Like-Kind Exchange Corner

By Mary B. Foster

New Ruling Approves Multi-Property, Combination Reverse and Forward Exchange

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A new IRS Chief Counsel Advice, CCA 200836024,[1] approved a technique under Code Sec. 1031 that effectively stretches the time period to complete a multi-property exchange up to 360 days by combining a reverse exchange with a deferred or "forward" exchange. Many taxpayers have been using this technique for several years, so this ruling provides reassurance to taxpayers that the IRS agrees with the technique's validity. Hopefully, this ruling will ward off any challenges by IRS field agents to this type of exchange.

This combination reverse and forward exchange technique is useful in two situations. First, the taxpayer may want to (1) acquire the first of multiple replacement properties up front in a reverse exchange, (2) dispose of the higher valued relinquished property later in a forward exchange, and (3) acquire the additional replacement properties after the disposition of the relinquished property to make up the difference between the relinquished property value and the first replacement property value. Second, the taxpayer may want to (1) sell the first of multiple relinquished properties up front in a forward exchange, (2) later acquire just one replacement property of higher value to both complete the initial forward exchange and to commence a reverse exchange, and (3) then dispose of the other relinquished properties in a separate exchange for a portion of the replacement property. Each of these situations is illustrated in more detail below.

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Reverse Exchange First

A taxpayer may intend to dispose of a relinquished property in the future, but the taxpayer must ac-

quire the first of multiple replacement properties now. This was the situation in CCA 200836024. The taxpayer enters into a qualified exchange accommodation arrangement with an EAT to acquire the first replacement property in a safe harbor reverse exchange under Rev. Proc. 2000-37,[2] This is sometimes called a "parking" arrangement because the EAT is parking the replacement property while the taxpayer arranges for the disposition of the relinquished property. The parking period cannot exceed 180 days under Rev. Proc. 2000-37.

When the relinquished property sells during the 180-day parking period, the taxpayer acquires the first replacement property from the EAT as one replacement property. The balance of the exchange proceeds are held by a qualified intermediary, or "QI," in a forward exchange for the acquisition of additional replacement property. The taxpayer then has an additional 45 days to identify the other replacement property and an additional 180 days to acquire the other replacement property under Code Sec. 1031(a)(3).[3]

Note that the reverse exchange and the forward exchange each have separate 45 and 180 day periods. While Code Sec. 1031(a)(3) requires that the taxpayer identify the replacement property in a forward exchange by the 45th day of the exchange period, Rev. Proc. 2000-37 likewise requires that the taxpayer identify the relinquished property in the reverse exchange by the 45th day of the parking period. The taxpayer must be careful to satisfy both sets of time requirements.

Example. The EAT acquires replacement property #1 valued at $600,000 on day 1. On day 45, the taxpayer identifies relinquished property A in its notice to the EAT for the reverse exchange. On day 120, the taxpayer disposes of relinquished property A valued at $1,000,000. The taxpayer has 60 more days (or until day 180) to take title to replacement property #1 and still fall within the 180-day deadline for the safe harbor reverse exchange. The taxpayer has 180 more days (or until day 300) to acquire a second replacement property with the remaining $400,000 of exchange proceeds for the forward exchange. The identification notice for the forward exchange is due by the 45th day of the forward exchange (or day 165). If the taxpayer has not acquired replacement property #1 from the EAT by day 165, then the taxpayer must remember to identify replacement property #1 in the 45-day identification notice for the forward exchange.

Note that the first replacement property acquired from the EAT in the example represents one property for the purposes of the three-property identification rule of Reg. §1.1031(k)-1(c)(4)(i)(A), so the taxpayer may identify up to two additional replacement properties in the forward exchange. Alternatively, the taxpayer may utilize the 200-percent identification rule of Reg. §1.1031(k)-1(c)(4)(i)(B) and identify more than three total replacement properties in the forward exchange. The taxpayer must be careful not to become confused with the many deadlines.

Repayment of Taxpayer Advance Prior to End of Exchange

The taxpayer may have advanced the purchase price of replacement property #1 to the EAT, and the EAT gave the taxpayer a promissory note for $600,000 evidencing that advance. The taxpayer may have borrowed the funds from a line of credit or other funding source with an interest rate in excess of the interest rate earned on the exchange funds while held with the QI. Thus, when the relinquished property sells, the taxpayer wants to be repaid the $600,000 from the relinquished property sales proceeds so the taxpayer can pay off the line of credit. Yet, the forward exchange is not complete because the taxpayer will acquire additional replacement property, and, therefore, the exchange funds are still subject to the "(g)(6)" restrictions found in the deferred exchange regulations.[4] As such, the taxpayer is not entitled to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the QI before the end of the exchange period (unless the taxpayer fails to identify additional replacement property by the 45th day of the exchange period, or the taxpayer has received all the replacement property that the taxpayer is entitled to under the exchange agreement). Thus, the QI cannot disburse exchange funds to the taxpayer without violating the QI safe harbor and potentially making the entire exchange taxable.

This (g)(6) language in the deferred exchange regulations has taxpayers wary of being repaid for their advances to an EAT prior to the final completion of the exchange. However, this repayment was allowed in CCA 200836024 without a discussion other than the statement that "all guidelines were followed to assure that the taxpayer was not in

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constructive receipt of any of the exchange funds during the two exchange periods." This is the correct result for these repayments. Under the deferred exchange regulations, the taxpayer can receive funds from parties other than the QI without affecting the QI safe harbor.[5] Therefore, when the EAT transfers replacement property #1 to the taxpayer, the QI can pay the EAT the purchase price of $600,000 for replacement property #1, and the EAT can then repay the $600,000 to the taxpayer. While the taxpayer is receiving the exchange funds in an indirect manner, the exchange funds are received from the EAT, *i.e.,* a party other than the QI. Further, they are received in repayment of an advance of cash already made by the taxpayer and not a taxable disbursement of exchange proceeds to the taxpayer. The boot offset rules of Code Sec. 1031 provide that cash received by the taxpayer in an exchange can be offset by cash paid by the taxpayer in computing gain recognized in the exchange. Therefore, if the payment of the $600,000 by the QI to the EAT and then to the taxpayer were collapsed into just a payment by the QI to the taxpayer, the payment still should be a nontaxable return of cash boot paid by the taxpayer.[6]

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Reasoning of CCA 200836024

The IRS Chief Counsel Advice addresses whether the structure violates the Congressional intent because: (1) there could be up to 360 days between the day on which replacement property is parked with an EAT at the inception of the reverse exchange and the day the forward exchange is completed, and (2) the taxpayer is entitled to two separate 45-day identification periods. This could, therefore, be contrary to the identification and replacement provisions set forth in Code Sec. 1031(a)(3). However, the IRS reasoned that there was no violation because there are two exchanges taking place instead of one, and the taxpayer met the requirements of both Rev. Proc. 2000-37 and the deferred exchange regulations. As such, the taxpayer was permitted 45 days to identify replacement property in a forward exchange and 45 days to identify relinquished property in a reverse exchange. In addition, the taxpayer was permitted to park property with an EAT for a period not exceeding 180 days in the reverse exchange, and, in the forward exchange, the taxpayer had to close its exchange by acquiring replacement property within the exchange period.

The IRS also noted that section 4.03(1) of Rev. Proc. 2000-37 provides that property will not fail to be treated as being held in a qualified exchange accommodation arrangement as a result of an EAT entering into "an exchange agreement with a taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under §1031." Thus, the IRS reasoned that "section 4.03 seems to anticipate, and permit, transactions in which parked property is transferred in connection with a deferred exchange."

The taxpayer in CCA 200836024 never acquired additional replacement property and the remaining exchange proceeds were released to the taxpayer in the next tax year, apparently when the 180-day exchange period expired. The taxpayer reported the receipt of the remaining exchange proceeds as gain in the second tax year under the installment sale rules of Code Sec. 453 and Reg. §1.1031(k)-1(j)(2). The analysis of the CCA, however, is applicable to when additional replacement property is actually acquired in the forward exchange.

Forward Exchange First

A taxpayer that has begun a forward exchange with one relinquished property may want to acquire a portion of a replacement property in the forward exchange, and have an EAT acquire the balance of the replacement property to use as replacement property for another relinquished property in a subsequent exchange. The portion of the replacement property held by the EAT should be treated as a separate property and transferred to the taxpayer in the subsequent exchange within 180 days of the EAT's acquisition of the portion of the replacement property.

Example. The taxpayer disposes of relinquished property A for a value of $400,000 on day 1. The taxpayer also has relinquished property B that is on the market for $600,000, with no buyer lined up yet. The taxpayer wants to exchange both of these relinquished properties into replacement property #1 valued at $1,000,000. On day 45 of the forward exchange of relinquished property A, the taxpayer identifies a $400,000 interest in replacement property #1 in a written notice to QI. On day 180, the taxpayer acquires a $400,000 or 40-percent undivided interest in replacement property #1 in the forward exchange and the EAT acquires the remaining 60-percent undivided inter-

est in a safe harbor reverse exchange. The taxpayer has 180 additional days (or until day 360) to sell relinquished property B and to exchange it into the 60-percent remainder of replacement property #1 held by the EAT. The taxpayer must remember to identify relinquished property B in either the qualified exchange accommodation agreement with the EAT, or the 45-day written notice to the EAT for the reverse exchange (which falls on day 225).

While the IRS has issued CCA 200836024 approving the reverse-first structure, it has not issued any guidance for the forward-first structure. Nevertheless, the analysis in the reverse first memorandum discussed above should also apply to the forward-first structure. If the taxpayer complies with the identification and receipt requirements of both forward and reverse exchanges, they should each be treated as separate, valid exchanges.

ENDNOTES

1 CCA 200836024 (May 12, 2008).

2 Rev. Proc. 2000-37, 2000-2 CB 308.

3 Reg. §1.1031(k)-1(b)(1) and (2).

4 Reg. §1.1031(k)-1(g)(6).

5 Reg. §1.1031(k)-1(g)(4)(vii).

6 *F.B. Biggs,* 69 TC 905, Dec. 35, 035 (1978) (taxpayer allowed to offset cash received at closing with prior advance). *See* Rev. Proc. 2003-39, IRB 2003-22, 971, 2003-1 CB 971 for program exchanges, which allows the netting of amounts owed by the seller of the replacement property against the purchase price and the QI's payment of such amount to the taxpayer.

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