

Investors are finding Reverse Exchanges are a useful strategy to defer capital gains tax

May 22, 2012 - Spotlights

Reverse Exchanges are a powerful tool for investors attempting to defer payment of capital gains and depreciation recapture taxes. Allowing investors more flexibility within the regulated timelines, a Reverse Exchange may be the answer if the investor finds new replacement property he must take title to before being able to close on the sale of the relinquished property.

The Reverse structure gives investors the flexibility to make an offer on foreclosed property. With the instability of the foreclosure/short sale being completed timely, this saves the investor from unnecessarily selling first and then getting stuck out there with nothing to purchase. Once assured the foreclosure purchase will close, a Reverse Exchange can be set up to acquire the new (replacement) property and the old (relinquished) property can then be listed for sale.

Another creative approach is the combination of a Reverse Build-to-Suit Exchange, allowing the investor to build or make improvements to the replacement property prior to the relinquished property sale. A taxpayer selling a business property, such as a manufacturing facility, that cannot be taken off-line until the replacement property is fully functional will benefit from this method.

Revenue Procedure 2000-37 established the "safe-harbor" regulations for a Reverse Exchange, assuring the IRS will not challenge the exchange if these guidelines are adhered to. Note that due to the intricate details of a Reverse, not all Intermediaries will provide this service.

When contemplating a Reverse Exchange, there are a few major points to keep in mind:

- * As with a Forward Exchange, the Qualified Intermediary must be in place prior to the first property closing. Taxpayers wrongly assume that the QI only needs to be notified prior to the sale side closing. Taxpayers cannot be on title to both properties at the same time and still receive the tax deferral benefit so they need to remember that if they take title to the replacement property prior to bringing the QI on board - it is too late to exchange!
- * Since the Taxpayer cannot hold title to both properties at the same time, title to one must be "parked" with an Intermediary, acting as the Exchange Accommodation Titleholder (EAT).
- * The exchange must be completed within 180 days. If the taxpayer cannot sell the relinquished property within that timeframe, the exchange will terminate and title will be conveyed to the Taxpayer. There will be no capital gains tax due since there was no sale, but the owner must be financially able to carry both properties.
- * There are other items to address, such as a new pass-through entity to be established for holding title, leasing the property back to the taxpayer during the exchange, prior lender approval if there will be financing on the parked property, environmental report reviews for commercial property and required liability insurance for the EAT while title is parked.
- * Reverse Exchanges take time and planning - they cannot be set up at the last minute like a plain vanilla forward exchange. Involving the owner and counsel early on ensures the best chance of

success.

In a climate where timing is everything and properties are taking longer to close, investors are finding Reverse Exchanges to be a useful strategy to defer capital gains tax. Although more involved than Forward Exchanges, the justification is the flexibility gained with this structure. Reverses are another beneficial tool for deferring capital gains taxes under Section 1031.

Patricia Flowers, CES, is assistant vice president for Investment Property Exchange Services, Inc. (IPX1031), Boston.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540