MADISON 1031

Reverse Exchanges:

Putting the Cart Before the Horse

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The Problem: Tight Deadlines

As mentioned in the article *"Beat the Buzzer: Replacement Property Identification"*, tight 1031 Exchange deadlines create problems for many investors. These deadlines are particularly challenging in hot markets, where prices are high and cap rates are compressed. We hear clients lament how difficult it is to find deals that make sense. On top of that, lending guidelines remain tight, so even if the right property is found, obtaining financing might be near impossible, which could completely unravel a 1031 Exchange. In a seller's market, like the current one, finding a buyer for the Relinquished Property isn't an issue—the problem is finding a suitable Replacement Property.

The Solution: A Reverse Exchange

More investors are turning to "Reverse Exchanges" as the solution. While the typical 1031 Exchange involves the taxpayer selling their Relinquished Property before closing on the purchase of their Replacement Property, it is possible to close on the Replacement Property first. By locking up the Replacement Property before closing on the sale of the Relinquished Property, the investor is spared much of the time crunch and uncertainty they would typically face in a standard 1031 Forward Exchange.

However, in order to defer capital gain, IRC §1031 requires an "exchange" of property, so the taxpayer may not own the Relinquished and Replacement Property at the same time. As a result, while the Replacement Property can close before the Relinquished Property, the taxpayer may not take title to it until after they have conveyed title of the Relinquished Property to a third party.

Authority

Provisions for Reverse Exchanges were not included in the statute or the final Deferred Exchange Treasury Regulations adopted in 1991 [26 CFR 1.1031(k)-1]. Instead, the concept was approved by the Internal Revenue Service in Revenue Procedure 2000-37, which was later amended by Revenue Procedure 2004-51. The approved structure involves a "Qualified Exchange Accommodation Arrangement" whereby an "Exchange Accommodation Titleholder" ("EAT") acquires legal title to either the Replacement Property or the Relinquished Property until the Relinquished Property can be sold to a third party. The EAT is usually a limited liability company that is owned by the Qualified Intermediary company hired by the taxpayer to facilitate the tax-deferred Exchange. This structure solves the dilemma the investor faces. By "parking" title to one of the properties with the EAT, the taxpayer avoids owning both properties at the same time.

Structure

Reverse Exchanges are like snowflakes in that no two transactions are identical in all their nuances. That said, here are the steps in the imaginary "routine" transaction would be as follows:

1. The Exchanger finds the ideal Replacement Property they absolutely must buy. The Seller insists on closing quickly, yet the Relinquished Property has not yet been sold. The parties go to contract;
2. One to two weeks prior to Closing on the Replacement Property, the Exchanger or their attorney contacts a Qualified Intermediary, who sets up the EAT. The parties enter into a Qualified Exchange Accommodation Arrangement Agreement ("QEAA"), which may give the Exchanger a call right, and may give the EAT a put right with regard to the Replacement Property. The Exchanger also assigns the Contract of Sale for the Replacement Property to the EAT. Prior to closing, the Seller is given written notice of the 1031 Exchange and the Contract Assignment;
3. The Exchanger secures financing for the EAT to acquire the Replacement Property, through a combination of the Exchanger's own funds and institutional lenders. The EAT will typically insist that the loan terms be non-recourse to the EAT, but the Exchanger is permitted to guaranty the loan. Any funds provided by the Exchanger directly will be borrowed by the EAT pursuant to a Promissory Note;
4. At Closing, the Seller deeds the property to the EAT, and the EAT executes all loan documents. The EAT may then also lease the Replacement Property to the Exchanger, so that the Exchanger has use of it during the Exchange Period and bears the burden for all maintenance, repairs, utilities, and other property related costs;
5. Similar to a Forward Exchange, from the Closing of the purchase the Exchanger has 45 days to identify the **Relinquished** Property they hope to sell, and a maximum of 180 days to close on the Relinquished Property;
6. The Exchanger finds a Purchaser for the Relinquished Property and enters into Contract. The Exchanger enters into an Exchange Agreement with the Qualified Intermediary, and assigns the benefits of the Contract to the Qualified Intermediary. The Purchaser is given written notice of the 1031 Exchange and the Contract Assignment;

7. At Closing, the Exchanger deeds the Relinquished Property to the Purchaser, and Purchaser pays the net sale proceeds to the Qualified Intermediary.
8. After the Relinquished Property closing, the Exchanger assigns the "call" provisions of the QEAA to the Qualified Intermediary, who then uses the sales proceeds to repay the EAT's loan to the Exchanger. The EAT transfers the Replacement Property to the Exchanger, either by deed, or more commonly, by transferring 100% of the membership interests in the EAT to the Exchanger. This completes the Reverse Exchange.

Other Factors

This article outlines only the most basic Reverse Exchange transaction, and there are many considerations that may alter the structure. For instance, in certain circumstances, it may be preferable to park the Relinquished Property, rather than the Replacement Property, particularly if the lender isn't comfortable providing a loan to the EAT. In other cases, the Investor may want to use the Exchange Funds to make improvements to the Replacement Property while it is still owned by the EAT. Depending on the jurisdiction, transfer tax issues may also have to be addressed. And, if the Replacement Property is less expensive than Relinquished Property, the taxpayer may want to acquire additional Replacement Properties after the Relinquished Property has been sold.

About Madison 1031

Madison 1031 is a Qualified Intermediary, handling all types of §1031 Exchanges nationwide for over two decades. Madison 1031's team of Exchange professionals -- including attorneys, accountants and Certified Exchange Specialists® -- represents a deep bench of experience that has facilitated thousands of forward, delayed and construction §1031 Exchange transactions. We educate our clients on the requirements for a successful §1031 Exchange and help them identify key issues that could impact their transaction. While Madison 1031 can handle even a last minute §1031 Exchange, the earlier we are involved the better able we are to assist. We coordinate the Closing with the Investor's attorney or title insurance company, depending on local custom, and guide the parties through the acquisition of the Replacement Property. Madison 1031 is committed to providing exceptional customer service every step of the way.

About Michael Brady, Esq. CES®

Michael S. Brady, Esq., CES® is Executive Vice President for Madison 1031 Exchange, a national Qualified Intermediary for tax-deferred Exchanges pursuant to Internal Revenue Code §1031. As a Certified Exchange Specialist® and an attorney, his responsibilities include consulting with clients and their advisors on the regulations affecting §1031 Exchanges, as well as giving seminars for attorneys, accountants, and real estate professionals, and publishing articles on tax and legal issues. Prior to joining Madison 1031, Mr. Brady was Vice President of Eastern Operations for Asset Preservation, Inc., the §1031 Exchange qualified intermediary subsidiary of Stewart Title Insurance Company, where he managed sales and operations staff handling several thousand transactions annually. During his career, he has headed up two other §1031 Exchange companies, and has acted as general counsel for a title insurance company. As an attorney, Mr. Brady has over 20 years' experience representing clients in commercial and residential real estate transactions, as well as a wide variety of business transactions and commercial litigation matters. Mr. Brady received a Bachelor of Arts degree from Binghamton University, and earned his Juris Doctorate from New York Law School, where he was a member of the Law Review and graduated Cum Laude.