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Use the right tools – Look again at Reverse 1031 Exchanges - by Stan Freeman

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Use your tools! The message that this article hopes to convey to active real estate investors is that reflexively relying on deferred 1031 exchanges to accomplish important objectives may not be the best use of well-understood tools that are available and dependable.

The current CRE market continues to be driven by investors trying to put money to work and the resulting shortage of good assets tilts the market profoundly in favor of sellers. So, it's relatively easy to sell what you own but it's likely to be very difficult to buy what you want. If you start a 1031 exchange by selling an existing property, the proceeds of the sale are given over to a QI, you have 45 days to ID potential replacements and 180 days to consummate one or more purchases. Following the sale you are now a buyer in a market that is brutal for buyers. Moreover, you are a buyer with deadlines that probably work against you and may cause your exchange to fail or may force you into acquiring something that is not at all ideal. The rest of this article contrasts this typical deferred exchange situation with that of a reverse exchange.

As you probably already know, in a reverse exchange the replacement property is acquired prior to the sale of the relinquished property. If you simply cannot assemble the financial means to acquire the replacement first, then you need not read any further and the deferred exchange option is the only one available to you. If you can acquire the replacement first, then there are important differences in your return on investment, identification requirements and flexibility as to deadlines.

Superior Return On Investment. In a typical reverse exchange, the replacement is held by a LLC owned by the accommodator and the relinquished continues to be held by the investor until it is sold. Also typical is a lease agreement between the accommodator and the investor for the replacement which enables the Investor to enjoy any and all income generated by the replacement. This is critical: in a reverse exchange involving income-producing properties, the Investor will receive the income from both the replacement and the relinquished during the exchange period, which is up to 180 days. Of course, there are expenses associated with both properties and there may be two debt service requirements but the "arbitrage" on these obligations is generally favorable for the investor or the investments might not make sense. So, instead of cash equity coming out of the sale of the relinquished being given over to the QI, where the return is essentially zero, in a reverse exchange, the investor is enjoying two sources of income and one source (the relinquished property) of depreciation write-off. It does not take a CPA to make this calculation and to see how much better financially – for the investor and not the QI – a reverse exchange can be. Tools to assess the ROI from different exchange process are available as web-based calculators.

Different 45 Day ID Requirements. Secondly, there is a potentially critical difference in the ID requirements for a reverse exchange. Once the replacement has been "parked" by the accommodator in a typical reverse, the investor has 45 days to ID the potential relinquished property that will be sold to complete the exchange. The ID requirement in a reverse exchange pertains to the relinquished and not the replacement! But the investor already owns the relinquished property (there may be multiple candidates for sale) and there is potentially a world of difference. If you ID three properties in a deferred exchange and cannot acquire any of them within 180 days, your exchange fails, the gain on the sale will be recognized and the QI is required by statute to hold your funds for the entire 180 day period. This happens with alarming frequency these days as the market is not at all friendly for buyers with deadlines. On the other hand, if you have acquired the replacement first in a reverse exchange, you are now a seller in a market tilted profoundly in your favor. Even you if you can't sell or elect not to sell your designated relinquished property in the ensuing 180 days, the failure of the reverse exchange simply means that you'll end up owning the replacement and the relinquished, which may not be what you initially contemplated, but you will not have a taxable event derived from the sale of the relinquished property.

Reverses With More Than 180 Days. Thirdly, recent developments have made reverse exchanges that can exceed 180 days quite a bit more accessible. This is true for both ongoing safe-harbor reverses in which more time is needed and for non-safe-harbor reverses where it is known from the start that more than 180 days are needed.

These situations have typically been addressed with "non-safe-harbor" reverse exchange structures which are complex and costly and, in general, only applied to situations with very large potential tax deferrals. In one case, an ongoing safe-harbor reverse exchange can be extended by having a "white knight" entity (formed by the accommodator and having real capital) acquire the relinquished from the investor prior to the 180th day of the safe-harbor reverse. In those cases where the need to go beyond 180 days is known at the outset, a non-safe-harbor reverse exchange can be used to provide safely up to 3 years (perhaps more) to make improvements or sell one or more relinquished properties. This structure also involves an accommodation entity that must have its own capital and holds title to the eventual replacement while the improvements are being made.

A recent tax court decision (Bartell) has made it possible to 1) start a safe-harbor reveres exchange in which the ability to convert to a non-safe-harbor structure that follows Bartell is included in the documentation and 2) start a non-safe-harbor reverse improvement exchange in which the accommodator entity is not required to have real equity in the project.

So, to summarize the options for going beyond 180 days:

One can use a standard safe harbor reverse and, if the relinquished does not sell timely, have an accommodator form a white knight to acquire the relinquished so that the exchange can be completed. This process is moderately complex and moderately expensive.

If the investor feels that there is a real possibility that more than 180 days will be needed, a safe-harbor reverse exchange can be used initially but the documentation will be such that a series of amendments can be applied to convert the reverse to one that follows Bartell. This process is slightly more expensive at the outset and has a moderate fee associated with the conversion to non-safe-harbor.

If it is certain that more than 180 days will be required to accomplish an objective (e.g. significant improvements are to be made), then a non-safe-harbor reverse exchange can be used. If the facts and circumstances are similar to that found in Bartell (which is the case with surprising frequency) then a similar structure can be used. This is also moderately complex and bears moderate expense. If the situation is dissimilar to Bartell, or the time needed is more than two years, then the traditional non-safe-harbor approach, in which the accommodator must satisfy a series of often-challenging “burdens and benefits” tests of ownership, can be used. This is more complex and more costly but it will accomplish the goals in a great many different situations.

Considering several very important factors found in today’s hyper-competitive CRE market – transaction risk, ROI and often crucial timing flexibility - the reverse exchange may be the informed CRE investor’s “secret weapon” for achieving advantages, both strategically and economically, that simply cannot be accomplished using a deferred 1031 exchange.

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