

Reverse 1031 Exchanges Gain Popularity

by Javier G. Vande Steeg

You probably know about the immensely popular Internal Revenue Code Section 1031 and the many benefits it provides. But chances are you've recently seen a variation of the 1031 exchange, called a reverse exchange, being used with unprecedented vigor. This article will explore why, and more importantly how, these transactions are performed. But first it is important to set the stage.

Let's begin by laying out some common 1031 exchange terminology.

- The taxpayer or party performing the exchange is the **exchanger**.
- The property that the exchanger sells is the **relinquished property**.
- The property the taxpayer acquires is the **replacement property**.

What exactly is a reverse 1031 exchange? The exchanger acquires the replacement prior to closing the sale of the relinquished property.

- The 45 days after the close of the relinquished property is the **identification period**.
- The 180 days after the close of the relinquished property is the

exchange period.

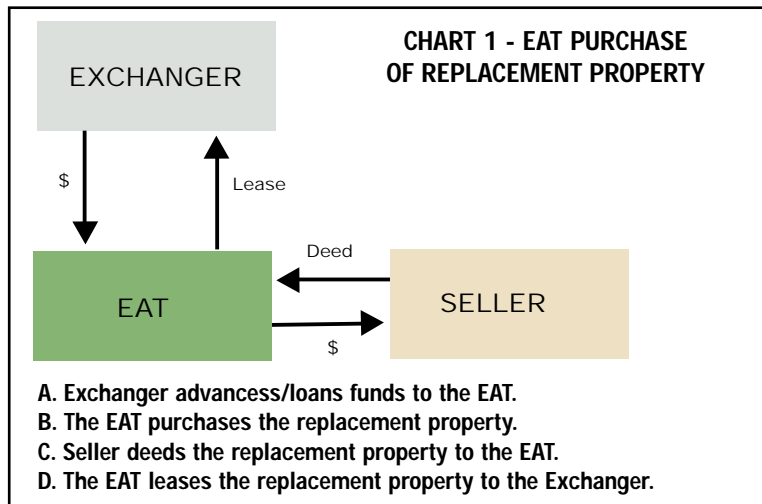
- The intermediary's titleholder in a reverse exchange is called an exchange accommodation titleholder, or **EAT**.
- The term used to describe the holding of title by the EAT is called a **parking arrangement**.
- The agreement between the EAT and the exchanger governing the parking transaction is called a qualified exchange accommodation agreement, or **QEAA**.
- The type of parking arrangement utilized when improvements are to be made to the parked property is called an **improvement exchange**.

What Exactly Is a Reverse 1031 Exchange?

The most basic answer is that the exchanger performs the exchange in reverse order. That is to say that the exchanger acquires the replacement prior to closing the sale of the relinquished property. (See Chart 1.) Therein lies the problem. Court case precedence makes it very clear that the exchanger could not own both the relinquished property and the replacement property at the same time. How then could an exchanger accomplish his/her goals? The answer is that the exchanger would typically have had a qualified



intermediary acquire the replacement property and park title until the relinquished property could be sold and closed. Subsequent to that closing, the replacement property would be deeded to the exchanger to complete the exchange. (See Chart 2.) However, lacking formal authority to structure such a transaction, practitioners debated and went to great lengths to overcome what was perceived to be a transaction killer—the qualified intermediary. Under audit the qualified intermediary would be deemed to be an agent of the exchanger and would only hold mere legal title. In other words, the qualified intermediary may not pass the “burdens and benefits” of ownership test, and the exchange would collapse. Due to this pitfall, exchangers and their intermediary would often structure the transaction so that the intermediary would actually attempt to possess the burdens and benefits of real property ownership. This was a difficult task, and no one really



knew whether or not they would pass the burdens and benefits test.

Therefore, reverse exchanges were performed only by aggressive exchangers willing to take a risk. The risk comes from the fact that the reverse-exchange variation had no formal IRS guidance on how it should be done. Therefore, anyone who performed a reverse 1031 did so in light of the fact that their transaction might be scrutinized and possibly defeated.

Things Have Changed for the Better

In September of 2000, the IRS finally issued long-awaited guidelines on how these transactions are to be handled. The

The items on the wish list in their proposed guidelines were almost all attained, with the exception of the allowable parking period of the property by the EAT. The proposal was to allow a property to be parked for up to two years. The IRS final version of the Revenue Procedure allowed only a 180-day parking period. This hurts the large commercial improvement exchanges because construction often does not progress much in 180 days.

Nevertheless, the Revenue Procedure cut a clear path for exchangers to take advantage of parking title with the EAT while not having to pass a benefits and burdens test. In fact, many of the

factors or situations that call for the acquisition of a property by an EAT for the benefit of the exchanger.

The first is the reverse exchange. Again, the reverse exchange utilizes the parking arrangement by the EAT for the taxpayer because the replacement property must be closed prior to the close of the relinquished property. This occurs for the following reasons:

- It is a sellers' market, which demands "close it or lose it" action.
- Conservative exchangers want to eliminate the risk of not being able to identify and close on a suitable replacement property, thereby risking their entire capital gain if they performed their exchange in the normal order of selling first and buying second (typical delayed exchange).
- The exchanger is selling multiple properties and cannot get all the relinquished properties closed before the replacement property must close.

The second situation is the improvement exchange. For example, let's say the relinquished property was an apartment building that sold for one million dollars, had debt of \$400,000 and equity of \$600,000 (closing costs not taken into consideration for purposes of the example). The exchanger wants to build rather than buy a commercial building. The exchanger has located the land and enters into a purchase agreement with the seller that is assignable by the exchanger. The purchase price of the land is \$300,000. Since there is a big difference between the value of the relinquished property and the new land, under 1031 rules

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guidance came in the form of Revenue Procedure 2000-37, which is best defined as a "safe harbor" for reverse exchanges. In other words, if you stay within the confines of the Revenue Procedure, your transaction will not be scrutinized.

Revenue Procedure 2000-37 was basically written and proposed by the American Bar Association and 1031 exchange industry experts.

permissible agreements and structure points contained in the Revenue Procedure clearly do not have burdens and benefits in mind, a definite sigh of relief for all involved.

Why Use an EAT?

Let's explore why these transactions are so valuable to the investor. There are two primary motivating

the transaction would equate to taxable “boot.” The parking arrangement will solve this problem. The EAT will park title to the land, and the exchanger will build the building. This is why the current 180-day parking period, as opposed to the desired two-year period, can hurt some improvement exchanges. In this example, however, if the exchanger has as many of the pieces together as possible before closing the relinquished property and parks title to the land with the EAT, it would be quite possible to put \$600,000 of improvements into the property. If they were able to improve the land by completing \$600,000 worth of capital improvements within the 180-day period, which began at the close of the relinquished property, the EAT would deliver title to the property to the exchanger in a 100% tax-deferred exchange! Note: The building need not be complete. For 1031 purposes you need to be concerned with getting enough capital improvements into the property to satisfy the relinquished property figures.

Of course there are many rules to follow, requirements to meet, and potential complications that you may encounter. But these are the two variations of the 1031 exchange that require the parking arrangement strategy. It should also be evident why they are so popular now that the Revenue Procedure provides a safe harbor to accomplish parking arrangements while enabling exchangers to take advantage of the benefits of parking title for the above reasons.

How They Work
Steps involved in the reverse

exchange: (See Charts 1 & 2)

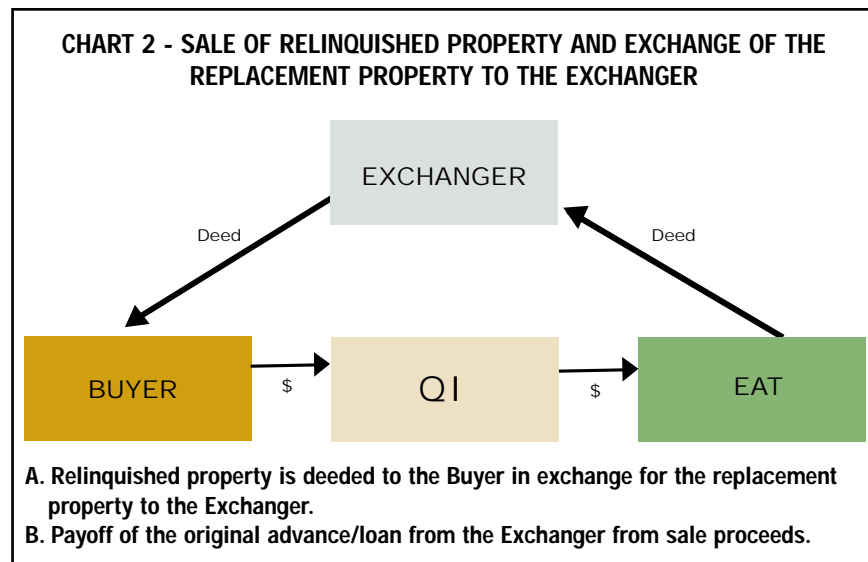
1. Exchanger assigns purchase agreement to EAT to acquire the replacement property
2. Exchanger loans required funds to EAT to close
3. 180-day parking period begins
4. EAT leases (triple net) property to exchanger
5. Exchanger finds a buyer for the relinquished property and closes in normal 1031 exchange fashion using a qualified intermediary
6. The EAT transfers the replacement property to the exchanger in order to complete the exchanger’s 1031 exchange

The same basic steps are taken in the improvement exchange, except that the EAT will remain on title typically throughout the parking period while the exchanger improves the property. In addition, a construction management agreement may be utilized depending on the complexity of the project.

To Park or Not to Park?
What are the issues to consider when contemplating a parking

arrangement?

- Expense. Parking transactions are very expensive in comparison to 1031 exchanges. You must consider the EAT formation expenses, additional transfer tax upon transfer of the property from the EAT to the exchanger, title insurance premiums, and additional escrow/closing costs.
- Security of your parked asset. 1031-qualified intermediaries who perform parking arrangements (many do not) can structure their EAT in many different ways. Some structures provide a great deal more security for the exchanger, which could mean that their parked asset will not be subject to undue risk. Single-asset entities formed specifically for a particular parking arrangement (and dissolved after the transaction is completed) should provide the best security for the exchanger.
- Complexity. In comparison to the standard 1031 delayed exchange, parking arrangements are far more complicated.



Lender issues, contractual issues, and transaction structuring can all require more attention and time.

Escrow/Closing Agent Issues

There has been a surge in parking arrangement activity since the Revenue Procedure was enacted, and it will undoubtedly continue. It is imperative that escrow/closing agents involved in these transactions understand a basic fundamental point. Simply put, the EAT becomes your buyer in every way. Even though the EAT is buying for the exchanger, you must replace them with the EAT. The qualified intermediary performing the EAT function should provide

you with detailed instructions and conditions to meet prior to closing. These may include title insurance requirements, proof of insurance requirements, settlement statement instructions, and debt/security instrument instructions.

The title insurance industry as a whole will benefit from the increased usage of parking arrangements. It is not uncommon to issue additional policies and binders and to collect escrow/closing fees that are sometimes double that of a standard closing. This is due to the fact that there will be an additional closing at a later date, and the closing agent who handled the acquisition normally also handles

the transfer from the EAT to the exchanger.

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