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The enduring benefits of Internal Revenue Code Section 1031

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Internal Revenue Code Section 1031 contains a mere 1,421 words-a fraction of the 3.4+ million words contained in all of Title 26 of the Code-yet the significance and the impact of those words cannot be overemphasized. Investors have enjoyed the advantages offered by Section 1031 since 1921. The overriding principle is relatively simple and has changed little since the code was first enacted-continuity of investment-exchanging one relatively illiquid asset for another illiquid asset should not result in current recognition of gain.

Many investors are familiar with the qualified intermediary (QI) safe harbor wherein a third party acts to facilitate the exchange by "acquiring and transferring" both the investor's old property (the relinquished property) and the investor's new property (the replacement property).

In addition to acquiring and transferring the properties, the QI, through a trust or escrow account or other exchange fund, will hold the proceeds of sale until replacement property is acquired. The investor's rights to receive the sale proceeds must be limited to certain specific instances in order for the investor to avoid being deemed to have constructive receipt of the cash, and as a result, be deemed to have sold the property and not exchanged it.

Perhaps the greatest challenge faced by investors engaging in Section 1031 exchanges in the last few years is the time constraints imposed by the code. More and more investors are structuring their tax-deferred exchanges as reverse exchange "parking arrangements," with the help of formal guidance from the IRS.

Revenue Procedure 2000-37 created a safe harbor "parking arrangement" that allows an investor to arrange for either relinquished property or replacement property to be acquired by a third party "exchange accommodation titleholder" (EAT) for a period of up to 180 days. During that time the EAT must be the owner of the property for federal income tax purposes while the investor can be the owner for financial reporting purposes. The Revenue Procedure has been hailed as decidedly taxpayer-friendly guidance that offers powerful planning opportunities for institutional and individual investors alike.

At the time the property is transferred to the EAT, the investor must intend that the property be either replacement property or relinquished property that is intended to qualify for non-recognition of gain under Section 1031. No later than five business days after the EAT acquires the property, the taxpayer and the EAT must enter into a qualified exchange accommodation agreement. The agreement must specify that the EAT is the beneficial owner of the property for federal income tax purposes, and all parties must report ownership of the property as such.

Mirroring the provisions of the code, the Revenue Procedure also contains an identification requirement. In the case of replacement property parking, a limited number of potential relinquished properties must be identified no later than 45 days after the transfer of the replacement property to the EAT.

Perhaps the most significant provisions of the Revenue Procedure are contained at Section 4.03 titled Permissible Agreements which lists a number of contractual agreements that can be entered into between the parties, regardless of whether the terms of the agreements are arm's length, without invalidating the arrangement.

These provisions make the Revenue Procedure a potent and valuable tool for taxpayers:

1. The taxpayer can guarantee some or all of the obligations undertaken by the EAT to secure financing to acquire the property.
2. The taxpayer can advance funds directly to the EAT.
3. The EAT can lease the property to the taxpayer.
4. The taxpayer can manage the property, oversee construction of improvements to the property, or otherwise provide services to the EAT in connection with the property.
5. The accommodation agreement can contain puts and calls at fixed or formula prices.
6. The EAT can also act as the QI on behalf of the taxpayer.

Parking replacement property under the Revenue Procedure has become an important device among institutional investors with the financial wherewithal to purchase property without third party financing. Indeed, many institutional investors "park" nearly every acquisition estimating that some viable disposition can be matched up with the parked property. And the safe harbor allows investors to control the management and development of the property, as well as to receive all of the economic benefits of the property prior to taking legal title while still qualifying under Section 1031.

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