

Increased Flexibility For Like-Kind Exchanges: The Reverse Like-Kind Exchange

One of the best strategies to defer capital gains that arise upon the sale of investment property is the use of a like-kind exchange. Internal Revenue Code Section 1031 defines a like-kind exchange as any exchange of property held for investment or for productive use in a trade or business for like-kind investment, trade or business property. Essentially, like-kind exchanges allow taxpayers to dispose of appreciated property without being taxed on the gain by virtue of exchanging it rather than selling it.

The term "like-kind" is broadly defined in Code Section 1031. In general, investors can defer the tax liability if they exchange the property for a similar category of property (i.e., real property for real property, personalty for personalty). For example, an amusement park may be exchanged for raw land, or a shopping center may be exchanged for an apartment building.

Historically, however, the greatest difficulty for taxpayers wanting to take advantage of Section 1031 has been the timing of the exchange. Taxpayers who wished to complete a like-kind exchange found it logistically difficult to perform a simultaneous exchange. It is far less complicated simply to sell a property and acquire another at a later time; or the reverse, to purchase relinquishment property first and then transfer the relinquished property.

Case law and Treasury regulations instruct that simultaneous exchanges of property are not required. Deferred exchanges, where replacement property is acquired after the relinquishing transfer, qualify under the like-kind exchange rules. However, regulations issued in 1991 outlined rules for deferred exchanges, but did not address exchanges where the replacement property is acquired before the relinquished property is transferred (reverse like-kind exchanges). Recently, the IRS outlined a safe-harbor for the use of reverse like-kind

exchanges, which lends needed guidance and objectivity to reverse exchanges.

Since the 1991 regulations, there have been numerous arrangements to facilitate deferred and reverse like-kind exchanges, called "parking arrangements." Replacement property is "parked" with an accommodation party until the transfer of the relinquished property is arranged. Until Rev. Proc. 2000-37, numerous complexities and practical issues surrounding like-kind exchanges made them a challenge to execute properly. Of particular concern were statutory time-periods for identification and exchange of the properties and how to treat qualified intermediaries and title companies who tried to facilitate parking arrangements. Practitioners had to deal with a great deal of uncertainty in this area. The new safe harbor establishes objective standards for parking arrangements by creating what is termed a qualified exchange-accommodation arrangement (QEAA). If the QEAA rules are met, the accommodation party is assured the requisite ownership treatment so as to accomplish the like-kind exchange.

For a property to be held in a QEAA it must meet the following requirements:

- Title must be held by a person who is not the taxpayer - called the exchange accommodation titleholder (EAT) and it is subject to federal income tax at all times from the date of acquisition until the property is transferred;
- When the property is transferred to the exchange-accommodation titleholder, the taxpayer must intend to make a tax-free exchange;
- No later than five days after the transfer to the exchange-accommodation titleholder, the taxpayer and titleholder must make a written agreement that the property is being

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held to facilitate a like-kind exchange;

- No later than 45 days after the transfer to the exchange-accommodation titleholder, the relinquishment property is properly identified;
- No later than 180 days after the transfer to the exchange accommodation titleholder, (a) the property is transferred to the taxpayer as replacement property, or (b) the property is transferred as relinquishment property to a person

who is not the taxpayer or to a disqualified person.

- The combined time period that the relinquishment property and the replacement property are held by the exchange accommodation titleholder is limited to 180 days.

Compliance with the safe harbor avoids a highly factual determination that may risk the benefit of the Code Sec. 1031 deferral of capital gains tax, as well as the ability to invest all sale proceeds (without reduction for taxes) in replacement property.

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