



Reverse Exchanges

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WHAT IS A REVERSE EXCHANGE?

Normally, an exchange occurs when an exchangor sells a property and subsequently purchases replacement property through the use of a qualified intermediary. What happens when the exchangor is unable to sell their property prior to the time they must close on the purchase of a replacement property? Every effort should be made to avoid this reverse order in closings by structuring for a simultaneous or delayed exchange. If this is not possible, the "Reverse Exchange" may be considered.

STRUCTURING THE REVERSE EXCHANGE

An exchangor cannot exchange into property they currently own (See Rev. Rul. 76-390, 1976-2 Cum. Bull. 243). Therefore, the reverse exchange uses an exchange accommodation titleholder ("AT") to purchase and warehouse either the relinquished property or replacement property until the relinquished property can be sold to a buyer. The actual exchange may then be performed as either a simultaneous or a delayed exchange depending upon the timing of these transfers. On September 15, 2000, the Internal Revenue Service published Revenue Procedure 2000-37 that provides for a *safe harbor* for those taxpayers wishing to utilize the reverse exchange format on or after that date. The rules of the safe harbor reverse are more completely discussed, below.

REVENUE PROCEDURE 2000-37

The main elements of the Revenue Procedure are as follows:

1. The safe harbor is available to all qualifying reverse exchanges entered into on or after September 15, 2000.
2. The exchange accommodation titleholder cannot be the taxpayer or a disqualified person.
3. There must be a written exchange agreement between the taxpayer and the exchange accommodation titleholder entered into within five days from the date the property (either the relinquished or replacement property) is acquired by the exchange accommodation titleholder.
4. The exchange agreement must state that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes.
5. The relinquished property must be identified within 45 days from the transfer of the replacement property to the exchange accommodation titleholder.(Exchange Last)
6. Similar to a delayed exchange, within 180 days from the date of acquisition by the exchange accommodation titleholder, the property held by the exchange accommodation titleholder must be transferred to either the taxpayer (when the replacement property is held by the exchange accommodation titleholder) or a person who is not the taxpayer or a disqualified person (when the relinquished property is held by the exchange accommodation titleholder).
7. The taxpayer is permitted to undertake certain activities and not violate the safe harbor. The taxpayer can: a) make and guaranty loans to the exchange accommodation titleholder; b) lease the property from the exchange accommodation titleholder; c) manage the property, supervise construction of improvements, or act as the contractor; d) enter into option agreements with fixed or formula prices with the exchange accommodation titleholder; and e) enter into agreements with the exchange accommodation titleholder that take into account a variation in the relinquished property's value from the date it was acquired by the exchange accommodation titleholder and the date it is ultimately sold to a buyer.

TWO VARIATIONS

Depending on the resources of the exchangor and the financing available, there are two variations of the reverse exchange.

1) Reverse Type "A" (Exchange Last)

The qualified intermediary, through the use of an AT, buys the replacement property, and retains ownership (no more than 180 days) until a buyer for the relinquished property is found. (Phase I) Once the relinquished property is sold, the proceeds from the sale are used to acquire the replacement property from the AT and the exchange is complete. (Phase II)



WHEN TO USE

The Reverse Type "A" is used when the exchangor is purchasing the replacement property for cash or the seller is providing the financing. If the down payment to acquire the replacement property in Phase I is less than the equity coming from the sale of the relinquished property, the exchangor could have taxable "boot" if the equities remain unbalanced. As the AT is the owner of the replacement property, the Type "A" format provides the opportunity to balance equities once the relinquished property is sold. In the above illustration, the exchangor is able to negotiate a small down payment of \$50,000.00 on the replacement property with short-term seller-financing until the relinquished property is sold. The AT retains ownership of the replacement property until the equity from the sale of the relinquished property is known. If the sale of the relinquished property nets more than \$50,000.00, the qualified intermediary can increase the equity in the replacement property without taxable boot to the exchangor by paying down the loan. The Type "A" format is also useful if the exchangor desires to improve the replacement property before it is transferred to them ("Reverse/Improvement Exchange"). The increase in property value due to improvement is counted as part of the acquisition cost and allows an exchangor to target a less expensive replacement property and use the equity in the relinquished property to increase its value.

FINANCING

If seller-carryback financing is not available, the exchangor must either provide the cash or arrange other financing. This is often difficult to accomplish. If outside financing is obtained, the AT will be required to execute a non-recourse loan guaranteed by the exchangor. Once the sale of the relinquished property is completed, the loan from the exchangor or lender is repaid with the sale proceeds. Any outstanding loan balance must be assumed by the exchangor.

DIFFICULTIES

- Since the replacement property is owned by the AT, the exchangor must enter into a Triple Net Lease with the AT. The lease payments owed to the AT will be offset by the loan payments the AT owes the exchangor. The ability for the exchangor to depreciate the replacement property will be unavailable until ownership is obtained.
- If a conventional loan is needed, it is extremely difficult to find a lender who will allow an AT as the titled owner.
- Insurance will have to be obtained to protect the AT against liability and loss during ownership of the property.

2) Reverse Type "B" (Exchange First)

The AT acquires the relinquished property with a loan (\$50,000) from the exchangor. The proceeds from the sale are used by the qualified intermediary to acquire and transfer the replacement property to the exchangor to complete the exchange. Once a buyer for the relinquished property is found (no later than 180 from the date the property was acquired by the AT), the sale proceeds are used to payoff the loan from the exchangor and any existing, secured financing.

WHEN TO USE

When it is necessary to obtain a conventional loan to purchase the replacement property. Most lenders require the borrower (exchangor) to be the titleholder. This format allows the exchangor to receive ownership of the replacement property immediately.



FINANCING

A conventional loan may be used by the exchangor to acquire the replacement property when using the Reverse Type "B" format.

DIFFICULTIES

This format has some of the same problems as Reverse Type "A".

- If the equity in the relinquished property is greater than the intended down payment on the replacement property, this format creates taxable "boot" unless only a portion of the relinquished property is acquired by the AT. It is unclear whether the Revenue Procedure allows an AT to buy only an undivided interest in the relinquished property. If this approach is taken then, upon the sale of the relinquished property, the remaining interest can be exchanged for other replacement property utilizing the delayed exchange format. Tax counsel should be consulted.
- Insurance will have to be obtained to protect the AT against liability and loss while they own the relinquished property.
- As in the Type "A" format, a Triple Net Lease will be required.
- Additional costs will be incurred by the Exchangor when selling the relinquished property to the AT. Furthermore, these costs may increase if the exchangor cancels the exchange because the property doesn't sell within the 180 day time limit. The AT will deed the relinquished property back to the exchangor which may result in property tax reassessment in addition to transfer costs. In states with excise tax, the taxing authority will usually charge for each transfer of the property, requiring payment of the excise tax twice.

LEGAL PRECEDENTS

The Reverse Exchange should always be evaluated by legal or tax counsel before proceeding. With the issuance of IRS Revenue Procedure 2000-37, I.R.B. 2000-40, Oct. 2, 2000, there is less necessity to rely on previous pronouncements or case law. Nonetheless, there are a few cases where the procedure has withstood judicial review. The IRS has likewise issued Private Letter Rulings which appear to favor reverse exchanges. The following are a few such cases and rulings: *J.H. Baird Publishing Company vs. Commissioner*, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4, the intermediary (a real estate agent) purchased and began to construct improvements on the replacement property. The Exchangor retained use of the relinquished property until the completion of the replacement property then concurrently exchanged for the replacement property. The court held that this was actually a simultaneous exchange. *In Re Exchanged Titles 159 Bank Rpt. 303* (Bkrpt C.D.Cal.1993), a bankruptcy court concluded the "reverse" nature of the exchange did not invalidate the exchange. *In Re Coastal Terminals Inc. v. U.S.* 632 F.2d 1171 (5th Cir. 1980), a buyer wanting to acquire Coastal's deep water port was instructed to acquire an inland site and construct a facility. Upon completion, the exchange of properties was consummated. The Court upheld the exchange of Coastal's port for the newly acquired facility. In two 1991 Private Letter Rulings 9110007 and 9149018, the IRS granted application of IRC §1031 where the intermediary acquired greater than 30 year leases on replacement property

This material is provided for informational purposes only and is not to be construed as tax advice. The reader is strongly advised to speak with a tax consultant before attempting to employ any of the concepts stated herein.

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