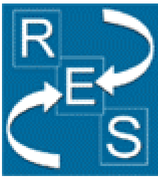

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Using New IRS Reverse §1031 Rules
For Tax Deferred Upgrades of Capital & Operating Equipment

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The use of tax-deferred exchanges for upgrading ownership in real property has long been a useful tactic, but for owners and users of capital and operating equipment, the realities of the business world have made this technique of little value…until now.

The ever-present problem for an operating business is that there usually is the need to acquire and make functional the "new" property before the "old" property is sold. Until September 2000, the IRS took the position that if a taxpayer acquired the new property before it disposed of the old property, the taxpayer could not defer taxes under §1031 on the sale of the old property.

With the issuance of Revenue Procedure 200037 (the "Rev. Proc."), the IRS eliminated the problem. Now it is possible for a taxpayer to, in essence, acquire the new property and use it, before it has sold the old property. The Rev. Proc. gives the taxpayer the "safe harbor" presumption that its exchange qualifies under §1031, if certain criteria are met.

In a "safe harbor" so-called Reverse Exchange, the taxpayer locates the property it wants to acquire as its Replacement Property. For instance, if the taxpayer is a metal processor, and wants, or needs to upgrade a major piece of capital equipment, it will first enter into a purchase contract to buy the new equipment. It will then enter into an agreement with an Exchange Accommodation Titleholder (or "EAT"), and assign the purchase contract to the EAT. The EAT then becomes the contract purchaser for the new equipment. The taxpayer and the EAT enter into a "Qualified Exchange Accommodation Agreement" in which the EAT agrees that, if the taxpayer (and/or some third-party lender) loans the purchase price to the EAT, the EAT will purchase the new equipment. The EAT will then lease the equipment to the taxpayer on a 'net lease' basis, for a nominal lease payment. Then, when the taxpayer has sold the old equipment, the EAT will transfer the new equipment to the taxpayer at the price which the EAT paid for the new equipment. This completes the taxpayer's exchange. The taxpayer has the benefit of getting the immediate use of the new equipment, without any interruption in its business activities. The taxpayer has the added benefit of selling its old equipment in a manner which brings the best price.

This is the essence of a "safe harbor" Reverse Exchange. The basic criteria are that the taxpayer and the EAT must enter into a written agreement which sets forth their rights and obligations. After the EAT has taken title to the new property, the taxpayer has to (i) identify the old property ("relinquished property") within 45 days after the EAT has purchased the new property and (ii) sell the old property, and complete the exchange by acquiring the new property ("Replacement Property") within 180 days after the EAT has purchased the new property. There is no requirement that the EAT put up its own money since the purchase of the new property can be financed 100% by the taxpayer and/or its lenders. There is also no requirement that the leaseback be on an "arms-length" arrangement.

If, for some reason, the taxpayer cannot meet either the 45day or 180day time limitation, then the *presumption* of the IRS "safe harbor" is lost. That does not mean, however, the

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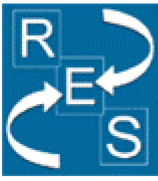

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taxpayer cannot get the benefits of tax-deferral using a Reverse Exchange structure.

Where the 'safe harbor' presumption is not available, the EAT's relationship with the taxpayer has to be structured so there is some element of "arms-length", principal-to-principal relationship. Unlike the "safe harbor" structure, the EAT must have enough "at risk" to be deemed, for tax purposes, the taxpayer's agent. Commonly, in these non-safe harbor situations, the EAT will invest 5%10% of its own funds to acquire the new property and the agreement will only give the taxpayer an agreed purchase price for a short period of time (1218 months). Further, the EAT will not have the right to "put" the new property it has acquired to the taxpayer, so if the taxpayer does not exercise its purchase option, the EAT will have to find another way to dispose of the new property. Finally, if the new property will undergo significant modifications between the time the EAT acquires it and the time it is transferred to the taxpayer, the EAT will have to be involved, at least in some capacity, in the construction process.

A typical non-safe harbor transaction is one where a taxpayer wants to purchase an aircraft with certain configuration (engine and/or interior), and the seller of the aircraft will not provide these modifications to the aircraft prior to transfer of title. Similar situations occur where machinery or equipment has to be specialized to meet certain needs (e.g., an offshore oil-drilling rig). Another situation is where the item has to be modified, or built from the ground up, and the person who is responsible for doing the actual construction does not want to have, or cannot have, ownership responsibility or liability (e.g., certain restrictions by governmental agencies, such as the FCC, may prohibit such activities).

In all Reverse Exchanges, the EAT is required to be treated as the taxpayer with respect to the property it holds. This means the EAT must file tax returns to properly report ownership (and capital improvements). It is also advisable for each Reverse Exchange transaction to be structured with a different single-purpose entity ("SPE"), so that any circumstance which adversely affects one property (e.g., a casualty during the retrofitting process), does not affect any other taxpayer, and the property which such other taxpayer is using to complete its separate, unrelated, "reverse" exchange.

Thus, it is critical that the transaction be carefully structured on two levels: First, at the level of the organization and operation of the EAT, and, Second, at the level of the relationship between the taxpayer and the EAT to ensure that either the IRS "safe harbor" requirements are met, or that the EAT is sufficiently "at risk" in the transaction to be deemed a principal, and not the agent of the taxpayer.

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