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**"REVERSE EXCHANGES: MODIFICATION OF POSITION BY IRS"**

**by**

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**I.    INTRODUCTION:** Most individuals involved in the tax-deferred exchange area, whether attorneys, CPAs, real estate practitioners, consultants, advisers or others involved in the regular use of tax-deferred exchanges, are certainly well aware of "reverse exchanges."

The normal approach for an exchange is for Taxpayer X to transfer or exchange his property (X-1) first, and to receive at the same time, or at a subsequent time, what is referred to as the "replacement property" (Y-1).

The "reverse exchange" has come about as a label to identify the circumstance where a taxpayer might first acquire the "replacement property," prior to transferring the "relinquished property." In the above example, Taxpayer X would acquire Property Y-1, prior to Taxpayer X transferring Taxpayer's X-1 Property as the "relinquished property".

The concept of a reverse exchange had been addressed for a number of years. Particular emphasis was placed on this issue because the government took the position, under its Regulations, Treasury Reg. §1.1031(k), that it did not support the concept of the reverse exchange. It said that such exchanges were not within Code §1031. The government's position was that if a taxpayer undertook an exchange whereby the taxpayer (as Taxpayer X in the above-noted example), first gained "replacement property," prior to the taxpayer transferring the "relinquished property" (Property X-1 in the prior example), such planning would not qualify within Code §1031.

This position by the government was within the Regulations, as noted 1/ and was contained in other Announcements by the Internal Revenue Service. Arguably, taxpayers would be well advised to avoid reverse exchanges outside of the special circumstances, noted below, given the position taken by the government, notwithstanding that such position may be without reasonable support. For some of these authorities, see the papers and references in the Footnote. 2/

Although reverse exchanges were discussed as something that the government attacked, many taxpayers and their representatives argued that such exchanges were "proper." However, the issue has been fairly moot, following the government's issuance of Revenue Proc. 2000-37. 3/

Revenue Procedure 2000-37, issued in the year 2000, supported the position that a "reverse exchange" would be allowed by the government. In other words, the government moved from its limitations, mentioned earlier, and allowed for a reverse exchange, assuming that the taxpayer carefully met all of the requirements of Revenue Proc. 2000-37 as to arrangements where property might be "parked" or "held," subject to completing the exchange.

Revenue Proc. 2000-37 specifically held: "This procedure provides a safe harbor under which the service will not challenge (a) the qualification of property as either 'replacement property' or 'relinquished property' for purposes of Code §1031 of the Code or (b) the treatment of the 'Exchange Accommodation Titleholder' as the beneficial owner of such property for Federal income tax purposes if the property is held in a "Qualified Exchange Accommodation Arrangement (QEAA)."

The Revenue Procedure went on to specifically hold that Revenue Proc. 2000-37 provided a safe harbor, where the Service will not challenge the qualifications of the exchange, if one meets the requirements, as noted.

This Revenue Proc. 2000-37 stated that on April 25, 1991 it was acknowledged that the Treasury Department and the Internal Revenue Service promulgated Regulations under §1.1031(k)-1 whereby tax-deferred exchanges that were "nonsimultaneous" in nature, sometimes referred to as "deferred like-kind exchanges," were proper under Code §1031.

However, it also noted: "The preamble to the final regulations states that the deferred exchange rules under Section 1031(a)(3) do not apply to reverse-Starker exchanges (i.e., exchanges where the replacement property is acquired before the relinquished property is transferred) and consequently the Regulations do not apply to such exchanges." 4/

Many taxpayers and their representatives have been very excited about the ability to undertake a reverse exchange, given the safe harbor provisions of Revenue Proc. 2000-37. However, recent action by the Treasury changed part of Revenue Procedure 2000-37, as noted below.

The focus of this short Note is on a Revenue Procedure issued in July, 2004, Revenue Proc. 2004-51. 5/ This Revenue Procedure speaks to a limitation under Revenue Proc. 2000-37. It attempts to restrict, somewhat, arguably, the scope of Revenue Proc. 2000-37 with the reverse exchange setting. This restriction is very important for many taxpayers involved in reverse exchanges.

**II. SCOPE OF REVENUE PROC. 2004-51:** Revenue Proc. 2004-51 states that it modifies Sections 1 and 4 of Revenue Proc. 2000-37. 6/

Revenue Proc. 2004-51 states that Revenue Proc. 2000-37 ". . . does not apply if the taxpayer owns the property intended to qualify as replacement property before initiating a Qualified Exchange Accommodation Arrangement (QEAA)."

In building to the conclusion (which restricts the reverse exchange in some settings), Revenue Proc. 2004-51 notes the reference to Revenue Proc. 2000-37 for parking arrangements. Revenue Proc. 2000-37 stated: "Parking transactions typically are designed to 'park' the desired replacement property with an Accommodation Party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange." 7/

Revenue Proc. 2004-51 cited Revenue Proc. 2000-37, relative to Section 4.01. It noted that the Service and the Treasury are aware of circumstances where taxpayers have interpreted language in Revenue Proc. 2000-37 to: ". . . permit a taxpayer to treat as a like-kind exchange a transaction in which the taxpayer transfers property to an Exchange Accommodation Titleholder and receives that same property as replacement property in a purported exchange for other property of the taxpayer." (Emphasis supplied.) 8/

The restriction under Revenue Proc. 2004-51 is specific. Revenue Proc. 2004-51 states: "An exchange of real estate owned by a taxpayer for improvements on land owned by the same taxpayer does not meet the requirements of Code §1031." (Emphasis supplied.) 9/

The conclusion reached by Revenue Proc. 2004-51 cites the case of DeCleene v. Comm. 10/ The DeCleene case covered the issue as to whether there was a sale of property, or a tax-deferred exchange. The Court concluded that the transaction was in fact a "sale;" it was not an exchange.

The taxpayer in DeCleene effectively transferred a piece of his property to a third party. However, there was an agreement that the third party would construct property on that property conveyed by the taxpayer. The third party would then transfer the "improved property" back to the taxpayer in what was alleged to be a tax-deferred exchange, wherein the taxpayer would transfer another piece of property that the taxpayer owned. The Court held that it was a "form and substance" argument and that the taxpayer in fact and in substance did not change his position; therefore, the tax-deferred exchange position was denied; it was treated as a "sale."

The Court said: "The conveyance and reconveyance of title (to the property in question) must be disregarded as having no tax significance because, at the end of the day, petitioner ended up where he started, with title to and beneficial ownership of the (same) property that the taxpayer owned." (Emphasis supplied.)

Revenue Proc. 2004-51 supports the same position that a taxpayer transferring property for other property owned by the taxpayer will not meet the requirements of a Code §1031 transaction, even with a parking arrangement, as noted.

Revenue Proc. 2004-51 went further and cited an older Revenue Ruling in 1967 that supported the same position that building a building on land already owned by the taxpayer is not a non-taxable transaction, even with an involuntary conversion. 11/

**III. THE MESSAGE:** The message under Revenue Proc. 2004-51 is that, although the government has acceded to a reverse exchange setting as qualified, potentially, under Code §1031, consistent with and following Revenue Proc. 2000-37, the government has tightened the reins on this type of setting as a result of issuing Revenue Proc. 2004-51.

The Internal Revenue Service and the Treasury Department further cautioned taxpayers by stating: "The Service and Treasury Department are continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party and the accommodation party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate." 12/

**IV. CONCLUSION:** Revenue Proc. 2000-37 only applies as a safe harbor position if taxpayers meet the requirements, very specifically noted, in Revenue Proc. 2000-37. Revenue Proc. 2000-37 has a number of specific hurdles that taxpayers must meet to have the protection of this safe harbor.

Revenue Proc. 2004-51 restricts the scope of Revenue Proc. 2000-37. In so doing, Revenue Proc. 2004-51 states that Revenue Proc. 2000-37, under Section 1.01, is modified to read: "This Revenue Procedure (2000-37) provides a safe harbor in which the Internal Revenue 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 'Qualified Exchange Arrangement' (QEAA) as defined in section 4.02 of this revenue procedure." 13/

Further, Revenue Proc. 2004-51 modified Revenue Proc. 2000-37 by adding a limitation to Revenue Proc. 2000-37. ".05 Limitation. 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."

The effective date for the restricted position of interpretation under Revenue Proc. 2004-51 is for transfers on or after July 20, 2004. 14/

Taxpayers can enjoy the safe harbor of Revenue Procedure 2000-37, but such use must be tempered by the limits under Revenue Procedure 2004-51.

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## FOOTNOTES

1. See Treasury Reg. §1.1031(k).
2. See also Levine, Mark Lee, Exchanging Real Estate (2004). See also Levine, Mark Lee, "Finally: An 'Approved' Process For Reverse Exchanges, Real Estate Issues, Counselors of Real Estate (Spring, 2001), reprinted with permission in Exchanging Real Estate, p. 11-178a (2004). See Levine, Mark Lee, "Just Say 'No' to Reverse Exchanges," Florida Real Estate Journal (October 16-31, 1999), reprinted with permission in Exchanging Real Estate, p. 11-165 (2004).  
See also TAM 2000-39005 (Technical Advice Memorandum). See also Raitz, Ronald, and Raitz, Bridgette, "Park Your Reverse Exchange," Commercial Investment Real Estate 30 (May-June, 2000). See also Sutton, Philip, "Guidance May Be Coming For Reverse Like-Kind Deal," Real Estate Forum 104 (April, 2000).
3. See Revenue Proc. 2000-37, 2000-40 I.R.B. 308, 2000 WL 1338979 (I.R.S. RPR). See also Private Letter Ruling 2001-11025 which examines the situation of a potential reverse exchange and concludes that Revenue Proc. 2000-37 did not apply.
4. Id. See also T.D. 8346, 1991-1 C.B. 150, 151.
5. Revenue Proc. 2004-51, 2004 WL 1615635 (I.R.S. RPR).
6. See Footnote #3, supra. Also see Revenue Proc. 2000-37, 2000-2 C.B. 308.
7. See Revenue Proc. 2004-51, Section 2.03.
8. See Revenue Proc. 2004-51, Section 4.01.
9. Id.
10. See DeCleene v. Comm., 115 T.C. 457 (2000). Revenue Proc. 2004-51 also cites the older case of Bloomington Coca Cola Bottling Co. v. Comm., 189 F.2d 14 (7th Cir., 1951).
11. See Revenue Ruling 67-255, 1967-2 C.B. 270.
12. See Revenue Proc. 2004-51, Section 2.06.
13. See Revenue Proc. 2004-51, Section 4.
14. See also "Like-Kind Exchanges Prior Ownership of Replacement Property Disqualifies Parking Arrangements, IRS Says," 139 BNA Daily Report for Executives G-1 (2004).  
See "IRS Revenue Procedure 2004-551 Modifying Safe Harbor Rules Provided In Earlier Guidance On Reverse Like-Kind Exchanges, Parking Transactions," 139 BNA Daily Report for Executives L-2 (2004).  
See "Highlights," 139 BNA Daily Report for Executives (2004).