

The Reverse Exchange

A reverse exchange is the “flip side” of a deferred (delayed) exchange. In a reverse exchange, the Exchanger for various reasons must acquire their like-kind replacement property before disposing of a relinquished property. Until recently, it was unclear whether reverse exchanges would be given nonrecognition treatment by the IRS. However, that question was answered by the IRS in the form of Revenue Procedure 2000-37 (“Rev. Proc. 2000-37”), which provides that tax deferral on reverse exchanges will be recognized if the transactions fall within the scope of an announced IRC §1031 “safe harbor.” The new reverse exchange rules can be expected to lead to two categories of reverse exchanges; those that fit neatly within the safe harbor guidelines, and those that do not fit within the safe harbor rules.

The “Safe Harbor” Reverse Exchange

In a reverse exchange structured under the safe harbor protection of Rev. Proc. 2000-37, the entity used to facilitate a reverse exchange is referred to as the Exchange Accommodation Titleholder (“EAT”), and the property held by the EAT is commonly called the “parked property”. The EAT will usually form a special purpose entity (the “Holding Entity”) to take title to the parked property. To complete a reverse exchange, the Holding Entity can take title to either the relinquished property or the replacement property under a “Qualified Exchange Accommodation Arrangement”. The document between the Exchanger, EAT and the Holding Entity is termed the “Qualified Exchange Accommodation Agreement” (“QEAA”).

Under Rev. Proc. 2000-37, a safe harbor reverse exchange must be completed within 180 days after the Holding Entity acquires the parked property. Additionally, under a safe harbor reverse exchange, the Exchanger must identify one or more relinquished properties within 45 days after the Holding Entity acquires the parked property. Rev. Proc. 2000-37 adopts the same identification rules that apply in delayed exchanges, which require written identification be delivered to another party to the exchange, such as the Holding Entity, EAT, or the Qualified Intermediary, and limits the number of alternative and multiple properties that can be identified.

The “Non-Safe Harbor” Reverse Exchange

Section 3.02 of Rev. Proc. 2000-37 specifically states, “the Service recognizes that “parking” transactions can be accomplished outside of the safe harbor provided in this revenue procedure”. Rev. Proc. 2000-37 leaves open the option for some Exchangers to structure a reverse exchange that does not comply with all of the provisions of the Revenue Procedure; therefore, Exchangers may elect to pursue reverse exchange structures that will take longer than 180 days or will not have identified relinquished property. Since there is no regulatory authority to assist in structuring a reverse exchange outside the parameters of the safe harbor, there is a much higher risk associated with such exchanges; thus, non-safe harbor reverse exchanges should be attempted only if there is an absolute need to proceed outside of Rev. Proc. 2000-37.

Experts in the field agree that unlike under Rev. Proc. 2000-37, a valid non-safe harbor exchange will require the Holding Entity to undertake more responsibility for ownership of the parked property than just bare tax ownership. Most tax experts believe that Holding Entities operating outside of the safe harbor of Rev. Proc. 2000-37 will need to be the owner of the parked property for both tax and financial reporting purposes, thus showing the assets and liabilities associated with the parked property on its books for GAAP purposes. As a result of this potentially adverse impact on the financial statements of the publicly traded parent corporation of most large Qualified Intermediaries, these Qualified Intermediaries, including IPX1031[®], will not be allowed to participate in non-safe harbor reverse exchanges. While IPX1031[®] cannot assist clients with non-safe harbor reverse exchanges by acting as the Holding Entity, IPX1031[®] can still participate in the exchange as the Qualified Intermediary working in conjunction with the Exchanger’s tax counsel and non-safe harbor Holding Entity.

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The Procedure - Parking the Replacement Property

In the most common type of reverse exchange, the Exchanger contracts with the EAT to have the Holding Entity purchase and retain title to the replacement property. In the first phase of the reverse exchange the Exchanger loans the necessary down payment funds to the Holding Entity, which in turn uses these funds along with funds provided by a third-party lender, if any, to close on the replacement property and take title in the Holding Entity's name. Under the terms of the parking agreement or the QEAA, the Holding Entity leases the property to the Exchanger under a triple net lease. In this way the Exchanger can begin to use the property or sublet the property while the Holding Entity is on title. On the rare occasion that a lease agreement is not possible, the Holding Entity may be willing to retain the Exchanger or a third party designated by the Exchanger as the property manager. The use of a property management agreement instead of a triple net lease adds substantial tax reporting obligations to the reverse exchange structure and, therefore, this type of arrangement should not be used unless other more suitable options are unavailable.

When the Exchanger sells the relinquished property identified in the exchange, it is transferred directly to the buyer through a simultaneous exchange with the Qualified Intermediary and the use of direct deed. The cash proceeds of the sale go to the Qualified Intermediary, which uses the proceeds to acquire the replacement property from the EAT. The EAT uses these proceeds from the sale to first repay the loan from the Exchanger and then any additional proceeds are used to pay down the third-party loan on the replacement property prior to transferring the parked property to the Exchanger. If there are more proceeds from the relinquished property sale than the Qualified Intermediary needs to acquire the parked property, the Qualified Intermediary can use the excess proceeds to purchase additional replacement property within 180 days of the transfer of the relinquished property, provided that such additional replacement property can be properly identified by the Exchanger within 45 days of the close of the relinquished property.

This type of reverse exchange works well when the Exchanger can pay all cash for the replacement property, when the seller is providing the financing, or when an Exchanger is working with a sophisticated third-party lender. If a loan from an institutional lender is required, the Exchanger should seek lender approval for this type of exchange prior to beginning the exchange because the Holding Entity (not the Exchanger) may be required to be the borrower on the loan as the titleholder of the property. Exchangers should be aware that despite Rev. Proc. 2000-37 many lenders are not familiar with reverse exchanges, many types of loans are not available when pursuing a reverse exchange, and the loan costs may be increased to cover the lender's document preparation and legal fees. In a safe harbor exchange, to protect the lender's security interest and to protect the Holding Entity from liability in the event of a default by the Exchanger, the Exchanger will guarantee the loan and the Holding Entity will only be the borrower on a non-recourse loan and deed of trust or mortgage.

The Procedure - Parking the Relinquished Property

An alternative to parking the replacement property is to have the EAT park the Exchanger's relinquished property. This type of reverse exchange begins with a simultaneous exchange involving the Exchanger, the Holding Entity, the seller of the replacement property, and the Qualified Intermediary. Here, with the assistance of the Qualified Intermediary, the Exchanger transfers the relinquished property to the Holding Entity and then simultaneously receives the replacement property from the seller. Both transfers occur through the Qualified Intermediary and the use of direct deed. Since the relinquished property has not yet been sold to a true buyer to provide exchange funds for the acquisition of the replacement property, the Exchanger must loan the funds to the Holding Entity. The funds are then put into the exchange through the Qualified Intermediary to be used to acquire the replacement property from the seller. This loan should equal the equity the Exchanger

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has in the relinquished property. As in the replacement-parking alternative, the Holding Entity leases the relinquished property to the Exchanger under a triple net lease agreement. In the second half of the transaction when the Exchanger has located a suitable buyer for the relinquished property, the relinquished property is sold and deeded from the Holding Entity to the buyer. The cash proceeds from the sale go to the Holding Entity and are used first to retire any existing third-party debt the Holding Entity took subject to, and then to repay the Exchanger for the original loan to the Holding Entity. If the price paid by the Holding Entity for the parked property differs from the actual price paid by the ultimate buyer, the Exchanger and the Holding Entity will enter into a purchase price adjustment agreement to increase or decrease the original purchase price and loan amount from the Exchanger as necessary to reflect the final purchase price.

Parking Replacement Versus Relinquished Property

- When dealing with replacement property of a residential nature, quite often institutional lenders will not make the acquisition loan to the Holding Entity even if guaranteed by the Exchanger. There, the only alternative is to have the EAT take title to the relinquished property so that the Exchanger can take direct title to the replacement property with a new loan from the institutional lender.
- To prevent a boot issue and the payment of capital gain taxes on excess proceeds from the sale of the relinquished property, the equity from the relinquished property must be reinvested in the replacement property prior to the Exchanger taking title. If the estimated proceeds from the relinquished property are greater than the funds available for the down payment on the replacement property, the Exchanger may wish to have the EAT take title to the replacement property so that the Holding Entity has an opportunity to use the excess funds from the sale of the relinquished property to pay down the debt on the replacement property prior to transferring title to the Exchanger, or the Exchanger can try to acquire additional replacement property at the time the relinquished property is sold and the 45-day identification period and 180-day exchange period start to run. If the EAT is taking title to the relinquished property, the down payment on the replacement property should equal or exceed the estimated equity in the relinquished property to avoid boot.
- Parking the relinquished property can be risky, since the Exchanger must be careful not to trigger a due-on sale clause in the relinquished property loan when the relinquished property is deeded to the Holding Entity. The transfer of the relinquished property to the Holding Entity may also trigger a reassessment for real estate tax purposes.
- Often the Exchanger does not know which relinquished property will be used in the exchange, or which relinquished property will sell first. In this situation, it is advisable for the replacement property to be parked with the EAT to allow the Exchanger the opportunity to tie up the replacement property until the Exchanger knows which relinquished property to use in the exchange or which one will sell first.

Practical Considerations

- To fall within the safe harbor protection of Rev. Proc. 2000-37, the Exchanger must identify the relinquished property to be exchanged within 45 days of the Holding Entity taking title to the parked replacement property, and the Holding Entity cannot remain on title for longer than 180 days.
- During the time the Holding Entity is on title to the property, the Holding Entity will require hazard and commercial general liability insurance, an acceptable recent Phase I Environmental Site Assessment Report, and an indemnity from any liability from the Exchanger.

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- Additional costs incurred by the Exchanger for a reverse exchange may be substantial. Additional title insurance may be required when the Holding Entity deeds the replacement property to the Exchanger; additional state, county, or local documentary transfer taxes may be assessed when property is deeded first to the Holding Entity and then to the Exchanger or the buyer; and the accounting, legal, and EAT's fees will almost certainly be significantly higher than the costs of a simultaneous or delayed exchange.
- If the Exchanger's transaction requires improvements be completed on the replacement property prior to the Exchanger acquiring title, the replacement property can be parked with the EAT. The Holding Entity will enter into a construction agreement with the general contractor and will borrow funds from the Exchanger or a third-party lender to finance the construction.
- In light of the practical difficulties and associated costs for all types of reverse exchanges, the Exchanger may wish to consider other available alternatives to delay the close of the purchase of the replacement property until the relinquished property sells to allow the Exchanger to complete a regular simultaneous or delayed exchange. For example, the Exchanger could apply an additional or non-refundable earnest money deposit for the benefit of the seller as consideration for the seller delaying the close of the replacement property, or the Exchanger could enter into an option to purchase the replacement property at a later date thereby providing enough time to sell the relinquished property.
- Recently, Rev. Proc. 2000-37 was modified by Revenue Procedure 2004-51 ("Rev. Proc 2004-51") to provide that the "safe harbor" of Rev. Proc. 2000-37 "does not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder". (Rev. Proc. 2004-51 Section 4). This new ruling has a potential impact on reverse improvement exchanges where the Exchanger is attempting to construct improvements on property it currently owns, and provides a "warning" for reverse improvement exchange structures where the replacement property is currently owned by an affiliate or related party.
- Despite the provisions of Rev. Proc. 2000-37, there may be additional state, county, or local transfer taxes that may be assessed twice: (1) when the replacement property is deeded from the seller to the Holding Entity to hold while the construction is completed, and (2) when the improved replacement property is deeded to the Exchanger to complete the exchange. In a recent Private Letter Ruling (PLR 200148042), the IRS held that the use of language in the QEAA stating that the Holding Entity is the agent of the Exchanger for the purpose of avoiding transfer taxes would not invalidate the safe harbor. Unfortunately, not all states and municipalities recognize an agent/principal transfer tax exemption and, therefore, the Exchanger should be aware that double transfer taxes may be an additional cost of the transaction in those jurisdictions. Also, the accounting, legal, and Qualified Intermediary and/or Holding Entity fees will almost certainly be significantly higher than on simultaneous or delayed exchanges where the deeding is direct and the Qualified Intermediary is not required to hold title to property.

Reverse and reverse build-to-suit exchanges can be a creative way to structure an exchange to best fit the Exchanger's investment goals. However, it is essential that Exchangers seek adequate legal and tax counsel in planning a reverse or reverse build-to-suit exchange prior to entering into the exchange.

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