Exchange Structures/Formats

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Simultaneous Exchanges

Simultaneous Two-Party Exchanges

- Section 1031 first appeared in the Tax Code in 1921:

  "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."

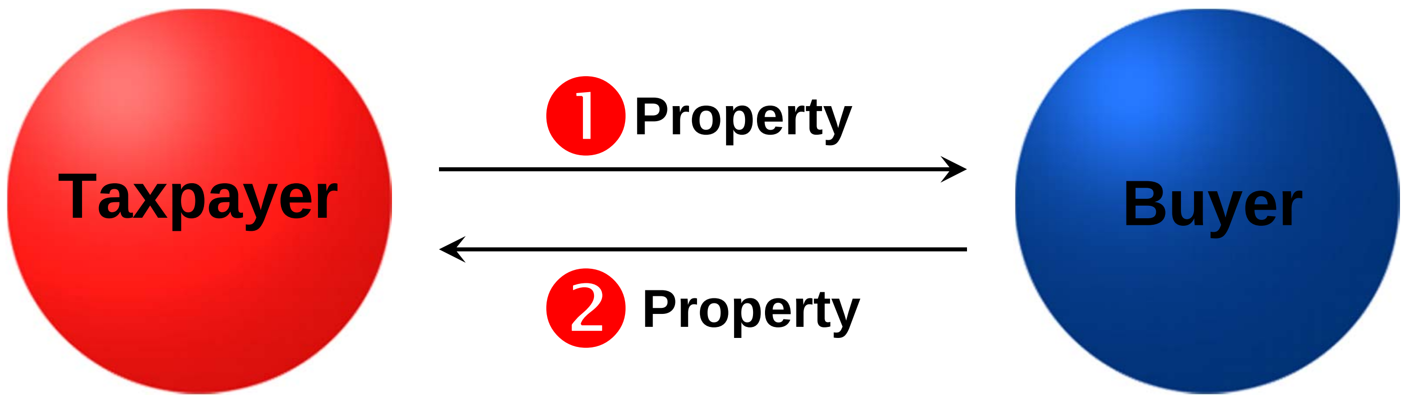
  — IRC §1031(a)(1)

- General belief that the exchange must be simultaneous to qualify

Simultaneous Two-Party Exchanges

- Stated rationale was no cashing out, rather a continuity of investment:
  - "If the Taxpayer's money is still tied up in the same kind of property as that which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with the tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value."

Two-Party Direct Exchange



Fair Market Value: $100K
Basis: $ 25K

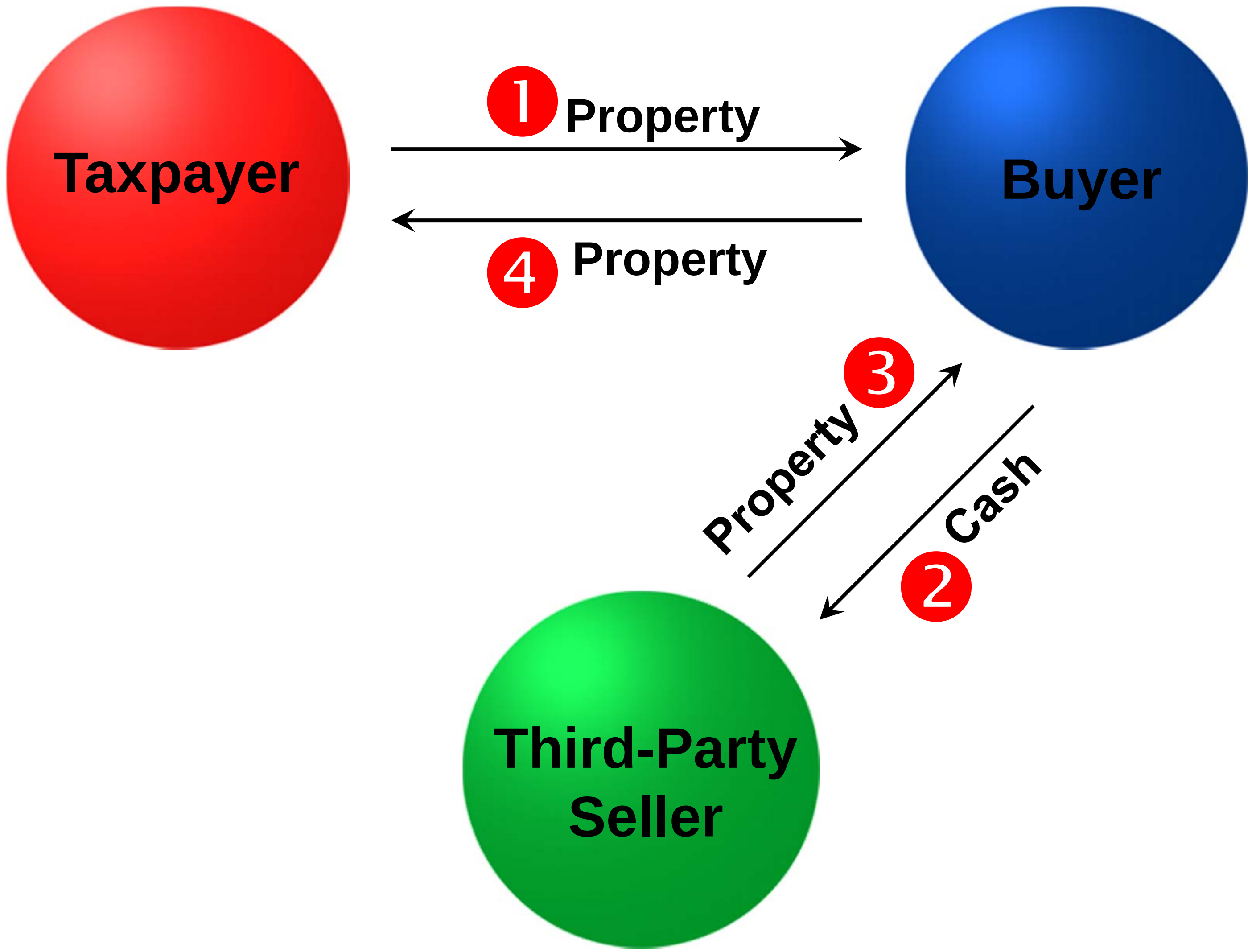
Fair Market Value: $100K
Basis: $ 75K

"Continuity of Investment"

Simultaneous Three-Party Exchanges

- Over time exchanges involving three parties became prominent
- This allowed Taxpayers to sell to a party of choice and receive replacement property from another party of choice
- Required active participation of Taxpayer's buyer
- Continued belief of a simultaneous transaction
- Used by related corporations to shift basis prior to property sale

Three-Party Simultaneous Exchange



Delayed Exchanges

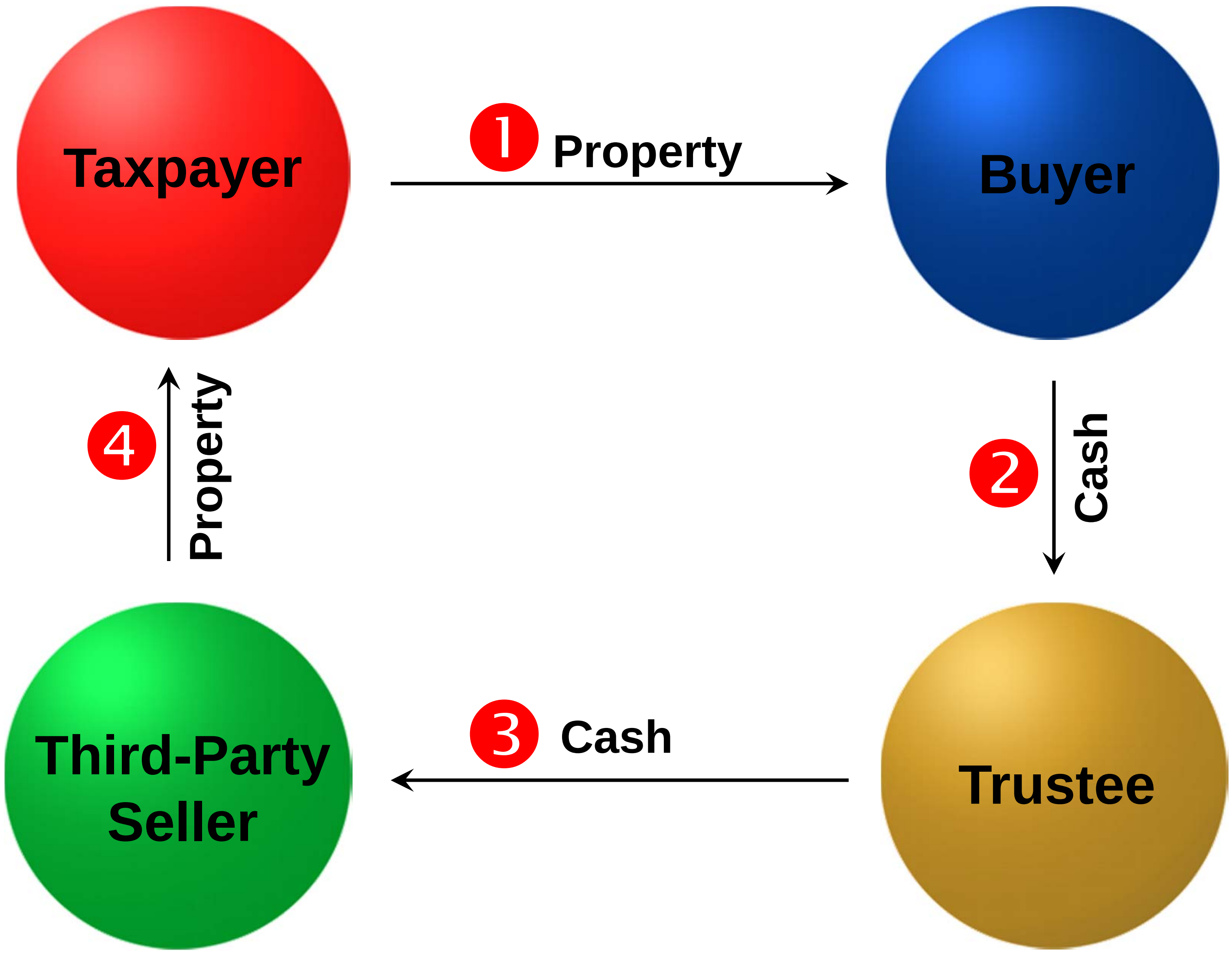
Delayed Exchanges

- In the 1970s, a Taxpayer challenged the notion that an exchange had to take place simultaneously to be valid
- After extensive litigation concluded in 1983, the Court held in favor of the Taxpayer
  - i.e. Section 1031 did not require an exchange to be simultaneous

Delayed Exchanges

- Taxpayer's name in this landmark case was T.J. Starker and the decision dramatically opened up the ability to exchange as we know today
- The Starker case involved a five year window between the Taxpayer sale of the property and receipt of replacement property from his Buyer
- "Direct Deeding" allowed for the 3rd party Seller to deed directly to the Taxpayer/exchanger

Starker Trust



Delayed Exchanges

- Tax Reform Act of 1984 was Congressional response to the holding in the Starker case
  - 45 days to identify replacement property
  - 180 days to acquire replacement property
- Omnibus Budget Reconciliation Act of 1989 introduced the related party rules in attempt to stop "abusive basis shifting"

1991 Deferred Exchange Regulations – The Safe Harbors

Qualified Intermediary Safe Harbor

- IRS and Treasury Dept. response to lack of clarity left by the Starker case
- The Qualified Intermediary provided a party with whom the Taxpayer could do an exchange and removed the need to the Taxpayer's buyer and seller to "cooperate" in the exchange

Qualified Intermediary Safe Harbor

(iii) A qualified intermediary is a person who –

(A) Is not the Taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) Enters into a written agreement with the Taxpayer (the "exchange agreement") and, as required by the exchange agreement, <u>acquires the relinquished property from the Taxpayer</u>, transfers the relinquished property <u>acquires the replacement property</u>, and transfers the replacement property to the Taxpayer.

Qualified Intermediary Safe Harbor

- There is an important difference between acquiring the relinquished property and the replacement property for tax purposes vs. title purposes
  - Acquisition and transfer by the QI can be accomplished simply by having the QI be a named party to the sale and purchase agreements
  - Acquisition and transfer can be accomplished by the QI coming into the chain of title to both properties

Qualified Intermediary Safe Harbor

- Industry standard is for the acquisition and transfer to occur via an assignment of Taxpayer's contract rights (and not obligations) and written notice of the same to the other parties to the contracts

  "(v) Solely for purposes of paragraphs (g)(4)(iii) and (g)(4)(iv) of this section, an intermediary is treated as entering into an agreement if the <u>rights</u> of a party to the agreement <u>are assigned</u> to the intermediary and <u>all parties</u> to that agreement are <u>notified in writing</u> of the assignment on or before the date of the relevant transfer of property".

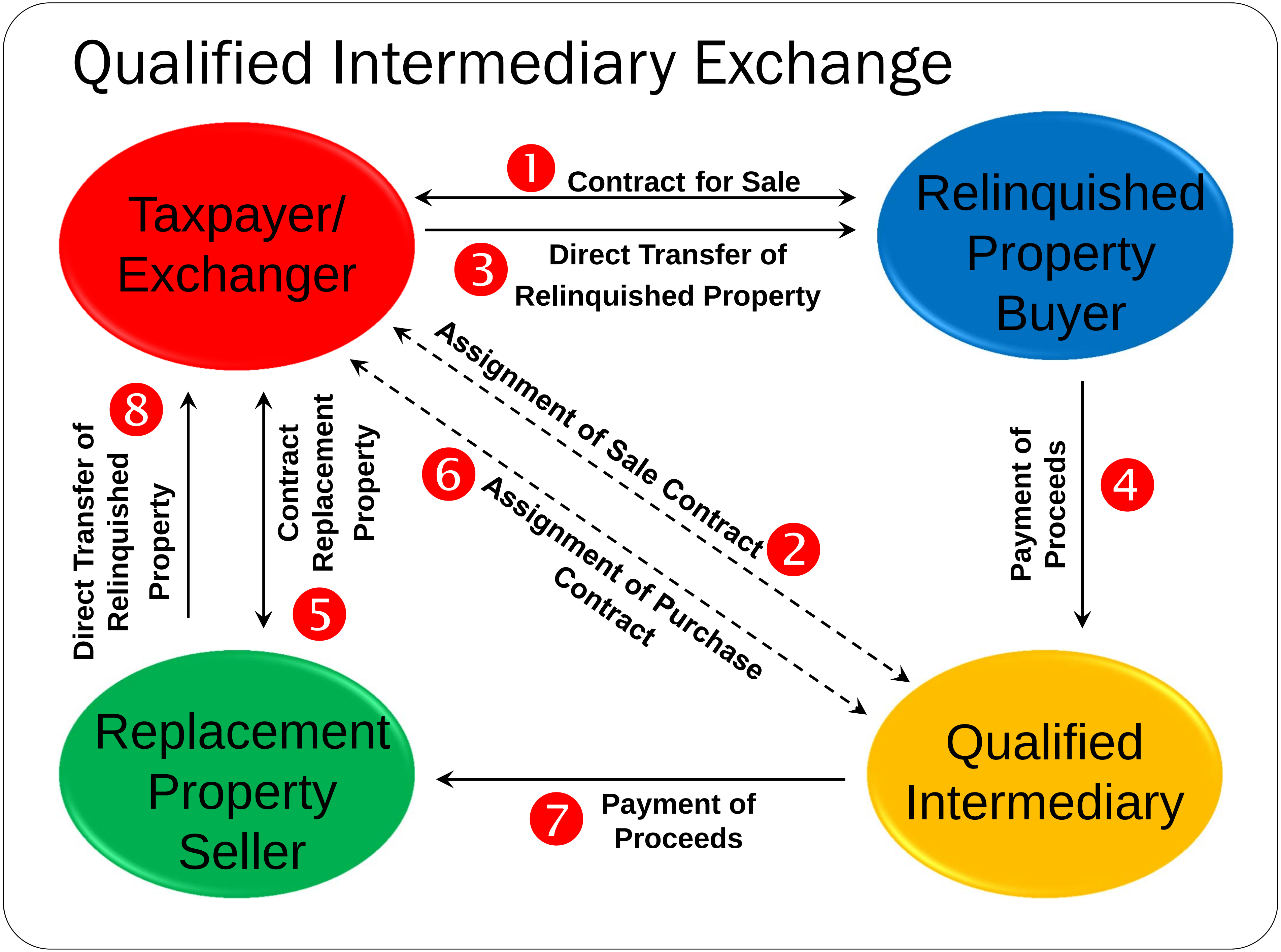
Qualified Intermediary Safe Harbor

- To be valid, all exchange agreements must insure against actual or constructive receipt of exchange proceeds and accordingly must include the following:

  "(vi) Paragraph (g)(4)(i) of this section ceases to apply at the time the Taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary."

Qualified Intermediary Safe Harbor

- "Direct Deeding" of properties confirmed in Rev. Rul. 90-34
  - "X's transfer of property to Y, in exchange for property of a like kind, qualifies as to X for nonrecognition of gain or loss on the exchange under section 1031 of the Code even though legal title to the property received by X is never held by Y."


Qualified Intermediary Exchange
Taxpayer/ Exchanger
Relinquished Property Buyer
Replacement Property Seller
Qualified Intermediary
1 Contract for Sale
2 Assignment of Sale Contract
3 Direct Transfer of Relinquished Property
4 Payment of Proceeds
5 Contract Replacement Property
6 Assignment of Purchase Contract
7 Payment of Proceeds
8 Direct Transfer of Relinquished Property

Qualified Trust/Escrow Safe Harbor

- These safe harbors are a codification of the Starker Trust concept, i.e. placing funds with a third party to ensure the buyer's funds remain available during the exchange period while avoiding the Taxpayer being in actual or constructive receipt of the funds
- As a practical matter it is difficult and costly to find a Trustee to act, particularly if the depository bank is not acting as the Trustee

Qualified Trust/Escrow Safe Harbor

- Customary for QI, Taxpayer and Escrow Agent to enter into a separate Escrow Agreement at the time of entering into the Exchange Agreement
- There are several banks that will act as Qualified Escrow Agent at no cost if the deposit is placed at the bank
- These Trust or Escrow agreements must provide that the Taxpayer has no rights to "receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent" in the account

Interest and Growth Factor Safe Harbor

- This safe harbor allows the Taxpayer to receive interest on the exchange deposit without being deemed to be in constructive receipt of the funds
- Cannot be received until the exchange transaction has ended, i.e. a (g) (6) event
- Any interest received will be taxable to the Taxpayer regardless of reinvesting the interest into the replacement property

Interest and Growth Factor Safe Harbor

- The Qualified Intermediary, Qualified Trust and Qualified Escrow services can only be provided by persons (companies) that are not "Disqualified Persons"
  - Cannot be a related party to the Taxpayer, such as a family member
  - or corporate entities where Taxpayer owns more than 10% of the stock

Interest and Growth Factor Safe Harbor

- Cannot be an agent of the Taxpayer such as an attorney, accountant, broker or real estate broker having provided services within two years prior to the sale of the relinquished property
- The "routine financial services" exception allow the Taxpayer's bank to act as Qualified Intermediary, Qualified Trustee or Qualified Escrowee

Preamble to the 1999 Regs – Extension of Safe Harbor to Simultaneous Exchanges

- "The rules in the proposed regulations, including safe harbors, apply only to deferred [delayed] exchanges. Commentators noted that the concerns relating to actual or constructive receipt also exist in the case of simultaneous exchanges. They requested that the safe harbors be made available for simultaneous exchanges. Upon review, the Service has determined it necessary to make only the Qualified Intermediary safe harbor available for simultaneous exchanges."

Property Parking Transactions

Preamble to the 1999 Regs – Receipt of Replacement Property Precedes Transfer of Relinquished Property

- "The Service requested comments on whether reverse-Starker transactions should qualify for tax-free treatment under any provision of Section 1031….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**."

Rev. Proc. 2000-37 – Reverse / Build to Suit Exchange Rules

- "Treasury and the Service have determined that 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 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 prior to the sale of the relinquished property**"

Parking Replacement Property

- General idea is to arrange for an Exchange Accommodation Titleholder, or an EAT, to step in the shoes and acquire the replacement property to avoid the Taxpayer acquiring it prior to the transfer of the relinquished property
- Per Rev. Proc. 2000-37 Taxpayer and EAT enter into a Qualified Exchange Accommodation Agreement as the overarching document
- Customary that the EAT is an affiliate of the Qualified Intermediary and each parcel that is parked with the EAT be acquired by a separate special purpose limited liability company

Parking Replacement Property

- The Relinquished Property must be transferred in exchange for the Replacement Property within 180 days from the date of parking
- A successful reverse exchange always includes a conventional “forward” exchange as well at time of sale of Relinquished Property, transaction sometimes referred to as “Exchange Last”
- The EAT is permitted to be acting as Taxpayers express agent - Letter Ruling 200148042

Parking Replacement Property

- Financing on behalf of EAT is arranged by Taxpayer
  - Can be 100% from a bank lender
  - Can be 100% financed by Taxpayer
  - Most often it is a combination of bank and Taxpayer loans to EAT
- Taxpayer often assumes the balance of the bank debt upon acquisition
- Management, taxes and expenses of the property is shifted to the Taxpayer via a Master Lease between the EAT and the Taxpayer

Parking Replacement Property

- Many EATs will require a Phase One Environmental Audit
- Liability insurance naming the EAT is required
- Immediately after the sale of the Relinquished Property, Taxpayer does a forward exchange with the Qualified Intermediary and receives the replacement property from the EAT
- Immediately after the sale of the Relinquished Property, Taxpayer does a forward exchange with the Qualified Intermediary and receives the replacement property from the EAT

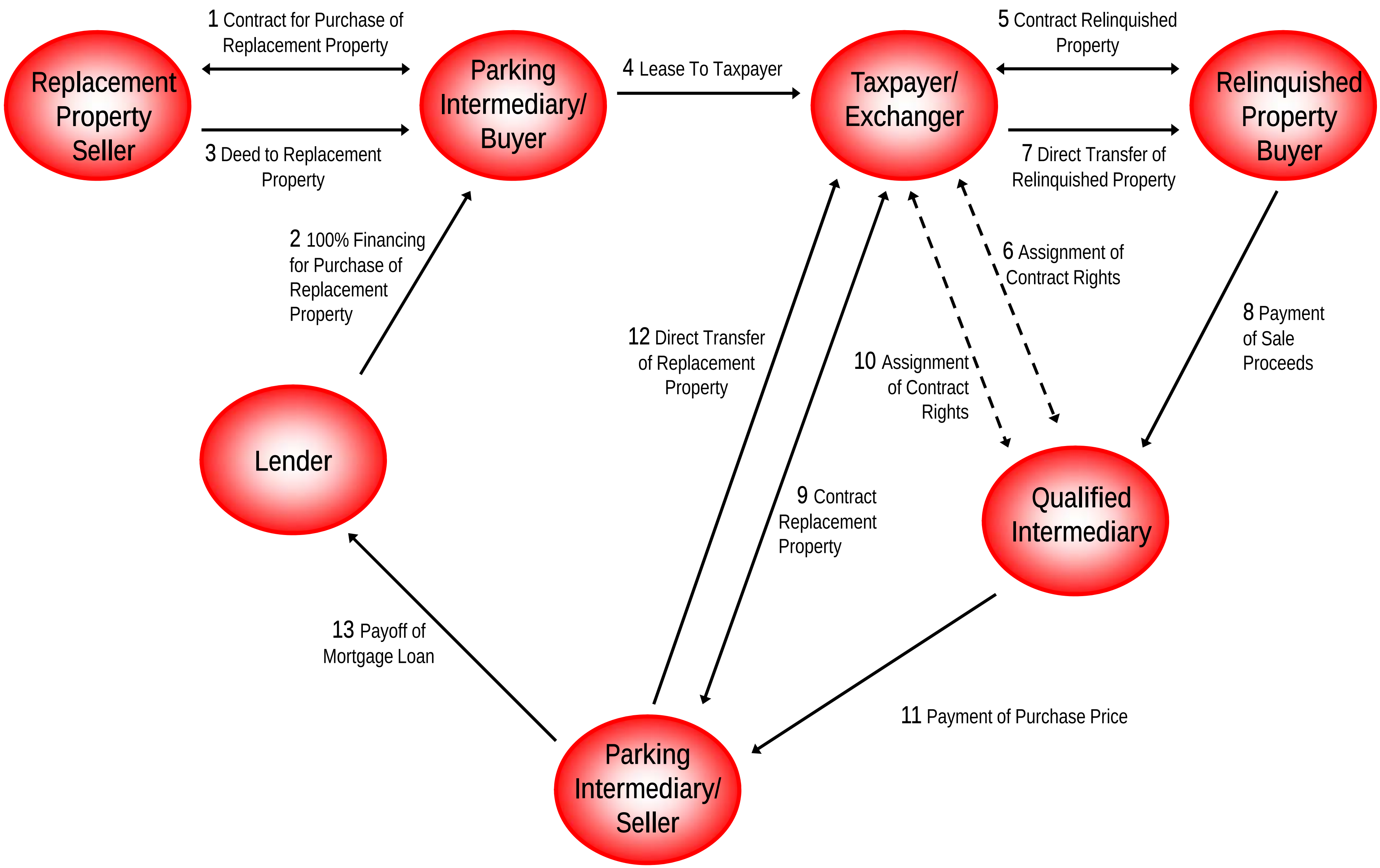
Parking Replacement Property

- The membership interest can by assigned by the member of the EAT to the Taxpayer so long as the Taxpayer is a single entity, i.e. an LLC, Partnership, Individual
- If an assignment of the membership is not viable, the EAT will issue a deed to the Taxpayer
- In many jurisdictions, the transfer by the EAT, as agent, to the Taxpayer, as principal, can be exempt for local and state transfer taxes

Parking Replacement Property

- Rev. Proc. 2000-37 .02(3) requires "The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement"
  - Real estate taxes accrued during the parking period reported by EAT
  - Taxpayer cannot take depreciation during the parking period

Parking Replacement Property



Parking Relinquished Property

- General idea is to arrange for an EAT to acquire the relinquished property from the Taxpayer immediately prior in time to the acquisition of the replacement property in order for the Taxpayer to sell before buying
- Per Rev. Proc. 2000-37 Taxpayer and EAT enter into a Qualified Exchange Accommodation Agreement as the overarching document
- Each separate relinquished property parking with the EAT requires a separate special purpose limited liability company
- Referred to as an "Exchange First" reverse exchange transaction and a conventional "forward exchange" is done at the time of the sale to the EAT

Parking Relinquished Property

- Safe harbor requires the parked property to be sold to a third party within 180 days of the parking
- The EAT is permitted to be acting as Taxpayers express agent - Letter Ruling 200148042
  - Making the EAT express agent of the Taxpayer may allow for conveyance of Relinquished Property to the EAT to be exempt from transfer taxes
- Purchase and Sale agreement is prepared between the EAT and Taxpayer Contract and Taxpayer's contract rights are assigned to the QI
- Management, taxes and expenses of the property is shifted to the Taxpayer via a Master Lease between the EAT and the Taxpayer

Parking Relinquished Property

- Financing on behalf of EAT is arranged by Taxpayer
  - Usually can acquire property subject to existing debt, so only excess market value needs to be financed (be aware of due on sale in mortgage)
  - Can be 100% financed by Taxpayer cash
- EAT may require Phase One Environmental Audit
- Liability insurance naming the EAT is required
- Contract with third party buyer should be in the name of the EAT as Seller; Taxpayer can guaranty obligations, reps, etc. in contract or by addendum

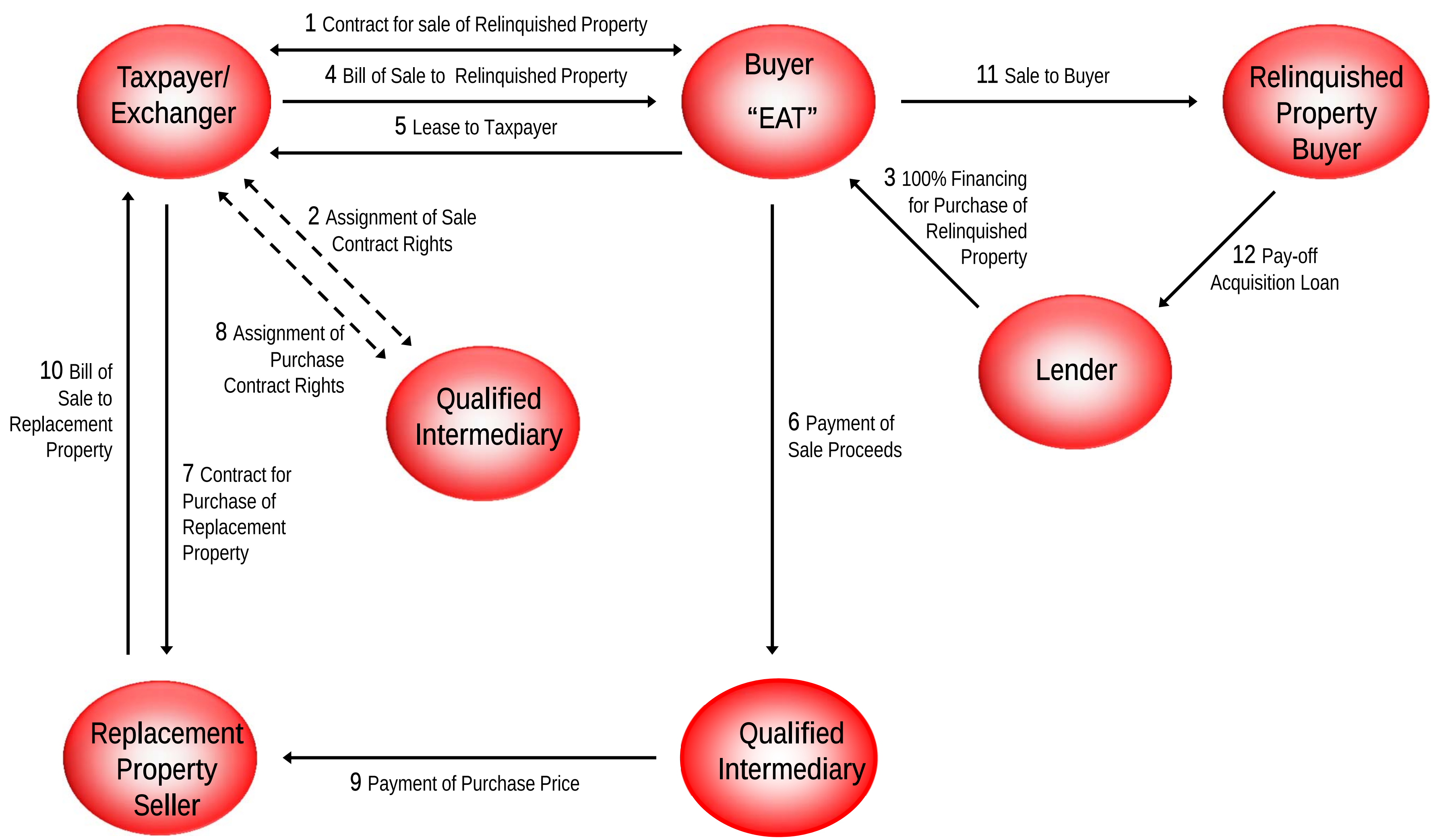
Parking Relinquished Property

- Rev. Proc. 2000-37 .03(7) provides in connection with variance of actual sale price that "The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the exchange accommodation titleholder's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the exchange accommodation titleholder".

Parking Relinquished Property

- Rev. Proc. 2000-37 .02(3) requires "The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement."
  - Real estate taxes accrued during the parking period reported by EAT
  - Taxpayer cannot take depreciation during the parking period
- Upon conveyance of the parked property to the end buyer, the title holding LLC is typically dissolved

Parking Relinquished Property



Determining Which Property to Park

- Consider value of respective properties
- Is the relinquished property subject to debt
- Difficult to pinpoint sale value of relinquished property
- Does either property have a transfer tax exemption
- Any type of special financing on the replacement property
- Environmental considerations

Build-to-Suit/Property Improvement Exchanges

- "The transfer of relinquished property is not within the provisions of Section 1031(a) if the relinquished property is transferred in exchange for **services.** Thus any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind." - Reg § 1.1031(k)-1(e)(4)
- General idea is for the EAT to acquire the Replacement Property and cause the desired improvements to be placed on the property prior to transferring the improved property to the Taxpayer

Build-to-Suit/Property Improvement Exchanges

- Must turn the property over to the Taxpayer with wholly or partially completed improvements within 180 days from the date property is parked
- May be a reverse transaction (replacement property construction begins prior to sale of relinquished property) or a forward exchange (begun after sale of relinquished property)
  - A forward B-t-S can be funded using the exchange proceeds
  - A reverse B-t-S has to be funded by a conventional loan and/or a loan by the taxpayer

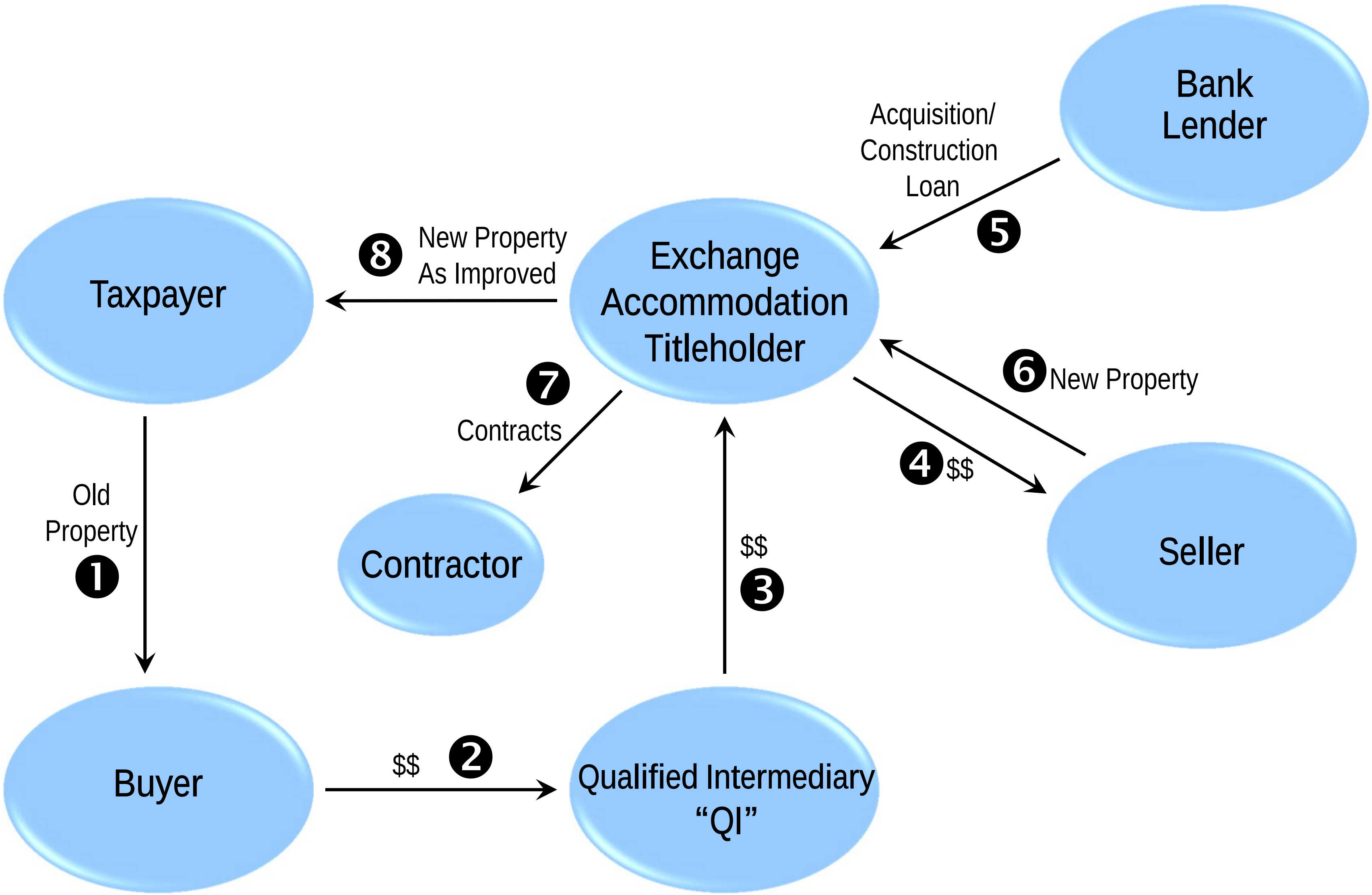
Build-to-Suit/Property Improvement Exchanges

- "A special purpose limited liability company is usually established to act as EAT
- Any existing contract to purchase the property is assigned to the EAT
- Liability insurance, including Builder's Risk Coverage, naming the EAT is required

Build-to-Suit/Property Improvement Exchanges

- Taxpayer involvement is permitted: "The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property" - Rev. Proc. 2000-37 .03(5)
- The membership interest can by assigned by the member of the EAT to the Taxpayer so long as the Taxpayer is a single entity, i.e. an LLC, Partnership, Individual
- Often the Taxpayer is able to assume any bank construction loan and continue the build out until completion

Build-to-Suit Exchange



Build-to-Suit/Property Improvement Exchanges on Taxpayer or Related Party Owned Land

- Taxpayer cannot build on land already owned or on land to be acquired as replacement property; this would constitute "services"
- Causing the EAT to acquire the land and make the improvements might appear to distance the land from being owned by the Taxpayer but disallowed per Rev. Proc. 2004-51

Build-to-Suit/Property Improvement Exchanges on Taxpayer or Related Party Owned Land

- If Replacement Property is owned by a related party who is will to make the improvements, Taxpayer cannot acquire replacement property from a related party
- If related party grants the EAT a long term lease (30 years or more) and the EAT makes the desired improvements within 180 days and assigns the lease to the Taxpayer (with 30 years or more to run) the Taxpayer can have a proper exchange for the value of the leasehold improvements

Build-to-Suit/Property Improvement Exchanges on Taxpayer or Related Party Owned Land

- In Letter Ruling 200251008 Taxpayer was a corp and related party was an LLC where corp was 80% owner which had a 45 year ground lease. The related party subleased a portion of the property to the EAT who improved it and assigned it to the taxpayer within 180 days

Build-to-Suit/Property Improvement Exchanges on Taxpayer or Related Party Owned Land

- In Letter Ruling 200329021 the Taxpayer was a corporate sub of a parent corp. The parent sub leased the property to the EAT for a term in excess of 30 years. The EAT made the improvements and assigned the lease to the Taxpayer within 180 days
- In PLR 201408019 involved a Limited Partnership being related to the Taxpayer and to a Ground Lessee. The Ground Lessee entered into a 30 year plus sublease with EAT who built improvements for up to 180 days where after EAT transferred the interest in the Ground Lease to Taxpayer

Build-to-Suit/Property Improvement Exchanges on Taxpayer or Related Party Owned Land

- Since the interest in the long term lease is recognized as a real property interest and the Taxpayers received the leasehold improvements from the EAT, and not the related party, the structure works
- The EAT (and later the Taxpayer) should pay some kind of fair market rent to the Lessor

LKE Program Exchanges

LKE Program Exchanges

- An ongoing program involving multiple exchanges of 100 or more properties – Rev. Proc. 2003-39
- The Taxpayer regularly enters into agreements to buy and sell personal property
- The Taxpayer uses a single Intermediary to accomplish the exchanges

LKE Program Exchanges

- The Taxpayer and Intermediary enter into a Master Exchange Agreement
  - The Master Exchange Agreement contains the (g)(6) language
  - The Master Exchange Agreement contains a blanket assignment of rights under the sale and purchase agreements
- The Taxpayer provides written notice to the other party of the written notice of assignment of rights
- The Taxpayer either receives or identifies the Replacement Property with 45 days of sale