BIOGRAPHICAL INFORMATION

Since 1989, Jeffrey A. Rattikin has envisioned and brought to market a multitude of innovative solutions to the land title, tax-deferred exchange and legal services industries. Mr. Rattikin has practiced commercial and residential real estate transactional law for 26 years. An AV-rated and Board Certified attorney (Residential Real Estate Law, Texas Board of Legal Specialization), Jeff has been honored with a number of local and state awards, including most recently a 2017 Top Real Estate Attorney designation by both Fort Worth, Texas Magazine and 360 West Magazine. He is a graduate of the University of Texas at Austin with a B.B.A. in Finance and Southern Methodist University School of Law. Mr. Rattikin serves as co-owner, counsel and Manager/Escrow Officer of a 73 year old privately held title company, and founder, owner and President of two companies offering regional and national qualified intermediary services to clients engaged in §1031 tax deferred exchanges. Mr. Rattikin is active in numerous local, state and national industry associations, faith-based initiatives in Ethiopia and Brazil, and local civic boards. Jeff’s creation and development of TexasLegalDocs.com, an innovative online legal services platform, has led to his most recent endeavor, joining forces as partner and President of GetLegal.com, a nationally-based, industry-leading online source for legal information, products and services. Mr. Rattikin is a frequent presenter and speaker at real estate, exchange and legal industry conferences, workshops and meetings. A father of four children, Jeff and his wife make their home in Fort Worth, Texas.
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UPDATE ON THE USE OF SEC. 1031 AND SEC. 1033 LIKE KIND EXCHANGES IN AGRICULTURE

I. INTRODUCTION

This article is intended to provide an update on certain issues pertaining to §1031 tax deferred exchanges as they relate to agriculture. It is intended to provide attorneys with a general understanding of select exchange issues that typically impact agricultural professionals. By design, this article does not go into great detail regarding tax ramifications, accounting procedures or case law related to exchanges, and is not intended to be a comprehensive treatment of any of the issues discussed. All parties interested in initiating a §1031 tax deferred exchange are urged to consult with a certified public account and/or tax attorney to analyze the particular tax aspects of the transaction. For a more detailed treatment of accounting procedures, case law and regulations related to §1031 exchanges, you are encouraged to review the excellent material presented on this topic at past Land Title Institutes and Advanced Real Estate Law seminars of the State Bar of Texas. For in-depth analysis of tax deferred exchanges, I would refer you to Long and Foster, Tax-Free Exchanges Under §1031, Thomson Reuters (2016) (hereinafter referred to as “Long and Foster”).

II. §1031 EXCHANGE BASICS

A. Statutory Basis

Generally, Section 1001 (c) of the Internal Revenue Code of 1986, as amended (the “Code”) provides that a taxpayer must recognize gain or loss on the “sale or exchange” of property. As a result, the taxpayer is subject to capital gains tax on any realized gain arising out of the sale of real estate held by the taxpayer for business or investment purposes.

However, §1031 of the Code represents one of the last legitimate tax shelters available to owners of real estate and other assets; §1031 provides a vehicle to allow asset owners to defer payment of capital gains tax by reinvesting proceeds derived from the sale of property to a third party in the purchase of similar, or “like-kind”, property. The 1984 Tax Reform Act, as well as the 1991 regulations, greatly liberalized the process of documenting and completing a §1031 exchange transaction. The new laws provided a mechanism whereby a seller could accomplish a non-simultaneous exchange without the necessity of involving the purchaser of the relinquished property, through the introduction of “deferred exchanges”. A deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business, or for investment (the “Relinquished Property”) and subsequently receives property to be held either for productive use in a trade or business, or for investment (the “Replacement Property”). The transaction must constitute an exchange as opposed to a transfer of property for money, and both properties must be of “like kind” nature. Amendments and regulations to the Code now allow a taxpayer to complete the sale of relinquished property to a purchaser, and identify potential replacement property within 45 days after the transfer of the relinquished property is completed. Thereafter, the replacement property must actually be acquired on or before the expiration of 180 days after the transfer of the relinquished property, or the due date (including extensions) for the taxpayer’s tax return for the taxable year in which the transfer of the relinquished property occurs, whichever is earlier. Under the deferred exchange regulations, if the taxpayer actually or constructively receives money or property in violation of the requirements of §1031, the transaction will constitute a sale, and not a deferred exchange, even if the taxpayer ultimately receives like kind replacement property.

B. Use of Qualified Intermediaries in Exchange Transactions

If a taxpayer actually or constructively receives money from the sale of Relinquished Property before it receives title to the like kind Replacement Property, the transaction will constitute a sale, rather than an exchange, and will not qualify for nonrecognition treatment. For purposes of evaluating whether a taxpayer is in actual or constructive receipt of money prior to its receipt of like kind Replacement Property, one must determine whether the taxpayer has the right to control or take possession of the funds at will, or whether certain limitations on its ability to control or access the funds lapse, expire or are waived.

In order to ensure that the taxpayer does not receive actual or constructive receipt of the proceeds of sale prior to the receipt of Replacement Property, §1031 and its regulations provide four safe harbors. The safest and most often used sale harbor provides for the use of a qualified intermediary to hold the funds during the pendency of the exchange. As long as the qualified intermediary holds the funds during the pendency of the exchange, and the taxpayer does not have actual or constructive control or possession of such funds, the taxpayer will not be held in constructive receipt of such funds so as to invalidate the exchange.

C. Exchange Prerequisites

In order for a property owner to successfully defer payment of capital gains tax on the sale of its relinquished property: (1) there must be an exchange; (2) the properties exchanged must be of “like kind”; and (3) the property transferred and the property received must be held for productive use in a trade or business, or for investment. These relatively simple concepts,
however, produce a wide range of issues that must be correctly analyzed in order to close a successful exchange.

1. The Exchange Requirement

a. Exchange vs. Sale/Reinvestment. Although it is in some senses a legal fiction, §1031 still requires an exchange of business or investment property, as opposed to a case sale of relinquished property and reinvestment of the proceeds in the replacement property. The Internal Revenue Services does not recognize that a taxable event has occurred in situations where a taxpayer merely trades one property for another. However, if a taxpayer sells a property and then voluntarily elects to use the proceeds to purchase another property, the taxpayer will be subject to capital gains tax on the sale of relinquished property. As a result, it is important to structure any exchange transaction in strict compliance with the provisions of §1031 and its regulations to ensure that the transaction is viewed as an “exchange” rather than a “sale/investment”.

b. Refinance of Replacement Property. If a taxpayer pays cash for a Replacement Property through the use of exchange funds held by an intermediary, and thereafter desires to place a lien on the property and pocket the loan proceeds, he/she may nullify the exchange. The IRS may claim that the cash purchase and subsequent refinance were “step” transactions, the effect of which allowed the taxpayer to pocket the proceeds of the sale of the Relinquished Property without paying capital gains taxes. Most commentators advise taxpayers to avoid a refinance within a year of the acquisition of the Replacement Property. If a taxpayer cannot wait a year, then there should be evidence of an independent business purpose behind refinancing the property. Certainly, any refinance of the Replacement Property should be handled in a separate transaction from the purchase, and the subsequent use of the loan proceeds should be documented to prove the independent business purpose of the loan. It is interesting to note that some tax courts, and even the IRS, seem to be “lightening up” on this issue, and have allowed post-exchange refinances See, e.g., Long and Foster §4.14.

2. The “Like-Kind” Requirement

Both the relinquished property sold by the taxpayer and the replacement property subsequently purchased by the taxpayer must be of “like kind” nature to each other. Although the regulations dealing with personal property are extremely strict in its analysis of whether one property is like kind to another, the regulations regarding real estate are much more liberal. For purposes of exchanging real estate for real estate, the regulations provide that it is immaterial whether the property is improved or unimproved, urban or rural, farmland or office tower, residential or commercial. For the most part, as long as the taxpayer is exchanging fee title in real estate for fee title in other real estate, the transaction will meet the like kind requirement. Exceptions to this rule come into play when the taxpayer attempts to include a property in which he or she owns, or will own, something less than fee title to the property (for instance, a leasehold interest or certain oil and gas payment rights).

a. Agriculture Applications

1) Minerals

a) Generally. In Texas, mineral interests are considered a real property interest; as a result, ownership of perpetual mineral rights, including overriding royalty interests, working interests, oil and gas leasehold rights (those that continue until the mineral deposit is exhausted, and therefore considered perpetual in nature), can be exchanged for any other fee interest in real estate, including raw land, shopping centers, office buildings or industrial warehouses.

b) Exception: production payments, whereby the right to payment will terminate within a specified time, are not perpetual in nature and therefore cannot be exchanged for a different type of real estate (P.G. Lake, Inc., 1 AFTR 2d 1394, 356 US 260, 2 L Ed 2d 743, 58-1 USTC 9428, 1958-1 CB 516 (1958)).

2) Water Rights

a) Generally. In Texas, perpetual water rights are like-kind to real estate, and can be exchanged for other interests in real estate.

b) Exception: If the water rights are limited in duration or amount, they are not considered like-kind to real property interests for purposes of §1031.
Donald Wiechens, et al. v. U.S., 228 F. Supp. 2d 1080 (D Ariz 2002), the Court ruled water rights limited in priority, quantity, and duration for a 50-year term were not like kind to a fee interest in real property even though the water rights were real property under state law. The Court denied the 1031 exchange on the basis that the water rights were restricted as opposed to unlimited use of real property. However, in Private Letter Ruling 200404044, the IRS approved a §1031 exchange where water rights were exchanged for a farm, even though the water rights were limited to a maximum diversion rate and quantity per calendar year. The distinction lay in the fact that overall water rights were perpetual; the annual extraction limitation was imposed merely by state regulation in the public interest, but did not limit the overall amount or duration of such rights.

3) Non-Realty Items. For non-real estate property interests, the “like-kind” rules are more strict, and require a closer nexus in type between the “use” of properties exchanged. For personal property, the exchange properties must be of “like-class” in accordance with the Product Classes listed in the The North American Industrial Classification System (“NAICS”), which replaced the Standard Industrial Classifications manual (“SIC”) in 2002, and described in General Asset Classes of Regulation in §1031(a). Only those properties within the same “like-class” may be exchanged in a valid §1031 exchange of personal property. See Reg. 1.1031(a)-2 et seq.

(a) Farm Equipment

(1) Farm Machinery and Equipment is categorized as product class 333111 under the NAISC manual.
(2) The most common types of farm machinery exchanges include planting, harvesting, haying and grass mowing and even dairy equipment

(b) Livestock

(1) Livestock held as “ordinary part of your farm business” for 12 months

(c) Crops

(1) Unharvested Crops are generally considered part of the real property in an exchange of agricultural land so long as:
(2) Crop used in trade or business and held for more than six months;
(3) Crop and land exchanged simultaneously and to the same person;
(4) EXAMPLE: In an exchange of a nursery, the unharvested trees and shrubs were considered part of the real-property in the exchange (Asjes v. Commissioner of Internal Revenue)
(5) Harvested Crops are not eligible for exchange under §1031 because they are considered inventory and taxable as income.

(d) Timber/Timberland

1. To qualify as a real property interest under §1031, timber must have been held as unsevered timber/timberland for investment or use in trade, with intent to hold replacement property for timberland use; not held as inventory for sale.

2. Severed timber is typically classified as personal, not real, property; timber and timberland held primarily for sale do not qualify, nor does a contractual right to cut timber.

3. The “Held-For” Requirement

a. Generally. In order to qualify for non-recognition under §1031, both the property transferred and the property received by the taxpayer must be held either for productive use in a trade or business, or for investment. A taxpayer will not obtain tax deferred treatment if the exchange involves the sale or purchase of property used for personal use (such as residences and vacation homes) or property held primarily for sale to a customer in the ordinary course of its trade or business (such as a real estate dealer or developer). The taxpayer’s intent at the time of purchase controls, and the IRS will consider various factors in an attempt to determine intent, such as the duration of ownership, extent of taxpayer’s efforts to sell the property, amount of development and improvement, advertising and frequency of sale of other real estate.

b. Agricultural Applications:

(1) Ranch/Farm Consisting of Home and Acreage. If a Relinquished Property or a Replacement Property consists of a portion which would qualify for an exchange and a portion which would not qualify for an exchange (such as a farm/ranch with a personal residence), then a taxpayer must divide the transactions into two separate transactions, initiating an exchange only on that portion of the property which will not be used for personal purposes. A reasonable amount of land should be surveyed out around the home for personal use, and the remainder shall constitute the exchange property.

4. Excluded, Non-Qualifying Property

a. Generally. Certain other property is excluded from tax deferred exchange treatment, including stocks, bonds, notes, securities and partnership interests. As a result, a taxpayer cannot use exchange proceeds from the sale of real estate to purchase stock in a corporation or an interest in a partnership that owns real estate. None of these interests are classified as “like kind” to an ownership interest in real estate.

b. Agricultural Applications:

(1) Royalty Trust and Real Estate Investment Trust (“REIT”) Units- Because these assets are typically traded on the open market through various exchanges, they resemble securities otherwise specifically excluded from §1031. Although the IRS has to date refused to give specific guidance on royalty trust units, officials have informally stated that publicly traded trusts, such as royalty trusts, do not qualify for 1031 exchange treatment.

(2) Delaware Statutory Trust (“DST”)—A DST is a grantor trust in which the trust beneficiaries’ interest are treated as an ownership interest in the underlying real properties (so long as the terms of Rev. Rul.
5. Exchange Deadlines

a. Identification of Replacement Property

After the completion of the sale of its Relinquished Property, a taxpayer must identify potential Replacement Property in a written document signed by the taxpayer and delivered before the end of the 45-day identification period, to another person involved in the exchange (most often, the qualified intermediary). In such written document, the Replacement Property must be identified unambiguously, such as by legal description, street address or distinguishable name (i.e., the Empire State Building). The taxpayer may identify up to three properties as potential Replacement Properties without regard to their fair market value (the "three property rule"). In the event the taxpayer identifies more than three properties, the total aggregate fair market value of all of the properties so identified may not exceed 200% of the aggregate fair market value of the Relinquished Property (the “200% rule”), or the taxpayer must actually acquire 95% of all properties identified (the “95% rule”). It is extremely important that the Replacement Property is unambiguously described. For that reason, a legal description of the actual property sought to be purchased is suggested. A street address may not be sufficient if, for example, it refers to a building situated on a highway on a 100 acre parcel of land. In this situation, it is unclear if the street address refers only to the building fronting the highway or to the entire 100 acre parcel of land. If a taxpayer will only purchase a portion of the replacement property, he/she must identify the percentage interest they anticipate obtaining with their exchange proceeds. An identification of potential Replacement Property may be revoked at any time prior to the expiration of the 45-day identification period, as long as such revocation is made in writing and delivered in the same manner as required for the original identification notice.

b. Acquisition of Replacement Property

The Replacement Property must actually be acquired in the taxpayer’s name on or before the expiration of 180 days after the transfer of the Relinquished Property, or the due date for the Taxpayer’s tax return for the taxable year in which the transfer of the Relinquished Property occurs, whichever is earlier. If the tax return date (usually April 15) occurs prior to the expiration of 180 days, then the taxpayer may file for an automatic extension to obtain the benefit of the full 180 day exchange period.

6. Required Value of Replacement Property

General Rule. In order to obtain the benefits of a fully deferred exchange, a taxpayer must not only use all its net proceeds held by the intermediary towards the purchase of replacement property, but it must also purchase property or properties with at least the same value seller the relinquished property. As a result, a taxpayer must replace any debt paid off at the closing of the relinquished property with new debt or additional equity in purchasing the replacement property. Any debt not so replaced will be considered boot, subject to tax liability.

7. Nature of Taxpayer’s Ownership Interest-Entity Issues

a. General Rule-Same Taxpayer Requirement. As a general rule, the person or entity selling the Relinquished Property must be the same entity which purchases the Replacement Property. As a result, if a corporation, for example, sells the Relinquished Property, that same corporation must take title to the Replacement Property in order for the exchange to succeed.

b. Marital Estate. If the Relinquished Property is held by husband and wife as community property, then the Replacement Property must be obtained by husband and wife as community property. Conversely, if the Relinquished Property is held by husband as his separate property, but he purchases replacement property along with his wife, then his exchange will fail.

c. Exceptions to the General Rule. It is permissible for an owner to sell relinquished property in its individual name and purchase replacement property in the name of a single member LLC (many lenders will require that property be purchased in the name of a single asset entity). It is also permissible for an individual to convey replacement property to a grantor trust subsequent to its purchase. However, an LLC with two members will not qualify for this exception.

d. Corporate/Partnership Issues-Drop and Swaps. If a corporation or partnership owns the relinquished property, then the same entity must purchase the
replacement property. However, many times some, but not all of the shareholders or partners desire to complete an exchange; the others desire to cash out. In such instances, recent holdings suggest that it is acceptable for an individual shareholder or partner to complete an exchange for his/her interest in the property as long as the corporation or partnership is dissolved prior to the closing and the real property divided among the shareholders or partners as tenants in common. Thereafter, each shareholder or partner can sell or exchange their undivided interest in the relinquished property at their discretion. See Magneson v. C.I.R., 753 F.2d 1490 (9th Cir. 1985); (many commentators, as well as the IRS, have questioned whether the “held for” test would be violated by an ownership entity that conveyed property to its individual owners whose sole intent in obtaining title was to immediately sell it to a third party). Care should be given to a situation involving a group of co-owners who act as a partnership in handling affairs related to the property. If they collectively have any duties or obligations other than as owners of undivided interests in the property (such as duties under a non-triple net lease), then they may be considered a partnership; the individuals may be hampered in their ability to complete an exchange for their undivided interest in the property.

Nonetheless, because the IRS continues to suggest that “drop and swaps” violate the “held-for” requirement, a risk-averse taxpayer may desire to play it conservatively and distribute assets out of the entity and into the individual owners at least one year in advance of putting the property up for sale. In 2008, as part of the IRS’ attempt to limit drop and swap transactions, Schedule B 14 was added to Form 1065. Schedule B 14 asks “At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property.” Prior to the inclusion of this check-the-box requirement, drop and swaps were frequently done on a “don’t ask, don’t tell” basis. However, to counter, the Tax Court in Bolker v. C.I.R., 720 F.2d 1039, 1045 (9th Circ., 1985) reiterated the Tax Court’s lenient treatment of drop and swaps, despite the IRS’s attempt to severely limit the ability of entities to perform these transactions through Form 1065.

8. Sale/Purchase with Related Parties

a. Sale to Related Party. Generally, a taxpayer can sell its Relinquished Property to a related party as part of an exchange, as long as both the taxpayer and the related party hold on to their respective properties for two years. Any prior disposition of either property will nullify the exchange.

b. Purchase from Related Party. Generally, tax advisors are advising their clients that completing an exchange by purchasing Replacement Property from a related party is not effective, and an exchange structured in such a way will fail.

III. BUILD-TO-SUIT/CONSTRUCTION EXCHANGES

A. Historically Prohibited. Many times a taxpayer involved in a §1031 Exchange may desire to complete the exchange by applying the proceeds from its sale of Relinquished Property towards the subsequent purchase of a replacement property and certain improvements to be constructed thereon. IRS regulations and tax court cases have imposed strict restrictions on a taxpayer’s ability to use exchange proceeds towards construction costs on replacement property. Basically, the IRS’ position is that a taxpayer cannot use a portion of the exchange funds to purchase replacement property in its own name, and subsequently spend the balance of the funds to construct improvements. Why? Because the IRS views construction costs as payment for labor and materials, rather than payment for fee title to real estate. As such, the payment for labor and materials does not constitute a like-kind exchange in connection with the sale of real estate. However, absent any clear, definitive guidance from the IRS, taxpayers continued to come up with creative ways to conduct these build-to-suit, or construction, exchanges.

B. Applicability of Rev. Proc. 2000-37. The release of Rev. Proc. 2000-37 by the IRS finally cleared the way for the legitimate use of exchange proceeds towards the construction of improvements on a desired replacement property, as long as the taxpayer strictly complies with the regulations. If a taxpayer enters into a Qualified Exchange Accommodation Agreement with an Exchange Accommodation Titleholder (“EAT”), the EAT may purchase the Replacement Property and construct desired improvements utilizing the exchange proceeds.

C. Procedure. After the sale of the Relinquished Property, the net proceeds will be held by the Qualified Intermediary under a regular exchange agreement with the Client. The
Client must identify its proposed replacement property, and proposed improvements, within 45 days of the sale. The Client will then retain the services of an EAT, who will purchase the unimproved Replacement Property utilizing a portion of the exchange proceeds loaned to the EAT by the Qualified Intermediary. Title to the Replacement Property will remain “parked” in the name of the EAT until construction is completed, or 180 days from the sale of the Relinquished Property, whichever comes first. The EAT will then contract for and complete the desired construction using the balance of the exchange proceeds, and ultimately deed the improved Replacement Property to the Client within 180 days of the sale of the Relinquished Property.

D. Deeds, Title Policies and Related Closing Issues. Deeds, title policies and settlement statements involving EATs should be handled the same way as outlined above in connection with Reverse Exchanges below.

E. Identification Requirements. As with any regular exchange, the taxpayer has 45 days to identify the desired replacement property. If the taxpayer also intends to use exchange proceeds toward construction activities, the identification must not only specifically describe the land, but also include a detailed summary of the new construction to be performed.

F. Construction Financing. If any financing is required to complete the construction over and above the exchange proceeds loaned by the qualified intermediary, the EAT will typically execute a non-recourse note and deed of trust with a friendly lender, guaranteed by the Client. The loan must be funded to the EAT.

G. Subsequent Transfer to Client. Only after the improvements are fully completed, or the imminent expiration of the 180 day exchange period, will the EAT transfer title to the improved, or partially improved Replacement Property to the Client. In this way, the Client sold real estate and subsequently took title to improved real estate, thereby avoiding the IRS’s prohibition on using exchange proceeds towards labor and materials on property owned by the Client.

H. Value of Improvements Included in Exchange. Only improvements which have been completed and incorporated into the structure as of the date of transfer shall be considered like-kind real property for purposes of § 1031. The EAT may not prepay the contractor for work yet to be done, or materials delivered to the site but not incorporated into the structure as of the date of transfer.

I. Time Deadline for Construction Exchanges. The construction must be completed and title to the Replacement Property must be transferred from the EAT to the taxpayer within 180 days of the sale of the Relinquished Property in order for the construction exchange to be successful.

J. Remaining Loan Obligations. In the event a loan is obtained to finance the construction, any remaining loan obligations at the time of transfer to the Client will typically be assumed by the Client.

K. Additional Documentation. Because the EAT will hold title to the Replacement Property during the pendency of the construction exchange, additional documentation, such as construction management agreements and leases, may be executed between the EAT and the Client. The regulations allow the taxpayer to negotiate the construction agreements and supervise contractor activity in lieu of the EAT, who holds title to the property.

L. Construction on Land Previously Owned. Various tax court cases and IRS rulings have made it clear that a taxpayer may not use exchange proceeds to complete improvements on property it already owns, even if the taxpayer temporarily conveys the property to an EAT prior to commencement of construction. If exchange proceeds are to be used for construction, it must be on new property purchased by the EAT from an unrelated third party.

M. Ground Lease on Related Party Property. Although it is clear that a taxpayer may not use exchange proceeds to construct improvements on his own, or a related party’s, property, a mechanism has been developed that has passed muster in a number of IRS decisions. That procedure involves the EAT taking a ground lease on property owned by a related party to taxpayer, constructing improvements on the ground lease, and then transferring the ground lease to taxpayer upon completion to complete the construction exchange. The ground lease should be an arm’s length agreement, fair market value paid to lessor, and have a duration of at least 35 years. A full discussion of this mechanism is beyond the scope of this article.
IV. REVERSE EXCHANGES

A. Guidelines. Typically, a taxpayer desires to sell its Relinquished Property and subsequently use proceeds to buy Replacement Property. However, for any number of reasons, many times the taxpayer must complete the purchase of the Replacement Property prior to the sale of Relinquished Property. These situations are called “reverse exchanges”. Unfortunately, the express provisions of §1031 and its regulations do not apply to reverse exchange situations. On September 15, 2000, the IRS finally released some procedural guidelines which, for the first time, set out procedures for reverse exchanges (IRS Revenue Procedure 2000-37, IRB 1 (September 15, 2000). If followed, the regulations create a safe harbor for such arrangements and the reverse exchange would not be subject to challenge.

B. New Players and Documentation. The guidelines introduced new players and new required documentation to the reverse exchange process. Under the new guidelines, a taxpayer seeking to accomplish a reverse exchange must first contract with an Exchange Accommodation Titleholder (the “EAT”) (typically a company providing qualified intermediary services for §1031 Exchange transactions). The EAT will prepare the reverse exchange documentation (including a Qualified Exchange Accommodation Agreement, Assignment of Replacement Property Contract, and Identification of Relinquished Property), under which the EAT would agree to purchase the Replacement Property utilizing a non-recourse loan from the seller or a friendly lender. The Replacement Property would in effect be “parked” with the EAT until the Relinquished Property is sold.

C. Parking Arrangement. Unlike regular exchanges in which title to the Replacement Property goes directly from Seller to Purchaser (known as “direct-deeding”) without passing through the qualified intermediary, the reverse exchange regulations require the EAT to purchase and hold the Replacement Property in the EAT’s name pending the taxpayer’s sale of Relinquished Property. This is commonly called a “parking arrangement”, and the EAT must actually hold all the benefits and burdens of ownership, without limitation.

D. Deed and Title Policy. Since the title to the Replacement Property will be held, at least temporarily, in the name of the EAT, the warranty deed must reflect “(name of EAT), as Exchange Accommodation Titleholder for (name of Client)”, as the Grantee. Prior to a change in the title insurance procedural rules, this requirement meant that the actual purchaser would not have direct title insurance coverage, since the title policy must be issued in the name of the actual Grantee of the deed. However, the title insurance rules have since been modified to facilitate the reverse exchange mechanism and now, pursuant to Procedural Rule P-63, the Owner’s Title Policy issued in connection with the purchase may reflect the insured as “(name of EAT), as Exchange Accommodation Titleholder for (name of Client), as their interests may appear”. This procedure effectively provides title insurance coverage to both the EAT and the eventual owner, without the need for any further modification or endorsement of the policy.

E. Purchase Price Financing. In reverse exchange situations, the Replacement Property will be purchased prior to the sale of the Relinquished Property. As a result, the qualified intermediary will not be in possession of any cash necessary to fund the purchase. Therefore, the purchase price must be financed utilizing a loan from a third party or the Client. In either case, the loan must be in the name of the EAT, on a nonrecourse basis.

To the extent the lender’s loan requirements reflect a down payment by the borrower, or the borrower must pay additional amounts into escrow to cover closing costs, the Client’s cash contribution must also be reflected on the settlement statement as a loan to the EAT, and the EAT will use those funds in addition to the lender’s loan proceeds to complete the purchase of the Replacement Property. The lender and the Client should wire the loan proceeds to the title company in advance of closing.

F. Settlement Statements. Since the EAT will actually purchase and take title to the Replacement Property, the EAT will sign the Settlement Statement at closing. Most EATs/qualified intermediaries ask that the Client’s signature also appear on the settlement statement reflecting that they have read and approved of the statement prior to closing.
G. Post-Purchase Time Requirements. After the EAT’s purchase of the Replacement Property, the Client has 45 days to identify potential relinquished property that Client intends to sell to complete the reverse exchange and defer capital gains taxes thereon. After entering into a contract, the Relinquished Property must be sold and title to the Replacement Property must be transferred from the EAT to the taxpayer within 180 days of the purchase of the Replacement Property, or the due date for the taxpayer’s tax return for the taxable year in which the transfer of the Relinquished Property occurs, whichever is earlier. If the tax return date (usually April 15) occurs prior to the expiration of 180 days, then the taxpayer may file for an automatic extension to obtain the benefit of the full 180 day exchange period.

H. Role of Qualified Intermediary—“Exchange within the Exchange”. In order to successfully complete a reverse exchange, a taxpayer must conduct a regular, or forward, exchange involving the sale of the Relinquished Property. After the EAT’s acquisition of the Replacement Property, the Client would enter into a normal exchange agreement with a Qualified Intermediary (typically an entity related to the EAT). Upon sale of the Relinquished Property, the Qualified Intermediary would transfer the net proceeds to the EAT in exchange for title to the Replacement Property. The EAT would use the proceeds to pay off the loan, and simultaneously deed the Replacement Property to the Client. In this way, a “reverse” exchange has been effectively converted into a “regular” exchange, whereby the taxpayer actually transferred the Relinquished Property prior to receipt of title to the Replacement Property.

I. Remaining Loan Obligations. In the event a loan is obtained to finance the acquisition of the Replacement Property that cannot be paid in full with the proceeds from the sale of the Relinquished Property, the remaining loan obligations will typically be assumed by the Client.

J. Additional Documentation. Because the EAT will hold title to the Replacement Property during the pendency of the reverse exchange, additional documentation, such as property management agreements and leases, may be executed between EAT and the Client.

K. Variation of Reverse Exchange utilizing a Single Member LLC. In lieu of the EAT taking title to, and subsequently conveying, title to the Replacement Property, sophisticated taxpayers are increasingly taking advantage of an alternative method allowed by the IRS. Prior to the purchase of the Replacement Property, the EAT forms a limited liability company to hold title, with itself as the sole member. The LLC then purchases the property, signs loan documents and accepts the deed and title policy in its name. In lieu of conveying fee title to the Replacement Property after the sale of the Relinquished Property, the EAT merely assigns its membership interest in the LLC to the Client. The IRS has endorsed this method, holding that it does not violate the “like-kind” exchange requirement since the LLC is a disregarded entity for tax purposes. In this way, there is no need for loan assumptions, title policy endorsements or subsequent conveyances, which could give rise to additional transfer taxes in some states.

V. “OUTSIDE THE SAFE HARBOR” EXCHANGES

A. This phrase is used to describe like-kind exchanges that do not follow the exact formalities provided in §1031, but are nonetheless may deemed permissible.

B. In Estate of George H. Bartell, Jr. v. Commissioner, 147 T.C. No. 5 (2016), the Tax Court rejected the IRS’s argument that an ‘exchange accommodation titleholder’ (EAT) must acquire the traditional benefits and burdens of ownership of the property to facilitate a Section 1031 exchange.

C. The recent case holding in Bartell indicates that non-safe harbor exchanges are still permissible in certain instances. Bartell highlights the importance of an independent accommodator in a non-safe harbor exchange.

D. Independent accommodator is defined as a person independent of the taxpayer who takes title to the Replacement Property in the construction (or reverse) exchange, so that the taxpayer does not own both the Replacement Property and the Relinquished Property at the same time. If the taxpayer were to own both properties (whether legally or beneficially) at the same time, then there could not be an “exchange” for §1031 purposes. J. H. Baird Publishing Co., 39 T.C. 608 (1962).

E. In Bartell, the Court found that because an accommodator acquired title to the
replacement property and not the TP, the future exchange was permissible under §1031.

F. The new cases seem to suggest that a reverse exchange may be successful even outside of the safe harbor. As a result, it may be possible for a taxpayer to leave a replacement property parked with the EAT for periods longer than 180 days and still qualify for tax deferred treatment once the relinquished property is sold.

VI. §1033 V. §1031

A. A §1033 Exchange arises when a taxpayer sells property to a governmental, or quasi-governmental authority pursuant to a condemnation, or under threat of condemnation. In such circumstances, the rules to obtain tax-deferred treatment are much more lenient:

1. A §1033 exchange does not require a Qualified Intermediary to hold funds during the pendency of the exchange; the taxpayer may hold the funds in his/her possession until purchase of the Replacement Property.
2. The taxpayer has two avenues to pursue Replacement Property:
   a. Functional Use: Replacement Property must have same functional use as the Condemned Property - i.e. apartment building for apartment building

      1) Land already owned by the TP may be improved via the proceeds from the Condemned Property.
      2) TP has two years to acquire Replacement Property or make improvements.

   b. Like-Kind: Similar to §1031, except that under §1033, TP has three years from condemnation to purchase Replacement Property.

3. The first day of the 1033 exchange replacement property is determined by the earlier of 1) the date when the property was destroyed or 2) the date when the threat of property condemnation or seizure occurred. The deadline for the replacement period is two years (or three years) after the end of the first tax year when any part of the gain was realized by the property owner.

4. 1033 does not require an identification of the Replacement Property within 45 days prior to purchase.
5. The taxpayer does not need to reinvest all the equity; they are only taxed to the extent of the trade down in value.
6. The taxpayer may not acquire Replacement Property from a related party.