

The Exchange



Putting It In Reverse: The Basics of a Reverse 1031 Exchange *By Anna Gregory Wagoner, Esq.*

What happens when a client contacts you to say that he wants to do a 1031 exchange but he has to buy his replacement property before he's going to be able to sell his relinquished property? Perhaps he planned to do a deferred exchange but a delay has occurred and he can't close on his relinquished property first, or maybe he's found the property he wants to buy but hasn't yet found a buyer for his old property. Is your client out of luck or is there a way to make his exchange work despite this problem? In 2000 the IRS issued Revenue Procedure 2000-37 that created a safe-harbor for exactly this type of scenario.

Prior to the issuance of the safe-harbor, taxpayers had been attempting for years to effect reverse exchanges with an accommodator parking either the relinquished property or the replacement property. The taxpayers attempted to make sure that the accommodator was the true owner of the property for federal income tax purposes, with all of the benefits and burdens of ownership, but these attempts would often fail, with the IRS determining that the accommodator was merely an agent of the taxpayer. In response to this issue, the IRS issued a safe-harbor which, if complied with, would result in the IRS not challenging either the qualification of the property as relinquished or replacement property or the treatment of the accommodator as the beneficial owner of the property for federal income tax purposes. The safe-harbor has strong non-inference language, meaning that reverse exchanges may still work outside the safe-harbor, although Investors Title does not facilitate non-safe-harbor reverse exchanges.

Under the reverse exchange safe-harbor an Exchange Accommodation Titleholder ("EAT") is used to hold title to the parked property for the taxpayer. The EAT must comply with the following requirements:

- Must have "qualified indicia of ownership"
- May not be a "disqualified person"
- May also serve as qualified intermediary in the exchange
- Must enter into a written agreement with taxpayer called a Qualified Exchange Accommodation Agreement ("QEAA")
- Must be a party subject to federal income tax

Must report its acquisition and disposition of the parked property on its tax return

The safe-harbor also outlines the requirements of the QEAA, along with permitted arrangements that will not destroy the reverse exchange:

A written agreement between the EAT and taxpayer must be in place within 5 days after the EAT's acquisition of the parked property

It must state the taxpayer's bona fide intent that the property the EAT acquires be either relinquished or replacement property in a like-kind exchange

If the EAT parks replacement property, the taxpayer must identify the relinquished property within 45 days

The EAT may not park property for more than 180 days

The EAT may take title in a special purpose entity, usually a single-member LLC

The taxpayer may loan the EAT funds for its purchase, or guarantee a third-party loan, and the loan to the EAT may be non-recourse

The EAT may ground lease the property to the taxpayer during its ownership, and the taxpayer may derive income from the property, manage the property and supervise improvements to the property

Puts or calls for conveyances of the property to the taxpayer are permissible if they do not exceed 185 days

In 2004, the IRS issued Revenue Procedure 2004-51 to modify Rev. Proc. 2000-37. The resulting change prohibits utilization of the safe-harbor to park replacement property owned by the taxpayer during the 180-day period preceding the EAT's acquisition. This was in reaction to taxpayer's attempts to circumvent the prohibition against using exchange funds to build improvements on property owned by the taxpayer. Taxpayers would convey property they owned to the EAT to park the property and construct the improvements, and then buy the improved property from the EAT with funds from the sale of their relinquished property. The modified Rev. Proc. put a stop to this type of activity.

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Once your client decides he wants to effect a reverse exchange, how is it typically structured?

The safe-harbor allows the EAT to park either relinquished or replacement property. It is rare for the EAT to park the relinquished property, for a number of reasons, not the least of which is that it is still probably unknown what the relinquished property will sell for. Therefore this discussion will be limited to parking replacement properties.

The EAT will hold title to the replacement property in a single-member LLC.

The EAT will draft the QEAA which must be signed by both EAT and taxpayer at or before the closing where EAT acquires the replacement property.

The property is triple-net leased back to the taxpayer during the time the EAT parks the property. The EAT will prepare the lease agreement and rent will be \$1 for a 6-month term. The taxpayer will be responsible for property taxes, insurance and maintenance on the property. The lease permits the taxpayer to sublet the property. Any existing leases on the property should be assigned directly to the taxpayer who may derive income from the property while the EAT holds title.

The EAT does not expend any of its own funds for the purchase of the property, so the taxpayer will either need to lend the EAT money out of his own funds or arrange for third-party financing, or a combination of both. All loans will be non-recourse to the EAT, but may be guaranteed by the taxpayer. The taxpayer is responsible for negotiating the terms of the loan but the loan documents must be reviewed by the EAT prior to closing.

The EAT will require some environmental due diligence in the form of an environmental questionnaire or Phase I report. The EAT may require a No Further Action letter if any known hazards are discovered on the property. If there is an environmental problem on the property, the EAT may refuse to take title.

Within 45 days from the date the EAT acquires the replacement property, the taxpayer must identify the relinquished property that he wishes to sell. He must close on the sale of the relinquished property and the purchase of the replacement property from the EAT within 180 days of the EAT's acquisition of the replacement property.

Once the taxpayer enters into a contract for the sale of the relinquished property, the QI, which plays a separate and distinct role than that of the EAT, will draft the exchange documents and send them to closing. At this point the transaction really just turns into a forward exchange, with the EAT as the seller of the replacement property. The funds from the sale of the relinquished property will be sent to the QI to be used for the purchase of the replacement property from the EAT for the taxpayer.

The EAT will sell the replacement property to the taxpayer for the same price that the EAT paid for it. The relinquished funds will be used to either pay off or pay down the loan taken out by the EAT and the EAT will convey title directly to the taxpayer. Any remaining balance on the third-party loan will be assumed by the taxpayer. Any remaining balance on the taxpayer loan will be forgiven in consideration of conveyance.

The EAT may transfer the property to the taxpayer by deed or by assignment of the membership interest in the LLC. Some advantages to taking assignment of the LLC are: no recording fees, no real estate transfer taxes, no assumption or payoff of the loan needed, no additional title policy or endorsement needed and no need to change the name of the insured on the property and casualty insurance. However, the LLC should apply for a new tax ID number concurrent with the change of ownership.

If the taxpayer is not assuming the sole membership interest in the LLC, the taxpayer should acquire title to the replacement property in the same way he held title to the relinquished property.

One point of confusion in reverse exchanges is that there are two separate 180-day timelines: one for the parking period and one for the deferred exchange period. As an example: the taxpayer parks replacement property worth \$60,000 in a reverse exchange, sells his relinquished property worth \$100,000 on day 180 of the reverse exchange and immediately acquires the parked replacement property worth \$60,000. The reverse exchange is over at this point, but he still has a new 45-day identification period and 180-day acquisition period in the forward exchange in which he can identify and purchase additional replacement property worth at least \$40,000.

Because reverse exchanges are so complex and costly to structure, as an alternative, it may be advisable for the taxpayer to try to delay closing on the replacement property, perhaps by an increase in the purchase price or an increased earnest money deposit.

What if the taxpayer is unable to sell his property within the 180-day timeframe?

In this case the reverse exchange has failed and the EAT will arrange to transfer the parked property to the taxpayer. The purchase price of the property will be the same as the purchase price the EAT paid upon acquisition. The balance of any third-party loan will be assumed by the taxpayer and the balance of any taxpayer loan will be forgiven in consideration of the conveyance. Because the taxpayer has not yet sold any property, he has not triggered any realized or recognized gain.

While the discussion above is a good overview of the entire reverse exchange process, every reverse exchange has its own set of different and complex issues. The accommodator cannot give tax or legal advice, so every taxpayer should obtain independent tax or legal counsel to guide them through the entire process.

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