

Reverse Exchanges

Abstract:

IRS has issued a Rev. Proc. that provides a “safe-harbor” for acquisitions of property on or after September 15, 2000. If followed, the acquisition of the property will qualify for like-kind treatment. This material charts out the procedures required.

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Prior to Rev. Proc. 2000-37, exchangers and qualified intermediaries were concerned about “reverse” exchanges, where the closing date for the purchase of the replacement property occurred prior to the closing date for the sale of the relinquished property. **Rev. Proc. 2000-37 provides “safe harbors”, that, if followed, will allow the acquisition of the replacement property prior to the sale of the relinquished property.**

Rev. Proc. 2000-37 is effective for acquisitions of property **on or after September 15, 2000.**

Terminology Changes	Regular Exchange	Reverse Exchange
A	Qualified intermediary (QI)	Exchange accommodation titleholder (EAT)
B	Exchange agreement	Qualified exchange accommodation Arrangement (QEAA)

In order to better understand a reverse exchange, a review of a **regular exchange** is shown in Chart 1 below. The closing date of the relinquished property triggers the 45-day identification period and the 180 day exchange period for the replacement property. **The 45-day and 180-day periods start the day after the closing date for the sale of the relinquished property.**

<p>Practitioner Note. See pages 543–45 in the <i>2000 Farm Income Tax School Workbook</i> for more details on the 45-day and 180-day rules specified by I.R.C. §1031.</p>
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The fact that a contract has been negotiated for the purchase of the replacement property prior to the sale of the relinquished property will not preclude a tax-deferred exchange result. A seller who has entered into a contract to sell the relinquished property may still enter into an exchange of that property, if **an exchange agreement is entered into prior to closing.** On the other side of the exchange, the seller of the relinquished property may enter into a contract to purchase the replacement property prior to closing on the sale of the relinquished property.

The most significant difference between a regular and reverse exchange is that in the latter, the Exchange Accommodation Titleholder (EAT) **must** take title to the replacement property.

Revenue Procedure 2000-37 defines the exchange accommodation titleholder (EAT) as:

“a person 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.”

1. Chad, the seller, lends funds to the exchange accommodation titleholder (EAT) for the purpose of the acquisition of the replacement property. In many cases, unrelated LLCs are being used as the EAT. In others, title companies or other facilitators are serving as the EAT.
2. The EAT then enters into a contract purchase, and subsequently closes, on the purchase of Jane's property. The EAT now owns the replacement property.
3. Rev. Proc. 2000-37 provides that no later than 5 business days after the title to the **replacement property** has passed to the EAT, Chad, the seller, and the EAT must enter into a “qualified exchange accommodation arrangement” (QEAA). Assuming a March 5, 2001, closing date for the purchase of Jane's property, the QEAA must be entered into by midnight, March 12, 2001.
4. Rev. Proc. 2000-37 provides that no later than 45 days after the title to the replacement property has passed to the EAT, the **property to be relinquished** must be identified. Therefore Chad has until midnight April 19, 2001, to identify the property he intends to sell.

<p>Practitioner Note. The 5 business day and the 45-day identification requirements run concurrently.</p>
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In this example, Chad, by written notice to his EAT, identified the property to be sold on April 1, 2001, well within the 45-day period, which ended on April 19.

Rev. Proc. 2000-37 provides that no later than 180 days after the title to the replacement property has passed to the EAT, the property to be relinquished is transferred to a person (in this case, Ann) who is not the taxpayer (Chad) or a disqualified person. In this example, the closing date for the sale of Chad's

relinquished property to Ann occurred on June 01, 2001, well within the 180-day period. The 180-day period would have expired at midnight on September 1.

In the example, Chad, through the EAT, closed on the sale of his relinquished property with Ann. At closing, the EAT directly deeded title to Chad's relinquished property to Ann. In return, the EAT received Ann's purchase proceeds into escrow for the eventual benefit of Chad.

Practitioner Note. The combined time period that the relinquished property and the replacement property can be held in a qualified exchange arrangement (QEAA) by the EAT cannot exceed 180 days.

As of the closing date for the sale of Chad's relinquished property to Ann, the EAT has possession of:

1. Title to the replacement property (acquired from Jane)
2. The escrowed net sales proceeds of the relinquished property (acquired from Ann)
3. A note payable to Chad evidencing the original \$300,000 loan Chad lent to the EAT

The final leg of the reverse exchange is the transfer by the EAT of the three items above to Chad. As indicated previously, the transfer of the replacement property by the EAT to Chad and the transfer of the relinquished property to Ann must occur by midnight September 1, in order to satisfy the 180-day requirement.

CONCLUSION

Regular exchanges continue to be the norm, with reverse exchanges being utilized in exceptional situations. Due to financing issues, EAT's are not usually willing to take on the costs or liability issues of borrowing large amounts of money in order to acquire the replacement property for the exchange. **As a result, reverse exchanges are more likely to occur when the exchanger is a high income, high net worth individual who actually loans the needed acquisition funds to the EAT.** Reverse exchanges allow a property owner, who owns highly appreciated real estate, to acquire the replacement property first, something that was previously not possible under the regular exchange rules.

Practitioner Note. Rev. Proc. 2000-37 specifically states that no inference is intended with respect to the federal income tax treatment of arrangements similar to those described in the Rev. Proc. that were entered into **prior** to the effective date September 15, 2000. The Rev. Proc. also indicates that certain transactions can still be accomplished outside the "safe harbors," and presumably still qualify for reverse exchange treatment. Therefore, it is possible that reverse exchanges

that occurred **prior** to September 15, 2000, that do not specifically follow the “safe harbor” guidelines **might** still be accepted by the IRS in exam situations.