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REVERSE EXCHANGES

Sometimes a taxpayer may find investment property to acquire before they have relinquished the property that they intend to exchange. The Revenue Procedure 2000-37 issued on September 15, 2000 gave taxpayers safe harbor 1031 exchange treatment for reverse exchange transactions. A reverse exchange occurs when the purchase of replacement property closes before the sale property is relinquished. However, when exchanging, the taxpayer may not own both the relinquished and replacement properties at the same time.

When the exchangor is performing this type of exchange, the Qualified Intermediary creates an Exchange Accommodation Titleholder (EAT) to park title to property through a Qualified Exchange Accommodation Agreement (QEAA) until the relinquished property is sold. The exchangor (or a lender) provides funds to purchase the replacement property, and a trust deed is recorded securing a note for the loan. After the sale of the relinquished property, the sale proceeds are deposited into the exchange value account, where they are then used to pay back the exchangor (or lender) for borrowed funds and remove the lien against the property. If the EAT acquired title to the relinquished property, a deed would be recorded from the EAT to the buyer. However, if the EAT acquired title to the replacement property, a deed would be recorded from the EAT to the exchangor. The timeline for a reverse exchange is the same as a forward exchange; the taxpayer has 180 days to complete the exchange from the date the EAT took title to either the relinquished or replacement property.

Two Types of Reverse Exchanges

Relinquished property reverse exchange: For this type of reverse exchange, the EAT takes title to the relinquished property. However, this could result in the EAT acquiring the relinquished property subject to an existing loan. This may trigger the due-on-sale clause of that existing lien, and thus, is used less frequently than a replacement property reverse exchange.

Replacement property reverse exchange: For this type of reverse exchange, the EAT takes title to the replacement property. It is crucial that financing is in the name of the EAT, although the exchangor guarantees the loan, not the EAT. Portfolio lenders, cash to purchase, third party financing, or seller carry-back financing are commonly used for this type of exchange.

When does a taxpayer need to take advantage of a reverse exchange?

- Taxpayer has found the ideal replacement property, but the relinquished property hasn't sold. Seller of replacement property will not wait for the relinquished property to sell.

Reverse Exchange Issues/Concerns

Reverse exchanges should be avoided, if possible. These transactions are costly, and there is risk – what happens if the exchange is not completed within the 180 day exchange timeline?!

If the taxpayer wants to avoid capital gains when eventually relinquishing property, they may need to perform a new exchange, acquiring another piece of replacement property. To accommodate the 180 day exchange timeline, some taxpayers may find themselves accepting a sale offer that they might not have accepted otherwise!

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45/180 day Timelines:
When performing a reverse exchange, the exchangor has 45 days to identify the relinquished property, and 180 days to complete the exchange.

Financing:
Financing for the purchase of replacement property can be difficult, as the EAT is acquiring title and not the exchangor. If the exchangor intends to acquire a loan with an institutional lender, they should make the lender aware of the reverse exchange, as many lenders will not provide financing for this type of transaction. Oftentimes private loans or cash work best with this type of structure.

Environmental Issues:
If the replacement property has any known environmental defects, the EAT will not take title to the replacement property for liability purposes. Given this potential liability, CES may request a copy of environmental reports before proceeding with the exchange transaction. Additionally, our exchange documents contain an environmental indemnity and release agreement for both exchangor and seller to execute.

Insurance:
During the time that the EAT is in title to the replacement property, CES will request that the exchangor add the EAT as an additional insured to the insurance policy. An all risk liability policy insuring not less than $1,000,000.00 must be furnished to CES before the purchase transaction is closed.

Additional Exchange Fee:
Reverse exchanges require much more oversight than a typical forward exchange. Depending on the specifics of each transaction, fees will vary. A typical reverse exchange fee is around $5,000.00. CES will be happy to consult with you regarding your contemplated exchange to discuss what fees you can expect to incur.

Attorney/Accountant:
CES' role is to provide efficient documentation for your exchange. CES cannot and does not give legal or accounting advice. Every exchange and every exchangor's circumstances are unique. Therefore, when performing a reverse exchange it is very important to have an attorney and/or accountant to review your documentation and to help structure the exchange correctly.

Typical Financing Arrangements For Replacement Property Reverse Exchanges

- Exchangor provides cash to the EAT to finance the acquisition, which is paid off with relinquished property exchange proceeds.

- Seller provides carry-back financing for all or a portion of the amount needed to acquire the replacement property. Seller is paid-off once the relinquished property closes.

- A third party provides financing for all or a portion of the amount needed to acquire the replacement property. Loan is paid-off once the relinquished property closes.

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- Lender makes a long-term assumable loan to the EAT in the amount needed to finance the acquisition when the exchange is complete. The exchangor provides the balance in the form of a temporary 2nd loan to the EAT which is paid off with relinquished property exchange proceeds. Exchangor assumes loan from EAT once the relinquished property closes.

- Lender makes a long-term assumable loan to the EAT in the amount needed to finance the acquisition when the exchange is complete. The same lender provides a temporary 2nd loan to the EAT secured by the property and the exchangor loans the balance to the EAT as a 3rd loan. The 2nd and 3rd loans are paid off with exchange proceeds. The exchangor assumes loan from EAT once the relinquished property closes.

- Lender makes a long-term assumable loan to the EAT in the amount needed to finance the acquisition when the exchange is completed. The same lender provides a temporary 2nd loan to the EAT secured by the property (100% financing) and cross collateralizes it with another property owned by the exchangor. The 2nd loan is paid off with exchange proceeds. Exchangor assumes loan from EAT once the relinquished property closes.

- Lender makes a long-term assumable loan to the EAT in the amount needed to finance the acquisition (100% financing) and cross collateralizes it with another property owned by the exchangor. The loan is paid down with exchange proceeds, and the original loan is modified, changing the grantor and the loan amount.