



Basic Reverse Exchanges

A reverse exchange is a 1031 exchange in which the New Property (Replacement Property) is acquired before the Old Property (Relinquished Property) is sold. The role of the Accommodator is to acquire either the Old or New Property on behalf of the Exchangor and hold legal title to it until the Old Property is sold to its ultimate buyer. The asset held in this manner is frequently said to be “parked” and the formal agreement between the Accommodator and Exchangor describing the parking arrangement is called the Qualified Exchange Accommodation Agreement or “QEAA”.

In a reverse exchange, the Accommodator forms a separate “Special Purpose Entity” to hold the property to be parked during the exchange. This entity – called the “Exchange Accommodation Titleholder” or EAT – is usually a single-member LLC. Using this approach, the assets in each exchange are kept legally separate and insulated from one another.

The formal IRS guidance regarding reverse exchanges is found in Rev. Proc 200-37. It describes the “safe harbor” upon which the reverse exchange processes rely. It says that the IRS will not challenge the status of an EAT as the beneficial owner for tax purposes of an asset involved in a parking arrangement (i.e. reverse exchange) if the Exchanger and Accommodator enter into a QEAA that meets its requirements and if the standard exchange deadlines are met. The standard deadlines apply to the Old Property in a reverse exchange, as opposed to potential New Property in a forward exchange. Thus, there are 45 days to identify potential Old Property to be sold and 180 days to complete the exchange by selling Old Property that has been properly identified. The Rev. Proc. also permits a series of arrangements in support of the parking arrangement that are not required to be at “arm’s length”. For example,

- The EAT is permitted to borrow the funds required to acquire the property being parked from the Exchanger at no interest
- The Exchangor may guarantee all of the obligations of the EAT, including loans made to the EAT by third-parties to acquire properties to be parked.
- The EAT is permitted to enter into a triple-net lease with the Exchanger for the parked property at no rent.
- The Rev. Proc. also permits adjustments for economic risk, meaning that the EAT is not at risk of a decline in the value of a property it holds nor is the Exchanger obligated to share with the EAT any appreciation in value during the exchange period.

Exchange Last

The Exchange Last is the most basic form of reverse exchange. In this form, an EAT is formed that will take title to and hold the New Property while the Exchanger finds a buyer for the Old Property and consummates a sale. If the Exchanger has enough cash to acquire the New Property without a loan, then the EAT will issue an interest-free note to the Exchanger for the purchase money and will enter into a rent-free triple-net Lease with the Exchanger that provides

total access to the New Property. Identification of one or more candidate Old Properties must occur within 45 days and the sale of one or more identified properties must occur within 180 days. Once a sale is imminent, a simultaneous 1031 exchange agreement is executed in which the Exchanger, through the QI, is the seller of the Old Property to its ultimate buyer and the EAT is the seller, through the QI, of the New Property to the Exchanger. (The execution of the exchange agreement at the end of the reverse exchange process is the reason that this form is called “Exchange Last”). As part of the exchange, there is a settlement process in which the purchase price for the New Property is “paid” to the EAT by the Exchanger while exactly the same amount of money is used to retire the Note from the EAT held by the Exchanger. Exchangers may elect to either take direct title to the New Property or to take an assignment of all the interests in the LLC underlying the EAT.

If the Old Property cannot be sold in the 180-day exchange period, then the reverse exchange fails. In this case, the EAT will sell the New Property to the Exchanger “at cost” and use the funds to retire the Note. When an Exchange Last fails, the result is that the Exchanger owns both properties but there is no taxable event associated with the Old Property because no sale has occurred.

In many Exchange Last transactions, there is a third-party lender that supplies some of the purchase money for the New Property. If so, it is likely that there will be loan documents between the EAT and the lender in addition to the EAT’s note to the Exchanger. If the EAT executes third-party loan documents, there will typically be a guarantee provided to the lender by the Exchanger as well as a Deed of Trust, Mortgage or other security instrument. At the conclusion of the exchange, both the third-party loan and the note held by the Exchanger can be retired at settlement. However, it is far more likely that the lender will encourage or require that the loan to the EAT remain in place and that the Exchanger assume the interests in the LLC as a means of transferring ownership of the New Property.

Exchange First

The other basic form involves the transfer of the Old Property to an EAT as part of a 1031 exchange at the beginning of the process (hence, the term “Exchange First”). The QI executes a simultaneous 1031 exchange in which the EAT, through the QI, is the buyer of the Old Property and the Exchanger, through the QI, is the Buyer of the New Property. The Exchanger acquires the New Property directly from its seller and takes title to it without the involvement of an EAT. The QEAA stipulates that it is the Exchanger’s responsibility to find a buyer for the Old Property and consummate a sale within the 180 day exchange period. When a buyer is found, the Exchanger negotiates a purchase and sale contract on the EAT’s behalf and title is then transferred to the buyer in a normal settlement process.

If the Old Property is not sold within 180 days, the best approach is to execute a rescission of the sale of the Old Property to the EAT so that no taxable event has occurred. If done properly at the end of a failed Exchange First, the rescission results in the Exchanger owning both properties but having no gains associated with the sale of the Old Property.