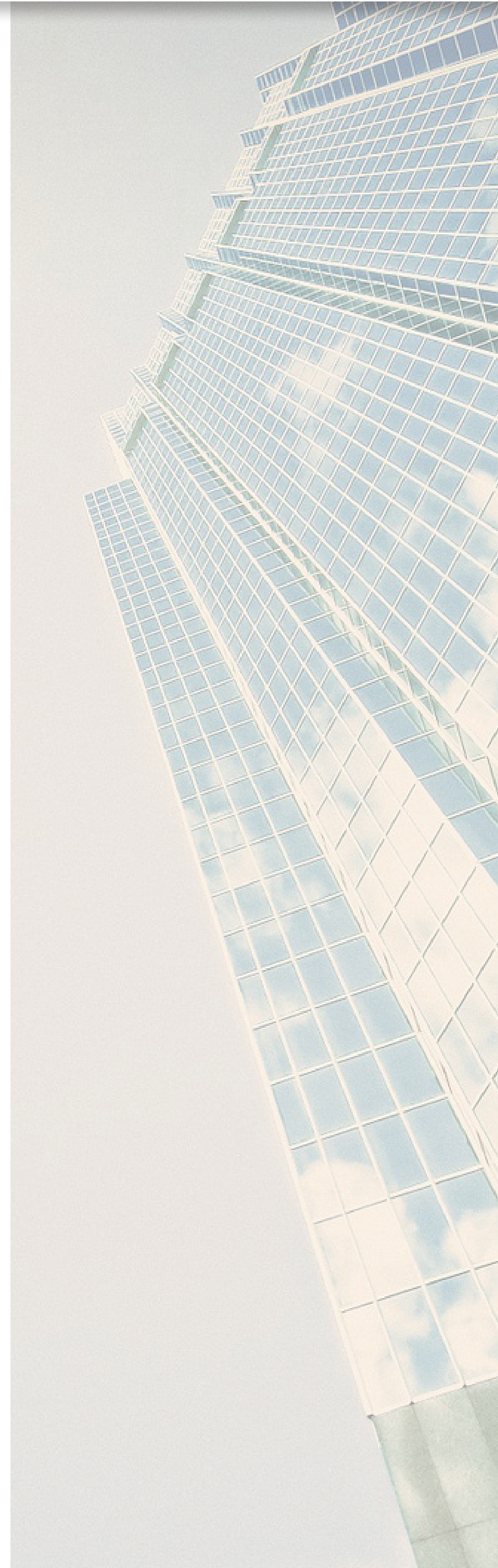
1031 EXCHANGE:
THE "REVERSE" EXCHANGE



The Reverse Exchange

A reverse exchange is the "flip side" of a deferred (delayed) exchange. In a reverse exchange the Exchangor for various reasons must acquire their like-kind replacement property before disposing of a relinquished property. For a period of time, it was unclear whether reverse exchanges would be given nonrecognition treatment by the IRS.

On September 15, 2000, that question was answered by the IRS in the form of Revenue Procedure 2000-37 ("Rev. Proc. 2000-37"). This Revenue Procedure 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 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. CATIC Exchange, LLC handles only those reverse exchanges that are in the "safe harbor" category.

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 Exchangor, 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. The durational limit on safe harbor transactions is taken from those of a delayed exchange, which by statute must be completed within the lesser of 180 days or the due date of the Exchangor's tax return for the year in which the relinquished property is transferred. Additionally, under a safe harbor reverse exchange the Exchangor must identify one or more relinquished properties within 45 days after the Holding Entity acquires the replacement 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.

Parking The Replacement Property

In the most common type of reverse exchange the Exchangor contracts with the Holding Entity to have it purchase and retain title to the replacement property. In the first phase of the reverse exchange the Exchangor loans the necessary down payment funds to the Holding Entity, who 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 Exchangor under a triple net lease. In this way the Exchangor 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 Exchangor or a third party designated by the Exchangor 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 Exchangor 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 deeding. The cash proceeds of the sale go to the Qualified Intermediary, who uses the proceeds to acquire the replacement property from the Holding Entity. The Holding Entity uses these proceeds from the sale to first repay the loan from the Exchangor and then any additional proceeds are used to pay down the third-party loan on the replacement property prior to deeding the replacement property to the Exchangor. If there are more proceeds from the relinquished property sale than the Qualified Intermediary needs to acquire the replacement 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 Exchangor within 45 days of the close of the relinquished property.

This type of reverse exchange works well when the Exchangor can pay all cash for the replacement property, when the seller is providing the financing, or when an Exchangor is working with a sophisticated third-party lender. If a loan from an institutional lender is required, the Exchangor should seek lender approval for this type of exchange prior to beginning the exchange because the Holding Entity (not the Exchangor) may be required to be the borrower on the loan as the titleholder of the property. Exchangors 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 Exchangor, the Exchangor will guarantee the loan and the Holding Entity will only be the borrower on a non-recourse loan and deed of trust or mortgage.

Parking The Relinquished Property

An alternative to parking the replacement property is to have the Holding Entity park the Exchangor's relinquished property. This type of reverse exchange begins with a simultaneous exchange involving the Exchangor, the Holding Entity, the seller of the replacement property and the Qualified Intermediary. Here, with the assistance of the Qualified Intermediary, the Exchangor 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 deeding. 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 Exchangor 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 Exchangor has in the relinquished property. As in the replacement-parking alternative, the Holding Entity leases the relinquished property to the Exchangor under a triple net lease agreement. In the second half of the transaction when the Exchangor 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 Exchangor 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 Exchangor 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 Exchangor as necessary to reflect the final purchase price.

Parking Replacement *vs* 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 Exchangor so the only alternative is to have the Holding Entity take title to the relinquished property so that the Exchangor 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 Exchangor 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 Exchangor may wish to have the Holding Entity 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 Exchangor, or the Exchangor 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 Holding Entity 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 Exchangor 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.

- Often the Exchangor 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 Holding Entity to allow the Exchangor the opportunity to tie up the replacement property until the Exchangor knows which relinquished property to use in the exchange or which one will sell first.

Considerations

- To fall within the safe harbor protection of Rev. Proc. 2000-37, the Exchangor 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 Exchangor.**

- Additional costs incurred by the Exchangor for a reverse exchange may be substantial. Additional title insurance may be required when the Holding Entity deeds the replacement property to the Exchangor; additional state, county, or local documentary transfer taxes may be assessed when property is deeded first to the Holding Entity and then to the Exchangor or the buyer; and the accounting, legal and Holding Entity's fees will almost certainly be significantly higher than the costs of a simultaneous or delayed exchange.

Considerations (cont.)

- If the Exchangor’s transaction requires improvements be completed on the replacement property prior to the Exchangor acquiring title, the replacement property can be parked with the Holding Entity. The Holding Entity will enter into a construction agreement with the general contractor and will borrow funds from the Exchangor 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 Exchangor 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 Exchangor to complete a regular simultaneous or delayed exchange. For example, the Exchangor 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 Exchangor could enter into an option to purchase the replacement property at a later date thereby providing enough time to sell the relinquished property.

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

CATIC Exchange, LLC cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice.

Ready to learn more?

Reach out today - we’re here to answer all your 1031 Exchange Questions.

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