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Reverse exchanges and other 1031 Exchange "parking" arrangements

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For the "true" real estate investor (by my definition: someone who is always on the hunt to purchase a bargain parcel of land, and is always ready to entertain a sale from his portfolio, at the right price, of course) the reverse exchange, in which the Exchanger buys first and sells later, offers some flexibility that is not often fully appreciated. When these investors find a property that they want to buy, they often need to act fast. They can't wait around to sell a property first and set in motion a forward exchange, so setting up the purchase as a reverse exchange may yield substantial tax benefits.

After the Exchanger acquires a property on a reverse exchange, they have up to 180 days to sell one of their properties and if they can do so, the capital gains taxes from that sale may be deferred. If the Exchanger is not successful in selling a property, there is no tax consequence, as nothing has been sold. This scenario contrasts sharply with a forward exchange, where the pressure to find and purchase a property can be significant, with potentially big tax liability if the Exchanger does not find a suitable property to acquire. We have too often seen situations where our clients settle on a less-than-ideal new investment property primarily to avoid taxes.

In the more common type of exchange, the forward exchange, the relinquished property is sold by the Exchanger, the Qualified Intermediary (QI) receives the net cash to hold in escrow, and later the QI sends the funds to the closing on the replacement property purchased by the Exchanger. The involvement of the QI in the forward exchange is fairly limited, and so is their fee.

There are a variety of other 1031 Exchange transactions, primarily the reverse exchange, which require the facilitator to temporarily hold title to real estate, in what is called a "parking" arrangement. These types of arrangements have been developed pursuant to IRS Revenue Procedure 2000-37. When a facilitator serves in this capacity, under the IRS regulations, their title changes to that of Exchange Accommodation Titleholder (EAT) rather than QI. In the reverse exchange, the EAT may hold title to either the replacement property being purchased by the Exchanger (more common) or to the relinquished property that will be sold by the Exchanger. A new Limited Liability Company is formed to hold title to the parked property, and the LLC serves as the EAT, with the facilitator being the sole member of the LLC.

When we provide services as the EAT, and purchase property on behalf of the Exchanger, we will also sign any loan and closing documents necessary to acquire the property. The rules do not mandate that we execute the personal loan guaranty, and the Exchanger still has the privilege of signing that document. The EAT will commonly grant a second mortgage on the parked property to the Exchanger, in an amount representing their cash infusion. So the EAT has no equity in the property it is holding.

When the Exchanger completes the second leg of the reverse exchange and closes on the sale of their relinquished property, the net funds from the sale will be transferred to the EAT, (similar to a forward exchange) and those funds will be disbursed, first to the Exchanger to reimburse them for their out-of-pocket advances, and then to the first mortgage lender. The parked property is then transferred from the EAT to the Exchanger either by deed, or by transfer of the LLC's membership interest.

Forward and reverse exchanges can be combined in interesting ways. For instance: buy a property on a reverse exchange for $200,000; then later sell a property for $500,000 which ends the reverse exchange and simultaneously starts a forward exchange; then buy another property for $300,000. The Exchanger has up to 180 days to complete each leg of such a combined exchange.

Parking arrangements are also used for Improvement Exchanges, also known as "Build to Suit," and can they can be incorporated into either a forward or reverse exchange. The typical scenario would have the Exchanger selling a property for $200,000, then finding a property they wish to buy for $150,000 that needs some work. If they simply bought that property, then completed the improvements at a later date, they would incur a capital gain of $50,000. In the improvement exchange parking arrangement, the EAT acquires the property, makes the $50,000 in improvements (using funds advanced by the Exchanger or its Lender) and then transfers title of the parked property to the Exchanger. Now the property is worth $200,000 when acquired by the Exchanger and they can defer all capital gains taxes.

This article is a summary outline of a complicated transaction. You must consult with competent professionals to guide you through such a project.

Thomas Jewell, Esq. is the owner of Maine Exchange Services, LLC, Portland, ME.