

# RULES FOR REVERSE EXCHANGES

A Reverse Exchange occurs ONLY when the New Property (Replacement Property) purchase must close before the Old Property (Relinquished Property) sale closes.

Reverse Exchanges were given the belated IRS blessing nearly 10 years after issuance of the Deferred Exchange Regulations. Revenue Procedure 2000-37 effective September 15, 2000 sets out Safe Harbor Rules for a Reverse Exchange.

An Exchangor cannot exchange into a property already owned by the Exchangor. Therefore, in a Reverse Exchange, the Facilitator Company will be required to take title to property to make the exchange work. The Facilitator Company essentially "warehouses" property until the Relinquished Property sale can close with a "real buyer".

Because of potential liability issues, a single member (disregarded entity) LLC will be used to take title to the property in question. The single member LLC will typically be wholly-owned by the Facilitator Company.

The Revenue Procedure sets forth two Safe Harbor ways to structure a Reverse Exchange:

## **1. The Facilitator Company holds title to the Replacement Property:**

In this type of Reverse Exchange, the Facilitator Company will hold title to (warehouse) the Replacement Property. Funds for the acquisition of the Replacement Property will come from the Exchangor in the form of a loan to the Facilitator Company. Ideally, this loan will be secured by a lien on the Replacement Property when the Facilitator Company takes title to the Replacement Property. Or, the loan may be secured by a pledge of the units in the property holding limited liability company.

If a third party loan or seller-carryback financing is required, loan arrangements must be made well before closing to secure the lender's willingness to loan to the Facilitator Company. If a third party lender is required, that loan will probably have to come from a portfolio lender.

For a discussion of the issues involved with a reverse exchange loan, see the enclosed "Tips for Lenders in Reverse Exchanges."

The Facilitator will lease the property to the Exchangor so that the Exchangor can control the Replacement Property immediately upon closing. The triple net lease will provide the Exchangor with all of the economic benefits (except depreciation) and with all of the economic burdens of ownership of the Replacement Property.

When the Relinquished Property sale closes, or not later than 180 days from the date that the Facilitator Company took title, the Facilitator Company will deed the Replacement Property to the Exchangor, or assign all of the units in the LLC to the Exchangor (provided Exchangor is a single "Taxpayer"). This is known as the exchange later structure because the exchange will occur later when the relinquished property closes.

In this type of Reverse Exchange, there should be no Excise Tax when the Facilitator deeds to the Exchangor.



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Revenue Procedure 2000-37 sets forth two time deadlines to meet in this form of a Reverse Exchange:

45 days from the date that the Facilitator Company takes title to the Replacement Property, the Exchangor must identify the potential Relinquished Property or Properties.

180 days from the date that the Facilitator Company takes title to the Replacement Property, the relinquished property must close and the Replacement Property must be transferred to the Exchangor.

\*Note a recent ruling by the IRS seems to indicate that a related party can "rescue" a failing Reverse Exchange by purchasing the Relinquished Property within the 180 days.

## **2. The Facilitator Company holds title to the Relinquished Property:**

In this type of Reverse Exchange, the Facilitator Company will hold title to (warehouse) the Relinquished Property. This structure is normally used when the lender on the Replacement Property is unwilling to make a loan to the Facilitator Company to purchase the Replacement Property.

Because the lender insists upon loaning to the Exchangor, rather than to the Facilitator Company, the Exchangor must take title to the Replacement Property prior to the actual sale of the Relinquished Property to a real buyer.

Funds for the acquisition of the Relinquished Property will come from the Exchangor in the form of a loan.

The Facilitator will lease the property to the Exchangor so that the Exchangor will continue to control the Relinquished Property. The triple net lease will provide the Exchangor with retention of all of the economic benefits (except depreciation) and with retention of all of the economic burdens of ownership of the Relinquished Property. This is known as the exchange first structure because the the exchange is occuring at the outset.

The Relinquished Property sale must close within 180 days from the date that the Facilitator Company took title to the Relinquished Property. If the Relinquished Property sale does not close to a real buyer within 180 days, the Relinquished Property will be deeded back to the Exchangor, and the transaction recinded.

This type of Reverse Exchange, where the Relinquished Property is warehoused, has three distinct disadvantages over the Reverse Exchange where the Replacement Property is warehoused:

**1. Due on Sale Problems** - The transfer of the Relinquished Property to the Facilitator Company may cause an acceleration of the loan on the Relinquished Property. In the event that the Relinquished Property never sells to a real buyer, the Exchangor may be handed back a property that is being foreclosed upon by the lender.

**2. Extra Excise Tax** - In the state of Washington, the Exchange Facilitator exemption



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(WAC 458-61A-213) is not available on a Reverse Exchange where the Relinquished Property is warehoused and later sold to a real buyer. There will be an extra Excise Tax due. If the Reverse Exchange ultimately fails because no buyer closes within the 180 day period, the initial Excise Tax cannot be recouped.

**3. Possible Tax Liability** - If the relinquished property never sells to a real buyer, tax on the sale of the relinquished property may be due if the IRS challenges a rescission theory (it is best to rescind the sale in the same year the sale occurred).

If the Reverse Exchange fails, that is, a real buyer fails to close the purchase within 180 days the Relinquished Property will be deeded back to the Exchangor.

If the Relinquished Property is deeded back to the Exchangor an exemption from the Excise Tax might be available in the state of Washington. The basis for this exemption will be the rescission exemption under WAC 458-61A-209.

In both types of reverse exchanges, the Facilitator and the Exchangor must enter into a Qualified Exchange Accommodation Agreement within 5 business days of the Facilitator's acquisition of the parked property. The Agreement must say that:

1. The Facilitator is holding the property for the benefit of the Exchangor in order to facilitate an exchange under 1031 and the Rev. Proc.;
2. The Facilitator and Exchangor agree to report the acquisition, holding and disposition of the property as provided in the Rev. Proc.; and
3. The Facilitator will be treated as the beneficial owner of the property for all federal income tax purposes.

A Reverse Exchange presents several issues that are not present with a "regular" (sell first-buy later) tax deferred exchange:

1. The Reverse Exchange carries with it a business risk: The Exchangor may end up owning more property than intended if the Relinquished Property sale fails to close in a timely fashion.
2. Because the Relinquished Property equity will not be available to acquire the Replacement Property by the required closing date of the Replacement Property, the Exchangor will have to fund the down payment out of pocket (or borrow to fund it).
3. There are special lender issues involved in a Reverse Exchange that require advance planning.
4. Depending on the structure of a Reverse Exchange an extra Excise Tax may be paid by the Exchangor in the state of Washington.

Revenue Procedure 2000-37 offers safe harbor guidance for a Reverse Exchange. Despite the special issues in a Reverse Exchange, when the Replacement Property is unique and "must" be acquired by the Exchangor, this safe harbor is most welcome.



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