

**REVENUE PROCEDURE 2004-51; 2004-33 IRB, AUGUST 16, 2004,
MODIFICATION TO REVENUE PROCEDURE 2000-37: EFFECTIVE
FOR TRANSFERS TO AN EAT ON OR AFTER JULY 20, 2004**

Background – Rev. Proc. 2000-37: In September of 2000, the IRS issued formal guidance on structuring reverse like-kind exchanges under IRC Section 1031 (Revenue Procedure 2000-37; 2000-40 IRB 1 September 15, 2000). The Revenue Procedure was the culmination of many years of study and consideration of the best way to address the situation where a Taxpayer has located and needs to close on its Replacement Property before transferring its Relinquished Property while structuring the transaction as a tax-deferred exchange under the provisions Section 1031.

The Service created a safe harbor “parking arrangement” that allows the Taxpayer to arrange for either Relinquished Property or Replacement Property to be acquired by a third party Exchange Accommodation Titleholder (EAT) for a period of up to 180 days. During that time the EAT, while not bearing any economic benefits or burdens of ownership, must nevertheless be the owner for federal (and as appropriate state) income tax purposes.

The Revenue Procedure specifies that the IRS will not challenge the qualification of property as either Replacement Property or Relinquished Property, as defined in the Treasury Regulations, or the treatment of an EAT as the beneficial owner of such property for federal income tax purposes, if the property is held in a “Qualified Exchange Accommodation Arrangement” (QEAA). Property is deemed to be held in a QEAA if the following requirements are met:

Qualified indicia of ownership is held by someone other than the Taxpayer (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.

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.

This language in the Rev. Proc. was interpreted by some practitioners and Taxpayers as permitting a transaction where a Taxpayer owns property, transfers it to an EAT who constructs improvements on the property, and transfers it back to the Taxpayer as replacement property in a 1031 exchange. As a result, the Service issued Rev. Proc. 2004-51 with the following modification to the language re: qualifying replacement property:

Headquarters

LaSalle Bank Building
135 S. LaSalle Street
Chicago, IL 60603
Toll Free (866) 677-1031
Fax (312) 992-4570

New England Branch Office

40 Court Street
Plymouth, MA 02360
Toll Free (877) 811-1031
Fax (508) 732-3201

New York Branch Office

565 5th Avenue
New York, NY 10017
Toll Free (877) 811-1031
Fax (212) 986-4205

Northern California Branch Office

3160 Crow Canyon Road
San Ramon, CA 94583
Toll Free (877) 448-1031
Fax (800) 669-0250

San Diego Branch Office

3900 5th Avenue
San Diego, CA 92103
Toll Free (877) 446-1031
Fax (619) 497-2491

chicagodeferred.com

“The Service will treat an exchange accommodation titleholder as the beneficial owner of property for federal income tax purposes if the property is held in a QEAA. Property held in a QEAA may, therefore, qualify as either “replacement property” or “relinquished property” (as defined in §1.1031(k)-1(a)) in a tax-deferred like-kind exchange **if the exchange otherwise meets the requirements for deferral of gain or loss under §1031 and the Regulations thereunder.**” [Emphasis added].

Additionally, new Section 4.05 was added to Rev. Proc. 2000-37 which provides the following:

“This revenue procedure does not apply to replacement property held in a QEAA if the property is owned by the Taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an Exchange Accommodation Titleholder.”

Thus, the new section provides for a 180-day look-back at the ownership of the intended Replacement Property.

Rev. Proc. 2004-51 was aimed, in part, at the “disappearing lease” transaction. Assume Taxpayer owns Property A and would like to construct improvements with proceeds from the sale of Property B [low basis property also owned by Taxpayer]. In order to avoid recognizing gain on the sale of Property B, Taxpayer transfers a 30-year leasehold interest in Property A to an EAT who constructs improvements on Property A. Taxpayer then sells Property B through a qualified intermediary, who acquires the leasehold interest and improvements from the EAT and transfers them to Taxpayer.

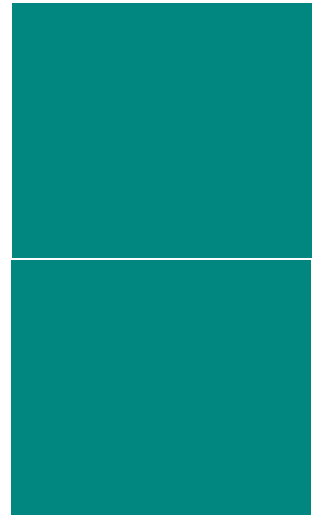
Presumably Taxpayer would assert that under Section 4.01 of Rev. Proc. 2000-37, as originally issued, the Service has agreed not to challenge the qualification of Property A with the constructed improvements as “Replacement Property”, or the treatment of the EAT as the beneficial owner of the property since it was held in a Qualified Exchange Accommodation Arrangement. However, based on the DeCleene case and the step transaction doctrine, it is doubtful that a court would respect either a lease to an EAT or a transfer of the property to the EAT where the EAT is obligated to construct improvements on the property, funded solely by the Taxpayer with no economic risk to the EAT and with the Taxpayer managing and directing the construction.

In *DeCleene v. Commissioner*, 115 T.C. No. 34 (November 17, 2000). Taxpayer transferred property it previously owned (Lawrence Drive) to WLC, in exchange for which WLC was to construct improvements on Lawrence Drive and transfer it back to Taxpayer. At the time of the transfer back to Taxpayer, Taxpayer would transfer McDonald Street property to WLC to complete the two party exchange. Taxpayer proceeded to quit claim the Lawrence Drive property to WLC. WLC gave Taxpayer a non-recourse note and mortgage on the property which was assigned to a bank who provided construction financing. When WLC completed the construction three months later, WLC transferred Lawrence Drive to Taxpayer, Taxpayer transferred McDonald Street to WLC. The Tax Court held that Taxpayer never disposed of Lawrence Drive, and remained its owner during the construction period. Because Taxpayer 1. previously owned the property, 2. was obligated to pay for the construction of the improvements and 3. was obligated to re-acquire the property on the completion of the improvements, the Taxpayer remained the beneficial owner of the property.

The likely IRS position is that the changes made by Rev. Proc. 2004-51 expressly reject these types of transactions because (a) the “property” was owned by the Taxpayer within the prior 180 day period and (b) an exchange of real estate owned by the Taxpayer for land owned by the same Taxpayer “does not otherwise meet the requirements of Section 1031”, presumably because of Rev. Rul. 67-255 [which holds that a building constructed on land owned by a Taxpayer is not of like-kind to involuntarily converted land of the same Taxpayer]. In addition, the IRS’s position set forth at Reg. 1.1031(k)-1(e)(4) states that relinquished property cannot be exchanged for production services.

While a Taxpayer might argue that if the lease is a fair rental value lease – there is no premium value due to lease payments that are less than market value – the property that is being transferred back to the Taxpayer is the improvements, which the Taxpayer never owned. This argument is probably irrelevant in light of the conclusion in the DeCleene case, Rev. Proc. 2004-51, and the step transaction doctrine.

In public statements at various forums, IRS representatives have explained that the IRS is not implying that a transfer by the Taxpayer to an EAT could never be accomplished outside the safe harbor. This might occur where the EAT actually acquires beneficial ownership of the property in contrast to limited ownership for tax purposes only.



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