

Ask The Lawyer

by Richard E. Scrimale

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Reverse Like-Kind Exchanges: NEW FLEXIBILITY

On September 18, 2000, the IRS issued Revenue Procedure 2000-37 (Rev. Proc. 2000-37) which permitted the use of a reverse, tax-free like-kind exchange (reverse exchange). Many taxpayers, despite the lack of any guidance or authority from the IRS, consummated reverse exchanges and took their chances on audit. Rev. Proc. 2000-37 has added a great deal of flexibility and clarity to taxpayers by creating a safe harbor for undertaking a reverse exchange.

To understand the significance of Rev. Proc. 2000-37, many taxpayers, in lieu of selling their properties, consider a tax-free like-kind exchange where they may defer the recognition of the gain, or a portion thereof, on the sale of property. In such instances, the taxpayer's recognition of the gain is postponed until the property acquired in the exchange is ultimately sold.

It was often difficult, if not impossible for a taxpayer to effectuate a like-kind exchange because the Internal Revenue Code required that the exchange had to be simultaneous. After numerous tax cases, the IRS issued regulations permitting tax-free like-kind exchange treatment in a "deferred" transaction. But the taxpayer was required to sell their property prior to acquiring the replacement property. The regulations added a great deal of flexibility to the structure and timing of a like-kind exchange, but many businesses could not take advantage of them on account of the initial disposition requirement.

Traditional Deferred Like-Kind Exchange

A deferred exchange may be necessary when a taxpayer finds a purchaser who wants their property who hasn't yet acquired property to turn over in exchange. Or, perhaps the taxpayer has not yet determined the needs for replacement property and seeks a delay in determining what property to accept in exchange.

Under the regulations, a taxpayer

can structure a deferred (non-simultaneous) exchange. The taxpayer transfers property to the purchaser but defers its receipt of replacement property. In order to qualify for like-kind exchange treatment, the following limits must be met:

- The replacement property must be "identified" no later than 45 days after the taxpayer's property is transferred; and
- The actual transfer of the replacement property must occur no later than the earlier of: 180 days after the transfer of the original property, or the due date (including extensions) of the taxpayer's tax return for the year in which the original property is sold.

During the time period from the sale of the original property and obtaining the replacement property, a "qualified intermediary" holds the proceeds from the sale of the original property in an escrow account pending their use to purchase the replacement property. While the proceeds are being held in escrow, any earnings will accumulate and be payable to the taxpayer or may be utilized in the purchase of the replacement property.

The funds cannot be utilized for the taxpayer's benefit. For instance, the funds cannot be loaned to the taxpayer or pledged as collateral for a loan while they are subject to the escrow.

Reverse Exchanges

Finally, Rev. Proc. 2000-37, sanctions certain reverse exchanges where a "qualified exchange accommodation titleholder" (similar to a qualified intermediary) "parks" the property subject to the exchange until the closing can occur. Based on the ability to park a piece of property, the qualified exchange accommodation, or temporary titleholder, may acquire the replacement property and make any necessary modifications or improvements to it so that the taxpayer can move their business with the least amount of interruption.

Generally, a temporary titleholder may take title to the replacement property prior to the sale of the original property. After the sale of the original property, the temporary titleholder will then transfer title to the replacement property. Alternatively, the temporary titleholder may take title to the original property before the taxpayer purchases the replacement property, and subsequently convey the original property to the ultimate purchaser. The time restraints for a reverse exchange are substantially similar to a traditional deferred like-kind exchange, including a similar deadline to complete the transaction.

Summary

There are many other specific requirements in order to consummate a like-kind exchange, deferred like-kind exchange or a reverse exchange. Prior to entering into any portion of the exchange, you should review the entire transaction with your attorney and accountant in order to protect the tax-deferred status of the transaction. □

Small-Biz Snapshot

Small-business owners were asked what percentage of their total business expenses goes toward physical facilities, like rent or mortgage, utilities and maintenance.



24.1%	Less than 10 percent
30.1%	10 percent to less than 20 percent
23.6%	20 percent to less than 30 percent
7.5%	30 percent to less than 40 percent
1.8%	40 percent to less than 50 percent
6.0%	50 percent or more
7.0%	Don't know or refuse to disclose

Source: National Federation of Independent Business