

# **SECTION 1031 UPDATE: INTERPLAY WITH RESIDENCE GAIN EXCLUSION AND REVERSE EXCHANGES**

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California Society of Tax Consultants

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Program Outline

## **SECTION 1031 UPDATE: INTERPLAY WITH RESIDENCE GAIN EXCLUSION AND REVERSE EXCHANGES**

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### **I. INTERACTION OF SECTION 121 AND SECTION 1031**

Introduction. The IRS recently issued guidance on the application of Section 121 and Section 1031 to a single exchange of property. The guidance is in the form of a “revenue procedure” that is provided for “administrative convenience,” rather than as a revenue ruling interpreting substantive law. This may be because neither Section 121 nor Section 1031(d) expressly address the issue of a basis increase in replacement property for gain excluded under Section 121. Most importantly, Rev. Proc. 2005-14 clarifies that gain realized by a taxpayer in a qualifying like-kind exchange of a home that is held by the taxpayer for use in its trade or business or for investment (e.g., as a rental property) at the time of the exchange, and was previously used as the taxpayer’s principal residence for at least two years during the preceding five years, may qualify first for the exclusion under Section 121 (up to \$250,000 or \$500,000 for certain joint returns), and then the balance of the gain may qualify for non-recognition treatment under Section 1031 and be deferred. Rev. Proc. 2005-14 also provides rules for mixed-use property where part of the property is used as the taxpayer’s residence and part of the property is held for business or investment purposes at the time of the exchange.

The Rev. Proc. confirms that Section 121 and Section 1031 are complementary and not mutually exclusive provisions. Both Section 121 and Section 1031 may apply when a principal residence is converted to investment property and exchanged within the 5-year period of Section 121. The Rev. Proc. adopts the favorable tax treatment predicted in our seminal article on this issue. See Phillips & Rocca, “The Interplay Between Section 121 and Section 1031: How to Sell and Exchange Real Estate and Never Pay Income Tax,” National Real Estate Development Center (April 16, 1998) (which is available on our web site under “Publications”). See also Weller and Phillips, “What’s New in Like-Kind Exchange,” 57<sup>th</sup> Institute on Federal Taxation, New York University (1999) at §14.04; Jason M. Kuratnick, “Mixed-Use Residence Exchanges: Deferral

Plus Exclusion in One Bowl,” 43 Tax Practice No. 11 (September 10, 2004).

Under Section 121(a), a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer’s principal residence for at least two years during the five-year period ending on the date of the sale or exchange. A taxpayer may exclude gain under Section 121 only once every two years. Section 121(b) provides generally that the amount of the exclusion is limited to \$250,000. A partial exclusion of gain may also be available to certain taxpayers under Section 121(c) if a sale or exchange is attributable to a change in place of employment, health or, to the extent provided in regulations, unforeseen circumstances. See Reg. 1.121-3T.

Joint taxpayers are eligible for a \$500,000 exclusion if the following three requirements are met:

- Either spouse meets the ownership requirements during the applicable two-year period.
- Both spouses meet the use requirements with respect to the property during the applicable two-year period.
- Neither spouse is ineligible for the exclusion by virtue of a sale or exchange of a principal residence within the preceding two years.

In addition, the \$250,000 exclusion is available when a husband and wife file a joint return if either spouse meets the statutory ownership and use requirements with respect to the property. That is, each spouse is entitled to the full \$250,000 exclusion with respect to property as to which he or she separately satisfied the use and ownership requirements. For this purpose, each spouse is treated as owning the property during the period in which either spouse owned the property.

Under Section 1031 no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (the “relinquished property”) if the property is exchanged solely for property of like kind (the “replacement property”) that is to be held either for productive use in a trade or business or for investment. Neither Section 121 nor Section 1031 address the application of both provisions to a single exchange of property. The exclusion of gain under Section 121 does not require a taxpayer to buy a replacement residence, whereas gain deferral under Section 1031 does require investment in replacement property. The question is whether and how the gain exclusion under Section 121 should apply to a residence converted to investment property and exchanged under Section 1031. Rev. Proc. 2005-14 adopts the complementary approach that is most favorable to taxpayers: first applying the gain exclusion under Section 121 (including an increased basis to the extent that boot is not received), and then allowing the remaining gain to be deferred under Section 1031.

Rev. Proc. 2005-14. The new revenue procedure applies to taxpayers who exchange a single property. The taxpayer must satisfy the requirements for both the exclusion of gain from the exchange of a principal residence under Section 121 and the deferral of gain on the exchange of like-kind properties under Section 1031. Further, the revenue procedure applies only to taxpayers who satisfy the requirement of Section 1031(a)(1) that the property be “held” for productive use in a trade or business or for investment at the time of the exchange. Under Rev.

Proc. 2005-14, Section 121 must be applied to gain realized before Section 1031. In addition, under Section 121(d)(6), the Section 121 exclusion does not apply to gain attributable to depreciation deductions for periods after 5/6/97 that are claimed with regard to the business or investment portion of a residence. Section 1031, may apply, however, to defer the recognition of gain attributable to such depreciation deductions.

In applying Section 1031, cash or other non-like kind property (boot) received in exchange for relinquished property is taken into account only to the extent the boot exceeds the gain excluded under Section 121 with regard to the relinquished property. Thus, the taxpayer may receive boot in the exchange up to the maximum amount of the exclusion (\$250,000 or \$500,000 for certain joint returns). Section 1031(b) applies to cause recognition of gain due to the receipt of boot only to the extent that the boot exceeds the amount of excluded gain under Section 121. Further, in determining the basis of the property received in the exchange to be used for the replacement property, any gain excluded under Section 121 is treated as gain recognized by the taxpayer. Thus, under Section 1031(d), the basis of the replacement property is increased by any gain attributable to the relinquished property that is excluded under Section 121. The net increase to basis will be reduced, however, to the extent that the gain exclusion is applied to boot received in the exchange.

Under the revenue procedure, a taxpayer who uses a portion of a property both as a residence and as a business property is treated as using the entire property as his or her principal residence for purposes of satisfying the two-year use requirement, but only if the residential and business portions of the property are within the same dwelling unit. Section 280A(f) is referenced under Reg. 1.121-1(e)(2) and defines the term “dwelling unit” to include a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling. If the business portion of the property is separate from the dwelling unit used as a principal residence, any gain allocable to the business portion is not excludable unless the taxpayer has also met the two-year requirement for that portion of the property. Thus, guest rental houses, separate structures used exclusively for business purposes, and similar property will not qualify for the Section 121 exclusion if they are part of a separate dwelling unit.

Rev. Proc. 2005-14 provides six examples that illustrate its application to an unmarried taxpayer who exchanges a single property with different uses at different times or with multiple uses at the time of the exchange. Example 1 involves a single dwelling unit that was used as the taxpayer’s residence from 2000 to 2004, then was rented to tenants from 2004 to 2006 and was exchanged for a rental property. Example 1 illustrates the complementary application of both Section 121 and Section 1031 to a property that is assumed to qualify under both provisions. Example 2 involves a property with two separate dwelling units under Reg. 1.121-1(e) and applies Section 121 to the residential portion and Section 1031 to the business portion of the property. Examples 3 through 6 involve a single dwelling unit under Reg. 1.121-1(e). The gain exclusion is first applied to exclude the gain on the residential portion, and excess amount of the exclusion is then applied to exclude the gain on the business portion since it is part of a single dwelling unit. The excess exclusion cannot exclude gain attributable to depreciation deductions after 5/6/97 but Section 1031 may apply to exclude recognition of that gain as well as any gain in excess of the

maximum exclusion amount under Section 121 (\$250,000 or \$500,000 for certain joint returns). A complete copy of Rev. Proc. 2005-14 follows.

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**Rev. Proc. 2005-14**

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### **SECTION 1. PURPOSE**

This revenue procedure provides guidance on the application of §§ 121 and 1031 of the Internal Revenue Code to a single exchange of property.

### **SECTION 2. BACKGROUND**

.01 Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange. Section 121(b) provides generally that the amount of the exclusion is limited to \$250,000 (\$500,000 for certain joint returns). Under § 121(d)(6), any gain attributable to depreciation adjustments (as defined in § 1250(b)(3)) for periods after May 6, 1997, is not eligible for the exclusion. This limitation applies only to depreciation allocable to the portion of the property to which the § 121 exclusion applies. See § 121-1(d)(1).

.02 Section 121(d), as amended by § 840 of the American Jobs Creation Act of 2004, Pub. L. 108-357, provides that, if a taxpayer acquired property in an exchange to which § 1031 applied, the § 121 exclusion will not apply if the sale or exchange of the property occurs during the 5-year period beginning on the date of the acquisition of the property. This provision is effective for sales or exchanges after October 22, 2004.

.03 Under § 1.121-1(e) of the Income Tax Regulations, a taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal residence for purposes of satisfying the 2-year use requirement if the residential and business portions of the property are within the same dwelling unit. The term "dwelling unit" has the same meaning as in § 280A(f)(1), but does not include appurtenant structures or other property. If, however, the business portion of the property is separate from the dwelling unit used for residential purposes, the gain allocable to the business portion of the property is not excludable unless the taxpayer has also met the 2-year use requirement for the business portion of the property.

.04 Section 1.121-1(e)(3) provides that, for purposes of determining the amount of gain allocable to the residential and business portions of the property, the taxpayer must allocate the basis and the amount realized using the same method of allocation the taxpayer used to determine depreciation adjustments (as defined in § 1250(b)(3)). Allocation based on the square footage of the residential and business portions of the property is an appropriate method of allocating the basis and the amount realized. *Poague v. United States*, 66 A.F.T.R.2d (RIA) 5825 (E.D. Va. 1990), *aff'd*, 947 F.2d 942 (4th Cir. 1991).

.05 Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of like kind (replacement property) that is to be held either for productive use in a trade or business or for investment. Under § 1031(b), if a taxpayer also receives cash or property that is not like-kind property (boot) in an exchange that otherwise qualifies under § 1031(a), the taxpayer must recognize gain to the extent of the boot. Section 1031 does not apply to property that is used solely as a personal residence.

.06 Section 1012 provides that the basis of property is its cost. The basis of property acquired in an exchange is its fair market value, unless otherwise provided in the Code or regulations (for example, § 1031(d)). See *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954).

.07 Under § 1031(d), the basis of the replacement property is the same as the basis of the relinquished property, decreased by the amount of cash received and increased by the amount of gain recognized by the taxpayer in the exchange.

.08 Neither § 121 nor § 1031 addresses the application of both provisions to a single exchange of property. Section 121(d)(5)(B), however, provides rules for applying § 121 and another nonrecognition provision, § 1033, to a single replacement of property. Under § 1033, in general, gain is recognized only to the extent the amount realized from a compulsory or involuntary conversion of property exceeds the cost of qualifying replacement property, and the basis of the replacement property is its cost reduced by the amount of the gain not recognized.

.09 Section 121(d)(5)(B) provides that, in applying § 1033, the amount realized from the sale or exchange of property is treated as the amount determined without regard to § 121, reduced by the amount of gain excluded under § 121. Under § 121(d)(5)(B), the amount realized from an

exchange of a taxpayer's principal residence for purposes of applying § 1033 is the fair market value of the relinquished property reduced by the amount of the gain excluded from gross income under § 121. Thus, Congress concluded that for exchanges meeting the requirements of both § 121 and § 1033, (1) the § 121 exclusion should be applied to gain from the exchange before the application of § 1033, (2) for purposes of determining gain that may be deferred under § 1033, the § 121 exclusion should be applied first against amounts received by the taxpayer that are not reinvested in the replacement property (amounts equivalent to boot that would result in gain recognition absent the application of § 121), and (3) the gain excluded under § 121 should be added in the calculation of the taxpayer's basis in the replacement property. See S. Rep. No. 830, 88<sup>th</sup> Cong., 2d Sess. 52-53, 1964-1 C.B. (Part 2) 505, 556-7 ("the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision which is reinvested in the new residence"); H.R. Rep. No. 749, 88<sup>th</sup> Cong., 1<sup>st</sup> Sess. 47, 1964-1 C.B. (Part 2) 125, 171.

### **SECTION 3. SCOPE**

This revenue procedure applies to taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain on the exchange of like-kind properties under § 1031. Thus, this revenue procedure applies only to taxpayers who satisfy the held for productive use in a trade or business or for investment requirement of § 1031(a)(1) with respect to the relinquished business property and the replacement business property (as defined below).

### **SECTION 4. APPLICATION**

.01 *In general.* Taxpayers within the scope of this revenue procedure may apply both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain from the exchange of like-kind properties under § 1031 to an exchange of property by applying the procedures set forth in this section 4.

.02 *Computation of gain.*

(1) *Application of § 121 before § 1031.* Section 121 must be applied to gain realized before applying § 1031.

(2) *Application of § 1031 to gain attributable to depreciation.* Under § 121(d)(6), the § 121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. However, § 1031 may apply to such gain.

(3) *Treatment of boot.* In applying § 1031, cash or other non-like kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property), is taken into account only to the extent the boot exceeds the gain excluded under § 121 with respect to the relinquished business property.

.03 *Computation of basis.* In determining the basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property), any gain excluded under § 121 is treated as gain recognized by the taxpayer. Thus, under § 1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under § 121.

## SECTION 5. EXAMPLES

In each example below, the taxpayer is an unmarried individual and the property or a portion of the property has been used in the taxpayer's trade or business or held for investment within the meaning of § 1031(a) as well as used as a principal residence as required under § 121.

*Example 1.* (i) Taxpayer A buys a house for \$210,000 that A uses as A's principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of \$20,000. In 2006, A exchanges the house for \$10,000 of cash and a townhouse with a fair market value of \$460,000 that A intends to rent to tenants. A realizes gain of \$280,000 on the exchange.

(ii) A's exchange of a principal residence that A rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both §§ 121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because A owns and uses the house as A's principal residence for at least 2 years during the 5-year period prior to the exchange, A may exclude gain under § 121. Because the house is investment property at the time of the exchange, A may defer gain under § 1031.

(iii) Under section 4.02(1) of this revenue procedure, A applies § 121 to exclude \$250,000 of the \$280,000 gain before applying the nonrecognition rules of § 1031. A may defer the remaining gain of \$30,000, including the \$20,000 gain attributable to depreciation, under § 1031. See section 4.02(2) of this revenue procedure. Although A receives \$10,000 of cash (boot) in the exchange, A is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain. See section 4.02(3) of this revenue procedure.

These results are illustrated as follows.

|                 |                           |           |
|-----------------|---------------------------|-----------|
| Amount realized |                           | \$470,000 |
| Less:           | Adjusted basis            | \$190,000 |
|                 | Realized gain             | \$280,000 |
| Less:           | Gain excluded under § 121 | \$250,000 |
|                 | Gain to be deferred       | \$30,000  |

(iv) A's basis in the replacement property is \$430,000, which is equal to the basis of the relinquished property at the time of the exchange (\$190,000) increased by the gain excluded under § 121 (\$250,000), and reduced by the cash A receives (\$10,000)). See section 4.03 of this revenue procedure.

*Example 2.* (i) Taxpayer B buys a property for \$210,000. The property consists of two separate dwelling units (within the meaning of § 1.121-1(e)(2)), a house and a guesthouse. From 2001 until 2006, B uses the house as B's principal residence and uses the guesthouse as an office in B's trade or business. Based on the square footage of the respective parts of the property, B allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse. In 2006, B exchanges the entire property for a residence and a separate property that B intends to use as an office. The total fair market value of B's replacement properties is \$360,000. The fair market value of the replacement residence is \$240,000 and the fair market value of the replacement business property is \$120,000, which is equal to the fair market value of the relinquished business property. From 2001 to 2006, B claims depreciation deductions of \$30,000 for the business use. B realizes gain of \$180,000 on the exchange.

(ii) Under § 121, B may exclude gain of \$100,000 allocable to the residential portion of the house (2/3 of \$360,000 amount realized, or \$240,000, minus 2/3 of \$210,000 basis, or \$140,000) because B meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit and B has not met the use requirements for the guesthouse, B may not exclude the gain allocable to the guesthouse under § 1.121-1(e). However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and B receives no boot, B may defer the remaining gain of \$80,000 (1/3 of \$360,000 amount realized, or \$120,000, minus \$40,000 adjusted basis, which is 1/3 of \$210,000 basis, or \$70,000, adjusted by \$30,000 depreciation) under § 1031.

These results are illustrated as follows:

|                            | <b>Total property</b> | <b>2/3 residential property</b> | <b>1/3 business property</b> |
|----------------------------|-----------------------|---------------------------------|------------------------------|
| Amount realized            | \$360,000             | \$240,000                       | \$120,000                    |
| Basis                      | \$210,000             | \$140,000                       | \$70,000                     |
| Depreciation adjustment    | \$30,000              |                                 | \$30,000                     |
| Adjusted basis             | \$180,000             | \$140,000                       | \$40,000                     |
| Realized gain              | \$180,000             | \$100,000                       | \$80,000                     |
| Gain excluded under § 121  | \$100,000             | \$100,000                       |                              |
| Gain deferred under § 1031 | \$80,000              |                                 | \$80,000                     |

(iii) Because no portion of the gain attributable to the relinquished business property is excluded under § 121 and B receives no boot and recognizes no gain or loss in the exchange, B's basis in the replacement business property is equal to B's basis in the relinquished business property at the time of the exchange (\$40,000). B's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$240,000).

*Example 3.* (i) Taxpayer C buys a property for \$210,000. The property consists of a house that constitutes a single dwelling unit under § 1.121-1(e)(2). From 2001 until 2006, C uses 2/3 of the house (by square footage) as C's principal residence and uses 1/3 of the house as an office in C's

trade or business. In 2006, C exchanges the entire property for a residence and a separate property that C intends to use as an office in C's trade or business. The total fair market value of C's replacement properties is \$360,000. The fair market value of the replacement residence is \$240,000 and the fair market value of the replacement business property is \$120,000, which is equal to the fair market value of the business portion of the relinquished property. From 2001 to 2006, C claims depreciation deductions of \$30,000 for the business use. C realizes gain of \$180,000 on the exchange.

(ii) Under § 121, C may exclude the gain of \$100,000 allocable to the residential portion of the house (2/3 of \$360,000 amount realized, or \$240,000, minus 2/3 of \$210,000 basis, or \$140,000) because C meets the ownership and use requirements for that portion of the property.

(iii) The remaining gain of \$80,000 (1/3 of \$360,000 amount realized, or \$120,000, minus \$40,000 adjusted basis, which is 1/3 of \$210,000 basis, or \$70,000, adjusted by \$30,000 depreciation) is allocable to the business portion of the house (the office). Under section 4.02(1) of this revenue procedure, C applies § 121 before applying the nonrecognition rules of § 1031. Under § 1.121-1(e), C may exclude \$50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit. C may not exclude that portion of the gain (\$30,000) attributable to depreciation deductions, but may defer the remaining gain of \$30,000 under § 1031.

These results are illustrated as follows:

|                            | <b>Total property</b> | <b>2/3 residential property</b> | <b>1/3 business property</b> |
|----------------------------|-----------------------|---------------------------------|------------------------------|
| Amount realized            | \$360,000             | \$240,000                       | \$120,000                    |
| Basis                      | \$210,000             | \$140,000                       | \$70,000                     |
| Depreciation adjustment    | \$30,000              |                                 | \$30,000                     |
| Adjusted basis             | \$180,000             | \$140,000                       | \$40,000                     |
| Realized gain              | \$180,000             | \$100,000                       | \$80,000                     |
| Gain excluded under § 121  | \$150,000             | \$100,000                       | \$50,000                     |
| Gain deferred under § 1031 | \$30,000              |                                 | \$30,000                     |

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$240,000). C's basis in the replacement business property is \$90,000, which is equal to C's basis in the relinquished business property at the time of the exchange (\$40,000), increased by the gain excluded under § 121 attributable to the relinquished business property (\$50,000). See section 4.03 of this revenue procedure.

*Example 4.* (i) The facts are the same as in *Example 3* except that C also receives \$10,000 of cash in the exchange and the fair market value of the replacement business property is \$110,000, which is \$10,000 less than the fair market value of the business portion of the relinquished property (\$120,000).

(ii) Under § 121, C may exclude the gain of \$100,000 allocable to the residential portion of the house (2/3 of \$360,000 amount realized, or \$240,000, minus 2/3 of \$210,000 basis, or \$140,000).

(iii) The remaining gain of \$80,000 (1/3 of \$360,000 amount realized, or \$120,000, minus \$40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C applies § 121 to exclude gain before applying the nonrecognition rules of § 1031. Under § 1.121-1(e), C may exclude \$50,000 of the gain allocable to the business portion of the house but may not exclude the \$30,000 of gain attributable to depreciation deductions. Under section 4.02(2) of this revenue procedure, C may defer the \$30,000 of gain under § 1031. Although C receives \$10,000 of cash (boot) in the exchange, C is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain attributable to the relinquished business property. See 4.02(3) of this revenue procedure.

These results are illustrated as follows:

|                            | <b>Total property</b> | <b>2/3 residential property</b> | <b>1/3 business property</b> |
|----------------------------|-----------------------|---------------------------------|------------------------------|
| Amount realized            | \$360,000             | \$240,000                       | \$110,000 +<br>10,000        |
| Basis                      | \$210,000             | \$140,000                       | \$70,000                     |
| Depreciation adjustment    | \$30,000              |                                 | \$30,000                     |
| Adjusted basis             | \$180,000             | \$140,000                       | \$40,000                     |
| Realized gain              | \$180,000             | \$100,000                       | \$80,000                     |
| Gain excluded under § 121  | \$150,000             | \$100,000                       | \$50,000                     |
| Gain deferred under § 1031 | \$30,000              |                                 | \$30,000                     |

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$240,000). C's basis in the replacement business property is \$80,000, which is equal to C's basis in the relinquished business property (\$40,000), increased by the gain excluded under § 121 (\$50,000), and reduced by the cash (\$10,000) received. See section 4.03 of this revenue procedure.

*Example 5.* (i) The facts are the same as in *Example 3* except that the total fair market value of the replacement properties is \$540,000. The fair market value of the replacement residence is \$360,000, the fair market value of the replacement business property is \$180,000, and C realizes gain of \$360,000 on the exchange.

(ii) Under § 121, C may exclude the gain of \$220,000 allocable to the residential portion of the house (2/3 of \$540,000 amount realized, or \$360,000, minus 2/3 of \$210,000 basis, or \$140,000).

(iii) The remaining gain of \$140,000 (1/3 of \$540,000 amount realized, or \$180,000, minus \$40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C excludes the gain before applying the nonrecognition rules of § 1031.

Under § 1.121-1(e), C may exclude \$30,000 of the gain allocable to the business portion, at which point C will have excluded the maximum limitation amount of \$250,000. C may defer the remaining gain of \$110,000 (\$140,000 realized gain minus the \$30,000 gain excluded under § 121), including the \$30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

|                            | <b>Total property</b> | <b>2/3 residential property</b> | <b>1/3 business property</b> |
|----------------------------|-----------------------|---------------------------------|------------------------------|
| Amount realized            | \$540,000             | \$360,000                       | \$180,000                    |
| Basis                      | \$210,000             | \$140,000                       | \$70,000                     |
| Depreciation adjustment    | \$30,000              |                                 | \$30,000                     |
| Adjusted basis             | \$180,000             | \$140,000                       | \$40,000                     |
| Realized gain              | \$360,000             | \$220,000                       | \$140,000                    |
| Gain excluded under § 121  | \$250,000             | \$220,000                       | \$30,000                     |
| Gain deferred under § 1031 | \$110,000             |                                 | \$110,000                    |

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$360,000). C's basis in the replacement business property is \$70,000, which is equal to C's basis in the relinquished business property (\$40,000), increased by the amount of the gain excluded under § 121 (\$30,000). See section 4.03 of this revenue procedure.

*Example 6.* (i) The facts are the same as in *Example 3* except that the total fair market value of the replacement properties is \$750,000. The fair market value of the replacement residence is \$500,000, the fair market value of the replacement business property is \$250,000, and C realizes gain of \$570,000 on the exchange.

(ii) The gain allocable to the residential portion is \$360,000 (2/3 of \$750,000 amount realized, or \$500,000, minus 2/3 of \$210,000 basis, or \$140,000). C may exclude gain of \$250,000 from gross income under § 121. C must include in income the gain of \$110,000 allocable to the residential portion that exceeds the § 121(b) exclusion limitation amount.

(iii) The remaining gain of \$210,000 (1/3 of \$750,000 amount realized, or \$250,000, minus \$40,000 adjusted basis) is allocable to the business portion of the house. C may defer the \$210,000 of gain, including the \$30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

|                         | <b>Total property</b> | <b>2/3 residential property</b> | <b>1/3 business property</b> |
|-------------------------|-----------------------|---------------------------------|------------------------------|
| Amount realized         | \$750,000             | \$500,000                       | \$250,000                    |
| Basis                   | \$210,000             | \$140,000                       | \$70,000                     |
| Depreciation adjustment | \$30,000              |                                 | \$30,000                     |

|                               | <b>Total<br/>property</b> | <b>2/3 residential<br/>property</b> | <b>1/3 business<br/>property</b> |
|-------------------------------|---------------------------|-------------------------------------|----------------------------------|
| Adjusted basis                | \$180,000                 | \$140,000                           | \$40,000                         |
| Realized gain                 | \$570,000                 | \$360,000                           | \$210,000                        |
| Gain excluded<br>under § 121  | \$250,000                 | \$250,000                           |                                  |
| Gain deferred<br>under § 1031 | \$210,000                 |                                     | \$210,000                        |
| Gain recognized               | \$110,000                 | \$110,000                           |                                  |

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$500,000). C's basis in the replacement business property is \$40,000, which is equal to C's basis in the relinquished business property at the time of the exchange.

## **SECTION 6. EFFECTIVE DATE**

This revenue procedure is effective January 27, 2005. However, taxpayers may apply this revenue procedure in taxable years for which the period of limitation on refund or credit under § 6511 has not expired.

## **DRAFTING INFORMATION**

The principal author of this revenue procedure is Sara Paige Shepherd of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Shepherd at (202) 622-4960 (not a toll-free call).

## II. INTRODUCTION TO REVERSE EXCHANGES

What is a “Reverse Exchange”? In a deferred exchange, the relinquished property is transferred first, and the replacement property is acquired second. In a reverse exchange, the timing of the transfers is reversed: the replacement property is acquired first, and the relinquished property is subsequently transferred. For various reasons, a taxpayer may want or need to acquire the replacement property before disposing of the relinquished property. This article discusses how the taxpayer may structure a “reverse exchange,” including the legal authorities, mechanics and practical considerations.

In a “pure” or “true” reverse exchange, the exchanger agrees to transfer the relinquished property at a future date in exchange for the present receipt of the replacement property. The exchanger owns both the relinquished and replacement properties concurrently during the period between the receipt of replacement property and transfer of relinquished property. Example 1: A and C agree to exchange properties. On February 1, 2005, C transfers property Y to A. On March 1, 2005, A transfers property X to C. The exchange is a deferred exchange for C and a “pure” reverse exchange for A.

The reverse exchange may also involve more than two parties. The other parties may not be effecting exchanges and may simply be buying or selling property. Conceptually, this is no different than a deferred exchange involving the exchanger, the buyer of relinquished property and the seller of replacement property. The only difference is the timing of the steps. Example 2: A owns property X and intends to sell it to B. A wants to acquire property Y in a like kind exchange for property X. Owner C of property Y requires a transfer date to A before X can be transferred to B. Pursuant to an integrated plan, C transfers Y to A and B pays the purchase price for X to C (with A paying any additional consideration for Y to C). Later, A transfers property X to B. Neither B nor C have made an exchange. A may have made a “true” reverse exchange.

In Example 1, it is hard to see how A could not have effected an exchange. The transaction merely involves a reciprocal transfer of property for other property without cash consideration. Example 2 is more uncertain since it involves cash consideration. The IRS might argue that A really sold property X for cash to B and reinvested the proceeds in property Y in a taxable transaction. But this simply presents the same issue (the taxpayer’s actual or constructive receipt of cash) that may be raised in any simultaneous or deferred exchange.

A reverse exchange is not literally covered by §1031(a)(3) which simply provides time constraints for deferred exchanges. “Pure” reverse exchanges were approved in Rutherford v. Commissioner, T.C. Memo 1978-505 (relating to an exchange of heifers) and PLRs 9823045 and 9814019 (exchange of power line easements). In Rutherford, the taxpayer received heifers in

exchange for his promise to deliver to-be-born calves in the future. The taxpayer received the heifers in 1973 and transferred the calves to the other party during 1974, 1975 and 1976. In other words, at the time the “replacement property” was received, the “relinquished property” did not exist. The court held that the taxpayer effected a Section 1031 exchange. In PLRs 9823045 and 9814019, the IRS stated that the exchange of easements was a reverse exchange and ruled that it was a valid like-kind exchange. The Starker decision also supports the qualification of a reverse exchange under §1031(a)(1). Among other things, the Starker case holds that an exchange need not be simultaneous. The court held that a contract right to assume the rights of ownership should not be treated any different than the ownership rights themselves when only like-kind property is ultimately received. See Starker v. United States, 602 F.2d 1341 (9<sup>th</sup> Cir. 1979).

Very few taxpayers fit within the facts of Rutherford or PLRs 9823045 and 9814019 which involve only two parties. A pure reverse exchange also presents difficult basis and depreciation issues arising out of the taxpayer’s ownership of both the replacement and relinquished properties until the exchange is completed. But T.D. 9115, 69 FR 9529 (March 1, 2004) contains new regulations that may apply to a true reverse exchange. The regulations allow the taxpayer to depreciate the unadjusted depreciable basis of the replacement MACRS property until the time of disposition of the relinquished MACRS property by the taxpayer. The taxpayer must then include in taxable income in the year of disposition of the relinquished MACRS property certain excess depreciation that was allowable.

“Exchange Last” and “Exchange First” Methods. For these reasons, the current practice is to avoid a pure reverse exchange by adopting one of two approaches: the “Exchange Last” method (providing for a future simultaneous exchange) or the “Exchange First” method (providing for a current simultaneous exchange). These approaches are really just variations on a buyer-accommodated-type exchange (see Alderson v. Commissioner, 317 F.2d 790 (9<sup>th</sup> Cir. 1963) or a seller-accommodated-type exchange (see Mays v. Campbell, 245 F.Supp. 375 (ND Tex. 1965), except that the accommodator holds title to the “parked” property for a period of time and later (instead of immediately) transfers it.

The “Exchange Last” “parking” or “warehousing” the replacement property with an independent party until the relinquished property can be transferred to a buyer. The taxpayer then does a simultaneous exchange of the two properties. Example: Taxpayer A owns property X and wants to acquire property Y. Property Y must be acquired before property X is ready to be sold. Accommodator D purchases Y, holds it until X is ready to close, and then transfers Y to A in a simultaneous exchange for X. Accommodator D simultaneously sells X to a buyer B and recovers the funds paid to purchase Y.

The “Exchange Last” method was successfully used by the taxpayer in Biggs v. Commissioner, 632 F.2d 1171 (5<sup>th</sup> Cir. 1980). In Biggs, the accommodator acquired the replacement property and held title to it for four months before the taxpayer’s simultaneous exchange. The taxpayer advanced the entire purchase price to the accommodator and secured the advance with a deed of trust on the replacement property. The taxpayer was obligated to reimburse the accommodator for all costs of acquiring and holding title to the property when the property was transferred by

the accommodator to the taxpayer. The taxpayer's loan was repaid out of the relinquished property sales proceeds. The court admitted that the exchange would have been meaningless if the accommodator was acting as the taxpayer's agent because the taxpayer would have merely made an "exchange" with himself. But the court rejected the Service's contention that the accommodator was acting as the taxpayer's agent. Rather, the court found that the accommodator accepted title to the replacement property, "albeit at Biggs' request, merely in order to facilitate the exchange." A modified form of this structure was also used in J.H. Baird Publishing Company v. Commissioner, 39 T.C. 608 (1962), acq. 1963-2 C.B. 4 (accommodator acquired and held the replacement property while build-to-suit improvements were made and later exchanged the property).

The "Exchange First" method starts with a simultaneous three-party exchange of the relinquished and replacement properties using an independent party. The independent party acquires the replacement property and trades it with the taxpayer for the relinquished property. The independent party then holds the relinquished property until it can be sold. Example: Taxpayer A has property X and wants property Y. Accommodator D acquires Y by purchase from C and immediately exchanges Y with A, receiving X. D holds X until it can be sold to buyer B. This structure presents the risk that beneficial ownership of the relinquished property may not be deemed to transfer, notwithstanding the transfer of legal title to the accommodator. Thus, the taxpayer may be treated as subsequently selling the relinquished property through the accommodator (viewing it as a conduit for temporarily holding title).

Both methods attempt to avoid having the exchanger treated as the owner of the parked property during the gap period between the acquisition of replacement property and the sale of relinquished property to a buyer. The advantages of the Exchange Last method over the Exchange First method include additional time, flexibility, less risk and ease of reconciling equity values. First, if the acquisition of a specific replacement property will not fully defer gain realized on the disposition of the relinquished property, Section 1031(a)(3) time periods will start later if Exchange Last is used. Second, if the exchanger is not certain about which of several relinquished properties will be used in the exchange, the decision can be made when a contract to sell one of them is made, rather than at the time the replacement property is acquired. In a safe harbor exchange, however, the relinquished property must be identified within 45 days after the accommodator acquires the replacement property. Third, if Exchange Last is used, the parked property will not have previously been owned by the exchanger. Thus, there may be less risk that the accommodator's transitory ownership of the parked property will be disregarded. Finally, since the exchange takes place concurrently with the sale of the relinquished property, reconciliation of equity values can occur with knowledge of the actual market value of the relinquished property, rather than based on a value assumed at the time of the replacement property's purchase.

The advantages of Exchange First over Exchange Last include meeting financing, management and closing requirements. A lender who provides financing for acquisition of the replacement property often requires that the exchanger be the borrower and take title to the replacement property. Only Exchange First allows the exchanger to be on title and execute a deed of trust for the replacement property. Further, if the replacement property has particular management,

leasing, environmental or litigation problems, acquisition of title by the exchanger may be necessary. Finally, it may just be too late to change closing documents, such as deeds already drawn and executed that convey title of the replacement property to the exchanger.

In addition to tax considerations, many business and practical considerations must be taken into account in a reverse exchange. These considerations include the identity of the accommodator, financing the acquisition of replacement property, lease or management of the parked property, termination of the transaction (“sunset provisions”), the construction of any improvements, and tax and financial reporting. Reverse exchanges under the safe harbor of Rev. Proc. 2000-37 allow many arrangements between the exchanger and an accommodator that are not on arms-length terms. For reverse exchanges outside of the safe harbor, the accommodator cannot be the exchanger’s agent and should have “enough” benefits and burdens of ownership to be treated as the owner of the parked property for purposes of Section 1031.

Rev. Proc. 2000-37 provides an administrative safe harbor for reverse exchanges that are parking transactions and use either the exchange last or exchange first method. The property must be held in a “qualified exchange accommodation arrangement” (QEAA). Section 4.02 of the Rev. Proc. spells out six formalistic requirements for a QEAA, including (1) title or other qualified indicia of ownership to the parked property must be held by a person qualified to be an exchange accommodation titleholder (EAT); (2) the taxpayer must have a bona fide intent that the parked property qualify as replacement or relinquished property under Section 1031; (3) the taxpayer and the EAT must enter a written qualified exchange accommodation agreement that contains specified provisions within five (5) business days after the EAT acquires the parked property; (4) if the exchange last method is used, the taxpayer must identify the relinquished property within 45 days after the EAT acquires the replacement property; (5) the parked property must be transferred by the EAT and the transaction must be completed within 180 days after the EAT acquires the parked property; and (6) the combined time period that the relinquished property and the replacement property are held in a QEAA must not exceed 180 days.

The inflexible 180-day time limitation is the key to qualifying a reverse exchange under the safe harbor. Within 180 days after the EAT acquires the parked property, the EAT must transfer the parked property. The parked property must be transferred to the taxpayer if the EAT holds the replacement property under the exchange last method, or to the buyer if the EAT holds the relinquished property under the exchange first method. A “safe harbor” reverse exchange necessarily means a parking transaction with an EAT that is completed within 180 days. Parking transactions that are not completed in 180 days (or otherwise do not meet the requirements of the Rev. Proc.) are referred to as “non-safe-harbor” reverse exchanges. Section 3.04 of the Rev. Proc. provides that if the requirements of the safe harbor are not met (for example, the parked property is not transferred by the EAT in 180 days), the Rev. Proc. does not apply. In that event, the determination of whether the taxpayer or the EAT is the owner of the parked property for tax purposes and the proper treatment of the transactions between the parties is made under general tax principles and without regard to the liberal rules of the Rev. Proc.

Section 4.03 of the Rev. Proc. allows many “permissible agreements” between the taxpayer and the EAT even though the agreements do not contain arms-length terms, including loans,

guarantees, indemnities, leases, management, contractor or other service agreements. Section 4.03 also allows puts and calls at fixed or formula prices effective not more than 185 days after the EAT acquires the parked property, and arrangements that account and compensate for variations between the actual and estimated value of the relinquished property if the exchange first method is used. These permissible agreements are crucial to allow the EAT to hold bare legal title to the parked property and effectively shift all or substantially all of the benefits and burdens of ownership to the taxpayer. Further, the parked property will still qualify as being held in a QEAA even though the accounting, regulatory, or state, local or foreign tax treatment of the arrangement differs from the treatment required by the Rev. Proc.

Planning Considerations for Reverse Exchanges. In planning for a reverse exchange, the value and equity of the relinquished and replacement properties must be considered. Even if the sales price of the relinquished property is not known, the exchanger should estimate the value and equity, structure financing for the replacement property accordingly, and anticipate any boot that will be received. At the conclusion of the exchange, the exchanger must trade even or up in both value and equity from the relinquished property to the replacement property, or the exchanger will receive boot and must recognize gain.

The retirement of debt created in reverse exchanges raises additional issues. In the exchange last method, the debt is secured by the replacement property and paid off with relinquished property sales proceeds. To the extent of any deficiency in proceeds, the exchanger takes the replacement property subject to the debt, assumes the debt or provides its own funds to retire the debt. If the proceeds exceed the debt, further properties can be acquired in the exchange or the exchanger receives boot. Under the exchange last method, the time limit for additional properties under Section 1031(a)(3) only begins to run when the exchanger receives the replacement property. In the exchange first method, the debt is secured by the relinquished property. If the debt is due to a third party, the exchanger will need to make up any shortfall between the proceeds from sale and the amount of the debt payoff. If the debt is due to the exchanger, it will generally be canceled. If the proceeds of sale exceed the debt and are not retained by the accommodator, the excess proceeds will be available for use in further acquisitions only if the Section 1031(a)(3) time periods have not elapsed. Under the exchange first method, the time limits begin to run immediately when the exchanger receives the replacement property and the accommodator acquires the relinquished property. The time periods do not start later when the accommodator sells the relinquished property.

Another planning issue is the exit strategy or “sunset provisions” if the exchange is not timely consummated. In either the exchange last or exchange first structure, the accommodator will not want to hold the parked property indefinitely. What happens if the relinquished property is not sold? PLR 200111025 indicates the kind of “sunset provisions” that may be used in a non-safe-harbor transaction using the exchange last method. An option providing price protection to the exchanger was used for 18 months (options under the safe harbor may only be effective for 185 days). If the option was not exercised, a notice and sale procedure could be used so that the accommodator could dispose of the parked property. A similar suggestion is to create a short fuse option to purchase at a fixed price (i.e., exercisable only between 12th and 18th month of the lease term), coupled with rental escalations applying thereafter. In non-safe-harbor

transactions, some accommodators structure the option so that the parked property must be purchased after a certain time period at appraised fair market value. The accommodator gets to keep any upside but is not responsible for any downside. It is unclear how long fixed-price call or put options may last in a non-safe-harbor transaction. Some practitioners believe that an option lasting from 12 to 18 months should not, in and of itself, undermine ownership of the parked property by the accommodator for tax purposes.

Tax Reporting of Reverse Exchanges Advisors should also properly structure and plan for the tax reporting requirements applicable to an EAT (or other accommodator) and the taxpayer in a typical parking transaction. Under both the exchange last and first methods, the EAT must report activity associated with either the replacement or relinquished property, including the receipt of income, payment of expenses, capitalization of costs and claiming any depreciation deductions. The EAT must also report any gain or loss on the sale or other disposition of the property. Under the exchange first method, the taxpayer must currently file Form 8824 and report the exchange of the relinquished property for the replacement property. The taxpayer must also report the activity associated with the replacement property that the taxpayer now owns and any income, expenses or costs as a lessee or manager of the relinquished property after the exchange. Under the exchange last method, the taxpayer must report the relinquished property that the taxpayer continues to own and any income, expenses or costs as a lessee or manager of the replacement property. The taxpayer must subsequently file Form 8824 for the tax year in which the exchange under the exchange last method occurs. Both parties must take into account rent, interest, taxes, insurance and other accrued income or expenses in accordance with their method of accounting.

Rev. Proc. 2000-37 provides that, in a safe harbor parking transaction, the EAT must be treated as the beneficial owner of the property for all federal income tax purposes. Further, the parties must report the transaction and the tax attributes of the property on their respective tax returns consistently and in accordance with the EAT's beneficial ownership for federal income tax purposes. Thus, in general, the EAT and only the EAT may claim depreciation with respect to the replacement property under the exchange last method or the relinquished property under the exchange first method. The same goes for a non-safe-harbor parking transaction in which the EAT must be respected as the owner of the property under general tax principles and the authorities under Section 1031. The taxpayer must not claim depreciation deductions or otherwise report the income, expenses and costs of the owner of the property while the property is held by the EAT. Thus, tax reporting for the EAT and the taxpayer may involve depreciation deductions, income and expenses under leases or management agreements, interest income and expenses under loans, taxes, construction and other capitalized costs, gain or loss on the sale or other disposition of the property, and Form 8824 for reporting of the exchange. Further, the parties will need to show the assets and liabilities arising out of the parking transaction on the balance sheets of their respective tax returns. Various Forms 1099 may also need to be filed in connection with the transactions.

The EAT may have to claim depreciation deductions if it holds depreciable property used in a trade or business or held for the production of income. Merely because the EAT intends to dispose of the property at a future date does not necessarily mean that the property is inventory

in the hands of the EAT. Rental property, for example, may still be considered used in a trade or business or held for the production of income in the interim period. Since the depreciation allowance is mandatory, the EAT may be forced to claim it or the Service could reduce the EAT's basis on sale by the amount of depreciation allowable but not claimed. However, this remains unclear. Section 3.03 of Rev. Proc. 2000-37 indicates that the EAT may be precluded from claiming depreciation deductions (e.g., as a dealer). What is clear is that the taxpayer should not claim depreciation deductions as the owner of the parked property while the EAT holds title.

The EAT and the taxpayer will need to take into account and report on their respective tax returns the following items in accordance with their method of accounting:

- a. rent received and paid under the master lease, including base rent and additional rent under a net lease for taxes, insurance, repairs and maintenance;
- b. the EAT should report the gross rent received under a net lease and deduct the taxes, insurance and other expenses paid;
- c. the EAT should report the gross rent received from the property and management fees paid to the taxpayer if a management agreement is used (the EAT will deduct the management fees and the taxpayer will report the management income);
- d. rent received under subleases must be reported by the taxpayer and the taxpayer will deduct the rent paid to the EAT under the master lease;
- e. interest paid or accrued on the loans incurred by the EAT, including loans from taxpayer or its affiliates, should be deducted by the EAT in accordance with its method of accounting, and the taxpayer should similarly report interest income;
- f. other fees or income should be included in income, deducted or capitalized as appropriate by the parties, including set-up or acquisition fees, exchange fees, financing fees, guaranty fees, construction fees and option fees;
- g. if the EAT is a new entity, the EAT will amortize its organizational costs under Sections 248 or 709(b);
- h. reimbursements of the EAT's costs should be reported;
- i. appropriate 1099 Forms may need to be issued by the EAT and the taxpayer, including forms to third parties;
- j. the EAT should account for deposits received from tenants, including any deposits received under a master lease;
- k. all capitalized costs, including construction expenditures, should be shown on the EAT's

balance sheet;

- l. all loans should be reflected in the EAT's liabilities, including loans from the taxpayer or its affiliates;
- m. accrued expenses, including interest and taxes that are not deductible in accordance with the EAT's method of accounting, should be shown as a current liability;
- n. the capital and net worth of the EAT will be known from the balance sheet (it would be useful for the EAT to have some capital and net worth if a "benefits and burdens" test is applied).

Under the exchange first method, the taxpayer will currently report the exchange of the relinquished property for the replacement property as a simultaneous exchange on Form 8824. The current form has no special reporting requirements or boxes to check for a parking transaction under Rev. Proc. 2000-37 or a reverse exchange. The EAT will report gain or loss from the sale of the relinquished property in the tax year that it sells the relinquished property. Under the exchange last method, the taxpayer will report the exchange at a future date when the relinquished property is sold. The taxpayer will then report the exchange as a simultaneous exchange on Form 8824. The EAT will report gain or loss on the sale or exchange of the replacement property. In summary, advisors should consider all of the tax reporting requirements associated with a parking transaction. These reporting requirements may add significantly to the costs of the transaction and should be taken into account by the EAT in determining its fees or other income for facilitating the exchange.