



REVERSE EXCHANGES

GENERAL OVERVIEW OF REVERSE EXCHANGES

While most exchanges are structured as “forward” or “delayed” exchanges, where the relinquished property is sold first and the replacement property is subsequently acquired within 180 calendar days, parking arrangements are structured much differently. A parking arrangement is necessary (a) when an exchanger wishes to acquire the replacement property before selling the relinquished property, (b) the exchanger needs to make improvements on the replacement property before taking title to it; or (c) a combination of the above (i.e., where the exchanger acquires and improves the replacement property prior to selling the relinquished property). These are the reverse, improvement, and reverse-improvement exchanges, respectively.

Whereas in a delayed exchange, title to the replacement property passes from the seller to the exchanger, in a parking arrangement, an entity known as an Exchange Accommodation Titleholder (EAT) forms and owns a pass-through entity, usually a limited liability company disregarded for federal income tax purposes, to take title to the “parked property” prior to its acquisition by the exchanger. The need for the EAT to hold title to either the relinquished or replacement property is driven by the fact that an exchanger may not own both the relinquished and replacement properties at the same time. Thus, until the relinquished property is sold, the replacement property is “parked.”

On Sept. 15, 2000, the IRS released Rev. Proc. 2000-37, which provided a safe harbor for structuring parking arrangements. This Revenue Procedure was amended by Rev. Proc. 2004-51. In order to fall within the safe harbor provisions the exchanger must, among other things, have an EAT hold title to the parked property; identify the relinquished property within 45 days of the acquisition of the replacement property by the EAT; and complete the exchange within 180 days.

A key component to structuring a safe harbor reverse exchange is the formation of the disregarded entity to hold title to the parked property for the EAT. The EAT would form a pass-through Limited Liability Company, disregarded for federal income tax purposes from its sole member, the EAT. If the exchanger would like to acquire the interest of the EAT’s disregarded entity instead of the underlying parked property held by that disregarded entity, then the Exchanger or its advisor must advise QI and EAT in writing.

EAT requires (in most cases) that a Phase I Environmental Site Assessment be performed on any and all properties contemplated to be parked with the EAT, prior to the EAT entity taking title. Said Phase I ESA must be completed in accordance with ASTM standards, be certified to the EAT entity and Legal 1031 EAT Holdings, LLC, and be performed within the preceding six months from the anticipated date of acquisition by the EAT entity.



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REVERSE EXCHANGE CONSIDERATIONS

As discussed, the exchanger may not own both the relinquished property and the replacement property at the same time. Accordingly, the exchanger has the option of parking either the relinquished property or the replacement property. There are several items to consider when deciding which property should be parked:

1. Duplication of transfer tax and/or title insurance – In a reverse exchange the EAT will hold title to the parked property and then deed it out to the exchanger or a buyer. This can sometimes result in a duplicate transfer tax and/or title insurance fee. Many states, including New York, have exceptions for the duplication of transfer taxes. It is important to ascertain what the costs are associated with parking a property in a given state.
2. Ability to park a property – Many times an exchanger's attempts to park a property can be frustrated by a condominium or cooperative apartment board simply for the reason that they do not want an "entity" on title. It is important to research whether a board will allow a property to be parked.
3. Lending consideration – Many residential lenders will not lend to an EAT because it is a non-conforming loan. Commercial loans are generally not a problem.
4. Cash considerations – Parking a replacement property as opposed to a relinquished property can yield different cash requirements to complete a transaction. When structuring a transaction as an exchange there is a requirement that the exchanger buy a property of equal or greater value, contribute all the net cash proceeds from the sale of the relinquished property into the replacement property, and obtain equal or greater debt on the replacement property than was paid off on the relinquished property. When parking a replacement property, the exchanger is permitted to obtain as much financing as they want while the property is parked, so long as they pay the debt down with the cash obtained from the relinquished property. When parking a relinquished property, the exchanger is required to purchase the replacement property using an amount of cash equal to the amount of net cash that will be obtained once the relinquished property is sold.



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GENERAL COMMENTS:

A reverse exchange is more costly than a delayed exchange because the intermediary has to form an LLC, have the risk of being on title to a property, prepare much more documents, and file a tax return for the EAT entity. Accordingly, it is always a good idea to weigh the cost of a reverse exchange versus asking for, or even paying for, an extension on the purchase of the replacement property.

- Taxpayer or their agent locates a worthwhile replacement property to purchase, however, the relinquished property is not yet sold. The taxpayer is unable to extend the closing of the replacement property but wishes to acquire the replacement property as soon as possible. With a reverse exchange, the taxpayer can acquire the replacement property first, securing the property, and transfer the relinquished property after.
- Taxpayer's closing falls through on their relinquished property or the closing is delayed, and taxpayer is already under contract to purchase the replacement property. If the taxpayer is unable to extend the closing of the replacement property, they will need to utilize a reverse exchange to complete the replacement property closing first and close on the sale of the relinquished property after.
- In a "seller's market" where properties remain on the market for a short period of time, the taxpayer can negotiate to buy a replacement property first, secure the property, then sell their relinquished property after. This eliminates the concern to meet the identification deadlines and identify replacement property within the 45-day period.
- In a "buyer's market" where properties remain on the market for a longer period, the taxpayer can take advantage of a valuable "buy opportunity" by closing the replacement property first. The taxpayer can utilize the full 180-day exchange period to complete the sale and closing of the relinquished property.
- Where a business is relocating from the relinquished property to the replacement property, a reverse exchange minimizes business disruption. This structure allows the business to acquire their new space and transfer all property/employees to that new space, before closing on the sale of their old space, effectively allowing the business access to both spaces at the same time.

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