Parking Arrangements: Reverse Exchanges and Construction Exchanges

IRC § 1031 like-kind exchanges are popular, reliable, IRS approved transactions that allow taxpayers to defer paying taxes on profits when property (usually real estate) that is held for productive use in trade or business or for investment is exchanged for like-kind property (e.g., real estate exchange for real estate) that will also be held for productive use in trade or business or for investment.

In a typical IRC § 1031 exchange, the taxpayer sells relinquished property through a qualified intermediary (a "QI") and later acquires replacement property through the same QI. If the process is handled in accordance with Treasury Regulations, it is considered as if the taxpayer exchanged the relinquished property for the replacement property. This process is commonly referred to as a "forward" exchange because it proceeds in the normal direction – sell first, buy second. Sometimes it is referred to as a "delayed exchange" because there is usually a delay between the sale of the relinquished property and the purchase of the replacement property.

Reverse Exchanges

Sometimes a taxpayer needs to buy the replacement property before the relinquished property can be sold. This is called a "reverse exchange" because it proceeds in the opposite direction from a forward exchange. A reverse exchange poses a special problem. The taxpayer cannot simultaneously own both the relinquished property and the replacement property. That would make it impossible to exchange one property for the other. Therefore, in a reverse exchange, either the relinquished property or the replacement property must be "parked" with some relatively friendly third-party until the relinquished property is sold.

That third-party (I will assume that it is a limited liability company, and therefore neuter gender.) is sometimes referred to by the IRS and by tax practitioners as an "accommodation party" because it is accommodating the taxpayer to structure the exchange. In a traditional reverse exchange, the IRS insists that an accommodation party must not be acting as the agent of the taxpayer. It must act on its own account and for its own benefit. In addition, an accommodation party must have "substantial indicia of ownership" in the parked property: The accommodation party must have a financial stake in the property, that is, some significant benefit if the property appreciates in value and/or if the property makes money from operations, and/or it must have some significant risk if the property loses value and/or loses money from operations. The IRS and the courts have not given much help in clarifying what the limits are for an accommodation party to act as the taxpayer’s agent and what the minimum financial interest is that the accommodation party must have in the parked property. For this reason, traditional reverse exchanges are, for the most part, expensive, risky and rare.

The IRS has a particular interest in keeping the rules murky for traditional reverse exchanges. If those rules were easy to comply with, a taxpayer could park any property that it might acquire with an accommodation party for an unlimited period of time and use it some day in the future as replacement property for an exchange that the taxpayer has not yet even thought about doing. That is more flexibility than the IRS wants to give. However, the IRS has not been heartless. It has given a substantial amount of flexibility and a tremendous amount of certainty in reverse exchanges by creating a safe harbor in *Revenue Procedure 2000-37*.

This is a rough sketch of how a safe harbor reverse exchange works under the *Rev. Proc. 2000-37*: Either the relinquished property or the replacement property is "parked" in a manner similar to what we discussed above, but it is parked with a person or business entity that the revenue procedure calls an "*exchange accommodation titleholder*" or "EAT". An EAT is similar to an accommodation party in a traditional *non*-safe harbor reverse exchange. It holds legal title (or something that is equivalent to legal title) to the parked property during the exchange period. Unlike an accommodation party, an EAT need not have any financial interest in the property nor any investment in the property nor any risk from owning the property. In short tax jargon, an EAT needs "indicia of ownership," but does not need "substantial indicia of ownership." The EAT can act as the taxpayer's agent for all purposes except for federal income tax purposes. The taxpayer can have the full use and benefit of owning the parked property during the exchange period with only one exception: The taxpayer *cannot* depreciate the parked property while it is owned by the EAT. There can be a formal lease between the EAT and the taxpayer during the exchange period. However, a lease is not required. It is acceptable (and often preferable) for the parking agreement simply to authorize the taxpayer to use, to improve and/or to benefit from the parked property.

In return for these important leniencies, the IRS requires that the taxpayer must have a current bona fide intention to exchange property. The taxpayer's relinquished property must be identified within the same 45-day period that is required for the identification of replacement property in a forward exchange. The number of relinquished properties that the taxpayer can identify is limited in a safe harbor reverse exchange to the same extent that relinquished properties are limited in a forward exchange. That is, (a) the taxpayer can identify any three relinquished properties, regardless of their value (the 3-property rule); or (b) the taxpayer can identify any number of potential relinquished properties, so long as their aggregate value is not more than two times the value of the replacement property (the 200-percent rule); or (c) the taxpayer can rely on the fact that the relinquished property is actually exchanged during the first 45 days of the reverse exchange period (the 45-day rule); or (d) if the taxpayer has identified too many relinquished properties, the exchange can still be valid if the taxpayer relinquished 95% of the property that was identified as relinquished property in this exchange (the 95-percent rule). The entire transaction must be completed within the same 180-day exchange period that applies to a forward exchange.

There are some important differences between parking a replacement property and parking a relinquished property. There are some advantages to parking the replacement property: (i) It is usually possible to secure the cooperation of the new mortgage lender for the replacement property to agree to carve out an exception from the "due on sale clause" which will allow for the transfer of the property from the EAT to the taxpayer at the end of the exchange. On the other hand, transferring the relinquished property from the EAT to the taxpayer ordinarily would trigger the "due on sale" clause for the existing mortgage on that property. (ii) If the replacement property is parked, the taxpayer has some time to choose which relinquished property will later be sold. When the relinquished property is parked, there is no longer a choice. (iii) When the replacement property is parked, the actual exchange of properties does not technically happen until the relinquished property is sold. When the relinquished property is parked, the exchange technically occurs as soon as the replacement property is acquired. If the relinquished property is sold for more than the replacement property cost, then the clock starts running prematurely on the time that the taxpayer has to acquire other replacement property. (iv) When the replacement property is being purchased, it is common to have current due diligence information, particularly a Phase I environmental report, that the EAT will want to review prior to taking title. The taxpayer rarely can provide current due diligence information on the relinquished property. (v) Closing costs and transfer taxes can sometimes be saved when beneficial ownership of real estate is transferred by transferring ownership of the single purpose entity ("SPE") that holds title to the property, rather than by transferring a deed to the property itself. It is relatively easy to arrange for the eventual transfer of the replacement from the EAT to the taxpayer by transferring ownership of an EAT. However, there are often serious obstacles to arranging for such a transfer when the relinquished property is parked.

Despite these advantages, sometimes the structure for an exchange will not work if the replacement property is parked. In those cases, it is good to keep in mind the option of parking the relinquished property.

There is a problem in forward exchanges that often crops up. The taxpayer would like to acquire replacement property that is owned by a related party. However, *IRC § 1031(f)* puts some severe restrictions on that practice – a discussion for another time. These restrictions, do *not* apply to the purchase of relinquished property by a related party. Therefore, in a reverse exchange, when the purchase of the relinquished property falls through, it is often possible to arrange for the relinquished property to be purchased by a related party, sometimes in a transaction involving substantial take-back financing from the taxpayer. This strategy is referred to as a "related party to the rescue" transaction.

Construction Exchanges

Construction exchanges are in some ways very similar to reverse exchanges. Both involve a parking arrangement. In a construction exchange, however, the purpose of the parking arrangement is different. *IRC § 1031* allows for the cost of construction on replacement property to be counted as part of the purchase price of that property, but only to the extent that the improvements have been made to the property before the taxpayer acquires it. Once the taxpayer owns the replacement property it is too late. Moreover, payment for bricks and mortar sitting at the construction site does not count for exchange purposes until those bricks and mortar have been attached to the ground. The cost of services performed for construction counts, but not the cost of services that have not yet been performed. In a construction exchange, the parking arrangement allows these improvements to be made while the property is in the hands of a friendly party.

Generally, a traditional *non*-safe harbor construction exchange has all of the issues and dangers of a non-safe harbor reverse exchange. Therefore, the *Rev. Proc. 2000-37* safe harbor parking arrangements are just as useful for construction exchanges as they are for reverse exchanges. In the taxpayer's identification notice, both the replacement property and the general nature of the improvements that will be made to that property should be described. When the property is acquired, it is parked with an EAT during the construction period. All construction that the taxpayer wants credit for in the exchange must be completed by the end of the ordinary 180-day exchange period. Exchange proceeds held by the qualified intermediary can be used to make payments for construction as it progresses, but only to the extent of materials that have been attached to the real estate and work that has been completed.

The 180-day limit on construction is often a serious problem in a safe harbor construction exchange, but the expense and risk of a non-safe harbor construction exchange is still daunting. There is one type of non-safe harbor construction exchange that is worth a close examination whenever the 180-day time limit is too short. That is to get permission from the third-party seller to make improvements prior to closing of title. The third-party seller has, of course, "significant indicia of ownership." So long as nothing in the sales agreement effectively transfers ownership of the property to the taxpayer and so long as the taxpayer does not pay an inordinate portion of the purchase price prior to closing title, permission by the seller to allow the buyer to improve the property should not raise any red flags. The seller can protect itself by charging reasonable rent, by requiring the taxpayer to provide construction insurance and indemnification, and by requiring payment of a significant deposit. The taxpayer/buyer can protect itself by researching title in advance of construction, by recording a memorandum of the agreement of sale, and by obtaining appropriate indemnification from the seller.

Despite the undeniable attractions of building while property is still owned by the seller, for a variety of reasons, most taxpayers find it impractical to reach a mutually acceptable agreement to do that. Therefore, safe harbor construction exchanges remain by far the more popular option although the time for construction is severely limited.