

# NEW DEVELOPMENTS IN THE WORLD OF REVERSE LIKE-KIND EXCHANGES

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## Tags

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Recently, the N.Y.S. Department of Taxation and Finance (the “Department”) issued a taxpayer-friendly advisory opinion (the “Advisory Opinion”)<sup>1</sup> in a reverse like-kind exchange. Under the like-kind exchange rules, a taxpayer disposes of a relinquished property before acquiring a replacement property. In a reverse like-kind exchange, a taxpayer first acquires the replacement property, generally, by using an Exchange Accommodation Titleholder (“E.A.T.”) to allow the like-kind exchange under Code §1031 to proceed in the correct order. Additional information regarding the Federal requirements for a reverse like-kind exchange can be found in the October 2016 edition of *Insights*.<sup>2</sup>

In the Advisory Opinion, the Department addressed whether a conveyance of real property from an E.A.T. to a taxpayer as part of a reverse like-kind exchange is subject to Real Estate Transfer Tax (“R.E.T.T.”). The Advisory Opinion was requested by the E.A.T. in question, who was an independent agent facilitating the reverse like-kind exchange.

The following article outlines the steps taken in a typical reverse exchange and examines the application of R.E.T.T. with respect to the various conveyances of property.

## STEPS IN A REVERSE LIKE-KIND EXCHANGE

### The Replacement Property

1. A taxpayer (the “Exchangor”) and the E.A.T. first enter into an accommodation agreement to effectuate a reverse exchange. Pursuant to the agreement the E.A.T. is acting as the Exchangor’s agent for all purposes, except for Federal and, as appropriate, state income tax purposes.
2. The Exchangor contracts to buy the replacement property and assigns its rights under the contract to the E.A.T.
3. The E.A.T. then closes on the property and acquires the legal title directly or through a disregarded entity such as a single-member limited liability company.
4. R.E.T.T. is paid on the conveyance of the replacement property to the E.A.T.

The E.A.T. acquires the legal title with the funds provided by the Exchangor (the “Loan”). The E.A.T. is not required to advance or expend any of its own funds.

<sup>1</sup> N.Y.S. Department of Taxation & Finance, Advisory Op. No. TSB-A-16(2)R.

<sup>2</sup> Nina Krauthamer and Rusudan Shervashidze, “Estate of Bartell Offers Taxpayers Relief in a Reverse Deferred §1031 Exchange,” *Insights* 9 (2016).

Under the accommodation agreement, the E.A.T. will act as an agent, will be reimbursed for all its costs associated with the replacement property, and will receive fees for the services provided.

In order to keep the E.A.T. economically neutral with respect to the replacement property during the so-called Parking Period, the E.A.T., as fee owner, will execute a master triple-net lease of the property to the Exchangor as master lessee (the "Lease Agreement"). The income and expenses reported by the E.A.T. during the Parking Period are designed to be a wash. Under the Lease Agreement, the amount of the rent due from the Exchangor is set equal to the outstanding monthly interest obligation of the E.A.T. under the Loan. Therefore, for Federal income tax purposes, the E.A.T. would report rental income and claim a matching deduction for interest paid to the Exchangor under the Loan.

### **The Relinquished Property**

1. The Exchangor enters into a purchase and sale contract for the relinquished property with a purchaser.
2. Pursuant to an "exchange agreement," the Exchangor assigns its rights (but not its obligations) in the purchase and sale contract for the relinquished property to the Qualified Intermediary ("Q.I."). Under the purchase and sale contract, the Q.I.'s rights for the relinquished property are subject to the right of the purchaser to acquire the relinquished property.
3. At the Q.I.'s direction, the Exchangor transfers the relinquished property directly to the purchaser.
4. R.E.T.T. is paid on the conveyance of the relinquished property to the purchaser.
5. The Q.I. places the proceeds of the sale in a trust account for the benefit of the Exchangor (referenced below as the "trust account").

### **The Exchange**

Through the Q.I., the Exchangor has effectuated selling the relinquished property to the purchaser. Next, the E.A.T. will purchase the replacement property with funds supplied by the Exchangor as one or more nonrecourse loans. The loans will consist of funds advanced by the Exchangor, including loans provided by one or more third-party lenders arranged by the Exchangor and secured by the replacement property. The E.A.T. will not be expected to pay any costs directly unless the Exchangor has provided the funds to the E.A.T. in advance.

The Exchangor then assigns its rights for the replacement property to the Q.I. under a Qualified Exchange Accommodation Arrangement ("Q.E.A.A."). Alternatively, the Exchangor contracts to purchase from the E.A.T. (i) the replacement property or (ii) the ownership interest in the disregarded entity of the E.A.T. that holds the title to the replacement property. Then, the Exchangor assigns its rights to acquire the replacement property under such contract to the Q.I.

Under either scenario, the Q.I. buys the replacement property from the E.A.T. with the funds from the trust account and the E.A.T. transfers the replacement property directly to the Exchangor. The E.A.T. repays the Exchangor any portion of the loans

not funded by third-party lenders, and any mortgage is either extinguished or transferred along with the replacement property.

## APPLICATION OF R.E.T.T. UNDER N.Y. TAX LAW §1402

N.Y. imposes R.E.T.T. on the conveyance of real property, or an interest therein, when the consideration exceeds \$500. The consideration for the interest conveyed excludes the value of any lien or encumbrance remaining thereon at the time of conveyance.<sup>3</sup> “Conveyance” means the transfer(s) of any interest in real property by any method, including, but not limited to, sale, exchange, assignment, surrender, mortgage foreclosure, transfer in lieu of foreclosure, option, trust indenture, taking by eminent domain, conveyance upon liquidation or by a receiver, or transfer or acquisition of a controlling interest in any entity with an interest in real property.<sup>4</sup> Furthermore, an “interest in the real property” includes title in fee; a leasehold interest; a beneficial interest; an encumbrance; development rights; air space and air rights; or any other interest with the right to use or occupancy of real property or the right to receive rents, profits, or other income derived from real property. This includes an option or contract to purchase real property.

However, R.E.T.T. does not apply to conveyances of real property without consideration nor otherwise than in connection with a sale, including conveyances of real property as *bona fide* gifts.<sup>5</sup> “Consideration” means the price actually paid or required to be paid for the real property or interest therein, including payment for an option or contract to purchase real property, whether or not expressed in the deed and whether paid or required to be paid by money, property, or any other thing of value. It includes the cancellation or discharge of an indebtedness or obligation. It also includes the amount of any mortgage, purchase money mortgage, lien, or other encumbrance, whether or not the underlying indebtedness is assumed or taken subject to.<sup>6</sup>

As a Federal income tax matter, the Exchangor is considered to have exchanged the relinquished property for the replacement property, although the E.A.T. acquired the replacement property on the Exchangor’s behalf prior to the sale of the relinquished property. The question raised in the Advisory Opinion was whether R.E.T.T. applied under N.Y. Tax Law §1402 to the transfer by the E.A.T. to the Exchangor of the replacement property.

In the Advisory Opinion, the Department<sup>7</sup> stated that there are only two conveyances that must be considered when dealing with a reverse like-kind exchange for the purposes of R.E.T.T.:

- The sale of the replacement property to the E.A.T. that obtains legal title directly or acquires the title indirectly through its ownership of its disregarded entity

<sup>3</sup> N.Y. Tax Law §1402.

<sup>4</sup> N.Y. Tax Law §1401(e).

<sup>5</sup> N.Y. Tax Law §1401(f).

<sup>6</sup> N.Y. Tax Law §1405(b)(4).

<sup>7</sup> N.Y. Tax Law §1401(d).



- The transfer of the relinquished property from the Q.I. to the purchaser

The sole purpose of the intermediate conveyances to the E.A.T. and the Q.I. is to conform the timing of the transfer of the relinquished property to the buyer, and of the acquisition of the replacement property by the Exchangor, to the structure required for a like-kind exchange under Code §1031.

Furthermore, the Department pointed out that during the reverse like-kind exchange the E.A.T. does not use any of its own funds to pay for the acquisitions of the properties, nor does it hold any responsibilities with regard to maintenance of the property. The E.A.T. is paid only its fees for services, and except for the limited responsibilities to pay income tax on those fees, it is held harmless in all other respects. If, after acquisition of the replacement property, the E.A.T. leases the property to the Exchangor prior to the conclusion of the exchange, the Exchangor's rent paid to the E.A.T. would equal any payment made by the E.A.T. on a mortgage that secures a loan for the purchase price. Thus, the E.A.T. remains economically neutral under the terms of the Q.E.A.A. The E.A.T. does not report gain or loss from the purchase or sale of the properties because the E.A.T. is serving as the agent or nominee for the Exchangor. No consideration is provided for the conveyance from the E.A.T. to the Exchangor. As such, the Department concluded that this conveyance is exempt from R.E.T.T. under N.Y. Tax Law §1405(b)(4).<sup>8</sup>

*“There are only two conveyances that must be considered when dealing with a reverse like-kind exchange for the purposes of R.E.T.T.”*

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<sup>8</sup> Advisory Op. No. TSB-A-16(2)R.