

Reverse Exchanges

Background

There are times when a taxpayer must take title to a desired replacement property before he can transfer the property to be relinquished. This is known as a reverse exchange and is not currently allowed under the IRC 1031 Like-Kind Exchange regulations.

However, the exchange industry had for a number of years requested that the IRS establish some type of procedure to accommodate this situation. In the absence of IRS guidance, exchangers were using third parties to take title to the eventual replacement property, having them own and operate the property and sometimes building improvements, until such time as the exchanger could transfer their relinquished property and purchase the replacement property from the third party owner. These were called “parking arrangements”.

In September, 2000, the IRS published IRS Revenue Procedure 2000-37, Procedures for the Accommodation of Reverse Exchanges. This procedure establishes “safe harbor” rules to formally provide for and document such “parking arrangements”. The procedure requires that the relinquished or eventual replacement property be held by the “exchange accommodation titleholder,” (EAT), in a “qualified exchange accommodation arrangement,” (QEAA).

Taxpayers and advisors should be aware that if the services of an EAT are required, it can be expensive and requires strict adherence to the Revenue Procedure.

The QEAA must meet the following requirements:

- a. The EAT will have legal title to the property or “such other indicia of ownership”.
- b. It is the bona fide intent of the taxpayer to do an exchange.
- c. A written QEAA is prepared within five days of transfer of ownership to the EAT, and the written agreement provides that:
- d. The EAT is holding the property for the benefit of the taxpayer in order to complete an exchange under Section 1031;
- e. The EAT will be treated as the beneficial owner of the property for federal income tax purposes; and
- f. The EAT will file federal tax returns as necessary.
- g. Within 45 days after transfer of ownership to the EAT, the relinquished property must be identified. The taxpayer may identify alternate or multiple relinquished properties.

- h. No later than 180 days after transfer of ownership to the EAT, the replacement property must be transferred to the taxpayer.

Disqualified Exchange Accommodation Title Holder

The EAT may not be the taxpayer or a disqualified party as set forth in IRS Regulation 1.1031(k)-1(k). Qualified intermediary, (QI), companies have set up separate entities or have made separate working arrangements with companies that have been established to serve as an EAT.

Permitted Contractual Arrangements

The following legal or contractual arrangements may be made without invalidating the QEAA:

- The taxpayer or a disqualified person may guarantee the obligations of the EAT, including debt, or may indemnify the EAT against cost and expenses.
- The taxpayer or disqualified person may loan or advance funds to the EAT, or guarantee a loan or advance to the EAT.
- The taxpayer or disqualified person may lease the property from the EAT.
- The taxpayer or a disqualified person may manage the property, supervise improvement of the property, act as a contractor, or otherwise provide services to the EAT with respect to the property.
- The taxpayer and the EAT may enter into a contract relating to the purchase or sale of the property.
- The EAT may also serve as the QI.

How Does The Process Work?

The EAT may take title to either the **replacement** property or the **relinquished** property.

Replacement Property: The process for the EAT to take title to the replacement property is basically as follows:

1. The taxpayer selects a QI to do the like-kind exchange part of the transaction.
2. The taxpayer ratifies contract with current owner to purchase replacement property.
3. Taxpayer selects an EAT to purchase and hold replacement property. (Note: Normally the EAT will be an LLC set up specifically for this transaction.)
4. The taxpayer assigns replacement property contract to the EAT.
5. The taxpayer and the EAT sign the QEAA. This agreement also serves as the contract for taxpayer to purchase replacement property from the EAT. There may also be management and lease agreements between the taxpayer and the EAT. This gives the taxpayer the authority to manage the replacement property on a day-to-day basis, and to coordinate directly with any contractors.
6. The taxpayer arranges for financing for the EAT to purchase replacement property (usually a combination of a loan to the EAT and the guarantee of a loan to the EAT by a commercial lender).
7. The EAT takes title to replacement property.
8. The taxpayer identifies relinquished property within 45 days of transfer of replacement property to the EAT.
9. The taxpayer receives contract on relinquished property, and completes normal exchange documentation with the QI.
10. The taxpayer/exchanger completes settlement on relinquished property. Exchange escrow funds go to the QI.
11. If necessary, the taxpayer makes normal 45-day identification of replacement property.
12. The taxpayer assigns the QEAA (which includes contract to purchase replacement property) to QI. The QI then completes normal exchange documentation for replacement property.

13. The replacement property is transferred from the EAT to the taxpayer/exchanger. The property is purchased with the exchange escrow funds from the QI, with the assumption of the loans made to the EAT or through new financing. Normally transfer occurs immediately following closing on the relinquished property. Transfer may be delayed if new construction must be completed to meet the reinvestment requirements.
14. The exchanger reports exchange to IRS on Form 8824. The EAT reports the transaction to the IRS and State tax authorities.

Relinquished Property: Often, due to already established financing, it is better for the EAT to take title to the relinquished property. This then sets up a normal exchange in which the taxpayer is transferring the relinquished property before receiving the replacement property. The process for the EAT to take title to the relinquished property is as follows:

1. The taxpayer has a contract to purchase the replacement property by a certain date, and either he or she doesn't have a buyer for the relinquished property or the buyer cannot go to settlement before the date the replacement property must be transferred.
2. The taxpayer selects a QI and an EAT to do the like-kind exchange.
3. The taxpayer and the EAT sign the QEAA. This Agreement also serves as the contract for the EAT to purchase and hold the relinquished property. It may provide for the taxpayer to lease back and manage the property. The QEAA will stipulate that the EAT must transfer the relinquished property to a third party buyer within 180 days of the EAT taking title to the relinquished property.
4. The QI prepares the exchange documents for both properties with the EAT as the purchaser of the relinquished property and the taxpayer as purchaser of the replacement property.
5. Both the QEAA and the replacement property contract are assigned to the QI.
6. The EAT will purchase the relinquished property by the assumption of any existing loans and by borrowing from the taxpayer the cash equity in the property.
7. To purchase the replacement property, the taxpayer must use his or her own funds and/ or arrange new financing.
8. The EAT takes title to the relinquished property.
9. The taxpayer takes title to the replacement property. This completes the like-kind exchange part of the transaction. **Critical:** The relinquished property must be transferred to the EAT before the replacement property is transferred to the taxpayer.
10. The EAT gets a third party contract to purchase the relinquished property, or, if the taxpayer already had a contract on the relinquished property, it is assigned to the EAT.
11. Before the end of the 180-day period, the EAT transfers the relinquished property title to the third party buyer.
12. The proceeds from the sale are sent by the EAT to any lenders on the replacement property to pay down the principal. If the taxpayer purchased the replacement property with cash, then any proceeds would go to the taxpayer. Boot would be avoided because cash-in offsets cash-out.
13. The exchanger reports exchange to IRS on Form 8824. The EAT reports the transaction to the IRS and State tax authorities.

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