ILLINOIS STATE BAR ASSOCIATION

REAL PROPERTY

January 2001
Vol. 46, No. 3

Editor's note

We are fortunate to have articles in this newsletter from experienced real estate practitioners who are known authorities on the topics about which they have written. The first article, by Gary R. Gehlbach, explains the recent IRS regulatory changes governing 1031 exchanges of property. These new regulations sanction so-called "reverse" exchanges under certain conditions. Mr. Gehlbach's article articulates the IRS regulations governing those exchanges. The second article, by Martin S. Edwards, further explains the new IRS regulations governing "reverse" exchanges and discusses practice issues to consider when creating such exchange arrangements. Both articles help to uncomplicate what is normally a complicated topic.

Richard F. Bales is the author of the third article dealing with title underwriting of covenants, conditions and restrictions. This article was previously published in *Title Issues,* the in-house newsletter of Chicago Title Insurance Company and is being reprinted here with the permission of the author. Mr. Bales is well-known for his comprehensive and informative articles covering the insuring of title. This article is no exception and should provide important information for both experienced and more recent real estate counsel.

I hope that you find these newsletter articles instructive.

Prof. Barbara B. Bressler
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IRS issues long awaited reverse exchange rules

By Martin S. Edwards, Esc., President, North Star Deferred Exchange Corp., Chicago

During the one-year period between the promulgation of the 1990 proposed exchange regulations and the issuance of the final regulations in April of 1991, the IRS solicited comments in regard to allowing pure reverse exchange transactions. A pure reverse exchange was understood to mean that the taxpayer would acquire the replacement property prior to the sale of the relinquished property. The final regulations ultimately failed to allow a safe harbor for such a reverse closing sequence. However, in the preamble to those regulations, the IRS stated:

> After reviewing the comments and the applicable law, the Service has determined that the deferred exchange rules of Section 1031(a)(3) do not apply to reverse-Starker transactions. Therefore, the final regulations, like the proposed regulations do not apply to reverse-Starker transactions. However, the Service will continue to study the applicability of the general rule of Section 1031(a)(1) to these transactions.

Apparently the continued study took quite some time. In the interim, various property parking arrangements became popular to avoid the characterization of a transaction as a reverse exchange. The most typical structure would allow for a third party to acquire the replacement property from the seller, and transfer it to the taxpayer upon sale of the relinquished property. A less often used alternative involved a third party acquiring the taxpayer's relinquished property. This would allow the taxpayer to complete the exchange while the taxpayer and third party continued to work toward finding a permanent end buyer.

A Technical Advice Memorandum (hereinafter "TAM") dated May 31, 2000, was published on September 29, 2000, disqualifying a reverse exchange transaction involving a transaction where the replacement property was parked with a third party. Under the particular facts of the case, the third party was deemed to be acting as an agent of the taxpayer. Reading this TAM left the practitioner with uncertainty as to the necessary degree of independence between the taxpayer and third party. Fortunately, on September 15, 2000, the IRS issued Revenue Proclamation 2000-37, which provided a safe harbor for reverse exchanges completed as part of a properly structured "parking" transaction. This Revenue Proclamation went a long way toward clearing up the uncertainty that had existed for nearly ten years.

Revenue Proc. 2000-37

Section 1 of the Rev. Proc. sets out the safe harbor stating that the Service will not challenge the qualification of the property as a replacement or relinquished property or the third party's standing as beneficial owner for federal income tax purposes.

The second section summarizes the history of the regulations particularly as they pertain to reverse exchanges. Paragraph .05 of this section speaks to the various efforts being taken by taxpayers to avoid the direct application of the pure reverse exchange restrictions. The last paragraph concludes by stating:

> …that it is in the best interest of sound tax administration to provide taxpayers with a workable means of qualifying their transactions under Section 1031 in situations where the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that it arranges for the acquisition of the

replacement property and actually accomplished (sic) the exchange within a short time thereafter.

Section 3 states that no inference is intended for transactions which may have preceded the effective date of the Rev. Proc., nor for other parking transactions which might take place in the future which may not comply with the terms of the safe harbor. This is partcularly important in the context of the build-to-suit transaction where the replacement property cannot be constructed within the 180-day window set forth in the Rev. Proc.

Section 4 establihses the concept of a Qualified Exchange Accommodation Arrangement (QEAA). Similarly, Paragraph .02 of section 4 sets forth the concept of the third party titleholder who is holding title or a "qualified indicia of ownership" as an "exchange accommodation titleholder" (hereafter referred to as an "EXAT") acting pursuant to a written "qualified exchange accommodation agreement." The parties must enter into this agreement within five business days of the acquisition of the parked property. The agreement must provide for a parking arrangement of no more than 180 days and, in the case of parking a replacement property, the identification of the applicable relinquished property within 45 days of acquisition of the the replacement property. There is an obvious symmetry between these time limits and those found in the conventional exchange regulations. Paragraph .03 of this section continues by allowing the exchange accommodation titleholder to also act as the qualified intermediary; the taxpayer to guarantee any necessary loan; the taxpayer to directly loan or advance funds; the taxpayer to lease, manage or provide contractor services in regard to the parked property, and; the parties to agree upon puts and calls regarding the property.

As stated above, section 5 sets forth an effective date of September 15, 2000, for properties that are acquired on or after this date by the accommodation titleholder.

Parking the replacement property

It is generally simpler to park the replacement property, rather than the relinquished property, with the EXAT. This is usually accomplished via a bridge loan extended to the EXAT by the taxpayer's lender, or directly by the taxpayer or his related business. The loan is non-recourse to the EXAT and secured by the parked property. In the case of a third party loan, the taxpayer is usually asked to guarantee the loan. Since the loan is for the full purchase price, the taxpayer will usually be asked to provide additional collateral to secure the guaranty. Alternatively, the lender may lend 80% loan-to-value and the taxpayer may make a second mortgage to the EXAT.

The EXAT will not want to be involved in the management of the property while it is being held and will enter into a triple net lease with the taxpayer, as lessee, in order to shift taxes, maintenance and insurance responsibilities to the tenant/taxpayer. Some EXATs prefer to deal with this issue through the use of a management agreement. However this will increase the level of accounting the EXAT must undertake. The lease may provide that, in lieu of payment of rent to the EXAT, the tenant may cover the debt service of the EXAT to its lender.

The taxpayer will wish to lock in his rights to acquire the parked property when ready, and usually accomplishes this by the use of a purchase and sale contract with the EXAT as seller. The contract often contains puts and calls to insure the property will be available when the taxpayer is ready, and to insure an exit strategy for the EXAT if the taxpayer does not acquire the property within some agreed upon time period. Under the new safe harbor the maximum time period to hold title to the parked property is 180 days.

Depending upon the nature of the property, most EXATs will require a copy of a Phase One environmental audit naming the EXAT as a party. In the event of an undisclosed environmental problem, failure to be named as a party will result in a defense based upon a lack of privity. Should it be too late to be named a party, most companies having prepared the Phase One are willing to provide a "reliance letter" in favor of the EXAT that has the same effect as if the EXAT was named directly as a party. The EXAT will also demand evidence of liability insurance in its name. If there is a lease in effect, the lease will require the lessee to maintain insurance insuring the EXAT, as lessor.

Once the relinquished property is ready for sale, the transaction is closed with the assistance of a qualified intermediary. Immediately thereafter, the taxpayer uses the funds in the exchange account, together with the proceeds of a new loan as necessary, to purchase the parked property from the EXAT. The sale proceeds received by the EXAT are, in turn, used to retire its acquisition loan. The excess, if any, is retained by the EXAT as its fee. Some EXATs arrange the transaction so that there is no excess. Rather they simply charge a fee for the parking accommodation service. Under this scenario, the taxpayer has not received the replacement property until a point in time after she has sold her relinquished property and can report it as such on the applicable IRS Form 8824.

Parking the relinquished property

When the EXAT parks the relinquished property, the taxpayer is able to complete an immediate straightforward exchange for the replacement property. This process is begun with the EXAT acquiring the relinquished property from the taxpayer through a third party loan, or through a loan from the taxpayer or a related entity. The EXAT usually takes title to the property subject to existing loans in order to simplify the financing of the purchase.

The EXAT will wish to review a Phase One environmental audit, or if one is not available, may agree to take an environmental indemnity from the taxpayer. Liability insurance will be required as well. Once again, the parked property is usually leased to the taxpayer or is the subject of a management agreement with the taxpayer. Eventually the parked property will be sold by the EXAT to a permanent buyer, and the proceeds of such sale will be applied to pay off the acquisition debt and any other debt to which the property is subject.

Just as in the case of parking the replacement property, due to the involvement of the EXAT, the transaction may be reported on the taxpayer's IRS Form 8824 as non-reverse.

Determining which property to park

The primary difficulty with parking the relinquished property is attempting to determine value for purpose of sale to the EXAT. Unless there is an outstanding contract for the purchase of that property with an end buyer at the time of the interim sale to the

EXAT, which would establish a value, anything else involves a "best guess" by the taxpayer. Inevitably the taxpayer and EXAT are forced to find ways to adjust for overages, or for shortfalls, at the time the property is sold by the EXAT to an end buyer. These issues are not present when parking the replacement property. The taxpayer simply pays the EXAT the amount the EXAT expended, plus an amount representing the EXAT's fee. However, several factors may be present to motivate the parties to consider parking the relinquished property.

At times the relinquished property has a much lesser value than the replacement property. When this is the case, the debt service on the bridge loan for the parked property may be greatly reduced by parking the relinquished property. Likewise, when the relinquished property is subject to debt, only the taxpayer's equity must be covered via the bridge loan to the EXAT, and this too may also reduce the carrying costs of the bridge loan. Another consideration in determining which property to park is the applicability of a local transfer tax ordinance to the parked property. Often a transfer tax will be paid upon the EXAT's acquisition of the parked property, and again upon the EXAT's disposition of the property. If the value of the relinquished property is less than the replacement property, or the relinquished property is in a jurisdiction which does not have a local transfer tax, the savings alone may justify arranging to park the relinquished property. A final factor, which is sometimes relevant in these considerations, is the environmental condition of the property. As an example, the taxpayer may agree to acquire the replacement property subject to the need for some environmental remediation, but the EXAT would likely be unwilling to assume any such risk. This, too, would be case for parking the relinquished property.

Build-to-suit and property improvement exchanges

Another common problem faced by many taxpayers occurs when the value of the relinquished property exceeds the purchase price of the replacement property, and the taxpayer wishes to apply some of the excess value toward replacement property construction or improvement. Pursuant to applicable Treasury Regulations, any "production" upon the replacement property once the taxpayer is in title will be deemed as receipt of "services" and thus not be like-kind to the real property sold. In theory, it is possible for the seller to improve the property prior to transfer to the taxpayer, and increase the sale price by the cost of the improvements. Alternatively, it may be possible to arrange for a contractor to take interim title to the replacement property, and improve it prior to a subsequent conveyance to the taxpayer. These options clearly have some drawbacks.

A common technique used to deal with this situation involves a third party accommodator acquiring and improving the target property according to the taxpayer's plans and specifications. Once the value of the property is at least equivalent to the value of the relinquished property, the taxpayer can acquire the parked property for a cost that includes the value of the desired improvements. In order to fall into the new safe harbor, this parking service must be no longer than 180 days from the accommodator's acquisition of the property. If due to the extensive nature of the required improvements a greater amount of time is necessary, the client may consider this parking technique and choose to fall outside the safe harbor. Also, the taxpayer's advisor should keep in mind that the holding period might also be lessened in the event the relinquished property is sold prior to parking the replacement property. If that is the case, the 180 day exchange period from the date of sale of the relinquished property would require the purchase of the parked property within that time period, regardless of the date the replacement property was parked.

In cases where the taxpayer sells the relinquished property before the replacement property is parked, it may be possible to use the proceeds of the sale for acquisition and improvement costs. This is usually referred to as a "build-to-suit, or improvement exchange." When the replacement property is acquired and improved prior to the sale of the relinquished property, it is referred to as a "reverse build-to-suit" transaction. As is the case with other parking transactions, the intermediary will require applicable insurance coverage and a Phase One environmental audit or an environmental indemnity.

The various parking arranagements described have been utilized by many taxpayers for the last ten years, but not without some degree of tax risk. Through strict compliance with the new safe harbor provisions, taxpayers should now be able to structure these transactions without fear upon audit that such an arrangement might be set aside.

Reprinted from *Real Property,* a newsletter of the Illinois State Bar Association, January, 2001. Edited slightly for clarity.

Real Estate Law Newsletter

Published at least four times per year.

Published by Illinois State Bar Association, 424 S. 2nd St., Springfield, IL 62701.

Annual subscription rate for ISBA members: $18.

Underwriting covenants, conditions and restrictions

By Richard F. Bales, Esq., Assistant Regional Counsel, Chicago Title Insurance Company, Wheaton

"Covenants, conditions, and restrictions" (hereafter CC&Rs) is a generic term for privately-created rules and regulations that frequently govern the use and improvement of real property. They are a long-time staple of the title insurance policy, appearing regulary as Schedule B exceptions to title. For this reason many attorneys may feel that very little can be done in terms of acquiring CC&R title insurance coverage for their clients other than perhaps verifying that the limitations affect the land under examination.

But as "Sporting Life," one of the characters in George