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New Limits on “Reverse” Like-Kind Exchanges
— by Neil E. Harl*

In 2000, the Internal Revenue Service announced a safe harbor for “reverse” like-kind exchanges of eligible property. On July 20, 2004, the IRS narrowed the scope of the safe harbor created in 2000.

General rule on like-kind exchanges

In a like-kind exchange, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or held for investment if it is exchanged for like-kind property which is to be held for productive use in a trade or business or held for investment. In a “reverse Starker” exchange, the replacement property is acquired before the relinquished property is transferred. Until the issuance of Rev. Proc. 2000-37, the like-kind exchange rules did not specifically apply to transactions in which the taxpayer received the replacement property before transferring the relinquished property.

But in that revenue procedure, IRS issued guidelines for reverse like-kind exchanges that involve “parking” the replacement property with an accommodation party until the relinquished property is transferred to the ultimate transferee. Once the arrangement is in place, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property and the accommodation party transfers the relinquished property to the ultimate transferee. It has also been possible, under the guidelines, for the accommodation party to acquire the replacement property on behalf of the taxpayer and exchange that property with the taxpayer for the relinquished property with the relinquished property held until a transfer of the property occurs to the ultimate transferee.

The safe harbor

Under the safe harbor of Rev. Proc. 2000-37, IRS stated that it would not challenge the qualification of property held in a “qualified exchange accommodation arrangement” (QEAA) as either replacement property or relinquished property or the treatment of the exchange accommodation title holder as the beneficial owner of the property for federal income tax purposes. It was not necessary for the taxpayer to have to establish that the exchange accommodation title holder (EAT) bore the economic benefits and burdens of ownership for the accommodation party to be treated as the owner of the property.

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The next issue of the Digest will be published on January 3, 2005. Happy Holidays to you and yours.
The new limitations

Apparently, some taxpayers had been interpreting the safe harbor as permitting like-kind exchange treatment for transactions in which the taxpayer transferred property to an exchange accommodation title holder and received that same property as replacement property as a purported exchange for other property of the taxpayer. The 2004 revenue procedure also notes that in some types of “parking” transactions, the taxpayer was reinvesting the proceeds of the sale of one piece of real property in improvements to other real property already owned by the taxpayer or a related person.15

Change in scope of “reverse” like-kind exchanges

In response to these types of transactions, IRS has now modified the safe harbor rules16 to provide that the safe harbor will not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date that qualified indicia of ownership of the property are transferred to an exchange accommodation title holder.17

This change is effective for transfers on or after July 20, 2004, of qualified indicia of ownership to exchange accommodation titleholders.18

IRS (and the Treasury Department) indicate that they will continue to study “parking” transactions and may issue further guidance if they determine that other transactions are not consistent with the policies underlying the like-kind exchange rules.19

FOOTNOTES


3 I.R.C. § 1031.

4 I.R.C. § 1031(a)(1). See Ltr. Rul. 9850001, Aug. 31, 1998 (liquidation of taxpayer into holding company followed by merger of holding company with another corporation did not affect requirement that replacement property be held for productive use in a trade or business or for investment); Ltr. Rul. 200131014, May 2, 2001 (transfer of S corporation’s replacement properties in like-kind exchange to its wholly-owned single member LLC did not violate requirement that replacement property must be used in trade or business after exchange; single member LLC either disregarded or reliance placed on default classification). See also Rev. Rul. 75-292, 1975-2 C.B. 333 (like-kind exchange followed by immediate transfer of replacement property by taxpayer to corporation failed I.R.C. § 1031 tests—acquired for purpose of transferring to new corporation).

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


7 Id.

8 See 4 Harl, supra note 1.

9 Rev. Proc. 2000-37, 2000-2 C.B. 308 (allows accommodation party to be treated as owner of the property for tax purposes, enabling transactions to qualify as like-kind exchange).

10 Id.

11 Id.


13 Id.

14 Id.


18 Id., sec. 6.


CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

REFUND. The debtor filed for bankruptcy in 2002 and filed a federal income tax return which claimed a refund resulting from the child tax credit and the earned income tax credit. The debtor sought to exclude the refund from bankruptcy property as post-petition property. The court held that the child tax credit refund could not be obtained until after 2002; therefore, that portion of the refund was not included in the bankruptcy estate. The trustee conceded that the only portion of the refund which was included in the estate was that portion attributable to income earned by the debtor prior to the bankruptcy petition date. In the Matter of Schwarz, 314 B.R. 433 (Bankr. D. Neb. 2004).

FEDERAL AGRICULTURAL PROGRAMS

WETLANDS. The Natural Resources Conservation Service had determined that the plaintiff had wetlands on the plaintiff’s property and the plaintiff had filed an appeal of that determination but later withdrew the appeal. The plaintiff claimed that a district