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## **Tax court issues a favorable ruling on a reverse non safe harbor 1031 tax deferred exchange - by Brendan Greene and Mark McCue**

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Internal Revenue Code (IRC) Section 1031 allows a property owner, who holds property for “the productive use in a trade or business or for investment”, to defer paying any capital gains taxes if the property owner sells such property, identifies “like kind” property within forty-five days of the

sale, and acquires other “like kind” property within 180 days of the sale. The theory behind Section 1031 is that real estate investors selling and reinvesting in new investment property are not cashing out of their investment, and that the replacement property is a continuation of the old investment.

While forward exchanges are the most common, reverse exchanges are being more frequently used. In a Reverse 1031 Exchange, the replacement property is acquired before the relinquished property is sold.

Internal Revenue Code Section 1031 does not specifically authorize so-called reverse exchanges and up until year 2000, taxpayers were at a loss as to how to properly structure a reverse exchange. However, on September 15, 2000, the IRS issued Revenue Procedure 2000-37 which provides a “safe harbor” for reverse exchanges completed as part of a properly structured “parking transaction”. If an exchanger follows these guidelines, then the exchange will withstand IRS scrutiny.

In a “parking transaction”, the exchanger does not initially take title to the replacement property. Instead, the replacement property is “parked” with an Exchange Accommodation Titleholder (EAT), which is typically the Qualified Intermediary (QI), and the Exchanger and the EAT enter into a written Qualified Exchange Accommodation Agreement (QEAA). The EAT holds title to the Replacement Property until such time as the Exchanger arranges for the transfer of the Relinquished Property to the Buyer in a simultaneous or deferred exchange. The EAT is typically a single member limited liability company (LLC) where the QI is the sole member.

When the replacement property is purchased and “parked” with the EAT, the taxpayer has 45 days from the date of purchase to identify the relinquished property or properties, and 180 days from the date of purchase by the EAT to sell the relinquished property.

It is important to note that Revenue Procedure 2000-37 provides that the parking arrangement set forth is not the only way to structure an exchange and many taxpayers structure non-safe harbor exchanges for a variety of reasons. The most common reason is that the 180 day time limit in Revenue Procedure 2000-37 makes it difficult or impossible to complete exchanges where substantial improvements need to be made to the replacement property.

In 2016, the tax court issued a decision which may have a significant and favorable impact on Reverse 1031 Exchanges. In the case of *Bartell v. Commissioner*, 147 T.C. No. 5 (2016), the tax court determined that “where a section 1031 exchange is contemplated from the outset and a third-party exchange facilitator, rather than the taxpayer, takes title to the replacement property before the exchange, the exchange facilitator need not assume the benefits and burdens of ownership of the replacement property in order to be treated as an owner for section 1031 purposes before the exchange”.

The impact of the decision in *Bartell* is that it makes it significantly easier to structure a non-safe harbor reverse exchange, provided that an EAT is involved. The case also allowed for the holding of replacement property for seventeen months (and arguably up to 24 months) before completing the exchange.

The Bartell decision overturned the long-standing IRS requirement in non-safe harbor exchanges that the EAT have the traditional benefits and burdens of ownership such as appreciation, risk of loss, taxes, and other liabilities with respect to the property. This requires very specific and somewhat complicated documentation and tax filings.

It is unclear if the IRS will challenge the decision or if other circuits of the tax court will rule differently. In the meantime, however, many taxpayers may look to structure a reverse exchange in accordance with the favorable guidelines in the case.

We have seen a substantial increase in reverse exchanges over the last couple of years as investors have become more familiar and knowledgeable as to how they work. Also, lenders have become more comfortable with reverse exchanges and are more willing to lend on these transactions.

Reverse exchanges are more complicated than the typical forward tax-deferred exchanges, but with proper structuring, a reverse exchange gives the exchanger more options in the pursuit of finding replacement properties. Let us help you properly structure your reverse exchange.

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