What to know about financing a property in a reverse exchange

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Property parked in a reverse exchange may be financed in a number of ways. In safe harbor parking transactions, the exchange accommodation titleholder (EAT) does not lend or advance its own funds. The funds to acquire the parked property may be borrowed from the taxpayer, a party related to or affiliated with the taxpayer, or a traditional lender, such as a financial institution. Safe harbor reverse exchanges are 100% financed, typically by a single loan from the taxpayer (or an affiliate) or a combination of senior debt from a bank and subordinated debt from the taxpayer. Here are some of the issues that frequently come up in financing the parked property:

Identity of the Borrower

Often title to the parked property is held by an entity that is a disregarded for federal income tax purposes (such as a single member LLC or a limited partnership). The loan is made to the entity that acquires the property, rather than a loan to the EAT. For tax purposes, the EAT will be considered the borrower. For all other purposes, the LLC will be the borrower.

Interest Rate

When the loan is from the taxpayer (or an affiliate), the parties can choose any interest rate, even a zero interest loan. Frequently, a below-market rate loan will require that interest be imputed at the applicable federal rate. The imputed interest rules will not apply to any obligation with a stated maturity date of six months or less. Since the maximum term of a reverse exchange is 180 days, imputed interest is not a concern. If the parked property is income-producing, and a lease or management agreement is not used, the interest rate can often be set high enough to offset any income that would be taxable to the EAT.

EAT Liability on Debt

The EAT will generally not become personally liable on the debt. Since the EAT is an accommodator only, and not a true equity participant, most lenders will consent to the EAT having no personal liability. The EAT will carefully review the loan documents to make sure that it has no recourse liability on the loan. However, the entity holding title to the property (the LLC) will often be required by the bank to be liable on the note. If the LLC signs the note, and the EAT does not, the EAT will often be satisfied. Often the EAT is asked to make warranties and representations to the lender, which could result in personal liability to the EAT. The EAT will carefully review any representations and warranties it must make.

Principal Amortization

In a reverse exchange, the transfer price for a parked property is typically the principal amount of the debt. If principal is paid during the parking arrangement, the EAT should address how principal amortization is treated. Compass treats principal payments on bank debt as additional principal advanced on the subordinate debt from the taxpayer. This maintains the principal amount of the debt constant during the term of the parking arrangement. Another technique is for bank debt to be interest only for a period of six months.

Transfer and Assumption

When the parking arrangement is wrapped-up, the membership interest in the LLC is assigned to the taxpayer. The loan documents should permit this transfer. The EAT will want a loan statement from any bank to show the amount of any debt to which the property is subject on the transfer date.

Securitized Debt

One of the more difficult issues is obtaining lender consent to assume existing debt for property being parked in a reverse exchange. Parking property with existing securitized debt requires consent and cooperation of the indenture trustee. The entity acquiring the property must be a bankruptcy remote entity. This requires special provisions in the LLC's organization documents. If the lender will not allow the EAT to become the member of the LLC that is acquiring property with securitized debt, the taxpayer may decide to park the relinquished property instead (in an "exchange first" parking arrangement).

Compass' principals have significant experience in real estate finance and understand how these issues need to be addressed from both an income tax and real estate perspective. Our independence allows us to be flexible, and do what is necessary in order to get the transaction completed for our clients. If you have any questions about financing property in an exchange, please contact us.

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