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Reverse Like-Kind Exchanges: A Principled Approach

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I. INTRODUCTION

A. *Section 1031*

Section 1031(a)(1)[1] provides an exception to the general rule that gain and loss must be recognized on the sale or exchange of property.[2] To qualify for nonrecognition under section 1031(a)(1),

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1 I.R.C. § 1031(a)(1)(2001).

2 See I.R.C. § 1001(c) for the general rule requiring recognition.

the transaction must meet four requirements: (1) there must be an exchange, (2) the property the taxpayer receives must be of a like kind to the property the taxpayer transfers, (3) the taxpayer must hold both properties for use in a trade or business or for investment, and (4) the properties cannot be disqualified under section 1031(a)(2). Courts have held that section 1031(a)(1) applies to exchanges involving multiple parties if the exchange is structured properly.[3] The Ninth Circuit and Congress also have provided that section 1031(a)(1) applies even though the taxpayer transfers relinquished property some time before receiving replacement property,[4] commonly known as deferred exchanges.[5] By holding that exchanges involving multiple parties and deferred exchanges qualify for section 1031 treatment, the courts and Congress have provided taxpayers with various exchange structures to use to avoid gain recognition when exchanging property for other property of a like kind. Although the structures that are currently allowed are helpful, more guidance is needed.

B. The Reverse Exchange Issues

A taxpayer may locate replacement property that it wishes to acquire currently at a favorable price while deferring the transfer of the relinquished property to a time when, hopefully, a better price can be obtained.[6] A transaction such as this, in which the taxpayer receives replacement property before the taxpayer transfers relinquished property, is known as a reverse exchange.[7] Section 1031

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[3] See *infra* Part II.B.2 for an in depth discussion of judicial decisions that allow section 1031(a)(1) treatment to taxpayers who enter into transactions involving multiple parties.

[4] Starker v. United States, 602 F.2d 1341 (9th Cir. 1979); *see also* I.R.C. § 1031(a)(3)(2001).

[5] *Like-kind Exchanges - Limitations on Deferred Exchanges; and Inapplicability of Section 1031 to Exchanges of Partnership Interests*, 56 Fed. Reg. 19,933 (May 1, 1991) (to be codified at 26 C.F.R. pt. 1) (Preamble to the Regulations).

[6] Section of Taxation American Bar Association, *ABA Members Urge IRS Guidance on Reverse Exchanges*, TAX NOTES TODAY (Jan. 7, 1993)(LEXIS, FEDTAX lib., TNT file, elec. cit., 93 TNT 4-52).

[7] Ronald C. Stasch, *Stasch Urges Tax-free Treatment for Reverse 'Starker' Exchanges*, TAX NOTES TODAY (July 26,1990)(LEXIS, FEDTAX lib., TNT file,

does not provide any specific guidance regarding whether gain or loss must be recognized when a taxpayer enters into a reverse exchange. In 1991, the Treasury Department (Treasury) promulgated regulations that apply to deferred exchanges.[8] At that time, the Treasury specifically stated that those regulations would not apply to reverse exchanges.[9] For many years there has been no specific guidance regarding reverse exchanges; therefore, Amany taxpayers [were] unwilling to do them directly because of concerns that the [Internal Revenue Service would] challenge whether such transactions qualify for nonrecognition under [section] 1031. Consequently, most reverse exchanges occur through the use of cumbersome (and costly) parking or lease-option arrangements.[10]

In a recently-published revenue procedure, the Internal Revenue Service (Service) responded to pleas from tax practitioners and, at long last, published guidance in this area.[11] The revenue procedure published by the Service provides a safe harbor for taxpayers who wish to use parking arrangements, but does not address reverse exchange structures that do not involve parking arrangements.[12] Although the revenue procedure is helpful to taxpayers, it leaves several issues unresolved. Furthermore, taxpayers should be given additional guidance regarding pure reverse exchanges.

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elec. cit., 90 TNT 155-40).

8 *See supra* note 5.

9 *Id.*

10 Section of Taxation American Bar Association, *supra* note 6. See *infra* Parts III. C and D for an in-depth discussion of parking arrangements.

11 Rev. Proc. 2000-37, 2000-40 I.R.B. 308; *see also* Tech. Adv. Mem. 00-39-005 (May 31, 2000) (Published September 29, 2000). The Service took the position that an exchange accommodator was an agent of the taxpayer and that a transfer made to the exchange accommodator should be treated as a transfer to the taxpayer. *Id.* The Service did not allow like-kind exchange treatment to the taxpayer in this situation because it found that the taxpayer through its agent received the replacement property and later transferred the relinquished property in a separate non-interdependent purchase and sale transaction. *Id.*

12 Rev. Proc. 2000-37, 2000-40 I.R.B. 308.

C. Applying Section 1031 Principles to Reverse Exchanges

1. Reverse Exchanges and Section 1031 Purpose and Requirements

Taxpayers should not have to resort to using parking or lease-option arrangements if reverse exchanges can be structured in a manner that clearly satisfies the purpose and meets the requirements of section 1031. In enacting the like-kind exchange provisions, Congress eliminated administrative inconvenience associated with valuing replacement property and deferred recognition of gain or loss associated with an investment until a taxpayer discontinued the investment. As will be shown, properly structured reverse exchanges satisfy this intent. The only other issue is whether a transaction structured as a reverse exchange can meet the section 1031 exchange requirement (assuming the other two section 1031 requirements are met).[13] An analysis of the legislative history, judicial decisions, and the Treasury Regulations reveals that the exchange requirement of section 1031 can be broken down into two components: (1) a requirement that there be a property-for-property transfer and (2) that the transfer be reciprocal.[14] The application of these principles to reverse exchanges reveals that three different structures can be used to effectuate a reverse exchange that, if completed within a reasonable time, will satisfy the purpose and meet the exchange requirement of section 1031. The three types of structures are: a two-party reverse exchange, a three-corner reverse exchange, and a four-corner reverse exchange.

2. The Service Should Publish Additional Guidance

Although these three types of exchanges, when properly structured and completed in a reasonable time, satisfy the purpose and exchange requirements of section 1031, taxpayers may be unwilling to use them until they are more certain that the Service will

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13 This paper assumes that the other two requirements of section 1031 are satisfied in each example discussed herein.

14 I.R.C. § 1031 (2001)

not challenge the structures. In publishing Rev. Proc. 2000-37, the Service has provided a safe harbor for taxpayers wishing to use parking arrangements, but has failed to provide any guidance on true reverse like-kind exchanges. Therefore, the Service should publish guidance stating that it will not challenge whether the three types of reverse exchanges identified herein qualify for like-kind exchange treatment if they are structured correctly.[15]

This article discusses the current regulatory treatment of like-kind exchanges and the need for guidance for the use of reverse exchanges. Part I introduces section 1031 of the Code, reverse exchange issues, and the application of section 1031 to reverse exchanges. Part II fully examines the principles and requirements of like-kind exchanges. Part III identifies the issues of regulating reverse exchanges and evaluates proposals and published guidance for the treatment of reverse exchanges. Finally, Part IV presents the ultimate conclusion that more guidance is necessary for taxpayers to comfortably and successfully engage in reverse exchanges.

II. EXISTING PRINCIPLES OF LIKE-KIND EXCHANGES

A. The Purpose of Section 1031

The beginning point in analyzing whether section 1031 should apply to reverse exchanges is to clearly determine what Congress intended in enacting the like-kind exchange provisions. Congress first granted tax-deferred treatment to taxpayers exchanging like-kind property in 1921.[16] The Revenue Act of 1921 provided:

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[15] Barton Massey, *Safe Harbor Guidance For Reverse Like-Kind Exchanges to Come Soon, IRS Official Promises*, TAX NOTES TODAY (Jan. 25, 2000)(LEXIS, FEDTAX lib., TNT file, elec. cit., 2000 TNT 16-2). On January 22, 2000, Kelly Alton, special counsel to the assistant chief counsel, income tax and accounting, told the American Bar Association Section on Taxation that she expected the Service to issue guidance on reverse exchanges during 2000. *Id.* Rev. Proc. 2000-37 is a fulfillment of this expectation, but the guidance is limited to exchanges involving parking arrangements. 2000 I.R.B 308.

[16] Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230.

> For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized (1) [w]hen any such property held for investment, or for productive use in a trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use . . . .[17]

The readily realizable market value language led one court to believe that one of the purposes for enacting this statute was the administrative inconvenience created by trying to determine the market value of an asset.[18] Indeed, the legislative history referring to the market value language states that no part of the present income-tax law has been productive of so much uncertainty and litigation or has more seriously interfered with those business readjustments which are peculiarly necessary under existing conditions.[19] Congress believed that by excepting like-kind exchanges from gain and loss recognition it would be are moving a source of grave uncertainty [and would] permit business to go forward with the readjustments required by existing conditions . . . .[20] The discussion in the House of Representatives also provides that the 1921 Act relieves such transactions from delay, simplifies the tax return, and promotes such exchange of property.[21] In excepting like-kind exchanges from the general recognition rules, Congress believed that it would eliminate some inconvenience for both taxpayers and the Service.

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17 *Id.*

18 Century Elec. Co. v. Commissioner, 192 F.2d 155, 159 (8th Cir. 1951).

19 H.R. REP. NO. 67-350, at 10 (1921); *see also* S. REP. NO. 67-275, at 11 (1921).

20 H.R. REP. NO. 67-350, at 10 (1921); *see also* S. REP. NO. 67-275, at 11 (1921).

21 61 CONG. REC. 5201 (1921).

In 1924 the readily realizable market value language was removed from the statute.[22] The report from the House Committee on Ways and Means stated:

> The provision is so indefinite that it cannot be applied with accuracy or with consistency. It appears best to provide generally that gain or loss is recognized from all exchanges, and then except specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result.[23]

This statement shows that, by removing the readily realizable market value language from the statute, Congress made it clear that it was concerned about the problems associated with trying to determine the value of property received in a transaction. This change, along with the change excepting like-kind exchanges from the general recognition rule, provides clear evidence that one purpose Congress had in enacting the like-kind exchange provisions was to remove some inconvenience that would otherwise arise.

Congress also determined that a taxpayer should not pay taxes until gain or loss is realized in cash.[24] This purpose is made evident by the committee report from the House Committee on Ways and Means. That committee, in 1934, stated:

> [I]f the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in

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[22] Act of March 4, 1923, ch. 294, 1, 42 Stat. 1560.

[23] H.R. REP. NO. 68-179, at 13 (1924).

[24] H.R. REP. NO. 73-704, at 13 (1934).

> cash, marketable securities, or other property not of the same kind having a fair market value.[25]

The court in *Jordan Marsh Co. v. Commissioner*[26] accepted this statement as Congress' true intent for providing tax-deferred treatment to like-kind exchanges. The court stated that, in enacting the like-kind exchange provisions, Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort.[27] The court also stated that "[t]hese considerations, rather than concern for the difficulty of the administrative task of making the valuations necessary to compute gains and losses, were at the root of the Congressional purpose . . . ."[28] Although Congress was concerned about administrative convenience in enacting the like-kind exchange provisions, it appears that its primary purpose was to defer recognition of gain or loss until a taxpayer actually terminated an investment. In analyzing whether reverse exchanges should be granted section 1031 treatment, both of these purposes should be considered. If a taxpayer decides to continue an investment by replacing one property with another property and does so through a reverse exchange, the exchange should qualify for tax-deferred treatment if all the other requirements of section 1031 are met.

B. The Exchange Requirement

To receive like-kind exchange treatment, a transaction must meet the requirements in section 1031. The 1924 Act provided that four requirements must be met for a transaction to qualify as a like-kind exchange.[29] Other than a few minor changes in wording, the general rule in the 1924 Act remains unchanged in our current statute.[30] The four requirements are: (1) that there be an exchange, (2)

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25 Id.

26 269 F.2d 453, 456 (2d Cir. 1959).

27 *Id.*

28 *Id.*

29 Revenue Act of 1924, ch. 234, § 203(b)(1), 43 Stat. 253, 256.

30 The Revenue Act of 1928 made minor language revisions and changed the section number to 112(b). In 1954, the number was changed to § 1031(a).

that the property received in the exchange be of a like kind to the property transferred, (3) that both the property the taxpayer transfers and the property the taxpayer receives be held for use in a trade or business or for investment, and (4) that neither the property the taxpayer transfers nor the property the taxpayer receives is a disqualified asset.[31] Of the three requirements, the most important question in analyzing reverse exchanges is whether an exchange has occurred. For purposes of this article, all the properties involved will be assumed to be of a like kind and held by the taxpayer for use in a trade or business or for investment.

Today, a large body of law exists that deals with the definition of exchange for purposes of section 1031.[32] The evolution of this body of law seems to have begun during a now-famous floor discussion between Congressman Green, who was then Chairman of the House Committee on Ways and Means, and Congressman La Guardia.[33] The pertinent portion of the discussion went as follows:

> La Guardia: Under this paragraph is it necessary to exchange property? Suppose the property is sold and other property immediately acquired for the same business. Would that be a gain or loss, assuming there is greater value in the property acquired? . . .
>
> Green: If the property is reduced to cash and there is a gain, of course it will be taxed.
>
> La Guardia: Suppose that cash is immediately put back into the property, into the business?
>
> Green: That would not make any difference.[34]

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[31] I.R.C. § 1031(a)(1), (a)(2)(2001).

[32] See *infra* Part II.B. through E. for a discussion of the body of law that addresses the definition of exchange for purposes of section 1031(a)(1).

[33] 65 CONG. REC. 2799 (1924).

[34] *Id.*

This discussion clearly provides evidence showing that to qualify for tax-deferred treatment under the like-kind exchange provisions, Congress intended that the taxpayer exchange property for property, not property for cash. Therefore, the receipt of cash for property will cause a transfer to fail to meet the exchange requirement of section 1031. As will be seen, this conclusion is supported by the regulations and numerous court decisions.

Treas. Reg. 1.1002-1(d) states that "to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only."[35] The comments by Congressman Green and the language in the regulations provide two elements that must be present for an exchange to occur: (1) the taxpayer must transfer property and receive property (hereinafter "property-for-property" requirement) and (2) the transfer must be reciprocal (hereinafter "reciprocal" requirement). Courts have been very strict in construing the property-for-property requirement.[36] In construing the reciprocal requirement, courts have developed both narrow and broad standards. Courts require a taxpayer to transfer property to and receive property from one, and only one, exchange partner, but allow taxpayers to structure such sole exchanges in many different ways in order to achieve a reciprocal transfer.[37]

1. The Property-for-Property Requirement

The current regulations provide that "exceptions from the general rule requiring the recognition of all gains and losses ... are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception."[38] Since section 1031 is an exception to the general rule requiring recognition of gains and losses, it should be strictly construed. Perhaps the most

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[35] Treas. Reg. § 1.1002-1(d) (1957).

[36] *See e.g.* Carlton v. United States, 385 F.2d 238 (5th Cir. 1967); Halpern v. United States, 286 F.Supp. 255 (N.D. Ga. 1968).

[37] *See e.g.* Mercantile Trust Co. v. Commissioner, 32 B.T.A. 82 (1935); W.D. Haden v. Commissioner, 165 f.2d 588 (5th Cir. 1948); Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1980).

[38] Treas. Reg. § 1.1002-1(b) (1957).

poignant example of a court strictly construing the property-for-property requirement can be found in *Carlton v. United States.*[39] In *Carlton*, the taxpayer owned ranch land located in Florida.[40] The taxpayer entered into a contract with General providing General with an option to purchase the ranch land from the taxpayer for a specified price.[41] The contract also provided that the taxpayer could require General to acquire other land as designated by the taxpayer and transfer the other land to the taxpayer in lieu of a cash payment or mortgage.[42] The taxpayer subsequently found two other properties (Lyons and Fernandez) suitable for the purpose of exchange.[43] General entered into a contract to purchase Lyons and Fernandez.[44] The taxpayer intended to use Lyons and Fernandez to continue the ranching activities for which the ranch land was used.[45]

On August 3, the date of closing, the taxpayer transferred the ranch land to General.[46] As consideration for the taxpayer's ranch land, General transferred to the taxpayer the cash needed to purchase Lyons and Fernandez, and assigned its rights to purchase such property to the taxpayer.[47] On that same day, the taxpayer used a portion of the funds to purchase Lyons.[48] On the following day, the taxpayer used the remaining portion of the funds to purchase Fernandez.[49]

In deciding whether the transaction qualified for like-kind exchange treatment, the court stated that "[t]he only question presented here is whether the transfer of the properties constituted a sale or an exchange."[50] The court then recognized that although the taxpayer did indeed continue ranching after the exchange (satisfying the continuation-of-an-investment purpose of section 1031), that aspect of

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39 385 F.2d 238 (5th Cir. 1967).
40 *Id.* at 239.
41 *Id.*
42 *Id.*
43 *Id.*
44 *Id.* at 240.
45 *Id.* at 239.
46 Id. at 240.
47 *Id.*
48 Id.
49 *Id.*
50 *Id.* at 241.

the transaction did not control.[51] The court stated that "it is well settled that a sale and repurchase do not qualify for nonrecognition treatment under [section 1031]"[52] and that it could not close [its] eyes to the realities of the transaction.[53] The court made it clear that each step of the transaction, not merely the beginning and the end, must be considered.[54] Looking at each step, the court concluded that the taxpayer received cash as consideration for the ranch land, and that the taxpayer in turn purchased the Lyons and Fernandez properties.[55] In arriving at this decision, the court relied upon the fact that the money transferred to the taxpayer was not earmarked by the exchange partner to be used exclusively to purchase the Lyons and Fernandez properties and that the taxpayer had unfettered and unrestrained use of the proceeds.[56]

The *Carlton* decision provides an excellent example of how strictly courts will construe the property-for-property requirement in determining whether a transaction qualifies as an exchange for purposes of section 1031. In *Carlton*, the taxpayer's intent to continue an investment was clear; however, that intent did not influence the court's decision.[57] In making its decision, the court focused on the fact that the taxpayer actually received cash instead of property from the exchange partner.[58] Once the court concluded the taxpayer had actually received cash, it would not be influenced by either the taxpayer's intent nor the substance of the transaction.[59] After reading *Carlton*, it is apparent that in structuring reverse exchanges, taxpayers must be very careful to ensure that money is not received or transferred in such a way that the transaction fails to meet the property-for-property requirement.

The district court for the Northern District of Georgia held that a taxpayer may fail to meet the property-for-property require-

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51 *Id.*
52 *Id.*
53 *Id.*
54 *Id.*
55 *Id.* at 242.
56 *Id.* at 243.
57 *Id.*
58 *Id.* at 242-43.
59 *Id.* at 243.

ment even though the taxpayer does not actually receive money.[60] In *Halpern v. United States*, the taxpayers were involved in an exchange that involved multiple parties.[61] Ultimately, the taxpayers transferred property and received other property and cash.[62] To get to the end result, the taxpayers transferred their property to Chennault.[63] In exchange, Chennault transferred property to the taxpayers and transferred cash to the Lawyers Title Insurance Company (Lawyers Title).[64] Lawyers Title used the cash it received from Chennault to purchase replacement property for the taxpayers.[65]

In deciding that the transaction did not qualify for like-kind exchange treatment, the court stated that "the failure to actually receive the cash does not automatically require a corollary finding that a transaction is an exchange."[66] The court stated that since the taxpayers did not have to use the proceeds transferred to Lawyers Title to purchase the replacement property, but could actually receive the proceeds and use them as they please (i.e. the taxpayers' use of the proceeds was unfettered and unrestricted), the decision in *Carlton* should apply.[67] Therefore, the court held that the taxpayers had failed to satisfy the property-for-property requirement and consequently would not receive section 1031 treatment.[68] This case illustrates that a transaction in which a taxpayer constructively receives cash will not meet the property-for-property requirement.

Although the results in these two cases seem somewhat harsh, the principle is followed in numerous other cases.[69] The results from these cases provide clear guidance to taxpayers: if the taxpayer receives cash (actually or constructively) in a transaction instead of

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60 Halpern v. United States, 286 F. Supp. 255 (N.D. Ga. 1968).

61 *Id.*

62 *Id.*

63 *Id.*

64 *Id.* at 258.

65 *Id.* at 258- 259.

66 *Id.* at 258.

67 *Id.* at 259.

68 *Id.*

69 *See, e.g.*, Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33, 36 (6th Cir. 1945); Barker v. Commissioner, 74 T.C. 555 (1980); Rogers v. Commissioner, 44 T.C. 126 (1965) *aff'd. per curiam*, 377 F.2d 534 (9th Cir. 1967).

property, the transaction does not satisfied the property-for-property requirement. Therefore, such a transaction will not qualify as an exchange for purposes of section 1031. For a reverse exchange to satisfy the property-for-property requirement, the taxpayer should avoid receiving cash from one of the parties involved in the transaction and must also be cautious about transferring cash to a seller.

2. The Reciprocal Requirement

Although courts strictly construe the property-for-property requirement, they have been lenient in allowing taxpayers to find ways to satisfy the reciprocal requirement even though multiple parties are involved.[70] A look at cases involving multiple parties in which the courts have held that the transaction qualifies for like-kind exchange treatment, one common element exists: even though multiple parties are involved the courts have been able to find in each case that the taxpayer transferred property to one party and received replacement property from that same party.[71] In some instances, courts disregard the passage of title and look at the flow of rights connected to the property.[72] In such cases, the courts have found that if the taxpayer transfers rights to one other party and receives rights from that same party, the reciprocal requirement is met.[73] Thus, it appears that a taxpayer will meet the reciprocal requirement if the taxpayer actually transfers property (either in the form of a set of rights or rights and legal title) to one other party and receives replacement property (either in the form of a set of rights or in the form of rights and legal title) from the same party. If the taxpayer can establish that the transfer was with only one other party, courts allow the taxpayer to use various structures to complete the exchange. This rule is illustrated by the following cases.

70 *See, e.g.*, Mercantile Trust Co. v. Commissioner, 32 B.T.A. 82 (1935); W.D. Haden v. Commissioner, 165 F.2d 588 (5th Cir. 1948).

71 *See, e.g.*, W.D. Haden v. Commissioner, 165 F.2d 588 (5th Cir. 1948).

72 *See, e.g.*, Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1980).

73 Id.

Mercantile Trust Co. v. Commissioner[74] is an example of how the courts allow taxpayers to structure transactions involving multiple parties in a manner that meets the reciprocal requirement. In *Mercantile Trust*, Emerson Hotel desired to purchase property (the Baltimore Street property) owned by the taxpayer.[75] The taxpayer did not want to enter into a cash sale of the Baltimore Street property, so it required the Title Company, acting as Emerson Hotel's agent, to purchase the Lexington Street property from an independent third party and transfer it to the taxpayer in exchange for the Baltimore Street property.[76] The Board of Tax Appeals held that the taxpayer actually entered into an agreement with the Title Company in which the taxpayer was obligated to transfer the Baltimore Street property to the Title Company and could compel the Title Company to transfer the Lexington Street property to the taxpayer.[77] The Board found that the taxpayer and the Title Company carried the contract out according to their agreement and held that in so doing, effected an exchange that qualified for like-kind exchange treatment.[78] This decision demonstrates that a taxpayer can structure a transaction involving multiple parties in such a manner that the end result will produce an exchange between only two parties and satisfy the reciprocal requirement.

In 1948, the Fifth Circuit, in *W.D. Haden v. Commissioner*,[79] provided taxpayers even more flexibility with which they could structure exchanges that would satisfy the reciprocal requirement. The exchange in *Haden* involved four parties: the taxpayer, Haden Co., which owned lot No. 16; Beeley, who owned lot No. 15; Texas Co., which owned lot No. 17; and Goodwin, an independent real estate man who acted as intermediary to facilitate the transaction.[80] The only contract signed by the taxpayer was with Goodwin, agree-

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74 32 B.T.A. 82 (1935).

75 *Id.* at 83-84.

76 *Id.* at 83, 85.

77 *Id.* at 85.

78 *Id.* at 87, 88.

79 165 F.2d 588 (5th Cir. 1948).

80 *Id.* at 590.

ing to exchange No. 16 for No. 17 with no money consideration.[81] Goodwin had also entered into contracts with Beeley and Texas Co. to ensure that the taxpayer would receive lot No. 17.[82] To effectuate the agreement between the taxpayer and Goodwin, Goodwin requested that Texas Co. convey lot No. 17 to the taxpayer and the taxpayer convey lot No. 16 to Beeley (Beeley also transferred cash to Goodwin as part of the agreement).[83] The court held that this transaction qualified for like-kind exchange treatment.[84] In so holding, the court stated that the "[t]axpayer simply carried out the contract it had made with Goodwin by conveying at Goodwin's direction to another. [The] [t]axpayer did not sell to Beeley or get any of his money. It exchanged its lot for another one.[85] In finding that an exchange had occurred, this court did not require the actual title to pass to or from only one person.[86] The court did, however, note that the taxpayer had only one exchange partner B Goodwin.[87] The other parties entered into contracts with Goodwin, not with the taxpayer.[88] Thus, the reciprocal requirement is met when the taxpayer transfers and receives legal title to property from different parties if the taxpayer is carrying out obligations and receiving benefits from a contract made with only one exchange partner.

In 1963, two different circuit courts held that other transactions involving multiple parties can qualify as exchanges.[89] The first of the two cases to be decided was *Alderson v. Commissioner*.[90] In *Alderson*, the taxpayer entered into an agreement on May 21, 1957 with Alloy to sell Buena Park to Alloy for cash.[91] Sometime after entering into the agreement with Alloy, the taxpayer located the

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81 *Id.*
82 *Id.*
83 *Id.*
84 *Id.*
85 *Id.*
86 *Id.*
87 *Id.*
88 *Id.*
89 Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963).
90 Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963).
91 *Id.* at 791.

Salinas property and decided it would be better to exchange the Buena Park property for the Salinas property.[92] On August 19, 1957, the taxpayer and Alloy amended their original agreement to provide that Alloy would acquire the Salinas Property and transfer the Salinas property to the taxpayer in exchange for Buena Park.[93] The amended agreement also provided that if Alloy was unable to transfer the Salinas property to the taxpayer by September 11, 1957, Alloy would purchase Buena Park for cash.[94]

As part of the agreement, Alloy transferred money to an escrow which acquired the deed to the Salinas property and then transferred the Salinas deed to Alloy.[95] In the end, the taxpayer deeded the Buena Park property to Alloy on August 26, 1957 and received a deed for the Salinas property from Alloy on August 29, 1957.[96] The court held that this final transfer between the taxpayer and Alloy qualified as an exchange of like-kind property.[97] This decision expands a taxpayer's ability to structure a reciprocal transfer by allowing taxpayers to amend agreements that originally called for cash consideration into agreements requiring an exchange of like-kind property. The decision also states that a default clause requiring the exchange partner to transfer cash in the event that it cannot obtain and transfer like-kind property does not violate the property-for-property requirement.

Another case involving multiple parties was *Coastal Terminals, Inc. v. United States*, decided in 1963.[98] In that case, the taxpayer, Coastal Terminals, decided to dispose of its deepwater oil terminal and acquire inland terminals.[99] Pursuant to this plan, the taxpayer acquired options to purchase three sites on which it could construct inland terminal facilities.[100] Because steel was in short supply, the taxpayer also obtained commitments from Chicago Bridge and

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92 *Id.*
93 *Id.*
94 *Id.*
95 *Id.*
96 *Id.*at 791-92.
97 *Id.* at 795.
98 320 F.2d 333 (4th Cir. 1963).
99 *Id.* at 334.
100 *Id.*

Iron Company for steel that it would need to construct the terminal facilities.[101] Shortly thereafter, Delhi-Taylor offered to purchase the taxpayer's deepwater terminal.[102] Delhi-Taylor was unwilling to pay the cash price that the taxpayer was asking, so it proposed that the two parties enter into an agreement whereby Delhi-Taylor would obtain the inland sites on which the taxpayer held options, construct the necessary facilities, and then transfer the inland terminals to the taxpayer in exchange for the taxpayer's deepwater terminal.[103] The agreement also provided that in the event that Delhi-Taylor was unable to consummate the exchange that it would pay cash for the deepwater terminal.[104]

The transaction was carried out as agreed: the taxpayer assigned the options on the three inland sites and the steel commitment to Delhi-Taylor, Delhi-Taylor constructed the inland terminal facilities, and then transferred the inland terminals to the taxpayer in exchange for the deepwater terminal.[105] In holding that the transaction qualified as an exchange, the court stated that the transaction should not be separated into each component, but should be looked at as a whole.[106] The court saw that the taxpayer exchanged the deepwater terminal for the inland terminals, qualifying as an exchange.[107] The court also was able to once again find a reciprocal transfer had occurred even though Delhi-Taylor obtained options to purchase the inland sites from the taxpayer.

The facts in *Biggs v. Commissioner*[108] are even more complicated, but the result is the same. The taxpayer, Biggs, desired to transfer his Maryland property (the Maryland property) for a piece of property in Virginia (the Virginia property).[109] To accomplish this task, the owner of the Virginia property transfer title to Shore Title

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101 *Id.*
102 *Id.*
103 *Id.* at 334-35.
104 *Id.* at 335.
105 *Id.* at 335-336.
106 *Id.* at 335-336.
107 *Id.* at 339.
108 632 F.2d 1171 (5th Cir. 1980).
109 *Id.* at 1172-73.

Company (Shore Title).[110] The taxpayer advanced approximately $115,000 to Shore Title to enable it to acquire title to the property.[111] Shore Title then entered into an agreement with Powell whereby Shore Title agreed to sell the Virginia property to Powell or Powell's assigns.[112] Powell and the taxpayer then entered into an agreement whereby Powell would transfer the rights in the Virginia property to the taxpayer in exchange for the taxpayer transferring the rights in the Maryland property to Powell.[113] Powell subsequently transferred the rights in the Maryland property to the Lessanses, who transferred the rights to Ocean View.[114] Then Shore Title executed a deed to the Virginia property to the taxpayer, and the taxpayer executed a deed to the Maryland property to Ocean View.[115]

Although this transaction is very complicated and involved many different parties, the court held that an exchange did occur.[116] In making this decision, the court reiterated the fact that the exchange partner (in this case Powell) was not required to receive title to the property being transferred to the taxpayer for the transaction to qualify as an exchange.[117] Powell's receipt of the rights to the Virginia property and transfer of such rights to the taxpayer was sufficient to satisfy the exchange requirement.[118] The court also stated that the "the ultimate transfers of the Maryland and Virginia properties were part of a single, integrated plan, the substantive result of which was a like-kind exchange."[119] This decision created greater leniency for meeting the reciprocal requirement by allowing the taxpayer to advance the cash that was used to purchase the replacement property, and by allowing the taxpayer to be involved in the acquisition of the replacement property and still be allowed like-kind exchange treatment.

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110 *Id.* at 1173.
111 *Id.* at 1174.
112 *Id.*
113 *Id.*
114 *Id.*
115 *Id.* at 1175.
116 *Id.* at 1178.
117 *Id.* at 1177.
118 *Id.* at 1178.
119 *Id.*

The decisions in these cases demonstrate that although the courts require a reciprocal exchange, taxpayers can employ different techniques to create a reciprocal exchange. In effect, the exchange in each of these cases was between two parties, one of whom had, in his own manner, previously acquired property which was to be subsequently exchanged with that of the taxpayer.[120] Although a court made this comment before some of the cases mentioned above were decided, the comment is an excellent statement of the reciprocal requirement. If a taxpayer can structure a transaction in such a manner that an exchange occurs between the taxpayer and one other party (the exchange partner), the reciprocal requirement will be met. As seen above, the reciprocal requirement does not mandate that legal title pass through the hands of the exchange partner so long as the taxpayer and the exchange partner exchange rights in the properties. If the taxpayer and the exchange partner do exchange rights, the transaction qualifies as an exchange.

C. *Starker*, Deferred Exchanges, and the Purpose of 1031

In *Starker v. United States*, the Ninth Circuit revolutionized the world of like-kind exchanges and extended the exchange requirement by holding that a deferred exchange (one in which the taxpayer transfers relinquished property and receives replacement at a later time) can qualify for like-kind exchange treatment.[121] The *Starker* decision also caused Congress to ultimately legislate in the area of deferred exchanges.[122] Starker, the taxpayer, transferred property to Crown Zellerbach Corporation (Crown) in exchange for

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[120] Halpern v. United States, 286 F. Supp. 255, 258 (N.D. Ga. 1968); *cf.* Rev. Rul. 57-244, 1957-1 C.B. 247. The Service allowed like-kind exchange treatment to a taxpayer who transferred property to one party and received property from another party. Rev. Rul. 57-244. The taxpayer and the other parties involved in the transaction had originally purchased all three lots that were involved in the transaction together. *Id.* Because the facts of this Ruling are so limited, it should not be assumed that a taxpayer will be granted like-kind exchange treatment in other types of transactions in which the taxpayer transfers property to one party and receives property from another party. *Id.*

[121] 602 F.2d 1341 (9th Cir. 1979).

[122] H.R. REP. NO. 98-432, pt. 2 at 1231 (1984).

Crown's promise to acquire suitable exchange property and transfer such property to the taxpayer no later than five years from the time the taxpayer transferred the property to Crown.[123] Crown promised that it would pay the taxpayer a "growth factor" equal to six per cent of the taxpayer's outstanding balance at the end of each year, and that, if it did not transfer all of the property to the taxpayer within a five-year period, it would pay the taxpayer cash equal to the amount of the taxpayer's outstanding balance at the end of the five-year period.[124] Crown completed the transfer of all of the properties it agreed to transfer two years after the taxpayer originally transferred property to it.[125] The Court held that qualification as a like-kind exchange does not require simultaneous transfer of property.[126] If simultaneity is not a requirement for a transfer to qualify as a like-kind exchange, simultaneity is *a fortiori* not a requirement for a transfer to qualify as an exchange. Therefore, an exchange can occur for the purposes of section 1031 even though exchange partners do not transfer properties simultaneously.

At the time the Ninth Circuit decided *Starker*, no law existed stating whether deferred exchanges qualified for section 1031 treatment. Consequently, the Court had to determine the meaning of section 1031.[127] The Court, however, was not so presumptuous that it believed it had correctly divined the law in this area. Therefore, it invited Congress to "clarify its meaning" if the Court had incorrectly applied the law.[128] Congress accepted this invitation by enacting into law section 1031(a)(3).

Section 1031(a)(3) provides two requirements that must be met for property received in a deferred exchange to be treated as like-kind property.[129] First, the property to be received must be identified no later than forty-five days after the day on which the taxpayer

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123 602 F.2d at 1342-43.

124 *Id.* at 1343.

125 *Id.*

126 *Id.* at 1355.

127 *Id.* at 1356.

128 *Id.*

129 I.R.C. § 1031 (2001).

transferred the relinquished property.[130] Second, the taxpayer must receive the property before the earliest of 180 days after the day on which the taxpayer transferred the relinquished property or the day on which the taxpayer's tax return is due.[131] This provision clearly curtails the leeway granted to taxpayers by the *Starker* decision. However, like the *Starker* decision, this legislation also clearly provides that the lack of simultaneity does not disqualify a transaction from being treated as an exchange for the purposes of section 1031.

Congress enacted section 1031(a)(3) due to its concern that like-kind treatment of Anon-simultaneous exchanges has given rise to unintended results and administrative problems.[132] To support this conclusion Congress stated that the rationale for allowing tax-deferred treatment for like-kind exchanges (i.e. the taxpayer has not realized a profit):

> is less applicable in the case of deferred exchanges. To the extent that the taxpayer is able to defer completion of the transaction B often retaining the right to designate the property to be received at some future point B the transaction begins to resemble less a like-kind exchange and more a sale of one property followed, at some future point, by a purchase of a second property or properties.[133]

This statement by Congress shows Congress' belief that one of the original purposes, namely tax-deferred treatment when a taxpayer continues an investment, is abused if too much time passes between the time the taxpayer transfers property and the time the taxpayer receives property. In light of this Congressional concern, the enactment of section 1031(a)(3) represents a statement by Congress that a taxpayer can preserve its original investment if, and only if, a short period of time lapses between the transfer of the original investment property and the subsequent receipt of the replacement

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130 I.R.C. § 1031(a)(3)(A)(2001).

131 I.R.C. § 1031(a)(3)(B)(2001).

132 H.R. REP. NO. 98-432, pt. 2 at 1232 (1984).

133 *Id.*

property. The legislative history also implies that to facilitate administrative convenience, the transfer must be completed prior to the taxpayer's tax return due date.[134]

Since like-kind exchange treatment is granted if replacement property is received no later than six months after relinquished property is transferred, the statute provides, *a fortiori,* that an exchange occurs even if the transfers are not simultaneous. Therefore, section 1031(a)(3) does not limit the definition of exchange to simultaneous transfers of property for purposes of section 1031.[135] Since simultaneity is not a requirement of section 1031, reverse exchanges should be allowed if they otherwise satisfy the purpose and requirements of section 1031.

D. Like-Kind Exchange Regulations

Once the door was opened by *Starker* for deferred like-kind exchanges, a new problem for taxpayers arose. In *Starker*, the taxpayer was dealing with a credit-worthy exchange partner, a luxury not all taxpayers enjoy. If a taxpayer is concerned that the exchange partner will not perform its part of the bargain, the taxpayer may want some sort of assurance that the exchange partner will purchase replacement property and transfer it to the taxpayer. A potential problem may arise if the taxpayer uses a security arrangement; the taxpayer may be deemed to have constructively received cash in the exchange, thereby losing like-kind exchange treatment.[136]

The Treasury has provided safer harbors that, if properly used by a taxpayer, will provide assurance that the taxpayer will not be deemed to have received cash in deferred like-kind exchanges.[137] If a

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134 *See id.*

135 In enacting section 1031(a)(3), Congress only addressed forward exchanges. There is no indication from the legislative history or the text of section 1031(a)(3), however, that Congress intended to limit the scope of nonsimultaneity to forward deferred exchanges. Part III.G. *infra* offers means by which reverse exchanges can be structured to satisfy Congress' purpose in enacting section 1031(a)(3).

136 *Halpern v. United States* provides an example of a transaction in which the taxpayer was held to have constructively received cash. 286 F.Supp. 255, 259 (N.D. Ga. 1968).

137 Treas. Reg. § 1.1031(k)-1(g) (as amended in 1994).

taxpayer uses one of the four safe harbors identified in Treas. Reg. 1.1031(k)-1(g)(2) through (g)(5) (as amended in 1994), the result will be "a determination that the taxpayer is not in actual or constructive receipt of money or other property for the purposes of section 1031 . . . ."[138] In promulgating the safe harbors, the Service specifically stated that the regulations would not apply to reverse exchanges.[139] The Service also stated that it would continue to consider the applicability of the general rule of section 1031(a)(1) to reverse exchanges.[140] Although the safe harbors do not apply to reverse exchanges, they show that the Treasury is willing to facilitate the use of multiple-party-deferred exchanges so long as the property-for-property and reciprocal requirements are met. If the Treasury is willing to provide safe harbors for forward deferred exchanges that meet the exchange requirement of section 1031, it should also provide guidance that facilitate reverse exchanges. To understand what the Treasury considers appropriate in structuring multiple-party-deferred exchanges, it is worthwhile to consider each of the safe harbors in the regulations. Doing so will unveil principles that can be applied to reverse exchanges.

The first of the four safe harbors allows the taxpayer to retain a security interest in the property, obtain a standby letter of credit which may be drawn upon in the event the exchange partner defaults, or obtain a guarantee from a third party.[141] If properly structured, each of these devices will be disregarded in determining whether the taxpayer has actually or constructively received money or other property in the transaction.[142] Therefore, retaining a security interest in the relinquished property will not cause the transaction to fail the property-for-property requirement.

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138 Treas. Reg. § 1.1031(k)-1(g)(1) (as amended in 1994).

139 *Like-Kind Exchanges B Limitations on Deferred Exchanges; and Inapplicability of Section 1031 to Exchanges of Partnership Interests*, 56 Fed. Reg. 19,933 (May 1, 1991) (to be codified at 26 C.F.R. pt. 1) (Preamble to the Regulations).

140 *Id.*

141 Treas. Reg. § 1.1031(k)-1(g)(2) (as amended in 1994).

142 *Id.*

The second safe harbor provides that if the exchange partner places cash or a cash equivalent in a qualified escrow or a qualified trust to secure the exchange partner's obligation to transfer replacement property to the taxpayer, the qualified trust or qualified escrow will be disregarded in determining whether the taxpayer was in actual or constructive receipt of the funds deposited therein.[143] If all the requirements in the regulations are satisfied, the taxpayer will be deemed to have met the property-for-property requirement even though cash in a qualified escrow or qualified trust secures the exchange partner's obligation to acquire replacement property and transfer it to the taxpayer.

The third safe harbor allows a taxpayer to use a qualified intermediary to facilitate the transfer of property which the Service will not consider the taxpayer's agent.[144] In structuring the transaction with the qualified intermediary, the taxpayer may arrange to have the intermediary receive and transfer the title to both the relinquished property and the replacement property.[145] The taxpayer may also arrange to have the rights of either property transferred to the intermediary and legal title pass directly between the taxpayer and the purchaser or seller.[146] This regulation follows the *Haden*[147] and *Biggs*[148] decisions, so it adds nothing new to the law, but it may provide some comfort for taxpayers.

The fourth safe harbor provides that in determining whether the taxpayer is in actual or constructive receipt of cash, the Service will disregard the fact that the taxpayer Ais or may be entitled to receive any interest or growth factor with respect to the deferred exchange.[149] Again, this is merely an example of the Treasury following a prior court decision B *Starker* in this case.[150] These safe har-

143 Treas. Reg.§ 1.1031(k)-1(g)(3) (as amended in 1994).

144 Treas. Reg. § 1.1031(k)-1(g)(4) (as amended in 1994).

145 Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(A) (as amended in 1994).

146 Treas. Reg. § 1.1031(k)-1(g)(4)(v) (as amended in 1994).

147 Haden v. Commissioner, 165 F.2d 558 (5th Cir. 1948).

148 Biggs v. Commissioner, 632 F.2d 1171(5th Cir. 1980).

149 Treas. Reg.1.1031(k)-1(g)(5) (as amended in 1994). *But see* Treas. Reg. § 1.1031(k)-1(h)(2) (as amended in 1994) ("[t]he taxpayer must include the interest or growth factor in income according to the taxpayer's method of accounting").

150 Starker v. United States, 602 F.2d 1341 (9th Cir. 1979).

bors provide taxpayers with guidelines they can follow when structuring deferred exchanges. Although they do not result in new methods that can be used to structure like-kind exchanges, the safe harbors do demonstrate that the Service does look for the two requirements of section 1031 exchanges. Under the safe harbors, the taxpayer will be deemed to have satisfied the property-for-property requirement. Also, since the taxpayer is transferring property to one and only one other party and receiving property from that same party, the reciprocal requirement will also be met. These regulations provide certain methods for satisfying each of those requirements. By relying on existing principles of like-kind exchanges, the Treasury could promulgate additional regulations or the Service could public a no-challenge position that would provide guidance for taxpayers wishing to enter into reverse exchanges.

E. Summary of the Section 1031 Purpose and Exchange Requirement

As outlined above, three requirements must be met to qualify for like-kind exchange treatment under section 1031(a)(1).[151] First, an exchange must occur.[152] Legislative history and the Treasury Regulations clearly state that an exchange occurs only when two requirements are present: (1) a property-for-property transfer and (2) a reciprocal transfer.[153] As seen above, the courts have been very strict in construing the property-for-property requirement[154]. If the taxpayer actually or constructively receives cash or a cash equivalent in the process of a transaction, the transaction will not qualify as an exchange even if the taxpayer immediately transfers the cash to another party for replacement property.[155]

As the cases discussed above illustrate, courts strictly require a reciprocal transfer, but are lenient in allowing taxpayers to structure transactions involving many different parties in such a way that the

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151 *See supra* Part I.A.

152 I.R.C. § 1031(a)(1)(2001).

153 65 CONG. REC. 2799 (1924); Treas. Reg. § 1.1002-1(d) (1958).

154 *See supra* Part II.B.1.

155 *See, e.g.*, Carlton v. United States, 385 F.2d 238 (5th Cir. 1967).

end result is a reciprocal transfer.[156] The courts and Treasury allow many different steps to occur, and if the taxpayer ultimately transfers property to one other person and the other person transfers property to the taxpayer, the courts have held that an exchange has occurred.[157] In fact, the courts and Treasury do not require that the taxpayer transfer title directly to the exchange partner or receive title to the replacement property directly from the exchange partner so long as the taxpayer and exchange partner exchange rights to the properties.[158] Although the Service has allowed like-kind exchange treatment in one revenue ruling where the taxpayer transferred property to one party and received property from another party, the facts of that ruling are very limited and should not be used as a general rule.[159] The courts have, however, consistently ruled that the reciprocal requirement has been met in cases where they have been able to identify the taxpayer transferring property (or rights in property) to and receiving property (or rights in property) from just one other party.[160] Therefore, a taxpayer can expect to receive a ruling that the reciprocal requirement has been satisfied if the taxpayer structures a transaction in such a manner that it transfers property to and receives property from only one other party.

The *Starker* court, Congress, and the Service clearly have provided that a transfer of property, followed by a subsequent receipt of property qualifies as an exchange for purposes of section 1031.[161] Simultaneity is not a requirement that must be satisfied for an exchange to occur for purposes of section 1031.[162] In enacting section 1031(a)(3), Congress provided that a deferred exchange is not in harmony with the purpose of section 1031 (the taxpayer does not continue its original investment and administrative inconvenience

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156 *See supra* Part II.B.

157 *See id.*

158 *See id.*

159 *See supra* note 120.

160 *See supra* Part II.B.2.

161 *See generally* Part II.

162 *See also* Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 658-59 (5th Cir. 1968) (holding that the timing of the transfer and receipt of property should be disregarded in situations in which the substance of a transaction is a like-kind exchange).

results) if too much time lapses between the time the taxpayer transfers property and the time the taxpayer receives property.[163] The statute deems a taxpayer to have a continuation of an investment if the taxpayer consummates an exchange within six months or prior to the due date of the taxpayer's tax return.[164] Therefore, a reverse exchange should be allowed section 1031 treatment if the taxpayer transfers property to and receives property from one, and only one, exchange partner, and the transaction is completed within a reasonable amount of time so as not to disrupt the purpose of section 1031.

III. REVERSE EXCHANGES

As mentioned earlier, the body of law dealing directly with reverse exchanges is scant.[165] In fact, a good argument exists that two private letter rulings issued by the Service to a single utility company on the same transaction represent the only body of law dealing directly with the reverse exchange issue.[166] Although some cases appear to address reverse exchanges, those cases are actually dealing with transactions that actually do not meet the exchange requirement at all, and therefore are not reverse exchanges.[167] Therefore, they do not provide much help for taxpayers. The American Bar Association Tax Section (ABA) has made two proposals to the Service in the last ten years, hoping the Service would provide some direction regarding reverse exchanges. In the first proposal, the ABA suggested that the Service should allow reverse exchanges.[168] In the second, it suggested that the Service should approve an alternative measure that circumvents the reverse exchange issue.[169]

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163 I.R.C. § 1031(a)(3)(2001).

164 *Id.*

165 *See supra* Part I.B.

166 Priv. Ltr. Rul. 98-23-045 (Mar. 10, 1998); Priv. Ltr. Rul. 98-14-019 (Dec. 23, 1997). Since section 6110(k)(3) provides that letter rulings can not be relied on as precedent, the letter rulings actually provide little assurance for taxpayers. I.R.C. § 6110(k)(3)(2001).

167 *See infra* Part III.A

168 Section of Taxation American Bar Association, *Report on the Application of Section 1031 to Reverse Exchanges*, 21 J. REAL EST. TAX'N 44 (Fall 1993).

169 Adam M. Handler, *Price Waterhouse Coopers Forwards Proposed Guid-*

A. Cases Purporting to Address Reverse Exchanges

The first case often cited as a reverse exchange case is *Rutherford v. Commissioner.*[170] In *Rutherford,* the taxpayer received twelve half-blood heifers in 1973 from Wardlaw and as consideration for the half-blood heifers, the taxpayer promised to transfer twelve three-quarter blood heifers to Wardlaw over a period of time ending in 1977.[171] To fulfill the obligation to transfer the twelve three-quarter blood heifers, the taxpayer artificially inseminated the twelve half-blood heifers and transferred twelve of the three-quarter heifers' offspring to Wardlaw.[172] There are two reasons this case should not be relied upon to support the validity of reverse exchanges. First, the facts indicate that the exchange may not have been a reverse exchange.[173] The taxpayer did not actually receive the registration papers for the twelve half-blood heifers until all of the twelve three-quarter blood heifers were transferred.[174] Wardlaw retained a security interest in the twelve half-blood heifers that was effective until all twelve three-quarter blood heifers were transferred.[175] If all twelve half-blood heifers had died prior to the taxpayer fulfilling his obligation, Rutherford would bear the risk of such loss.[176] These facts create some uncertainty as to when the half-blood heifers were actually transferred; it appears that legal title and the benefits and burdens of ownership of the twelve half-blood heifers did not transfer to the taxpayer until the taxpayer transferred the twelve three-quarter

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ance on Reverse Exchanges, 2000 TAX NOTES TODAY 16-27 (January 20, 2000) (The task force consisted of Adam M. Handler, Ron Platner, Bob Schachat, Lou Weller, and Fred Witt. Adam M. Handler, Howard Levine, and Lou Weller all contributed to the ABA proposal issued in 1993, *supra* note 174.); *see also* Paul J. Sax, *ABA Tax Section Members Push for Guidance on Reverse Like-Kind Exchanges,* TAX NOTES TODAY (July 27, 2000)(LEXIS, FEDTAX lib., TNT file, elec., cit. 2000 TNT 145-22). (repeating the proposal made in January 2000).

170 37 T.C.M. (CCH) 1851-77 (1978).

171 *Id.* at 1851-78.

172 *Id.*

173 *See id.*

174 *Id.*

175 *Id.*

176 *Id.*

blood heifers.[177] If the transfer of the twelve half-blood heifers did not occur until after the taxpayer transferred the last three-quarter blood heifer, the transaction was not a reverse exchange; it would have been a simultaneous exchange or a deferred exchange. Therefore, it probably is not a good case to rely upon to support the legal validity of reverse exchanges.

The second reason the case represents weak support for reverse exchanges is that it is arguably not a like-kind exchange. As mentioned earlier, the purpose of allowing tax-deferred treatment for like-kind exchanges is that the taxpayer is continuing an investment.[178] The Tax Court has stated that in an exchange of like-kind property, "the taxpayer's economic situation after the exchange is fundamentally the same as it was before the transaction occurred."[179] In *Rutherford*, the taxpayer could not be said to have continued an investment by receiving the twelve half-blood heifers because prior to receiving the heifers, the taxpayer did not have an investment in cattle.[180] Since the purpose of section 1031 is to defer gain or loss recognition until a taxpayer disposes of an investment, the transfer could not satisfy the purpose because the taxpayer did not have an investment to continue when it received the twelve half-blood heifers. One court has held that the taxpayer must continue an investment to satisfy the requirements of section 1031.[181] The taxpayer in *Rutherford* arguably did not meet that requirement,[182] so the exchange probably should not have been treated as a like-kind exchange. Furthermore, the facts in *Rutherford* are so unique, it is difficult to apply to most situations. Therefore *Rutherford* probably should not be relied upon to argue that section 1031 applies to reverse exchanges.

Other cases looked at transactions involving taxpayers who received property and subsequently transferred other property.[183]

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177 *Id.*

178 *See supra* Part II.A.

179 Koch v. Commissioner, 71 T.C. 54, 63 (1978).

180 37 T.C.M. at 7851-79.

181 Chase v. Commissioner, 92 T.C. 874 (1989).

182 37 T.C.M. at 7851-79.

183 Bezdjian v. Commissioner, 845 F.2d 217 (9th Cir. 1988); Lincoln v. Com-

These cases are important to look at because they demonstrate that a transaction will not meet the reciprocal requirement if the taxpayer does not receive property from the same party to whom the taxpayer transfers property. Between 1986 and 1998 four cases were decided in which the transactions involved were held to not qualify for section 1031 treatment.[184] The first of these cases involved a taxpayer who owned property in Hawaii.[185] In 1977, the taxpayer purchased some property in the state of Washington from the Craigs.[186] In 1978, the taxpayer sold the Hawaii property to five different purchasers, none of whom were related to the Craigs.[187] The taxpayer had the purchasers pay the purchase price directly to the Craigs and not to the taxpayer.[188]

The Tax Court held that the transfer did not qualify for like-kind treatment.[189] In making its decision, the Court stated that the taxpayer "must demonstrate that the transfers of property in this case were interdependent parts of an overall plan in order for such transfers to constitute an 'exchange' within the meaning of section 1031."[190] In determining that there was no interdependence, the Tax Court stated that the two transfers made no reference to the other transfers, the transfers occurred seven months apart, and the payments to Craig were made to satisfy the taxpayer's pre-existing obligation to Craig.[191] Because of this lack of interdependence, the Court found that no exchange had occurred, so the transaction could not qualify for section 1031 treatment.[192] In effect, because the taxpayer did not transfer property to and receive property from only one other

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missioner, 76 T.C.M. (CCH) 926 (1998); Dibsy v. Commissioner, 70 T.C.M. (CCH) 918 (1995); Lee v. Commissioner, 51 T.C.M. (CCH) 1438 (1986).

184 Bezdjian v. Commissioner, 845 F.2d 217; Lincoln v. Commissioner, 76 T.C.M. (CCH) 926; Dibsy v. Commissioner, 70 T.C.M. (CCH) 918; Lee v. Commissioner, 51 T.C.M. (CCH) 1438.

185 Lee v. Commissioner, 51 T.C.M.at 1443.

186 *Id.*

187 *Id.*

188 *Id.*

189 *Id.* at 1444.

190 *Id.*

191 *Id.*

192 *Id.*

party, the reciprocal element of the exchange requirement of section 1031 had not been met. Therefore, the exchange could not qualify as an exchange for section 1031 purposes.

Another case with similar facts was decided in the same manner by the Ninth Circuit in 1988.[193] In *Bezdjian v. Commissioner*, the taxpayers operated a gas station on property which they leased from Shell.[194] Shell offered to sell the gas station property to the taxpayers, but refused to accept any consideration other than cash from the taxpayers.[195] The taxpayers wanted to exchange other property it owned (the El Camino property) for the gas station, but, because Shell refused to enter into an exchange, the taxpayers took out a mortgage on their home and the El Camino property and purchased the gas station for cash.[196] Three weeks later, the taxpayers sold the El Camino property to the Leveys who assumed the mortgage and paid the remainder of the price in cash.[197] The taxpayers argued that this transaction should qualify for section 1031 treatment.[198]

The Ninth Circuit rejected the taxpayers' argument and held that the taxpayers had not exchanged the El Camino property for the gas station.[199] In so holding, the Court stated that the taxpayers "must make an exchange of property or an interest in property for other property of a like kind in order for it to qualify for nonrecognition."[200] The Court also referred to the *Biggs* decision and distinguished the facts of the instant case from that case by stating that in *Biggs*, the final analysis determined that there was an exchange between two parties.[201] The Court stated that in the present case, the taxpayers acquired one parcel of land in a purchase and sold another parcel to a separate party.[202] Neither Shell nor the Leveys made an exchange with the taxpayers; the two transactions involved cash con-

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193 Bezdjian v. Commissioner, 845 F.2d 217 (9th Cir.1998).
194 *Id.* at 218.
195 *Id.*
196 *Id.*
197 *Id.*
198 *Id.*
199 *Id.* at 219.
200 *Id.* at 218.
201 *Id.* at 218-19.
202 *Id.* at 219.

sideration.[203] Relying on these facts, the Court found that no exchange of property had occurred between the taxpayers and either of the other two parties.[204] This decision provides additional support for the notion that the lack of a reciprocal transfer causes a transaction to fail to qualify for section 1031 treatment. A taxpayer who receives property from one party and transfers property to another party does not meet the reciprocal requirement, as demonstrated by this decision.

In 1995, the Tax Court again found that a transaction failing to meet the reciprocal requirement would not qualify for section 1031 treatment.[205] In *Dibsy v. Commissioner*, the taxpayers purchased a liquor store (Sunshine Liquor) from Hanshaw in 1986.[206] The taxpayers operated the store until 1989.[207] In 1988, the taxpayers became aware that Hanshaw might sell another of its stores, Bayshore.[208] The taxpayers did not want to operate both Sunshine and Bayshore, so they entered into an agreement on March 23, 1988 to sell Sunshine to the Sathavorans.[209] On March 31, 1988, they entered into an agreement with Hanshaw to purchase Bayshore.[210] The Sathavorans subsequently decided not to purchase Sunshine, but the taxpayers purchased Bayshore on October 5, 1988 anyway.[211] The taxpayers sold Sunshine on March 31, 1989 to a party that was not related to Hanshaw.[212] On their 1989 tax return, the taxpayers treated the transfer of Sunshine as a like-kind exchange and did not report any recognized gain on the transfer.[213]

The court found that the taxpayers did not exchange Sunshine for Bayshore, but purchased Bayshore and sold Sunshine in two

203 *Id.* at 218
204 *Id.* at 219.
205 Dibsy v. Commissioner, 70 T.C.M. (CCH) 918, 922 (1995).
206 *Id.* at 919.
207 *Id.*
208 *Id.*
209 *Id.*
210 *Id.*
211 *Id.*
212 *Id.*
213 *Id.* at 918-919.

separate transactions,[214] not qualifying for like-kind treatment.[215] This decision is appropriate since the taxpayers obviously failed to meet the reciprocal requirement and consequently could not be found to have entered into an exchange for the purposes of section 1031.

The last case in this series is *Lincoln v. Commissioner,*[216] decided in 1998. In that case, the taxpayer purchased a lot called Big Sur from D'Esopo in 1992 and built a house on the lot which was to be rented.[217] In 1993, the taxpayer sold another lot, Pacific Grove, which it had owned prior to the purchase of Big Sur, to the Elvins.[218] The taxpayer had the Elvins deposit the purchase price in an account at Provident Central Credit Union, and instructed Provident to use the account balance to pay for the construction costs on Big Sur.[219]

The Tax Court found that an exchange did not occur, citing the Treas. Reg.§ 1.1002-1(d) requirement of a reciprocal transfer of properties.[220] The Tax Court held that such a transfer did not occur.[221] The Tax Court also stated that the taxpayers reliance on *Starker* was misplaced because although *Starker* allows nonsimultaneous exchanges to occur, it "does not, however, dispense with the requirement that there in fact be an exchange of property."[222] Thus, the issue in this case was not whether the transfers had to occur simultaneously but whether there was an actual exchange.[223] Since the Court found that there was no reciprocal transfer, it held that no exchange had occurred and the transaction did not qualify for section 1031 treatment.[224]

Although in each of these four cases, the taxpayer received property before transferring other property, none of the transactions

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214 *Id.* at 922.
215 *Id.*
216 76 T.C.M. (CCH) 926 (1998).
217 *Id.* at 927.
218 *Id.*
219 *Id.*
220 *Id.* at 927-28.
221 *Id.* at 928.
222 *Id.* at 928-29.
223 *Id.*
224 *Id.*

can be classified as a reverse exchange.[225] To be classified as a reverse exchange, an exchange must first occur. Since the courts in each case determined that the taxpayer received property from one party and transferred property to different party, they were able to determine no exchange occurred.[226] This is the correct result since the reciprocal requirement had not been met in any of the cases.[227] Since the reciprocal requirement had not been met, there was no exchange, and section 1031 treatment was unavailable. Because the courts in each of these cases ultimately looked only at the exchange requirement, they do not provide guidance for a taxpayer who meets the exchange requirement, but transfers relinquished property after receiving replacement property. Thus, the cases shed little light on the issue of non-simultaneity in reverse exchanges.

B. Reverse Exchange Allowed

In two private letter rulings, the Service has ruled that a reverse exchange qualifies for section 1031 treatment.[228] The facts upon which the Service based its ruling in both letter rulings are as follows: the taxpayer owned an easement over land owned by a separate party (the landowner).[229] The taxpayer had aerial power lines located on the easement.[230] The landowner desired to construct a building which would occupy part of the land over which the taxpayer held the easement.[231] Before the building could be constructed the taxpayer would have to relocate the power lines.[232] To induce the taxpayer to relocate its power lines, the landowner offered to transfer

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[225] Bezdjian v. Commissioner, 845 F.2d 217 (9th Cir. 1988); Lincoln v. Commissioner, 76 T.C.M. (CCH) 926 (1998); Dibsy v. Commissioner, 70 T.C.M. (CCH) 918 (1995); Lee v. Commissioner, 51 T.C.M. (CCH) 1438 (1986).

[226] *Id.*

[227] This is the same position the Service took in Tech. Adv. Mem. 00-39-005. *See supra* note 11.

[228] Priv. Ltr. Rul. 98-23-045 (Mar. 10, 1998); Priv. Ltr. Rul. 98-14-019 (Dec. 23, 1997).

[229] *Id.*

[230] *Id.*

[231] *Id.*

[232] *Id.*

to the taxpayer easements located elsewhere in exchange for the taxpayer's easements.[233] The taxpayer and the landowner entered into an agreement to effect this transfer.[234] The agreement provided that the landowner would transfer new easements to the taxpayer, the taxpayer would construct power lines on the new easements, and, when the power lines on the new easements were completely constructed and operational, the taxpayer would transfer its old easements to the landowner.[235] The Service ruled that this transaction met all the requirements necessary to qualify for section 1031 treatment.[236]

In ruling in favor of the taxpayer, the Service did not address the exchange issue directly.[237] To qualify for section 1031 treatment, the exchange requirement must be met.[238] Indeed, in examining the facts of the ruling, one can determine that an exchange had occurred. The taxpayer transferred an easement and received an easement.[239] This satisfies the property-for-property requirement.[240] The taxpayer also entered into the transaction with only one exchange partner.[241] Therefore, the reciprocal requirement was also satisfied.[242] The taxpayer also continued its original investment (power line easements) after the exchange.[243] The Service found that the other section 1031 requirements were also satisfied, so it followed that the transaction should be given section 1031 treatment. Since these rulings were merely private letter rulings, they do not provide authority for granting like-kind exchange treatment to all reverse exchanges,[244] but they do provide insight that the Service believes that reverse exchanges

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233 *Id.*
234 *Id.*
235 *Id.*
236 *Id.*
237 *Id.*
238 *See supra* Part II.B.
239 Priv. Ltr. Rul. 98-23-045.
240 *See supra* Part II.B.1.
241 Priv. Ltr. Rul. 98-23-045.
242 *See supra* Part II.B.2.
243 Priv. Ltr. Rul. 98-23-045.
244 I.R.C.§ 6110(k)(3)(2001); *see also* American Stores Co. v. Commissioner, 170 F.3d 1267, 1270 (10th Cir. 1999) ("[T]he Code prohibits the use or citation of Private Letter Rulings and Technical Advice Memoranda as precedent. (omit citation) It is well settled that they do not bind the Commissioner or this court.").

should qualify for section 1031 treatment.[245] The Service's view in these two private letter rulings demonstrate that the Service believes that simultaneity is not a prerequisite for reverse exchanges to qualify for section 1031 treatment. Since the Service is willing to provide section 1031 treatment to one taxpayer who entered into a reverse exchange, they should provide guidance for all taxpayers who desire to enter into reverse exchanges.

C. *Two Proposals*

1. The 1993 Proposal

The Tax Section of the American Bar Association (the ABA) has made two proposals to the Service suggesting that the Service provide guidance for reverse exchanges.[246] The first proposal made in 1993 suggested that the Service should promulgate regulations that would allow section 1031 treatment for certain reverse exchanges.[247] The ABA suggested that to qualify for section 1031 treatment, three requirements must be satisfied: A(1) [t]he reverse exchange must occur pursuant to a written exchange agreement; . . .(2) the taxpayer must transfer the relinquished property to the same person from whom he received the replacement property";[248] and (3) the exchange must be completed by the due date of the taxpayer's tax return.[249] The proposal also provided that the taxpayer could use a professional intermediary that met the requirements in Treas. Reg. § 1.1031(K)-1(g)(4) to facilitate the exchange and that the taxpayer could advance money to the seller of the replacement property without being con-

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[245] Comerica Bank, N.A. v. United States., 93 F.3d 225, 230 (6th Cir. 1996) ("While Private letter rulings [sic] are not binding authority, they may be cited as evidence of administrative interpretation.").

[246] Section of Taxation American Bar Association, *supra* note ABA 168; Handler, *supra* note 169; *see also* Rutherford v. Commissioner, 37 T.C.M. (CCH) 1851-77 (1978).

[247] Section of Taxation American Bar Association, *supra* note 168 at 48.

[248] *Id.*

[249] *Id.* at 48-49.

sidered to have constructively received cash from the sale of the replacement property.[250]

Other than providing too much time to transfer relinquished property and allowing the taxpayer to advance money to the exchange partner, this proposal does satisfy the requirements necessary for an exchange to receive section 1031 treatment. The requirement that the taxpayer transfer property and receive property satisfies the property-for-property requirement.[251] The requirement that the transfer occurs only between the taxpayer and the exchange partner (the qualified intermediary is deemed to be the exchange partner under the regulations[252]) satisfies the reciprocal requirement.[253] Therefore, the two elements of the exchange requirement are satisfied.

An exchange that occurs under this proposal may not meet the purposes or other requirements of section 1031.[254] By requiring that the exchange be consummated prior to the taxpayer's tax return due date, the proposal would satisfy the administrative convenience purpose.[255] However, Congress does not recognize a deferred exchange as a continuation of an investment if too much time passes between the transfer of relinquished property and the receipt of replacement property because the transaction begins to look like a sale followed by a repurchase.[256] If too much time passes before the relinquished property is transferred, the transaction begins to look like a purchase followed by a sale of other property. For example, a taxpayer could enter into an agreement to receive property and, in exchange, promise to transfer property at some time in the future. After several months, when the taxpayer transfers the property, the transfer may look more like the taxpayer was satisfying a contractual obligation than it would look like the taxpayer was exchanging property.[257] If that were the

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250 *Id.* at 50.

251 *See supra* Part II.B.1.

252 Treas. Reg. § 1.1031(k)-1(g)(4) (as amended in 1994).

253 *See supra* Part II.B.2.

254 *See supra* Part II.A.

255 *See id.*

256 *See supra* Part II.C.

257 See *supra* text accompanying note 185 *et seq.* for a discussion of the ruling by the court in *Lee v. Commissioner* in which the court stated that a transaction did not qualify for like-kind exchange treatment where one party to the transaction paid

case, the transaction would look like two different transfers: (1) the receipt of property in exchange for a promise, and (2) the transfer of property in satisfaction of an obligation. Merely entering into a written agreement will not eliminate this possibility. The same problem Congress addressed when enacting section 1031(a)(3) exists with reverse exchanges. By allowing reverse exchanges to be consummated no sooner than the taxpayer's tax return due date, more time may pass than Congress intends.[258] Thus, any ruling allowing reverse exchanges should require that the exchange be completed by the earlier of six months from the date the relinquished property is transferred or the taxpayer's tax return due date, causing the transaction to look more like a continuation of the taxpayer's original investment.

Reverse exchanges also raise additional issues. If a taxpayer receives replacement property used in a trade or business and operates that property and the relinquished property together for too long a period of time, the replacement property looks less like a continuation of the original investment and more like a different investment. For example, in *Dibsy v. Commissioner*, the taxpayer operated a liquor store.[259] When the taxpayer found that it could acquire a different store that it considered more desirable, the taxpayer purchased the other store and began to operate it as a business.[260] The taxpayer operated both the Bayshore store and the Sunshine store, receiving prof-

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a preexisting obligation of the taxpayer. 51 T.C.M. (CCH) 1438, 1443 (1996). The court found in that situation that the taxpayer had entered into two transactions: one involved the receipt of property in exchange for a promise to pay cash, the other involved in the transfer of property in exchange for a promise to pay the taxpayer's obligation. *Id.* The court found that this type of arrangement did not satisfy the exchange requirement. *Id.* The problem could arise in a two-party exchange if a court finds that the taxpayer actually exchanged a promise for the replacement property and later satisfied that promise by transferring relinquished property. The more time that passes between the receipt of replacement property and the transfer of relinquished property, the less the transaction looks like an exchange.

258 Sax, *supra* note 169 (stating that more than twenty-one months may elapse between the time the replacement property is received and the relinquished property is transferred).

259 70 T.C.M. (CCH) 918, 919 (1995).

260 *Id.*

its and losses on each store.[261] Thus, the taxpayer was able to benefit from both stores for a period of time. This made it possible for the taxpayer to get a much larger return than would have been possible if only the original investment were operated. By requiring the taxpayer to enter into a written agreement to transfer the relinquished property within six months, the ABA's proposal helps to ensure that the taxpayer does intend to continue an original investment.[262] By promising to transfer relinquished property, the taxpayer manifests its intent to replace the relinquished property. Furthermore, if the written agreement identifies the relinquished property to be transferred, the taxpayer's intent would be manifest more clearly.

Allowing the taxpayer to forward money to the seller of the replacement property also gives cause for concern. Courts could look at the forwarding of the funds and the subsequent receipt of funds as a purchase followed by a resale. If the taxpayer transfers cash to the seller and the seller agrees to transfer the cash back when it receives the proceeds in exchange for the relinquished property, the transaction looks like a purchase of the replacement property followed by a sale of the relinquished property. Because cash is fungible, there is no way to know that the seller actually returned the cash the taxpayer forwarded to the seller, as opposed to simply transferring the proceeds it received from the sale of the other property.

2. The 2000 Proposal

The ABA's second proposal (originally published in January of 2000) presents a means of avoiding reverse exchanges and possible negative treatment more than a means of structuring reverse exchanges that qualify for section 1031 treatment.[263] Under this proposal, the ABA asked the Service to issue a revenue procedure to provide some guidance.[264] The ABA suggested that the Service should state that it will not challenge the validity of an exchange that

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261 *Id.*

262 Section of Taxation American Bar Association, *supra* note 168; *see also* Bezdjian v. Commissioner, 845 F. 2d 217 (9th Cir. 1988).

263 Handler, *supra* note 169; *see also* Sax, *supra* note 169.

264 *Id.*

uses "qualified exchange accommodation arrangements."[265] A qualified exchange accommodation arrangement can be structured using one of two methods.[266] Under the first method, the exchange-last method,[267] a party that is unrelated to the taxpayer (the accommodation title holder) acquires title to replacement property and holds it until the taxpayer is prepared to transfer the relinquished property.[268] When the taxpayer is prepared to transfer the relinquished property, the accommodation title holder transfers title of the relinquished property in one of two ways: either the taxpayer transfers the relinquished property to the qualified intermediary and receives the replacement property from the qualified intermediary, or the taxpayer transfers the replacement property directly to the taxpayer and the taxpayer transfers the relinquished property directly to the accommodation titleholder.[269] The ABA suggested that the revenue procedure provide that the Service will not challenge the treatment of the accommodation titleholder as the beneficial owner of the property to which it holds title.[270] The proposal simply provides a means of structuring a simultaneous exchange.[271]

The second method, the exchange-first method,[272] involves the accommodation titleholder purchasing replacement property and transferring it to the taxpayer in exchange for the relinquished property.[273] The accommodation titleholder then holds the relinquished property until a buyer can be found.[274] If the accommodation titleholder is treated as the beneficial owner when it holds legal title to the relinquished property, the transaction should qualify as an exchange because a reciprocal transfer of title has occurred.[275] The transfer also would have been performed simultaneously, so it should

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265 *Id.*

266 *Id.*

267 *Id.*

268 Handler, *supra* note 169; *see also* Sax, *supra* note 169.

269 *Id.*

270 *Id.*

271 Massey, *supra* note 15.

272 Weller & Phillips, *supra* note 267 at § 14.02(3)(b).

273 Rutherford v. Commissioner, 37 T.C.M. (CCH) 1851-77 (1978).

274 *Id.*

275 *See supra* Part II.B.2.

meet all of the exchange requirements under section 1031. Because the exchanges under both of these methods would be deemed to be simultaneous exchanges, the proposal does not provide guidance for taxpayers who wish to structure pure reverse exchanges.

D. Revenue Procedure 2000-37

By issuing Revenue Procedure 2000-37,[276] the Service has adopted the general format set forth in the ABA's second proposal relating to parking arrangements. Revenue Procedure 2000-37 can be divided into three main parts: (1) the general rule, (2) the six requirements, and (3) the permissible agreements.[277]

1. The General Rule

The general rule provides that:

> The Service will not challenge the qualification of property as either "replacement property" or "relinquished property" (as defined in § 1.1031(k)-1(a)) for purposes of § 1031 and the regulations thereunder, or 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 (a AQEAA)].[278]

The significance of this rule is that the Service will accept the exchange accommodation titleholder as the beneficial owner of the property it holds title to even though the taxpayer might otherwise bear the economic burdens and benefits of ownership of the property.[279] This is contrary to the well-established federal tax principles under which the party bearing the economic burdens and benefits of

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276 2000-40 I.R.B. 308.

277 *Id.*

278 *Id* at § 4.01.

279 *Id* at § 2.06.

ownership is considered the owner of the property.[280] This represents the true advantage of Revenue Procedure 2000-37.

2. The Six Requirements

To benefit from Revenue Procedure 2000-37 property must be held in a QEAA[281]. Under the revenue procedure, property is deemed to be held in a QEAA if six requirements are met.[282] First, a person other than the taxpayer or a disqualified person must serve as the exchange accommodation titleholder,[283] and the accommodation titleholder must be "subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock [must be] owned by partners or shareholders who are subject to federal income tax."[284] Also, the exchange accommodation titleholder must hold a qualified indicia of ownership.[285]

For this purpose, a qualified indicia of ownership is defined as:

> [L]egal title to the property, other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (*e.g.*, a contract for deed), or interests in an entity that is disregarded ...for federal income tax purposes (*e.g.*, a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership[.][286]

The exchange accommodation titleholder does not have to take actual legal title to the property to meet this requirement. In fact, by receiving only an interest in a single member limited liability

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280 *Id* at § 2.03; *see also* Rev. Rul. 82-144, 1982-2 C.B. 34, 35.
281 Rev. Proc. 2000-37.
282 *Id.* at § 4.02.
283 *Id.* at § 4.02(1).
284 *Id.*
285 *Id.*
286 *Id.*

company, the exchange accommodation titleholder may be able to shield itself from liability that could otherwise arise from taking title to the property. This could become significant in structuring parking arrangements.

Second, at the time the exchange accommodation titleholder receives the qualified indicia of ownership, the taxpayer must have the "bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under section 1031...."[287] This requirement helps to establish the interdependence that courts have found lacking in many attempts taxpayers have made to qualify reverse exchanges for like-kind exchange treatment.[288]

Third, the taxpayer and the exchange accommodation titleholder must enter into a written agreement no later than five days after the accommodation titleholder receives a qualified indicia of ownership.[289] The agreement must provide that (1) the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under section 1031 and Revenue Procedure 2000-37, (2) the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in Revenue Procedure 2000-37, and (3) the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes.[290] Furthermore, the taxpayer and the exchange accommodation titleholder must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement.[291]

Fourth, the taxpayer must identify the relinquished property within forty-five days after the exchange accommodation titleholder receives a qualified indicia of ownership of the replacement prop-

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287 *Id.* at § 4.02(2).

288 *See supra* note 183 *et seq.* and accompanying text.

289 Rev. Proc. 2000-37 at § 4.02(3).

290 *Id.*

291 *Id.*

erty.[292] Identification must be made in accordance with Treas. Reg. § 1.1031(k)-1(c) (as amended in 1994) and the taxpayer may identify alternative and multiple properties, as described in Treas. Reg. § 1.1031(k)-1(c)(4).[293] The three-property rule and the 200-percent rule found in Treas. Reg. § 1.1031(k)-1(c)(4) will apply to the identification of the replacement property.

Fifth, in an exchange-last arrangement, within 180 days after the exchange accommodation titleholder receives a qualified indicia of ownership, the replacement property must be transferred either directly or indirectly through a qualified intermediary to the taxpayer.[294] If the transaction is an exchange-first arrangement, within 180 days after the exchange accommodation titleholder receives a qualified indicia of ownership, the relinquished property must be transferred to a person who is not the taxpayer or a disqualified person.[295]

Sixth, the replacement property and relinquished property cannot be held in a QEAA for more than a combined total of 180 days.[296] If all six of these requirements are met, the exchange accommodation titleholder will be deemed to be the beneficial owner of the property in which it holds a qualified indicia of ownership.[297]

Revenue Procedure 2000-37 also very leniently allows the taxpayer and the exchange accommodation titleholder to enter into various agreements while the property is held by the exchange accommodation titleholder.[298] Also, the revenue procedure does not require that such agreements contain terms that typically would result from arm's-length bargaining between unrelated parties.[299] These aspects of the revenue procedure must be examined.

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292 *Id.* at § 4.02(4).
293 *Id.*
294 *Id.* at § 4.02(5)(a).
295 *Id.* at § 4.02(5)(b).
296 *Id.* at § 4.02(6).
297 *Id.* at § 4.01.
298 *Id.* at § 4.03.
299 *Id.*

3. The Permissible Agreements

There are seven agreements that the revenue procedure specifically allows.[300] First, the revenue procedure provides that the exchange accommodation titleholder may enter into an exchange agreement with the taxpayer to serve as a qualified intermediary if the exchange accommodation titleholder otherwise qualifies as a qualified intermediary.[301] Second, the revenue procedure allows the taxpayer or a disqualified person to guarantee some or all of the obligations of the exchange accommodation titleholder.[302] The taxpayer or a related party may guarantee either secured or unsecured obligations of the exchange accommodation titleholder.[303] Furthermore, the taxpayer or a related party may indemnify the exchange accommodation titleholder against costs and expenses incurred in relation to the transaction.[304] This type of agreement allows the taxpayer to accept some of the costs of owning the property and to guarantee obligations of the exchange accommodation titleholder.

Third, under the revenue procedure, a taxpayer or a disqualified person is allowed to loan or advance funds to the exchange accommodation titleholder at other-than-market rates of interest.[305] A taxpayer or disqualified person may also guarantee a loan or advance to the exchange accommodation titleholder, allowing the taxpayer to make an interest-free loan to the exchange accommodation titleholder.[306] Fourth, the exchange accommodation titleholder may lease the property in which it holds a qualified indicia of ownership to the taxpayer or a disqualified person.[307] Since the revenue procedure does not require the exchange accommodation titleholder to charge arm's-length amounts for rent,[308] the lease can be for an amount well below or above market value. Thus, the taxpayer may take posses-

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300 *Id.*
301 *Id.* at § 4.03(1).
302 *Id.* at § 4.03(2).
303 *Id.*
304 *Id.*
305 *Id.* at § 4.03(3).
306 *Id.*
307 *Id.* at § 4.03(4).
308 *Id.* at § 4.03.

sion of the property rent-free while it is held by the exchange accommodation titleholder.

Fifth, the revenue procedure provides that the taxpayer or a disqualified person may manage the property, supervise improvement of the property, act as contractor, or otherwise provide services to the exchange accommodation titleholder with respect to the property and be paid an amount which is other than an arm's-length rate for such services.[309] Sixth, the taxpayer and the exchange accommodation titleholder may enter into option-type agreements or arrangements relating to the purchase or sale of the property.[310] Finally, the taxpayer and exchange accommodation titleholder may agree or arrange for the taxpayer to advance additional funds or receive funds from the exchange accommodation titleholder if the value of the relinquished property fluctuates while being held by the exchange accommodation titleholder.[311]

These provisions of the revenue procedure provide the taxpayer with a significant amount of comfort and leeway in structuring exchanges. By adding the last two permissible elements to an agreement, the economic burdens and benefits of ownership can be shifted from the exchange accommodation titleholder to the taxpayer. In addition, the taxpayer can become presently obligated to purchase the property and the exchange accommodation titleholder can become presently obligated to sell the property. Although Revenue Procedure 2000-37 provides great latitude to taxpayers, it leaves several questions unanswered.[312]

E. Special Issues Relating to Revenue Procedure 2000-37

1. The Transfer Issue

Revenue Procedure 2000-37 creates new issues for like-kind exchange transactions not previously seen in this area. As stated

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309 *Id.* at § 4.03(5).

310 *Id.* at § 4.03(6).

311 *Id.* at § 4.03(7).

312 *See* Bradley T. Borden, *New Safe Harbor Promotes Reverse Exchanges*, 66 PRACTICAL TAX STRATEGIES 68, 74-75 (February 2001).

above, under Revenue Procedure. 2000-37, the taxpayer may lease the property to which the exchange accommodation titleholder is deemed to hold a beneficial interest at rates well below an arm's-length rate.[313] The taxpayer may also manage such property and supervise construction thereon.[314] Furthermore, the taxpayer and exchange accommodation titleholder may enter into an agreement to compensate each other for any fluctuations in the value of the relinquished property during the period that the exchange accommodation titleholder holds the property.[315] These types of agreements are those historically considered when determining whether a transfer of property has occurred.[316] By stating that it will turn a blind eye on these factors, the Service has created a new legal concept that heretofore has not been present in the area of like-kind exchanges. In doing this, the Service has created a new standard for determining whether property has been transferred. It would appear that the Service did not rely on any law enacted by Congress or precedent established by the courts to do this; it merely created a new standard based on suggestions by practitioners and administrative convenience. Although convenient for taxpayers and tax practitioners, the revenue procedure appears to lack legal foundation.

2. Potential Income Tax Consequences

A taxpayer entering an exchange allowed by the revenue procedure must be aware of some potential income tax consequences that may result therefrom. For example, the revenue procedure provides that the taxpayer or a disqualified person may use the property to which the exchange accommodation titleholder holds beneficial title virtually rent-free by allowing the taxpayer to lease the property at a rate less than an arm's length amount.[317] In addition, the taxpayer may perform services with regard to the property and charge

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313 Rev. Proc. 2000-7 at § 4.03(4).

314 *Id.* at § 4.03(5).

315 *Id.* at § 4.03(6).

316 *See, e.g.*, Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981); *see also* Coleman, 53 T.C.M. (CCH) 598, 603 (1987) (listing the factors courts consider in determining whether an exchange has occurred).

317 Rev. Proc. 2000-37 at § 4.03(4).

the exchange accommodation titleholder less than an arm's-length rate to perform such services.[318] The rent-free use of the property by the taxpayer should result in income to the taxpayer, and the receipt of free services by the exchange accommodation titleholder should result in income to the exchange accommodation title holder.[319] The interest-free use of an advance or loan between the taxpayer and the exchange accommodation titleholder may also cause income to be recognized to one or both parties.[320] This may not be a disincentive to using a QEAA, but it should be considered by any taxpayer considering such an arrangement.

3. Depreciation

The revenue procedure clearly states that the issues relating to depreciation and the entering into of option-type transactions are not addressed in the procedure.[321] Therefore, taxpayers are left to speculate as to how these items should be reported. As far as depreciation is concerned, the agreement between the taxpayer and the exchange accommodation titleholder must provide that the exchange accommodation titleholder will be treated as the owner of property in which it holds a qualified indicia of ownership.[322] Therefore, the taxpayer will not be allowed to take a depreciation deduction for property held by the exchange accommodation titleholder.[323]

The exchange accommodation titleholder will most likely also be denied the deduction for depreciation. Under Sections 167(a)(1) and (2), a deduction for depreciation is allowed only if the taxpayer uses the property in a trade or business or holds it for investment.[324] Because the exchange accommodation titleholder purchases property as part of a QEAA, and knows when it is acquired

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318 *Id.* at § 4.03(5).

319 Commissioner v. Glenshaw Glass, 348 U.S. 426, 431-33 (1955) (holding that undeniable accessions to wealth, clearly realized, and over which they taxpayers have complete dominion are taxable income to the taxpayers).

320 I.R.C. § 1272(a), 7872(a)(b).

321 Rev. Proc. 2000-37 at § 3.03.

322 *Id.* at § 4.02(3).

323 Borden, *supra* note 312.

324 I.R.C. § 167(a)(1), (a)(2)(2001).

that it will be sold, the exchange accommodation titleholder arguably does not hold the property for either use in a trade or business or for investment.[325] Consequently, the exchange accommodation titleholder will not be allowed to take a deduction for depreciation on the property it holds, causing no depreciation to be allowed for property while it is held by the exchange accommodation titleholder.[326]

Revenue Procedure 2000-37 provides a safe harbor for taxpayers who wish to effect the equivalent of a reverse exchange.[327] The revenue procedure is very lenient in allowing taxpayers to enter into agreements with exchange accommodation titleholders. Although helpful, some issues are not addressed by Revenue Procedure 2000-37, leaving the question of the proper tax treatment of pure reverse exchanges unanswered.

F. Parking Arrangements Outside the Rev. Proc. 2000-37 Safe Harbor

Revenue Procedure 2000-37 specifically provides that this new safe harbor does not prohibit taxpayers from structuring parking arrangements outside the safe harbor.[328] In a private letter ruling published on March 19, 2001, the service took the position that a transaction involving a parking arrangement outside the Rev. Proc. 2000-37 safe harbor can qualify for section 1031 treatment.[329] In that ruling, the service provided that such parking arrangements must meet three requirements for an exchange outside the safe harbor to be recognized as a section 1031 exchange: A(1) the taxpayer must demonstrate its intent to achieve an exchange and the properties to be exchanged must be of like kind and for a qualified use; (2) the steps in the various transfers must be part of an integrated plan to exchange the relinquished property for the replacement property; and (3) the

325 Borden, *supra* note 312.
326 *Id.*
327 Rev. Proc. 2000-37 at § 4.01.
328 *Id.* at § 3.02.
329 Priv. Ltr. Rul. 01-11-025 (March 16, 2001).

party holding the replacement property must not be the taxpayer's agent.[330]

While the Service has sanctioned a parking arrangement occurring outside the Rev.Proc. 2000-37 safe harbor, its ruling omits a very critical analysis. As mentioned above, the significance of Rev. Proc. 2000-37 is that it treats the titleholder as the beneficial owner of the property it holds title to even though the taxpayer might otherwise bear the economic burdens and benefits of ownership of the property.[331] Without the protection of Rev. Proc. 2000-37, there is no guarantee that the titleholder will be treated as the beneficial owner of property of which it holds title. Instead, a benefits and burdens analysis must be applied to transactions falling outside the safe harbor to determine whether the taxpayer is deemed to be the beneficial owner of property even though another party may hold title to the property. Because the ruling neglects to consider this point its utility is extremely limited. Thus, exchanges falling outside the Rev. Proc. 2000-37 safe harbor must be carefully structured to avoid the inadvertent transfer of property.[332]

G. Reverse Exchanges that Should Qualify for Section 1031 Treatment

The Service should not leave the issue the way it now stands. More guidance is needed. For taxpayers who do not wish to use an exchange accommodation titleholder, the Service should provide guidance which directly addresses pure reverse exchanges. Because principles based in the existing law provide a framework in which reverse exchanges could be structured to qualify for like-kind exchange treatment, such guidance could easily be provided.

Based on the legal principles discussed above, three types of reverse exchanges should be allowed section 1031 treatment: (1)

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330 *Id.*

331 *See supra* Part III.D.1

332 *See, e.g.*, DeCleene v. Commissioner, 115 T.C. 34 (2000) (holding that the transfer to the titleholder in a parking transaction was a sham, so the transaction failed to qualify for section 1031 treatment) and Tech. Adv. Mem. 00-39-005, *supra* note 11.

two-party reverse exchanges, (2) three-corner reverse exchanges, and (3) four-corner reverse exchanges. To ensure that each of these exchanges conforms to the original purposes of allowing like-kind exchanges tax-deferred treatment, the taxpayer should, as the ABA proposed in 1993, be required to enter into a written agreement with the exchange partner. The agreement should provide that the taxpayer will transfer the relinquished property by the earlier of six months from the date the taxpayer receives the replacement property or the taxpayer's first tax return due date following the receipt of the replacement property. The agreement should also identify what property the taxpayer will transfer in the exchange. While this element is not one suggested by the ABA in its 1993 proposal, identifying the relinquished property at the time the agreement is entered into shows that the taxpayer intends to continue an investment with the replacement property.[333] By meeting these requirements, the transaction will not cause administrative inconvenience, and the taxpayer will show that the transaction is a continuation of the investment held in the relinquished property.

Private Letter Ruling 9823045 addresses a two-party reverse exchange.[334] As the facts of that ruling demonstrate, a two-party reverse exchange is a property-for-property transfer between the taxpayer and one exchange partner in which the taxpayer receives the replacement property and subsequently transfers the relinquished property.[335] This type of transfer would satisfy the property-for-property requirement because the taxpayer would transfer property and receive property. It would also satisfy the reciprocal requirement because only one other person would be involved in the exchange.

In the event that the exchange partner wants some sort of assurance that the taxpayer will actually transfer replacement property, the exchange partner should be allowed to retain a security interest in the replacement property, to require the taxpayer to place money into a qualified escrow or qualified trust,[336] to receive a letter of credit, or

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333 Section of Taxation American Bar Association, *supra* note 168.

334 Priv. Ltr. Rul. 98-23-045 (Mar. 10, 1998).

335 *Id.*

336 The requirements for qualified escrow and qualified trust found in Treas. Reg. § 1.1031(k)-1(g)(3)(ii) and (iii) (as amended in 1994) should be used for re-

to receive a third party guarantee. The Service should provide assurance that it will disregard such devices when determining whether in substance the taxpayer has purchased replacement property and sold relinquished property. This rule would mirror the rules in the regulations which allow such devices to be used in forward exchanges. Since such devices are necessary to carry out reverse exchanges in many cases, and since the Service has allowed their use in forward exchanges, they should be allowed in reverse exchanges.

The two-party reverse exchange described above will satisfy all of the requirements of an exchange for purposes of section 1031. First, an exchange will have occurred. The taxpayer will have transferred property and received property, satisfying the property-for-property requirement. By transferring property to one party and receiving property from only one party, the taxpayer will also satisfy the reciprocal requirement. Furthermore, if the taxpayer and the exchange partner agree in writing that the taxpayer will transfer property that is identified in the agreement before the taxpayer files its tax return, the taxpayer will be able to show that it is continuing its original investment. If completed by the time the taxpayer's tax return is due, the transfer will not create administrative inconvenience. Once a two-party reverse exchange is found to satisfy the purpose and requirements of section 1031 and the time limits are established in which the transaction must be completed, section 1031 should also be extended to three-corner and four-corner reverse exchanges if they meet the property-for-property and reciprocal requirements.

A three-corner reverse exchange is used when an exchange partner has no use for the taxpayer's relinquished property, but is willing to facilitate the transfer of such property. For example, suppose Taxpayer owns Whiteacre and desires to replace it with Blackacre which is owned by Exchange Partner. Exchange Partner is willing to sell Blackacre to Taxpayer now, but does not want to acquire Whiteacre for its own use. Third Party, however, does want to acquire Whiteacre for its own use, but it will take Third Party three months to obtain the necessary financing. Exchange Partner agrees

verse exchanges, substituting the word "taxpayer" with "exchange partner" where appropriate.

to facilitate the exchange. Therefore, on June 3, Taxpayer (who is a calendar year taxpayer) and Exchange Partner enter into an agreement whereby Exchange Partner agrees to transfer Blackacre to Taxpayer now and Taxpayer agrees to transfer Whiteacre to Exchange Partner in three months. On June 3, Third Party also agrees to purchase Whiteacre from Exchange Partner in three months. Because Exchange Partner does not want to be left without cash in three months, it requires Taxpayer to agree to pay cash in three months if Third Party is unable to obtain financing. At the end of three months, Third Party does have the financing, and Whiteacre is transferred to Exchange Partner who then sells it to Third Party.

This type of transaction should be granted section 1031 treatment. As shown above, a two-party reverse exchange can be structured to satisfy the purpose and requirements of section 1031. The only additional issue involved in a three-corner reverse exchange (assuming it is completed within the required time frame) is whether the exchange requirement is met. The three-corner transaction described above does meet the exchange requirement. Taxpayer received only property and transferred only property. Therefore, the property-for-property requirement is met. Since Taxpayer transferred property only to Exchange Partner and received property only from Exchange Partner, the reciprocal requirement is also met. Therefore, the transaction qualifies as an exchange for purposes of section 1031. Since the written agreement requirement and the time requirement are also satisfied, the exchange should meet the purposes of section 1031.

The agreement that Taxpayer pay cash if Third Party is unable to purchase Whiteacre is no different from the default agreements in *Coastal Terminals*[337] and *W.D. Haden.*[338] Therefore, such a provision should not affect the exchange requirement in reverse exchanges if no cash is actually paid. Furthermore, the Service should disregard the use of a security interest, a deposit by Taxpayer or Third Party of cash into a qualified escrow or trust, or a third-party guarantor in determining whether Taxpayer has actually or construc-

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337 Coastal Terminals, Inc. v. United States, 320 F.2d 333, 335 (4th Cir. 1963).
338 W.D. Hayden v. Commissioner, 165 F.2d 588, 590 (5th Cir. 1948).

tively received cash or substantively has entered into a purchase followed by the subsequent resale of property.

A four-corner exchange is necessary if the party who owns the replacement property does not desire to facilitate the transfer of the relinquished property to a third party. In such a situation, the taxpayer should be allowed to used a qualified intermediary to facilitate the exchange. In a four-corner reverse exchange, the qualified intermediary becomes the taxpayer's exchange partner. The seller of the replacement property transfers the replacement property to the qualified intermediary, the qualified intermediary transfers the replacement property to the taxpayer immediately, and within the required time period, the taxpayer transfers the relinquished property to the qualified intermediary who then transfers it to a purchaser. The qualified intermediary uses the funds received from selling the relinquished property to satisfy the purchase obligation it incurred in purchasing the replacement property. In such a transaction, the Service should agree to disregard the use of the qualified intermediary in determining whether an agency relationship exists between the taxpayer and the qualified intermediary.

Furthermore, the taxpayer should be able to receive the rights in the replacement property from the qualified intermediary and receive the legal title directly from the seller much like the court in *Biggs*[339] allowed. The taxpayer should also be allowed to transfer the rights in the relinquished property to the intermediary and transfer legal title directly to the purchaser, much like the taxpayer did in *Biggs*.[340] In either situation, the taxpayer should still be deemed to have satisfied the exchange requirement for purposes of section 1031 since there was a property-for-property exchange (*i.e.*, rights in property were exchanged for rights in other property, and no cash) and since the exchange satisfied the reciprocal requirement (*i.e.*, the taxpayer exchanged property with only the qualified intermediary). The timing principles that apply to two-party reverse exchanges apply to four-corner reverse exchanges also; therefore, four-corner reverse

339 Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1980).

340 *Id.*

exchanges should be granted section 1031 treatment if structured as stated above and if completed within the required time period.

Finally, since *Starker*[341] and the regulations allow a growth factor or interest to accrue on a forward deferred exchange without affecting the treatment of the transaction,[342] growth factors and interest should be allowed in reverse exchanges. The taxpayer entering into a reverse exchange, should be allowed a deduction for the growth factor or interest if it is of a character that would otherwise be deductible. Thus, in any of the methods used to effect a reverse exchange, even if the taxpayer agrees to pay a growth factor equal to the exchange partner's outstanding balance, the transaction should still qualify for like-kind exchange treatment.

H. The Depreciation Issue

When discussing reverse exchanges, the issue of depreciation must be considered. There is some question as to how depreciation should be handled while a taxpayer holds the relinquished property and the replacement property simultaneously.[343] In considering the proper treatment of depreciation, three time periods must be examined: (1) the period prior to the taxpayer's receiving the replacement property, (2) the period during which the replacement property and relinquished property are held simultaneously by the taxpayer (referred to as the gap period),[344] and (3) the period following the taxpayer's disposition of the relinquished property. There are no special issues regarding the proper depreciation deduction for the relin-

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341 602 F.2d 1341 (9th Cir. 1979).

342 Treas. Reg. § 1.1031(k)-1(g)(5) (as amended in 1994).

343 *See, e.g.*, Section of Taxation American Bar Association, *supra* note ABA 168 at 51 ("The taxpayer shall not be permitted to claim depreciation, amortization, or other cost recovery deductions with respect to the adjusted basis of the relinquished property as of the date of acquisition of the replacement property from and after the date on which the taxpayer receives the replacement property."); Sax, *supra* note 169 (questioning whether freezing depreciation is the economically correct result); Rev. Proc. 2000-37, 2000-40 I.R.B. 308 at § 3.03 (stating that the revenue procedure does not address "whether an exchange accommodation titleholder may be precluded from claiming depreciation deductions (e.g., as a dealer) with respect to the relinquished property or the replacement property").

344 Sax, *supra* note 169.

quished property prior to the taxpayer's receiving the replacement property - the taxpayer should deduct its normal depreciation during this period.

The most important period to consider is the gap period. During the gap period, the taxpayer who enters into one of the pure reverse exchanges listed above will own two properties simultaneously. Since the replacement property is a continuation of the investment the taxpayer had in the relinquished property, the taxpayer should not be allowed to take a depreciation deduction in an amount other than that which would be allowed for the relinquished property if the replacement property had not been acquired. Since the taxpayer does indeed own an asset, however, the taxpayer should be able to treat one of the assets as placed in service during the gap period. Therefore, during the gap period, the taxpayer should be allowed a deduction for depreciation equal to the amount that would have been allowed for the relinquished property had the taxpayer not entered into a reverse exchange.

Upon disposition of the relinquished property, the replacement property should be treated in the same manner as the replacement property with respect to so much of the taxpayer's basis in the replacement property as does not exceed the taxpayer's adjusted basis in the relinquished property.[345] If the taxpayer does receive boot and recognize gain, the basis of the replacement property may differ from the basis of the relinquished property.[346] In such cases, the excess of the basis in the replacement property over the basis in the relinquished property should be treated as newly acquired property and depreciated accordingly.[347] The application of the depreciation rules in this manner will produce a result that is consistent with both existing depreciation rules and the purposes behind allowing section 1031 exchange treatment.

The issue is no more complicated when a QEAA is used. Since the taxpayer is deemed to enter into a simultaneous exchange in a QEAA, the depreciation rules should be applied to the taxpayer in the manner in which they are normally applied to simultaneous

345 I.R.S. Notice 2000-4, 2000-3 I.R.B. 313.

346 I.R.C. § 1031(d)(2001).

347 I.R.S. Notice 2000-4.

like-kind exchanges. Although the subject of considerable conversation, the issue of depreciation in the context reverse exchanges or parking arrangements is not terribly difficult to address.

IV. CONCLUSION

The discussion above shows that pure reverse exchanges can be structured in such a manner that they satisfy the purposes Congress had for enacting section 1031 and its predecessors. A taxpayer who agrees in writing to transfer specific relinquished property to the transferor of replacement property can show that the purpose of the transfer was to continue the investment the taxpayer had in the relinquished property. If the taxpayer can complete the transaction prior to the date the taxpayer is required to file a tax return, the transaction will not result in administrative inconvenience, and will satisfy the other purpose of section 1031.

Properly structured reverse exchanges also meet the exchange requirement of section 1031. Two-party reverse exchanges, three-corner reverse exchanges, and four-corner reverse exchanges all can be structured in such a manner that the taxpayer receives property from one party and transfers property to that same party. Structuring a reverse exchange to occur in this manner will result in the transfer satisfying both the property-for-property requirement and the reciprocal requirement.

Since properly structured reverse exchanges satisfy the purpose of section 1031 and meet the exchange requirement of section 1031, such exchanges should be granted section 1031 exchange treatment. Since taxpayers have no assurance that the Service will not challenge properly structured reverse exchanges, taxpayers still bear the risk that the Service will challenge such transactions. Therefore, taxpayers may not be willing to enter into such transactions. To help alleviate taxpayers' fears in this area, the Service should provide guidance stating that they will not challenge the applicability of section 1031 to reverse exchanges that are structured in the manner discussed above.