

# CHICAGO DEFERRED EXCHANGE COMPANY

## REVERSE EXCHANGES UNDER IRC SECTION 1031

**REVENUE PROCEDURE 2000-37:** The Internal Revenue Service issued guidance on Reverse Exchanges: Revenue Procedure 2000-37, (effective September 15, 2000). The Rev. Proc. provides a safe harbor under which the Internal Revenue Service will not challenge the qualification of relinquished property or replacement property in certain “Reverse Exchanges”. Practitioners will discover significant planning opportunities are available as a result of the new Revenue Procedure, including the ability to treat the Exchange Accommodation Titleholder as the owner of property for federal income tax purposes, and the Taxpayer as the owner of the property for financial reporting purposes.

The Rev. Proc. defines a safe harbor for structuring a reverse exchange under Section 1031 and, in brief, provides the following:

1. The IRS will not challenge the qualification of property as either “replacement property” or “relinquished property” as defined in the 1031 Treasury Regulations. In addition, the IRS will not challenge the treatment of an “**Exchange Accommodation Titleholder**” (EAT) as the beneficial owner of such property for federal income tax purposes, if the property is held in a “**Qualified Exchange Accommodation Agreement**” (QEAA).

2. Property is deemed to be held in a QEAA if the following requirements are met::

i. Qualified indicia of ownership is held by someone other than the Taxpayer or a disqualified person (i.e.: the Exchange Accommodation Titleholder) who is subject to federal income tax. Qualified indicia of ownership can be demonstrated by: (a) legal title held by the EAT, (b) other indicia of ownership such that the EAT is treated as the beneficial owner of the property, as in a contract for deed, or (c) a single member LLC that holds legal title to the property (or some other entity that is disregarded for Federal income tax purposes), the membership interest of which is owned by the EAT.

ii. At the time the property is transferred to the EAT, the Taxpayer must have bona fide intent that the property represents either replacement property or relinquished property that is intended to qualify for non-recognition of gain under Section 1031.

iii. No later than 5 business days after the EAT acquires the property, the Taxpayer and the EAT must enter into a Qualified Exchange Accommodation Agreement. The QEAA must specify that the EAT is holding the property for the benefit of the Taxpayer to facilitate an exchange under Section 1031. The QEAA must also specify that the EAT is the beneficial owner of the property, and all parties must report ownership of the Property as such for federal income tax purposes.

iv. No later than 45 days after the transfer of the replacement property to the EAT, the Taxpayer must identify the relinquished property in a manner consistent with the 1031 Treasury Regulations (i.e.: the “three-property” or “200% rule”).

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v. No later than 180 days after the property is transferred to the EAT, the property is transferred to the Taxpayer as replacement property, or to a person who is not the Taxpayer or a disqualified person, as relinquished property.

vi. The combined period that the relinquished property or the replacement property is held in the QEAA does not exceed 180 days.

3. In addition, the Rev. Proc. provides the following:

i. The Exchange Accommodation Titleholder may also act as Qualified Intermediary in the exchange (provided the EAT is not a disqualified person).

ii. The Taxpayer (or a disqualified person) can guarantee all of the obligations of the EAT, including a guarantee of the debt incurred by the EAT to acquire the replacement property, and can indemnify the EAT against costs and expenses.

iii. The Taxpayer (or a disqualified person) can loan funds to the EAT to acquire the replacement property.

iv. The property can be leased by the EAT to the Taxpayer.

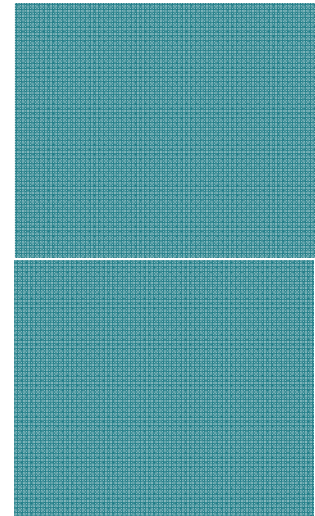
v. The Taxpayer (or a disqualified person) can manage the property, oversee improvements to the property, act as contractor and provide services to the EAT.

vi. The Taxpayer and the EAT can enter into agreements arranging for the purchase or sale of the property, including puts and calls, effective for a period not to exceed 185 days from the date the EAT acquires the property.

vii. The Taxpayer and the EAT can enter into an agreement to deal with fluctuations in the price of the relinquished or replacement property during the period of time that the property is owned by the EAT.

In addition, the planning opportunities presented by Revenue procedure 2000-37 afford significant flexibility in managing the timing of acquisitions and dispositions as tax deferred exchanges. However, we quickly became aware of two potential problems which could impact the business decision of whether or not to take advantage of the tax savings opportunities. The first was the potential assessment of duplicate transfer taxes at the state and local level. The second was the potential bankruptcy risk of an EAT. Both of these issues were addressed in two private letter rulings issued to Chicago Deferred Exchange Corporation. To date, these are the only two rulings the IRS has issued in the context of reverse exchanges under the Revenue Procedure.

**PLR 200148042** concludes that Chicago Deferred Exchange Corporation's Qualified Exchange Accommodation Agreement may contain an express declaration of agency for all purposes except federal income tax purposes. We are not aware of any jurisdiction where a transfer from an agent to a principal is a taxable event. We believe that it would be extremely unlikely that the Service would set up a deficiency in the event a customer of Chicago Deferred Exchange were to rely on this ruling.



**PLR 200201024** takes the concept that a single member limited liability company is not treated as an entity separate from its owner one step further by creating a “hybrid” single member LLC. In this situation CDEC was concerned that a Taxpayer may be reluctant to utilize the reverse exchange EAT structure because of risks arising from the potential bankruptcy of the EAT member of the LLC. The ruling concludes that the Taxpayer (or Taxpayer’s lender) could hold a non-economic membership interest in the LLC without causing the LLC to be treated as something other than a disregarded entity. We believe this ruling provides an unprecedented level of security to our customers.

**DeCleene v. Commissioner, 115 T.C. No. 34 (November 17, 2000):**

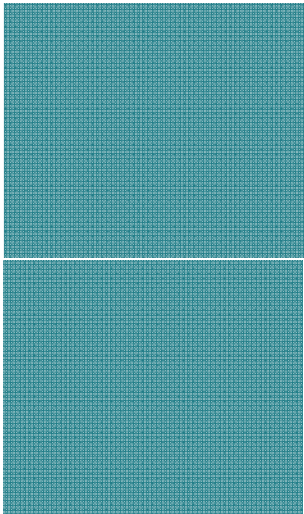
Taxpayer acquired the Lawrence Drive property on September 30, 1992. On September 24, 1993, Taxpayer entered into an exchange agreement with WLC pursuant to which Taxpayer agreed to convey, in the future, the McDonald street property to WLC in exchange for WLC conveying to Taxpayer the Lawrence Drive property (which Taxpayer had owned) with improvements built thereon according to Taxpayer’s specifications. On that same day, Taxpayer quit claimed title to the Lawrence Drive property to WLC who gave Taxpayer a non-recourse note and mortgage which was assigned to a bank which provided construction financing for the Lawrence Drive improvements. With construction completed three months later, Taxpayer and WLC exchanged the properties in December, 1993. The Tax Court viewed these transactions as an attempt to “implement a so-called reverse exchange without the participation of a third party facilitator.”

The Tax Court held that the purported exchange failed because Taxpayer “never disposed of the Lawrence Drive property and remained its owner during the three month construction period.” The Court concluded that because Taxpayer previously owned the property and obligated himself to pay for what was being built according to his specifications, and because he was obligated to reacquire the property upon construction of such improvements (for which both parties could demand specific performance), he remained the beneficial owner of the Lawrence Drive property.

There are some interesting aspects to this case, other than just the Court invalidating an attempt at a non safe harbor reverse exchange. First, the Court simply distinguished Rev Proc 2000-37 on the grounds that it was not effective. The Taxpayer did not appear to make an argument that there has been no change in the law, that Rev Proc 2000-37 is merely a procedural pronouncement of the IRS, and that if the EAT under the Rev Proc should not be viewed as an agent; WLC should not have been viewed as an agent.

The IRS’ position with regard to construction of improvements on land already owned by the Taxpayer has generally been consistent over the years.<sup>[1]</sup> And finally, the Court refused to impose penalties on the theory that the Taxpayer was able to rely on its counsel and accountants who structured the transaction. This is somewhat surprising since most experienced practitioners in the like-kind exchange area probably would have thought the transaction was very risky.

<sup>[1]</sup> See, e.g., LTR 8701015(October 2, 1986); LTR 9031015 (May 4, 1990). See also Bloomington Coca Cola Bottling Co. V. Com’r, 189 F.2d 14 (7<sup>th</sup> Cir. 1951). The IRS had actually ruled favorably in a transaction similar to DeCleene, but then subsequently revoked the ruling. See LTR 8847042 (August 26, 1988), revoked by LTR 8921058 (February 27, 1989).



**Part III**

**Administrative, Procedural, and Miscellaneous**

**26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment; 1.1031(k)-1: Treatment of deferred exchanges.**

**SECTION 1. PURPOSE**

This revenue procedure provides a safe harbor under which the Internal Revenue Service will not challenge (a) the qualification of property as either "replacement property" or "relinquished property" (as defined in Section 1.1031(k)-1(a) of the Income Tax Regulations) for purposes of Section 1031 of the Internal Revenue Code and the regulations thereunder or (b) the treatment of the "exchange 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" (QEAA), as defined in Section 4.02 of this revenue procedure.

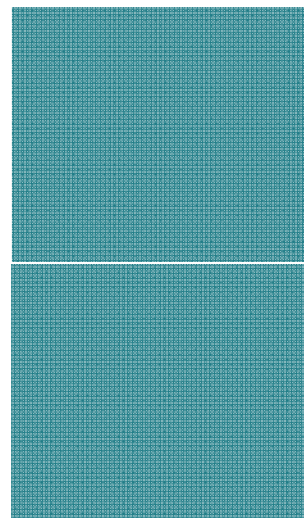
**SECTION 2. BACKGROUND**

.01 Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

.02 Section 1031(a)(3) provides that property received by the Taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the Taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the Taxpayer transfers the relinquished property, or the due date (determined with regard to extension) for the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

.03 Determining the owner of property for federal income tax purposes requires an analysis of all of the facts and circumstances. As a general rule, the party that bears the economic burdens and benefits of ownership will be considered the owner of property for federal income tax purposes. See Rev. Rul. 82-144, 1982-2 C.B. 34.

.04 On April 25, 1991, the Treasury Department and the Service promulgated final regulations under Section 1.1031(k)-1 providing rules for deferred like-kind exchanges under Section 1031(a)(3). The preamble to the final regulations states that the deferred exchange rules under Section 1031(a)(3) do not apply to reverse-Starker exchanges (i.e., exchanges where the replacement property is acquired before the relinquished property is transferred) and consequently that the final regulations do not apply to such exchanges. T.D. 8346, 1991-1 C.B. 150, 151; see *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979). However, the preamble indicates that Treasury and the Service will continue to study the applicability of the general rule of Section 1031(a)(1) to these transactions. T.D. 8346, 1991-1 C.B. 150, 151.



.05 Since the promulgation of the final regulations under Section 1.1031(k)-1, Taxpayers have engaged in a wide variety of transactions, including so-called "parking" transactions, to facilitate reverse like-kind exchanges. Parking transactions typically are designed to "park" the desired replacement property with an accommodation party until such time as the Taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the Taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party then transfers the relinquished property to the ultimate transferee. In other situations, an accommodation party may acquire the desired replacement property on behalf of the Taxpayer and immediately exchange such property with the Taxpayer for the relinquished property, thereafter holding the relinquished property until the Taxpayer arranges for a transfer of such property to the ultimate transferee. In the parking arrangements, Taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes.

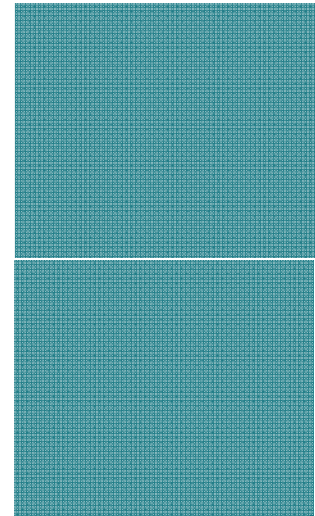
.06 Treasury and the Service have determined that it is in the best interest of sound tax administration to provide Taxpayers with a workable means of qualifying their transactions under Section 1031 in situations where the Taxpayer has a genuine intent to accomplish a like-kind exchange at the time that it arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter. Accordingly, this revenue procedure provides a safe harbor that allows a Taxpayer to treat the accommodation party as the owner of the property for federal income tax purposes, thereby enabling the Taxpayer to accomplish a qualifying like-kind exchange.

### **SECTION 3. SCOPE**

.01 EXCLUSIVITY. This revenue procedure provides a safe harbor for the qualification under Section 1031 of certain arrangements between Taxpayers and exchange accommodation titleholders and provides for the treatment of the exchange accommodation titleholder as the beneficial owner of the property for federal income tax purposes. These provisions apply only in the limited context described in this revenue procedure. The principles set forth in this revenue procedure have no application to any federal income tax determinations other than determinations that involve arrangements qualifying for the safe harbor.

.02 NO INFERENCE. No inference is intended with respect to the federal income tax treatment of arrangements similar to those described in this revenue procedure that were entered into prior to the effective date of this revenue procedure. 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.

.03 OTHER ISSUES. Services for the Taxpayer in connection with a person's role as the exchange accommodation titleholder in a QEAA shall not be taken into account in determining whether that person or a related person is a disqualified person (as defined in Section 1.1031(k)-1(k)).



Even though property will not fail to be treated as being held in a QEAA as a result of one or more arrangements described in Section 4.03 of this revenue procedure, the Service still may recast an amount paid pursuant to such an arrangement as a fee paid to the exchange accommodation titleholder for acting as an exchange accommodation titleholder to the extent necessary to reflect the true economic substance of the arrangement. Other federal income tax issues implicated, but not addressed, in this revenue procedure include the treatment, for federal income tax purposes, of payments described in Section 4.03(7) and whether an exchange accommodation titleholder may be precluded from claiming depreciation deductions (e.g., as a dealer) with respect to the relinquished property or the replacement property.

.04 EFFECT OF NONCOMPLIANCE. If the requirements of this revenue procedure are not satisfied (for example, the property subject to a QEAA is not transferred within the time period provided), then this revenue procedure does not apply. Accordingly, the determination of whether the Taxpayer or the exchange accommodation titleholder is the owner of the property for federal income tax purposes, and the proper treatment of any transactions entered into by or between the parties, will be made without regard to the provisions of this revenue procedure.

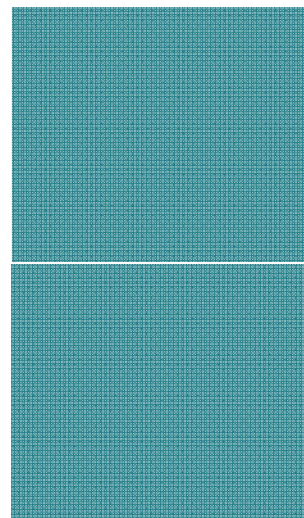
#### **SECTION 4. QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENTS**

.01 GENERALLY. The Service will not challenge the qualification of property as either "replacement property" or "relinquished property" (as defined in Section 1.1031(k)-1(a)) for purposes of Section 1031 and the regulations thereunder, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for federal income tax purposes, if the property is held in a QEAA.

.02 QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENTS. For purposes of this revenue procedure, property is held in a QEAA if all of the following requirements are met:

(1) Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the Taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax. Such qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred as described in Section 4.02(5) of this revenue procedure. For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (e.g., a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g., a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;

(2) At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the Taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under Section 1031;



(3) No later than five business days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, 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 this 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 this revenue procedure. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;

(4) No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the exchange accommodation titleholder, the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in Section 1.1031(k)-1(c). For purposes of this Section, the Taxpayer may properly identify alternative and multiple properties, as described in Section 1.1031(k)-1(c)(4);

(5) No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in Section 1.1031(k)-1(g)(4))) to the Taxpayer as replacement property; or (b) the property is transferred to a person who is not the Taxpayer or a disqualified person as relinquished property; and

(6) The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days.

.03 PERMISSIBLE AGREEMENTS. Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements:

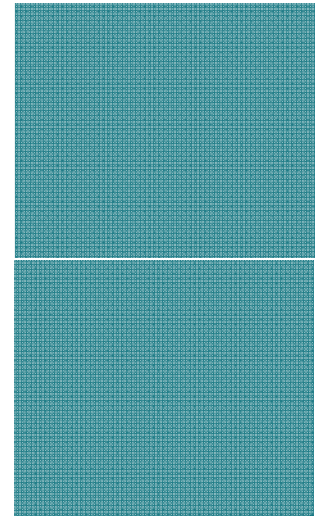
(1) An exchange accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor set forth in Section 1.1031(k)-1(g)(4) may enter into an exchange agreement with the Taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under Section 1031;

(2) The Taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses;

(3) The Taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder;

(4) The property is leased by the exchange accommodation titleholder to the Taxpayer or a disqualified person;

(5) 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;



(6) 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 185 days from the date the property is acquired by the exchange accommodation titleholder; and

(7) 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.

.04 PERMISSIBLE TREATMENT. Property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the Taxpayer and the exchange accommodation titleholder is different from the treatment required by Section 4.02(3) of this revenue procedure.

#### **SECTION 5. EFFECTIVE DATE**

This revenue procedure is effective for QEAs entered into with respect to an exchange accommodation titleholder that acquires qualified indicia of ownership of property on or after September 15, 2000.

#### **SECTION 6. PAPERWORK REDUCTION ACT**

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1701. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information are contained in Section 4.02 of this revenue procedure, which requires Taxpayers and exchange accommodation titleholders to enter into a written agreement that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. This information is required to ensure that both parties to a QEAA treat the transaction consistently for federal tax purposes. The likely respondents are businesses and other for-profit institutions, and individuals.

The estimated average annual burden to prepare the agreement and certification is two hours. The estimated number of respondents is 1,600, and the estimated total annual reporting burden is 3,200 hours.

The estimated annual frequency of responses is on occasion.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

#### **DRAFTING INFORMATION**

The principal author of this revenue procedure is J. Peter Baumgarten of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Baumgarten on (202) 622-4950 (not a toll-free call). <<END RULING>>

