(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Mirror, Mirror: Identifying Property In a Reverse Like-Kind Exchange

By David W. Hesford, David J. Nagle, and Ameek Ashok Ponda

David W. Hesford, David J. Nagle, and Ameek Ashok Ponda are Boston-based tax attorneys with Sullivan & Worcester LLP. The authors gratefully acknowledge the comments and input from Joseph Darby III, Paul Decker, Jonathan Dubitzky, Christopher Flanagan, Howard Levine, and Daniel Nir. Any errors or omissions remain the authors' own.

A taxpayer in a forward like-kind exchange can automatically identify replacement property by actually acquiring it during the applicable 45-day identification period. Invoking the mirror image of this rule in a reverse like-kind exchange to identify relinquished property, however, raises interesting questions, and a taxpayer who does so expecting to see the exact reflection of an automatic identification in a forward like-kind exchange may see a ghost image instead.

Copyright 2010 Sullivan & Worcester LLP.
All rights reserved.

Table of Contents

I.	Introduction	45
II.	Section 1031 Background	45
III.	Crowding Out in Forward Exchanges	46
IV.	LTR 200718028	49
V.	Crowding Out in Reverse Exchanges	51
VI.	Holding Up a Mirror to the Mirror	52
VII.	Conclusion	54

I. Introduction

Simultaneous real estate exchanges under section 1031 hardly ever occur. Most like-kind exchanges are instead nonsimultaneous forward or reverse exchanges. These forward and reverse deferred exchanges are often described as mirror images of each other, at least partly because the administrative safe harbor for reverse exchanges in Rev. Proc. 2000-37 adopts rules and conventions applicable to forward exchanges, such as a 45-day identification period during which identification must be made in a manner consistent with the principles for forward exchanges, as well as a 180-day transaction completion period.

While there is indeed symmetry between forward and reverse exchanges, reverse exchanges are not really mirror images of forward exchanges. The so-called automatic identification rule is a useful heuristic to illustrate this point. A taxpayer in a forward exchange can identify replacement property by actually acquiring it during the applicable 45-day identification period. Invoking this rule in a reverse exchange to identify relinquished property, however, raises interesting and curious questions, and a taxpayer who does so expecting to see the exact reflection of an automatic identification in a forward exchange may see a ghost image instead.

II. Section 1031 Background

Section 1031 provides for nonrecognition of gain and loss on an exchange of like-kind property.[1] Both the code and Treasury regulations permit not only a simultaneous exchange of like-kind properties, but also a "deferred exchange," defined under the Treasury regulations as "an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the 'relinquished property') and subsequently receives property to be held either for productive use in a trade or business or for investment (the 'replacement property')."[2] In a typical deferred exchange, commonly known as a forward exchange, the relinquished property is sold through a third

[1]Section 1031(a) provides for complete nonrecognition of gain and loss when trade-or-business or investment property is exchanged *solely* for like-kind property to be used in a trade or business or for investment. Section 1031(b)-(c) provides for complete nonrecognition of loss, but partial recognition of gain, when only some of the received property is like-kind and the balance is boot (*i.e.*, money or other property that is not like-kind). Section 1031(d) and reg. sections 1.1031(b)-1(c) and 1.1031(d)-2 provide rules for treating relief from liabilities as boot in the exchange. And section 1031(d) and reg. section 1.1031(d)-1 provide for a substituted (or exchanged) basis in the property received (adjusted for any boot received and gain recognized), the effect of which is to defer the nonrecognized gain or loss into the replacement property.

[2]Reg. section 1.1031(k)-1(a); *see also* section 1031(a)(1) (providing the general rule that "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."); section 1031(a)(3) (further providing that for replacement property to be "like kind," it must be identified within 45 days of, and the exchange must generally be completed no more than 180 days after, transfer of the relinquished property). Regulations further provide for the manner of identifying replacement property, including alternative and multiple replacement properties. *See infra* notes 11-14 and accompanying text.

party, usually a qualified intermediary,[3] who receives and uses the relinquished property sale proceeds to acquire replacement property that the QI then transfers to the taxpayer to complete the ''exchange'' between the QI and taxpayer.[4] As long as the replacement property is timely and properly identified and also timely received, the taxpayer will be eligible for section 1031 nonrecognition on disposition of its relinquished property.[5]

Although Treasury regulations still limit the definition of ''deferred exchange'' to one in which a taxpayer relinquishes property before receiving replacement property, since 2000 the IRS, through Rev. Proc. 2000-37, has also approved ''reverse exchanges'' in which an accommodation party, acting for all practical purposes as the taxpayer's agent, acquires replacement property for the taxpayer before the taxpayer relinquishes property in exchange therefor.[6] To effect a reverse exchange within the Rev. Proc. 2000-37 safe harbor, a taxpayer ''parks'' the replacement property with an exchange accommodation titleholder (EAT), and thereafter effects a like-kind exchange of relinquished property for the parked replacement property.[7]

A taxpayer who parks replacement property with an EAT is required to identify relinquished property in a manner ''consistent with the principles'' for identifying replacement property in a forward exchange.[8] As described below, the 3-property and 200-percent rules for identifying alternative and multiple replacement properties in a forward exchange translate easily into the mirror universe of reverse exchanges, but it is less obvious how to translate the automatic identification rule, under which replacement property received during the identification period is treated in all events as timely identified in a forward exchange.[9] In fact, a 2007 private letter ruling concerning automatic identification in a reverse exchange concludes that taxpayers who have parked property with an EAT may identify relinquished property merely by *commencing* (as opposed to *completing*) an exchange with an intermediary during the reverse exchange identification period.[10]

III. Crowding Out in Forward Exchanges

In a forward exchange, replacement property must be properly and timely identified in order to qualify as like-kind to the relinquished property.[11] This ordinarily requires that written identification be sent by the taxpayer to the QI[12] by midnight of the 45th day following disposition of the relinquished property.[13] The taxpayer

[3]*See* reg. section 1.1031(k)-1(g)(4)(iii) (''A qualified intermediary is a [third party not otherwise the taxpayer's agent] who . . . enters into a written agreement with the taxpayer (the 'exchange agreement') and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.'').

[4]*See* reg. sections 1.1031(b)-2 and 1.1031(k)-1. The modern era of like-kind exchanges began in 1990 with the issuance of Treasury regulations permitting a QI to serve as an accommodation party without being treated as the taxpayer's agent. *See* reg. section 1.1031(k)-1(o) and Notice of Proposed Rulemaking, 1990-1 C.B. 633; *see also* Mary B. Foster and Jeremiah M. Long, *Tax-Free Exchanges Under Section 1031,* sections 3:11-3:15 (2007). Even before issuance of the regulations, a purchaser of relinquished property could serve as an accommodation party in one of several varieties of triangular exchange. *See, e.g.,* Rev. Rul. 77-297, 1977-2 C.B. 304. Purchasers, however, rarely want responsibility for purchasing and delivering replacement property, so today QIs serve as counterparties in the vast majority of like-kind exchanges.

[5]*See* section 1031; *see also* reg. section 1.1031(k)-1(a) (''in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) before the taxpayer actually receives like-kind replacement property.'').

[6]*See* Rev. Proc. 2000-37, 2000-2 C.B. 308, *Doc 2000-24091, 2000 TNT 181-13*, as modified by Rev. Proc. 2004-51, 2004-2 C.B. 294, *Doc 2004-14861, 2004 TNT 140-12* (hereinafter, Rev. Proc. 2000-37). This article focuses exclusively on so-called exchange-last reverse exchanges, in which the replacement property is parked with an exchange accommodation titleholder (EAT) and later acquired through a forward exchange. *See* Rev. Proc. 2000-37, section 2.05 (''Parking transactions typically are designed to 'park' the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange.''). The alternative is an exchange-first reverse exchange, in which the EAT acquires and transfers the replacement property to the taxpayer in exchange for the relinquished property, and then the EAT holds the relinquished property until the taxpayer is able to arrange for its transfer to an ultimate buyer. *See Id.*

[7]While practitioners often refer to a transaction under Rev. Proc. 2000-37 as a safe harbor ''reverse exchange,'' the transaction is not simply a forward exchange in reverse order. That is, a reverse exchange is not a deferred exchange in which a taxpayer actually acquires replacement property through a QI *before* relinquishing like-kind property in exchange therefor through a QI. *See supra* notes 3 and 4; T.D. 8346, 1991-1 C.B. 150, 151 (reg. section 1.1031(k)-1 and the ability to use a QI do ''not apply to transactions in which the taxpayer receives the replacement property prior to the date on which the taxpayer transfers the relinquished property''); Rev. Proc. 2000-37, section 2.04 (same); TAM 200039005 (May 31, 2000), *Doc 2000-25005, 2000 TNT 191-12* (same). *Cf.* Lewis Carroll, *Through the Looking-Glass* 194 (Bantam Classic 2006) (1871) (''You don't know how to manage Looking-glass cakes,'' the Unicorn remarked. ''Hand it round first, and cut it afterwards.''). Instead, a reverse exchange is better described as a standard forward exchange coupled with an agency relationship (between the taxpayer and EAT) which, because the agency is ignored for federal income tax purposes under the revenue procedure, enables a taxpayer to commence the forward exchange at a later, more convenient time.

[8]Rev. Proc. 2000-37, section 4.02(4).

[9]*See infra* text accompanying notes 14 and 16.

[10]*See* LTR 200718028 (Feb. 5, 2007), *Doc 2007-11078, 2007 TNT 88-30*.

[11]*See* section 1031(a)(3)(A); reg. section 1.1031(k)-1(b).

[12]Also, written identification may be sent to ''any other person involved in the exchange other than the taxpayer or a disqualified person.'' Reg. section 1.1031(k)-1(c)(2)(ii); *see also* reg. section 1.1031(k)-1(k) (defining ''disqualified person'').

[13]*See* reg. section 1.1031(k)-1(b)(2), -1(c)(2). Also, to be treated as like-kind to the relinquished property, replacement property must be received by midnight of the 180th day following disposition of the relinquished property or, if earlier, the due date

(Footnote continued on next page.)

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

may identify more than one replacement property, but the maximum number of identified replacement properties may not exceed three in number (the 3-property rule) or, if they do exceed three, they may not have an aggregate fair market value greater than 200 percent of the value of the relinquished property (the 200-percent rule).[14] The QI typically uses the proceeds from the sale of the relinquished property (escrowed or otherwise) to acquire the replacement property, although exchange treatment depends not on the use of these particular funds but rather on the QI's acquisition and subsequent transfer to the taxpayer of replacement property under an exchange agreement.[15]

Whether or not the 3-property rule or the 200-percent rule is met, the taxpayer may satisfy the identification requirement with respect to replacement property that is actually received during the identification period, because ''any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period'' (the automatic identification rule).[16] Alternatively, a taxpayer may identify any number of replacement properties, as long as the aggregate value of all replacement properties identified during the identification period and received during the exchange period (generally 180 days) equals at least 95 percent of the fair market value of all of the properties identified (the 95-percent rule).[17] A taxpayer may also revoke an identification of replacement property by sending written notice of the revocation to the QI[18] during the 45-day identification period.[19]

Replacement property acquired during the identification period that is identified under the automatic identification rule may ''crowd out'' replacement property that has already been or is later identified by written notice, because *all* identifications of replacement property are taken into account for purposes of the 3-property, 200-percent and 95-percent rules. For example, a taxpayer who receives one replacement property during the 45-day identification period may identify just two additional replacement properties of any value under the 3-property rule, and must take that automatically identified replacement property into account when applying the 200-percent and 95-percent rules.[20]

The possibility of crowding out presents a potential concern in the context of multiple deferred exchanges, when acquiring replacement property for one exchange might seem inadvertently to identify it as replacement property for a different exchange. Suppose, for example, that taxpayer Sally initiates two forward exchanges 120 days apart as follows: (1) relinquish Property A for $40 through a QI on Day -120 (that is, at T minus 120 days);

(including extensions) for the taxpayer's federal income tax return that includes the disposition of the relinquished property. *See* section 1031(a)(3)(B); reg. section 1.1031(k)-1(b)(1)(ii), -1(b)(2), -1(d); *Christensen v. Commissioner*, 142 F.3d 442 (9th Cir. 1998), *Doc 98-13205, 98 TNT 79-15*, *aff'g* T.C. Memo. 1996-254, *Doc 96-16509, 96 TNT 109-21* (180-day period is truncated because taxpayer failed to extend filing deadline for federal income tax return). Additional time for identification and receipt may be available for taxpayers or properties affected by special circumstances, such as some federally declared disasters, terrorist acts, or military actions. *See, e.g.*, section 7508A; reg. section 301.7508A-1(b)(1); Rev. Proc. 2007-56, 2007-2 C.B. 388, *Doc 2007-19104, 2007 TNT 161-6*.

[14]*See* reg. section 1.1031(k)-1(c)(4)(i).

[15]*See* reg. section 1.1002-1(d) (''Ordinarily, to constitute an exchange, the transaction must be a *reciprocal* transfer of property, as distinguished from a transfer of property for a money consideration only.'') (emphasis added); and reg. section 1.1031(k)-1(a) (defining ''deferred exchange'' as ''an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the 'relinquished property') and subsequently receives property to be held either for productive use in a trade or business or for investment (the 'replacement property')''); Rev. Rul. 77-297 (though multiple parties may be involved economically, a formal, reciprocal exchange between two parties is needed for like-kind exchange treatment).

[16]Reg. section 1.1031(k)-1(c)(1). *See also* reg. section 1.1031(k)-1(c)(4)(ii)(A).

[17]*See* reg. section 1.1031(k)-1(c)(4)(ii)(B). The 95-percent rule does not seem to translate usefully into the mirror universe of reverse exchanges: A taxpayer using the 95-percent rule in a reverse exchange would, by definition, be relinquishing identified property of about twice (maybe more) the value of the replacement property that was parked, meaning that the excess value is being exchanged for taxable boot or perhaps, at best, other like-kind replacement property. *See supra* note 1.

(Footnote continued in next column.)

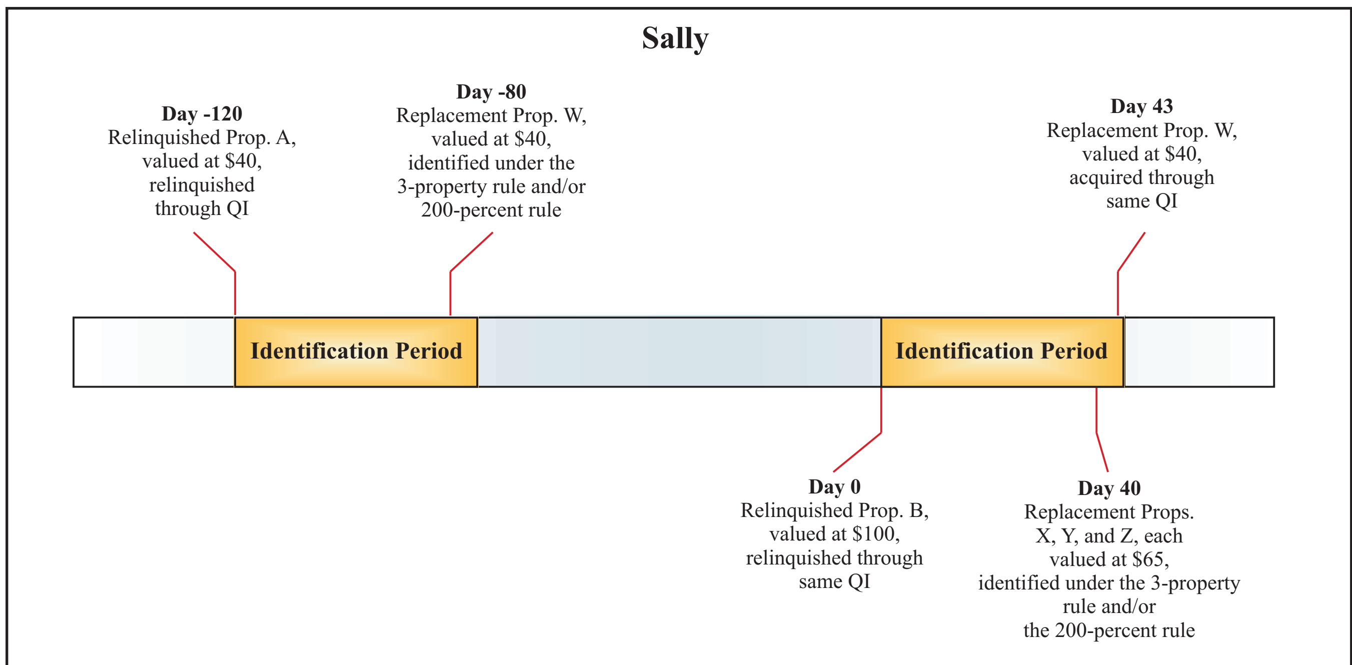
[18]Revocation must be sent ''to the person to whom the identification of the replacement property was sent.'' Reg. section 1.1031(k)-1(c)(6); *see also supra* note 12.

[19]*See* reg. section 1.1031(k)-1(c)(6). The operative provision simply states that ''an identification of replacement property may be revoked at any time before the end of the identification period.'' *Id.* Because of the automatic identification rule's operation ''in all events'' (reg. section 1.1031(k)-1(c)(1)), it is unclear whether a taxpayer may revoke the automatic identification of replacement property received by the taxpayer from the QI during the 45-day identification period. Nevertheless, the better view is that the revocation provision applies to *any* identification of replacement property, including property identified under the automatic identification rule. *See, e.g.*, reg. section 1.1031(k)-1(c)(4)(iii) (conclusion that ''all identifications of replacement property, other than identifications of replacement property that have been revoked . . . are taken into account'' implies that automatic identifications may also be revoked). In particular, the statutory scheme for deferred like-kind exchanges in section 1031(a)(3) provides for time limits on identification, not for automatic presumptions of identification. *Cf.* ILM 200836024 (May 12, 2008), *Doc 2008-18966, 2008 TNT 174-12* (when statutorily prescribed timelines in section 1031(a)(3) are observed, deferred like-kind exchange rules are to be applied liberally).

[20]Reg. section 1.1031(k)-1(c)(4)(iii):

> If, in a deferred exchange, B transfers property X with a fair market value of $100,000 to C and B receives like-kind property Y with a fair market value of $50,000 before the end of the identification period, under paragraph (c)(1) of this section, property Y is treated as [automatically] identified by reason of being received before the end of the identification period. Thus, under paragraph (c)(4)(i) of this section, B may identify either two additional replacement properties of any fair market value or any number of additional replacement properties as long as the aggregate fair market value of the additional replacement properties does not exceed $150,000.

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.



(2) on Day -80 identify Property W, valued at $40, as replacement property for Property A in a written identification under the 3-property rule and/or the 200-percent rule; (3) on Day 0 relinquish Property B for $100 through the same QI; (4) on Day 40 identify Properties X, Y, and Z, each valued at $65 (or a total of $195), as potential replacement properties for Property B, in a written identification under the 3-property rule and/or the 200-percent rule; and (5) on Day 43 acquire Property W for $40 through the same QI.[21] (See chart above.)

In this case, if on Day 43 Property W were automatically identified as replacement property for relinquished Property B simply by virtue of being received during the second identification period, acquiring Property W would crowd out Sally's earlier Day 40 written identification and would prevent that identification from qualifying under the 3-property rule and the 200-percent rule, even if Sally intended to exchange Property B for one or more of Properties X, Y, and Z, and not for Property W.

Sally should take comfort in Treasury's deferred exchange regulations, under which automatic identifications are not as free-floating as the concern expressed above might suggest. Under the regulations, it is "replacement property" (not merely "property") received by the taxpayer that is treated as automatically identified when received during the identification period. In this context, "replacement property that is received by the taxpayer" is properly construed as referring to property actually received in a deferred exchange "pursuant to an agreement."[22] Assuming then that Sally entered into one exchange agreement with her QI under which she relinquished Property A and used its sale proceeds to acquire Property W, and that she entered into another agreement with her QI under which she relinquished Property B and will use its sale proceeds to acquire one or more of Properties X, Y, and Z, Property W will not be treated as "replacement property that is received" vis-à-vis Sally's exchange of Property B, and she will not be treated as having automatically and inadvertently identified Property W as such.[23]

---

[21]The prevailing and better view is that Sally's exchanges of Property A and Property B will be treated as two separate exchanges if her dispositions of these relinquished properties are pursuant to two separate purchase and sale agreements, and particularly if two different, ultimate buyers are involved. *See* Howard J. Levine, 567-4th T.M., *Taxfree Exchanges Under Section 1031* A-25, and authorities cited therein (many of the authorities cited for support are outside section 1031); Foster and Long, *supra* note 4, at sections 6:8, 6:8:50, and authorities cited therein; American Bar Association Section of Taxation, "Comments Concerning Open Issues in Section 1031 Like-Kind Exchanges" (July 14, 1995), *95-7780, and 95 TNT 155-22*; IRS NSAR 010384, 2001 IRS CCA LEXIS 319 (Nov. 26, 2001).

[22]Reg. sections 1.1031(k)-1(a) (defining "replacement property" as received "pursuant to an agreement"), 1.1031(k)-1(c)(1) (providing for automatic identification of "replacement property that is received by the taxpayer" during the identification period).

[23]*See* reg. section 1.1031(k)-1(a) (defining a "deferred exchange" as "an exchange in which, *pursuant to an agreement*, the taxpayer transfers property held for productive use in a trade or business or for investment (the 'relinquished property') and subsequently receives property to be held either for productive use in a trade or business or for investment (the 'replacement property')") (emphasis added). In a typical situation, Sally would have assigned to the QI her agreements to sell Property A and purchase Property W under one certain exchange agreement, but assigned her agreement to sell Property B under a second exchange agreement. *See* reg. section 1.1031(k)-1(g)(4)(v). She would also have arranged for the Property A proceeds to be deposited in a segregated exchange trust account to protect herself in the event of a QI bankruptcy. *See* Bradley T. Borden,

(Footnote continued on next page.)

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

However, if Sally remains concerned that acquiring Property W on Day 43 may inadvertently identify it as replacement property for relinquished Property B,[24] then (assuming that compliance with the 95-percent rule would be impractical) Sally could still avoid any inadvertent crowding out by taking one or more of the following self-help measures:

1. Revoke a necessary and sufficient portion of her Day 40 written identification during the 45-day identification period of the Property B exchange.[25] Revoking the identification of Property Y on Day 44, for example, would enable Sally to satisfy both the 3-property rule and the 200-percent rule — with respect to the remaining identified Properties W, X, and Z — for purposes of identifying replacement property for Property B.[26]

2. Revoke the identification of Property W vis-à-vis the Property B exchange on Day 44 so that the remaining identified Properties X, Y, and Z satisfy either or both of the 3-property rule and the 200-percent rule. There may be some uncertainty, however, as to whether revocation is possible when Property W is treated as automatically identified for the Property B exchange, because it is unclear whether the revocation rule trumps the automatic identification rule.[27]

3. Postpone the closing of the Property W acquisition to Day 50 so that it occurs safely outside the automatic 45-day identification period for Property B. This avoids any risk of crowding out the identification of Properties X, Y, and Z. Note that even at Day 50, the Property W acquisition still occurs during the 180-day replacement property acquisition period for Property A.

4. Use a different QI for the Property B exchange so that all concerns arising from the overlap in timelines for the Property A and Property B exchanges are rendered moot. The transfer of Property W to Sally from the first QI (thereby completing the deferred like-kind exchange for Property A) would not trigger the automatic identification rule vis-à-vis the second QI for Property B, and thus there would be no crowding out of identified replacement Properties X, Y, and Z.[28]

As discussed below, similar issues may arise for taxpayers relying on the Rev. Proc. 2000-37 reverse exchange safe harbor, which requires taxpayers to identify relinquished property in the mirror universe of reverse exchanges in a manner ''consistent with the principles'' for identifying replacement property in forward exchanges.

IV. LTR 200718028

In LTR 200718028, the IRS considered a taxpayer that parked replacement property with an EAT under Rev. Proc. 2000-37, failed to make a timely written identification of relinquished property under the 3-property rule or the 200-percent rule, and then sought a private ruling that it had nonetheless properly identified relinquished property under the automatic identification rule.

Paul L.B. McKenney, and David Shechtman, ''Like-Kind Exchanges and Qualified Intermediaries,'' *Tax Notes*, July 6, 2009, p. 55, *Doc 2009-12868, or 2009 TNT 126-5*; *cf.* Rev. Proc. 2010-14, 2010-12 IRB 456, *Doc 2010-4802, 2010 TNT 44-30* (safe harbor method of reporting gain or loss when QI defaults on its obligation to acquire replacement property and transfer it to taxpayer). Thus, her paper trail and associated flow of funds would typically provide clear evidence that Property W is not ''replacement property that is received'' vis-à-vis Property B.

[24]For example, perhaps Sally's agreements assigning her right to sell Property A and her right to purchase Property W fail to specify that they are under one and the same exchange agreement, and perhaps Sally's QI commingles the proceeds from the sales of Properties A and B. In that case, the paper trail and flow of funds may be inconclusive as to whether Property W is ''replacement property that is received'' vis-à-vis Property A or Property B.

[25]*See* reg. section 1.1031(k)-1(c)(6).

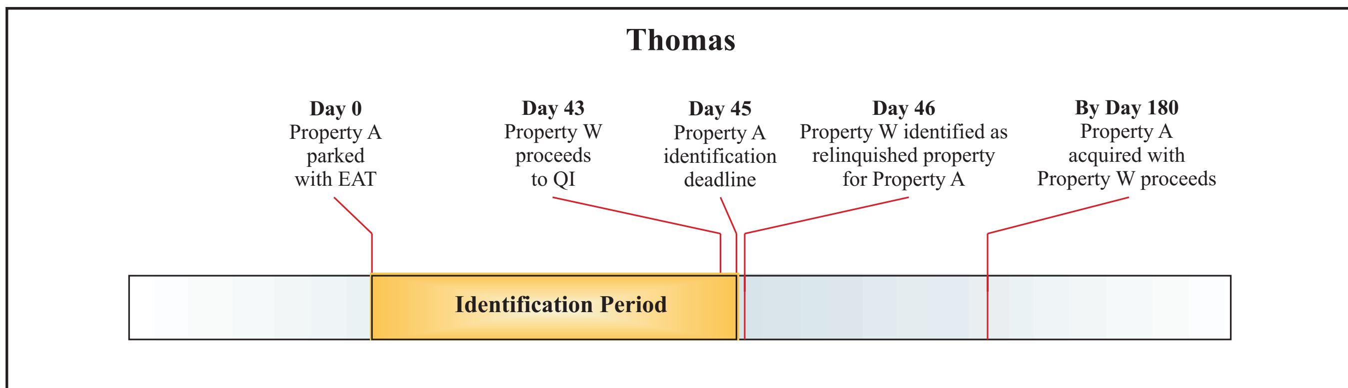
[26]*See* reg. section 1.1031(k)-1(c)(7), Example 6. This proposed solution is not ideal if Property W is treated as like-kind to both Properties A and B, whereas Properties X and Z are like-kind to Property B but not Property A. In other words, Sally still needs a ''maximal'' matching rule — like that found in reg. section 1.1031(j)-1 (which applies to multiple properties within a *single* exchange, but not necessarily more broadly across *multiple* exchanges), or that may be inferred from the holding in *Sayre v. United States*, 163 F. Supp. 495 (S.D. W. Va. 1958) (under segregated approach, farmland matched up with like-kind farmland, and residence matched up with cash and replacement residence) — so as to match up Property W only with Property A, and to match up Property X and/or Z (whichever closes) with Property B. It is unclear whether and to what extent a ''maximal'' matching rule applies to section 1031 exchanges outside the special reg. section 1.1031(j)-1 context. *See, e.g.*, reg. section 1.1031(j)-1(a)(1) (regulations provide an ''exception'' to the ''general rule''); Howard J. Levine, ''New Personal Property and Multi-Asset Exchange Regs. May Increase Taxable Gain,'' 73 *J. Tax'n* 16 (1990) (summarizing the ''matching'' versus ''pro rata'' approaches and the generally confused state of the law before reg. section 1.1031(j)-1); *cf.*, Rev. Rul. 68-55, 1968-1 C.B. 140, *amplified by*, Rev Rul. 85-164, 1985-2 C.B. 117 (each relinquished asset is exchanged for a pro rata piece of each of the assets received).

[27]*See supra* note 19.

[28]*See supra* notes 15, and 22-24. If her business plans allow flexibility, perhaps Sally should simply avoid crossing two exchange timelines. *Cf. Ghost Busters* (1984), when Dr. Spengler warns Dr. Venkman that crossing proton streams is bad:

Dr. Egon Spengler: There's something very important I forgot to tell you.
Dr. Peter Venkman: What?
Dr. Egon Spengler: Don't cross the streams.
Dr. Peter Venkman: Why?
Dr. Egon Spengler: It would be bad.
Dr. Peter Venkman: I'm a little fuzzy on the whole ''good/bad'' thing here. What do you mean, ''bad''?
Dr. Egon Spengler: Try to imagine all life as you know it stopping instantaneously and every molecule in your body exploding at the speed of light.
Dr. Ray Stantz: Total protonic reversal!
Dr. Peter Venkman: That's bad. Okay. All right, important safety tip. Thanks, Egon.

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.



The taxpayer — call him Thomas — had parked replacement property (Property A) with an EAT on Day 0. Two days before the 45-day deadline for identifying relinquished property, Thomas disposed of relinquished property (Property W) through a QI that held the sale proceeds in an exchange trust account intended to enable Thomas to exchange Property W for Property A within the 180-day exchange deadline for Property A. Then on Day 46, one day after the 45-day identification deadline for Property A, Thomas sent a signed notice to the EAT identifying Property W as relinquished property for Property A. On or before Day 180, Thomas acquired Property A using proceeds held in the exchange trust account from the sale of Property W.[29] (See chart above.)

In concluding that Property W was automatically identified as relinquished property for parked Property A, the IRS reasoned that just as ''any replacement property received within the 45-day identification period is treated as identified within the identification period'' in a forward exchange, so too ''relinquishing property through a QI before the expiration of 45 days from the date that replacement property is parked, satisfies [the reverse] identification requirement.''[30]

LTR 200718028 is initially surprising in at least two ways. First, in the forward exchange context, automatic identification occurs only when the taxpayer receives the replacement property during the applicable identification period — that is, a taxpayer who had previously relinquished property through a QI actually *completes* a deferred exchange by acquiring replacement property from the QI during the identification period. But the automatic identification in LTR 200718028 is different: A taxpayer who had previously parked property with an EAT merely relinquished property through a QI without actually *completing* an exchange during the identification period.[31] Second, while it is common market practice in reverse like-kind exchanges to use a QI affiliated with the EAT (or in fact to use the EAT as the QI), Rev. Proc. 2000-37 in theory permits the use of an EAT that is unaffiliated with the QI. Significantly, LTR 200718028 nowhere predicates the automatic identification of relinquished property on the EAT being, or being affiliated with, the QI; thus, based on a literal and overbroad reading, automatic identification could occur with respect to property parked with an EAT when, without the

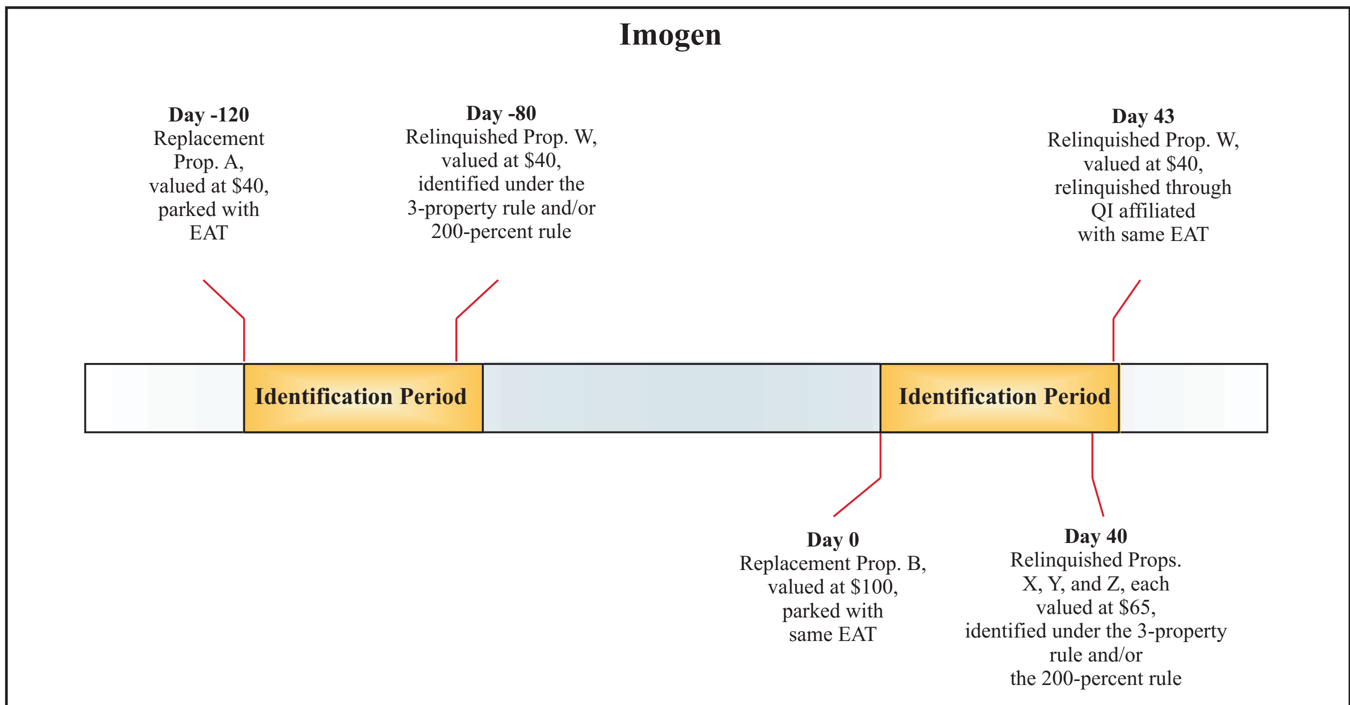
---

[29]Although LTR 200718028 is silent on this point, Thomas presumably identified Property A as replacement property for Property W.

[30]LTR 200718028. The reference to ''before the expiration of 45 days'' must mean ''within the 45-day identification period'' and thus it excludes days before the identification period commenced. Symmetry with the automatic identification of replacement property in forward exchanges, which must occur during the 45-day identification period, justifies treating the length of the reverse identification period as 45 days rather than a longer period. *See, e.g.*, reg. sections 1.1031(k)-1(b)(1)(i) and 1.1031(k)-1(c)(1) (automatic identification in a forward exchange must occur ''*before* the end of the identification period'') (emphasis added); reg. sections 1.1031(k)-1(a) and 1.1031(k)-1(b)(2)(i) (in a forward exchange, replacement property must be received after disposing of relinquished property, and the identification period commences on the disposition of the relinquished property). Also, the potential crowding-out problem in the mirror universe of reverse exchanges, discussed below, would be more acute if any property relinquished through a QI at any time before the 45-day deadline — including relinquishments before the parking of replacement property — were automatically identified as relinquished property.

[31]Automatic identification in the forward exchange context is a sensible result: Formal identification becomes superfluous because the actual exchange is *completed* within the timeline prescribed by section 1031(a)(3), and both the taxpayer and the QI know this. One might therefore have expected the automatic identification of relinquished property in the mirror universe of reverse exchanges to require a taxpayer to relinquish property through a QI in exchange for EAT-parked property that the taxpayer actually receives through the QI during the reverse identification period. As an alternative to that automatic identification, taxpayers who need additional time to ''unpark'' their replacement property could simply notify the EAT in writing of their choice of relinquished properties during the reverse identification period. In either case, the practical effect would parallel the effect of an automatic identification or a written identification in the forward exchange context: Either the identification would be automatic, because the exchange of properties would be *completed* within the applicable timeline, or the identification would be binding, because the taxpayer would evidence its choice of relinquished properties in a written notice to the EAT during the identification period. One could thus construct a sensible, symmetric reverse exchange identification regime on the premise that automatic identification requires a *completed* exchange during the reverse identification period; but this is not the premise adopted in LTR 200718028.

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.



EAT's knowledge, qualifying property is relinquished during the applicable 45-day identification period through an unaffiliated QI.[32]

These two points are analyzed in more detail below by examining the conclusion of LTR 200718028 through the following prism: Does the automatic identification rule articulated in that private letter ruling produce symmetry with automatic identification in the forward exchange context, as required by Rev. Proc. 2000-37's mandate that identification be made in a manner "consistent with the principles" governing forward exchange identifications?[33]

V. Crowding Out in Reverse Exchanges

In the mirror universe of reverse exchanges, the crowding-out phenomenon should, in theory, present itself in symmetrical fashion to the corresponding phenomenon in the forward exchange context. That is, one would expect analysis of the mirror image of Sally's forward exchanges discussed above to yield comparable results. Suppose that Sally's sister, Imogen, decides to mirror Sally's efforts by initiating two reverse exchanges 120 days apart, as follows: (1) on Day -120 park replacement Property A, valued at $40, with an EAT; (2) on Day -80 identify Property W, valued at $40, as relinquished property for Property A in a written identification under the 3-property rule and/or the 200-percent rule; (3) on Day 0 park replacement Property B, valued at $100, with the same EAT; (4) on Day 40 identify Properties X, Y, and Z, each valued at $65 (or a total of $195), as potential relinquished properties for Property B in a written identification under the 3-property rule and/or the 200-percent rule; and (5) on Day 43 relinquish Property W for $40 through a QI affiliated with the same EAT.[34] (See chart above.)

In this case, if on Day 43 Property W were automatically identified as relinquished property for replacement Property B simply by virtue of being relinquished through an affiliated QI during the second identification

[32]More precisely, relinquishing property through a QI during the 45-day identification period does not necessarily notify the EAT of the taxpayer's choice of relinquished properties vis-à-vis the parked property, particularly if the EAT is unaffiliated with the QI. *See, e.g.*, Alex H. Hamrick, *Advanced 1031 Real Estate Exchanges 2007*, National Business Institute, 38714 NBI-CLE 221 (2007) (discussing LTR 200718028 and noting that, in contrast to the forward exchange context in which by definition the QI knows it is conveying replacement property to the taxpayer, "with a reverse exchange, the taxpayer can [relinquish] property using a qualified intermediary (distinct from the EAT) without the EAT's knowledge or assistance."); Howard J. Levine, "Significant Recent Developments in Like-Kind Exchanges," 51 *Tax Mgmt. Memo.* 59 (Feb. 15, 2010) ("*Query:* A taxpayer could have multiple exchanges and [parking agreements] going on at the same time with multiple properties. Why should the fact that a relinquished property is sold mean that it necessarily ties in to a certain [parking] agreement?").

[33]Rev. Proc. 2000-37, section 4.02(4).

[34]The better reading of LTR 200718028 is that relinquishing property through a QI automatically identifies the relinquished property as such *only if* the QI is, or is affiliated with, the EAT that holds the replacement property for which it will be exchanged. It is commercial practice for taxpayers to use a QI affiliated with their EAT, and these were almost certainly the circumstances in LTR 200718028. As demonstrated below, limiting automatic identifications to such circumstances also has the virtue of enhancing symmetry with forward exchanges. *See supra* note 32 and accompanying text.

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

period (as LTR 200718028 suggests it might), relinquishing Property W would crowd out Imogen's earlier Day 40 written identification and would prevent that identification from qualifying under the 3-property rule and the 200-percent rule, even if Imogen intended to exchange Property W for Property A, not Property B. Concerns about crowding out may thus arise in essentially the same manner for Imogen's reverse exchange as they do for Sally's forward exchange.

As long as Imogen relinquishes Property W under an agreement that contemplates exchanging it for Property A, however, she should not be treated as having automatically and inadvertently identified Property W as relinquished property for Property B. After all, the mirror image of the rule for identifying replacement property would seem to be that relinquished property is treated as automatically identified when disposed of during the identification period, and in this context, "relinquished property that is disposed of by the taxpayer" should be construed as referring to property that is actually relinquished in a deferred exchange "pursuant to an agreement."[35] Assuming then that Imogen entered into one exchange agreement under which she has relinquished Property W and will use its sale proceeds to acquire Property A, Property W should not be treated as "relinquished property that is disposed of" vis-à-vis Imogen's exchange for Property B, and Imogen should not be treated as having automatically and inadvertently identified Property W as such.

However, if Imogen remains concerned that relinquishing Property W on Day 43 might inadvertently identify it as relinquished property for Property B,[36] she could avoid any inadvertent crowding out by taking one or more of the self-help measures analyzed in the forward exchange context, which apply symmetrically (ambiguities and all) in the mirror universe of reverse exchanges. Imogen's potential solutions are thus as follows:

1. Revoke a necessary and sufficient portion of her Day 40 written identification during the 45-day identification period of the Property B parking arrangement. Revoking the identification of Property Y on Day 44, for example, would resolve the crowding-out problem.[37]

2. Revoke the identification of Property W vis-à-vis the Property B parking arrangement on Day 44 so that the remaining identified Properties X, Y, and Z satisfy either or both of the 3-property rule and the 200-percent rule. As in the forward exchange context, it is unclear whether such a revocation is possible when Property W is treated as automatically identified for purposes of the Property B parking arrangement.[38]

3. Postpone the closing of the Property W disposition to Day 50 so that it occurs safely outside the automatic 45-day identification period for Property B. Note that as with the forward exchange, this avoids crowding out the identification of Properties X, Y, and Z for parked Property B, but the disposition still occurs during the 180-day exchange period for Property A.

4. Use a different EAT for the Property B parking arrangement to address all concerns arising from the overlap in timelines for the Property A and Property B parking arrangements.[39]

As these alternatives illustrate, the automatic identification principle expressed in LTR 200718028 produces practical symmetry between the identification rules for forward and reverse exchanges, all as required by Rev. Proc. 2000-37.

VI. Holding Up a Mirror to the Mirror

To investigate and test for additional symmetries,[40] now hold up a mirror to the mirror universe of reverse like-kind exchanges in which Thomas, as described in LTR 200718028, automatically identified relinquished property by initiating a forward exchange (relinquishing property through an affiliated QI) during his reverse exchange identification period.[41] Does symmetry compel the conclusion that initiating a reverse exchange (parking property with an affiliated EAT) during a forward exchange identification period automatically identifies the parked property as replacement property? Consider the following example, in which taxpayer Aliya initiates a reverse exchange during her forward identification period. (See chart on next page.)

In this example, does Aliya's parking Property S with the affiliated EAT constitute an automatic identification vis-à-vis her exchange of Property J, thus potentially crowding out her subsequent identification of Properties

---

[35]*See* reg. sections 1.1031(k)-1(a)(1) and 1.1031(k)-1(c)(1); Rev. Proc. 2000-37, section 4.02(4) ("Identification must be made in a manner consistent with the principles described in section 1.1031(k)-1(c)."); *supra* text accompanying notes 21-23.

[36]For example, Imogen might be concerned about inadvertent identification if her agreements assigning her right to sell Property W and her right to purchase Property A fail to specify that they are under one and the same exchange agreement. *See supra* note 24.

[37]As with the forward exchange, this solution is not ideal if Properties A and B are like-kind with Property W, whereas Properties X and Z are like-kind with Property B but not Property A. *See supra* note 26.

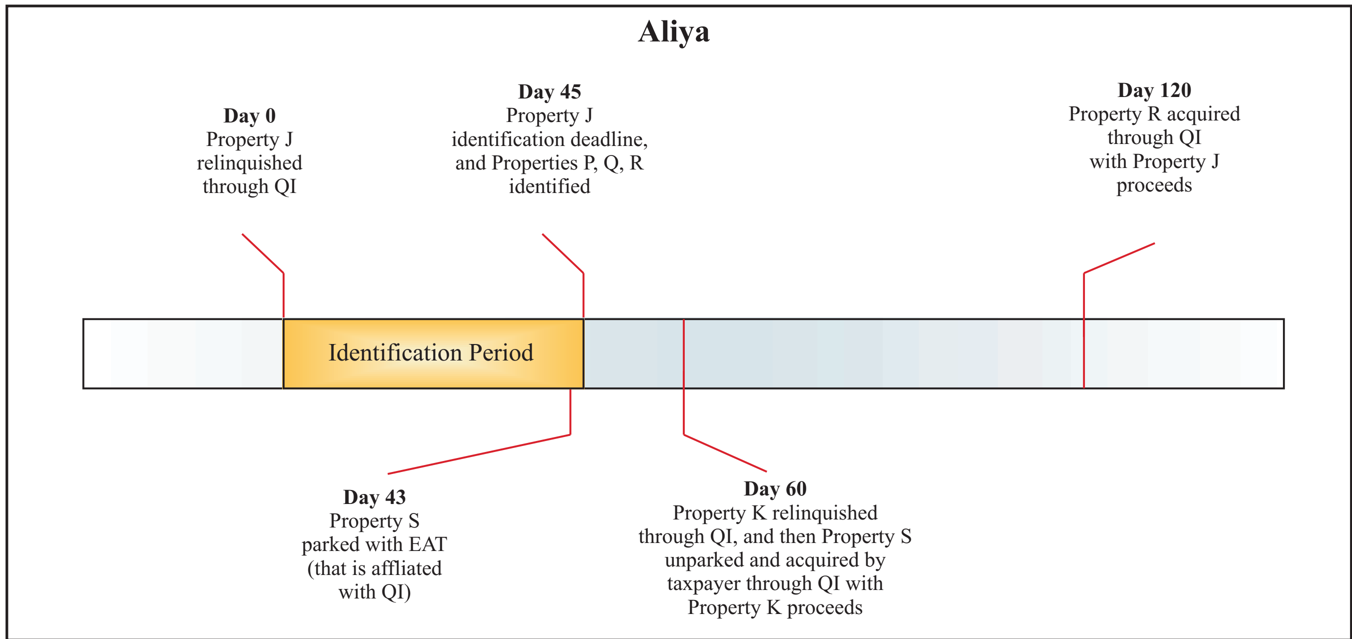
[38]*See supra* notes 19 and 27 and accompanying text.

[39]Again, LTR 200718028 is best read as permitting the automatic identification of relinquished property only if it is disposed of through a QI that is, or is affiliated with, the EAT with which replacement property has been parked. *See supra* notes 28, and 32-35.

[40]Symmetry is a very powerful tool in mathematics and physics and can often lead to discovery of new relationships and a deeper understanding of existing relationships. *See generally* Ian Stewart, *Concepts of Modern Mathematics* 95-112 (1995); Marcus Du Sautoy, *Symmetry: A Journey Into the Patterns of Nature* (2008).

[41]*See supra* text accompanying note 29. *Cf.*, Carroll, *supra* note 7, at 123 (while exploring the mirror universe, Alice at first cannot read the Jabberwocky poem, but then concludes correctly that "if I hold it up to a glass [mirror], the words will all go the right way again.").

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.



P, Q, and R?[42] To so conclude would be contrary to a plain reading of reg. section 1.1031(k)-1(c)(1), which requires that Aliya actually receive replacement property in order for it to be automatically identified as such. In fact, Aliya's parking arrangement with the EAT is the very antithesis of actually acquiring replacement property because, for federal income tax purposes, she does not beneficially own the parked property.[43] Thus, the only sensible conclusion is that commencing a reverse exchange with an EAT during a forward identification period with an affiliated QI does *not* result in automatic identification for the forward exchange.

The question is, why does the symmetry break down between these two apparently mirror-image fact patterns, such that Thomas is able to identify relinquished property by relinquishing it through an affiliated QI, but Aliya does not (and cannot) identify replacement property by parking it with an affiliated EAT? This difference reflects a fundamental asymmetry between forward and reverse exchanges: Whereas a forward exchange identification period commences on the disposition of relinquished property (that is, when the first of the two legs of a deferred exchange occurs), a reverse exchange identification period commences when a taxpayer parks replacement property with an EAT without actually acquiring that property for federal income tax purposes (that is, without commencing either the acquisition or the disposition leg of a deferred exchange). In other words, the breakdown in symmetry results from Rev. Proc. 2000-37's overlay of symmetric identification rules atop asymmetric transaction paradigms for forward and reverse exchanges.[44]

In terms of our examples, Aliya's 45-day identification period for her forward exchange starts when she initiates an actual exchange by relinquishing property, and she meets her deadline by taking the next logical step of identifying replacement property in writing or actually closing her deferred exchange by receiving replacement property. In the mirror universe of reverse exchanges under Rev. Proc. 2000-37, by contrast, Thomas's 45-day identification period for his reverse exchange starts when he parks property with an EAT (without actually initiating a deferred exchange), and he meets his deadline by taking the next logical step of identifying relinquished property in writing or actually initiating a deferred exchange (but apparently without actually closing that deferred exchange).[45] Thomas's parking of replacement

[42]If Aliya definitely intended to match Property S with her prior disposition of Property J, she would likely have dispensed with the EAT and simply taken title and ownership of Property S through her QI on Day 43, in which case the automatic identification rule for forward exchanges would appropriately apply. Instead, Aliya intends to match parked Property S with Property K, or perhaps she simply desires to keep her options open. Automatic identification in those circumstances would inappropriately and unnecessarily force Aliya to consider the several self-help measures developed by Sally. *See supra* text accompanying notes 25-28.

[43]*See* Rev. Proc. 2000-37, sections 2.06 and 4.02(3).

[44]As noted above, a safe harbor "reverse" exchange under Rev. Proc. 2000-37 is not simply a reordered forward exchange, but rather a forward exchange coupled with a disregarded agency. *See supra* note 7.

[45]Parking replacement property with an EAT commences the 45-day reverse exchange identification period, even though it is not an acquisition of replacement property for federal income tax purposes, *e.g.*, the taxpayer is not entitled to depreciation on the parked replacement property. *See* Rev. Proc. 2000-37, section 4.02(3) (requiring the taxpayer and the EAT to report the federal income tax attributes of the parked property on their federal income tax returns in a manner consistent with treating the EAT as "the beneficial owner of the property for all federal income tax purposes"). In contrast, the disposition of relinquished property that commences the forward exchange identification

(Footnote continued on next page.)

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

property is thus tantamount to acquiring it for purposes of starting his 45-day identification period. But when holding up a mirror to Thomas's reverse exchange, one should not expect that Aliya's parking of replacement property will be tantamount to acquiring it for purposes of effecting an automatic identification, much less completing her deferred forward exchange.

VII. Conclusion

Mirrors reflect their subjects. LTR 200718028 mirrors the deferred exchange regulations and reaches a conclusion that is, as best interpreted, based in Rev. Proc. 2000-37's mandate to identify relinquished property in accordance with the principles for identifying replacement property in forward exchanges. While certainly favorable to the taxpayer it addressed, the private letter ruling may suggest that taxpayers engaged in multiple, concurrent reverse exchanges could inadvertently identify relinquished property for an unintended transaction. Careful analysis of forward and reverse exchanges indicates that inadvertent identification is far less likely than LTR 200718028 might initially suggest, and in any event this article suggests several possible means to alleviate any crowding-out risk that might possibly arise.

A principal insight from this analysis is that forward and reverse exchanges are not true mirror images of each other. Whereas an automatic identification in the forward exchange universe closes a deferred exchange within 45 days of initiating one, an automatic identification in the reverse exchange universe merely initiates a deferred exchange within 45 days of initiating a parking arrangement. That is, parking replacement property in a reverse exchange is tantamount to acquiring it for the limited purpose of starting the reverse exchange identification period, even though no acquisition occurs for federal income tax purposes, and most tellingly, even though parking property is not treated as acquiring it when parking arrangements are analyzed in the forward exchange universe.

Adopting the identification rules used in forward exchanges while operating in reverse thus creates small but interesting anomalies, at least initially. For as Lewis Carroll's White Queen sagely observed, "That's the effect of living backwards . . . it always makes one a little giddy at first."[46]

---

period *is* a disposition for federal income tax purposes, and the taxpayer may no longer depreciate the property it has relinquished. *See* reg. section 1.168(i)-6(c)(5)(iv)(A) (providing that "depreciation is not allowable during the period between the disposition of the relinquished MACRS property and the acquisition of the replacement MACRS property."); T.D. 9314, 2007-1 C.B. 845, 846, *Doc 2007-4997, 2007 TNT 39-12* ("the IRS and Treasury Department believe that a taxpayer cannot depreciate property the taxpayer does not own."). Similarly, according to LTR 200718028, replacement property parked with an EAT is paired up with a later disposition of relinquished property through an affiliated QI so as to result in an automatic identification, even though parking the replacement property is not an acquisition that can be automatically matched up with the later relinquished property disposition so as to constitute a completed deferred exchange.

[46]Carroll, *supra* note 7, at 164.

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.