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Tax Watch

Reverse Exchanges Offer Investors Tax-Saving Benefits

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In an Internal Revenue Code Section 1031 exchange, when an investor must purchase the replacemen property before the relinquished property can be sold, he should consider using a reverse exchange.

In September 2000, the Internal Revenue Service clarified its position on reverse exchanges by issuing Revenue Procedure 2000-37. The procedure provides a safe-harbor guide to executing reverse exchan transactions.

Safe-Harbor Fundamentals
Despite the term reverse, the order of an exchange transaction does not truly change under the techniqu sanctioned by Rev. Proc. 2000-37. This safe-harbor method allows for a third party, or accommodation titleholder, to take title to the eventual replacement property. The AT parks the property and holds it until investor can dispose of the relinquished property. After selling the relinquished property, the investor completes the exchange by purchasing the property that the AT acquired on his behalf.

For example, Huff Co. is selling a property for $2 million under a contract requiring a 60-day due diligenc period and another 60 days to close. To reap the tax benefits of an exchange, Huff's real estate broker searches for a potential replacement property. Two weeks into the contract period the broker identifies tl perfect replacement property, but the seller insists on a 30-day closing period, shutting the door on completing a standard like-kind exchange.

Although Huff offers the buyer an incentive to accelerate the relinquished property's closing date, the bu will not budge. With significant tax advantages at risk, Huff's broker suggests a reverse exchange. After consulting with its tax professional, the company hires a service provider to establish an AT entity — usu a single-member limited liability company — to acquire the targeted $2.5 million replacement property. D to Huff's financial strength, the company draws $2.5 million on its $5 million line of credit and lends it to t AT to purchase the replacement property. During the holding period, the AT net leases the property bacl Huff.

Huff must complete the exchange within 180 days to comply with the automatic safe-harbor guidelines. Several weeks later, Huff sells the relinquished property and then purchases its replacement property fro the AT, completing the exchange.

Reverse exchanges also may be viable for investors who want to find perfect replacement property befo agreeing to sell existing property. Some investors may be wary of the challenges posed in meeting the 4 day identification requirement of standard exchanges. However, reverse exchanges overcome this objection and are suitable when investors are confident that the relinquished property can be sold within 180 days.

Alternatives to Consider
Several reverse exchange modifications exist for investors who find themselves in tricky situations.

Exchange First. Reverse exchanges may be invaluable when a relinquished property closing falls apar the last minute. For example, Tim is planning to do a regular exchange. His relinquished property closin scheduled for the morning and the replacement property closing is scheduled for the afternoon of the sa day. Tim's loan for the acquisition of the replacement property already is approved. The day before the closing is to take place, the purchaser of the relinquished property notifies Tim that her financing has be turned down and she will not be acquiring the property. Tim is in a difficult situation because he is obliga and wants to close on what was to be the replacement property. He can't have the AT park the replacem property because the loan already is approved in his name and there isn't time to change the financing.

The solution is for Tim to use the exchange first technique. Tim transfers the relinquished property to the instead of the replacement property the next morning and still closes on his replacement property as scheduled that afternoon.

However, the exchange first technique can be complicated. The relinquished property often has existing debt that cannot be transferred to the AT, and the equity, or the down payment on the replacement property, must match the actual proceeds from the eventual sale of the relinquished property in order to reap maximum tax benefits. Also, to qualify for safe-harbor protection, the relinquished property parked the AT must be sold within 180 days from the date it was parked.

Non-Safe-Harbor Reverse Exchanges. What if the timing of a reverse exchange will exceed 180 days One possible solution is to execute a non-safe-harbor reverse exchange. Rev. Proc. 2000-37 clearly indicates that reverse exchanges that do not comply with the guidelines still can be executed. However, prudent to use caution when executing these transactions. Three months after these guidelines were issued, the IRS gave a favorable private letter ruling for a reverse exchange that lasted 19 months (PLR 200111025). This transaction incorporated the use of fair market value rents and interest rates between investor and the AT. Many tax professionals feel that there should be some differences between safe-harbor and non-safe-harbor transactions, but because this is a developing area, opinions on the best ac steps are varied. It would be prudent to seek knowledgeable tax counsel before executing this type of reverse exchange.

Also, what if an investor wants to build the replacement property, but the time to acquire the lot and construct the necessary improvements will exceed 180 days? In this instance, a non-safe-harbor revers construction exchange may be worth considering. Under this alternative, the AT acquires the lot and be construction months before the investor sells the relinquished property and the 180-day acquisition cloc starts ticking. After selling the relinquished property, the investor must purchase the lot and make the needed improvements within 180 days. Completing the entire reverse exchange may take more than 18 days, but the time line between the relinquished property sale and the replacement property acquisition from the AT still may not exceed 180 days. If the tax advantages merit the additional costs and risk, cert safeguards can be put into place to craft a successful non-safe-harbor reverse construction exchange.

Qualifications

To qualify under the safe-harbor provisions, a reverse exchange must include a number of written eleme and be completed within 180 days to receive automatic protection. Using a reputable professional servic provider helps ensure that these mandatory documents are part of the transaction. The most common providers of AT services are qualified intermediary companies. The Federation of Exchange Accommodators (www.1031.org) is a good source for independent referrals.

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