arrangement” if all of the following requirements are met:
   a) Legal title to the property is held by a person (the “accommodation titleholder”) who is not the taxpayer or a disqualified person (as defined in Reg. § 1.1031 (k)-1 (k)) and either such person is or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 80 percent of its interests or stock are owned by partners or shareholders who are, subject to federal income tax.

   b) The taxpayer and the exchange accommodation titleholder enter into a written agreement (the “qualified exchange accommodation agreement”) that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and the revenue procedure and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding and disposition of the property as provided in the revenue procedure.

   c) Within two years of the date on which the exchange accommodation titleholder acquires legal title to the property, (1) if the property is intended to be used as replacement property, the property is transferred (either directly or indirectly through a qualified intermediary (as defined in Reg. § 1.1031 (k)-1(g)(4)) to the taxpayer or (2) if the property is relinquished property, the property is transferred to a person who is not the taxpayer or a disqualified person.

   d) The taxpayer and the exchange accommodation titleholder each treats the exchange accommodation titleholder, and the exchange
accommodation titleholder agrees to be treated, as the beneficial owner of the property for all federal income tax purposes.

e) At the time the qualified exchange accommodation arrangement is entered into, the taxpayer has a bona fide intent to use the property as either replacement property or relinquished property in an exchange that is intended to qualify for deferral of gain (in whole or in part) or loss under Section 1031.

3. Property shall not fail to be treated as being held in a qualified exchange accommodation arrangement as a result of any one or more of the following legal or contractual arrangements, whether or not any such contractual arrangements reflects arm’s-length terms:

a) The taxpayer or a disqualified person guaranties some or all of the obligations of the exchange accommodation titleholder, or indemnifies the exchange accommodation titleholder against costs and expenses.

b) The taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guaranties a loan or advance to the exchange accommodation titleholder.

c) The property is leased by the exchange accommodation titleholder to the taxpayer or a disqualified person.

d) The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor or otherwise provides services to the exchange accommodation titleholder with respect to the property.

e) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of two years from the date the property is acquired by the exchange accommodation titleholder.

f) In cases where the exchange accommodation titleholder holds title to the relinquished property, the taxpayer and the exchange accommodation titleholder enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the exchange accommodation titleholder’s receipt of the property be taken into account upon the exchange accommodation titleholder’s disposition of the relinquished property through the taxpayer’s
advance of funds to or receipt of funds from the exchange accommodation titleholder.

g) The accounting, regulatory or state, local or foreign tax treatment of the relationship between the taxpayer and the exchange accommodation titleholder is different from the requirements of section 2.d.

4. The taxpayer may transfer its rights and obligations under a qualified exchange accommodation arrangement to a person who bears a relationship to the taxpayer described in either section 267(b) or section 707(b) and who is identified in the qualified exchange accommodation agreement.

5. With the consent of the Commissioner, upon a showing that the exchange cannot reasonably be completed within the required time period, the two-year period provided in section 2.c. and/or 3.e may be extended for up to two additional one-year periods.

6. If the property is not transferred within the time period provided and as otherwise provided in sections 2.c. and 5, then the revenue procedure does not apply and the determination of whether or at what times the taxpayer or the exchange accommodation titleholder is treated as the beneficial owner of the property shall be determined without regard to the provisions of the revenue procedure.

B. The revenue procedure shall apply to qualified exchange accommodation agreements entered into on or after a prospective effective date. No inference should be intended with respect to the federal income tax treatment of similar arrangements or reverse exchanges (i.e., transactions where the taxpayer acquires the replacement property prior to such taxpayer disposing of the relinquished property) entered into prior to such date.

VIII. Conclusion.

Adoption of an appropriate safe harbor for reverse like-kind exchanges will greatly simplify tax administration, permit taxpayers to complete legitimate business transactions in an efficient manner and bring the state of the law in this area into conformity with modern commercial practices.