

## THE REVERSE EXCHANGE

A Reverse Exchange is an exchange where the Exchangor elects to close on a Replacement Property prior to closing on the Relinquished Property. They are more complex and require advanced planning to set up properly. There are also additional costs incurred in conducting a reverse exchange.

There are various reasons an Exchangor may need to explore the possibility of a reverse exchange:

- ❖ The Exchangor may wish to exchange in to a desirable property and is not able to close on the Relinquished Property in a timely manner, or the Seller of the Replacement Property may not be willing to wait for a deferred exchange to be completed.
- ❖ Unexpected delays in the Exchangor's ability to complete a transfer of relinquished property in what was intended to be a deferred exchange.
- ❖ The Exchangor wishes to avoid the risk of failing to meet the identification or exchange period requirements for a deferred exchange.
- ❖ Exchangor is looking at Replacement Properties that will not fit well into the timeframes of a deferred exchange, such as seeking to purchase a foreclosure property.

One feature that distinguishes a Reverse Exchange from a Deferred Exchange is that the Qualified Intermediary holds the Exchangor's property instead of the Exchangor's funds. These transactions are referred to as "parking transactions". The QI will form a separate entity known as an *Exchange Accommodation Titleholder* ("EAT") that will maintain books and records separate from those of both the Exchangor and the QI. To complete a reverse exchange the EAT can take title to either the Relinquished Property or the Replacement Property under a *Qualified Exchange Accommodation Arrangement*. The document between the Exchangor and EAT is called the *Qualified Exchange Accommodation Agreement* ("QEAA"). In the parking arrangements, taxpayers should arrange the transaction so that the EAT has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes.

Rev. Proc. 2000-37 provides a safe harbor under which the Internal Revenue Service will not challenge (a) the qualification of property as either "replacement property" or "relinquished property" (as defined in section 1.1031(k)-1(a) of the Treasury Regulations) for purposes of Section 1031 of the Internal Revenue Code; and (b) the treatment of the "exchange accommodation titleholder" as the beneficial owner of such property for federal income tax purposes, if the property is held in a *Qualified Exchange Accommodation Arrangement*". This is known as a "Safe Harbor Reverse Exchange"

The property held by the EAT is referred to as being "*Parked*". There are two types of Reverse Exchanges, one where the replacement property is parked under the QEAA, and

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Attorneys & Accountants 1031 Services, LLC is available to assist Exchangors and their advisors with exchange strategies and technical support, however Attorneys and Accountants 1031 Services, LLC cannot provide legal or tax services or advice and the Exchangor must consult with their legal and tax professionals as to the intended exchange and any legal or tax implications thereof.

one where the relinquished property is parked under the QEAA. In undertaking a reverse exchange, arrangements must be made to permit the EAT to finance not only the acquisition, but the carrying costs throughout the time the EAT is in title.

Parking the Replacement Property: Parking transactions typically are designed to "park" the desired replacement property with the EAT until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the Exchangor, within the 180 day exchange period, transfers the relinquished property through the delayed exchange format and the EAT transfers the replacement property to the Exchangor.

Parking the Relinquished Property: In this type of arrangement, the EAT acquires the desired replacement property on behalf of the Exchangor and immediately exchanges such property with the Exchangor for the relinquished property, thereafter holding the relinquished property until the transfer of such property to the ultimate transferee. The maximum time permitted for the EAT to remain in title is 180 days, during which time the property may, and often is, leased back to the Exchangor.

There are also Reverse Exchanges performed which fall out of the safe harbor provisions of Rev Proc 2000-37. In any reverse exchange situation, Exchangors are strongly urged to plan their reverse exchange strategy as far in advance as possible and to consult with their tax and legal advisors in conjunction with Attorneys & Accountants 1031 Services, LLC.

There is also a variation on the standard Reverse Exchange, known as a *Reverse Improvement or Build-To-Suit* exchange. In this type of situation, during the time the EAT holds the property, improvements are constructed upon the property. This is done for various reasons, such as where the Exchangor wishes to improve the Replacement Property to make the property more suitable for the Exchangor, and the value of the unimproved Replacement Property is less than the value of the Relinquished Property. For computing the value of the property for purposes of the exchange, only the value of improvements actually in place at the time of the exchange are included. In this type of exchange, the Exchangor must arrange for the EAT to be able to pay for all improvements, as the EAT generally has no ability to finance the improvements. This generally requires available funds or a loan where the Exchangor is a guarantor.

The Exchangor should consult with their tax and legal professionals prior to planning for the Reverse Exchange, as many jurisdictions impose transfer taxes on both the transfer to the EAT and the Exchangor, and there can be additional title insurance, legal, recording, inspection, insurance and formation expenses which can significantly offset tax savings for this type of arrangement.

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