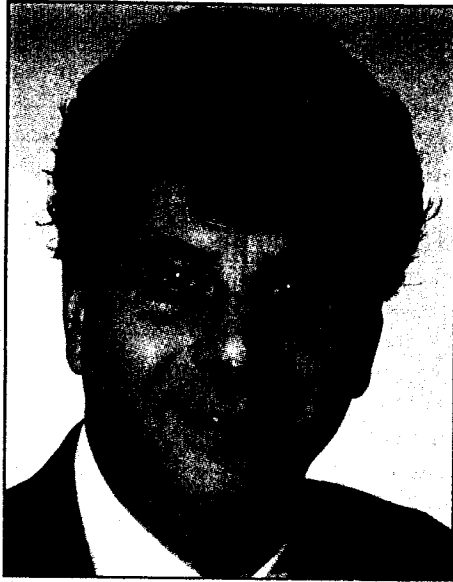


Advantages and Benefits of a Reverse Exchange

Although the delayed exchange represents the majority of transactions that occur under section IRC 1031, there are several sophisticated exchange strategies that can be employed to help exchangers achieve more complex exchange objectives. The most widely used of those strategies is the Reverse Exchange. When properly executed, the Reverse Exchange allows investors more options, greater creativity and increased flexibility.

The role of a Qualified Intermediary in a Reverse Exchange

Before describing how a reverse exchange is structured, it is important to understand the role of the Qualified Intermediary in this transaction. In addition to preventing constructive receipt of non like-kind property, the Qualified Intermediary fulfills a more expanded role. In order for the reverse exchange to satisfy all of the IRC 1031 requirements the exchanger needs an entity to facilitate the exchange called an Exchange Accommodation Titleholder. The Exchange Accommodation



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Titleholder takes title to either the Replacement or Relinquished property during the exchange. During the time the Exchange Accommodation Titleholder is on title, the exchanger will have the full 180 days of the exchange period to either sell the Relinquished Property or improve the Replacement Property prior to taking title. The prop-

erty is held by the Exchange Accommodation Titleholder in a special purpose entity and is referred to as the parked property. The Exchange Accommodation Titleholder and the Qualified Intermediary can be the same or related entities.

Reverse Exchange Particulars

The IRS views a 1031 exchange as a continuation of an investment. In order satisfy this IRS requirement, the exchanger can never be on title to both the Relinquished Property and the Replacement Property at the same time nor be in possession of anything other than like-kind property.

A reverse exchange enables a taxpayer to effectively acquire like-kind Replacement Property prior to disposing of their Relinquished Property, while still allowing a taxpayer achieve his investment objectives and comply with the 1031 requirements.

The reasons an investor might decide to do a Reverse Exchange vary. Sometimes the ideal replacement property becomes available before the relinquished property has sold or has been listed for sale. Typically an investor

recognizes the need to act quickly to secure the replacement property before someone else does. Also, a reverse exchange allows an exchanger the flexibility to offer three different relinquished properties for sale, letting the market decide which property sells first. Another example is a business owner who needs to expand but cannot sell his property, used in the course of a trade or business, until he has acquired a suitable replacement. Finally, an investor may just be unable to control the timing of the sale and purchase transactions.

Reverse Exchange Structure and Timelines

The exchanger executes a purchase agreement for the desired replacement property. Prior to closing, the exchanger hires a Qualified Intermediary to act as the Exchange Accommodation Titleholder. The exchanger provides the Exchange Accommodation

Titleholder (EAT) some combination of cash and borrowed funds (non recourse to the EAT) to purchase the replacement property. At closing, the

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purchase agreement for the replacement property is assigned to a Special Purpose Entity formed by the Exchange Accommodation Titleholder expressly to hold the replacement property. Under the terms of this parking agreement, the Holding Entity leases the property back to the exchanger under an absolute net lease. That enables the exchanger to begin to use or sublet the property while the Holding Entity is on title.

The time lines for a reverse exchange are the same as those for a delayed exchange. A successful closing represents day zero. The reverse exchange must be completed within 180 days of the holding entity acquiring the parked property. Also the exchanger must identify the possible relinquished properties within the first 45 days of the exchange period using either the 3 property or the 200% identification rule.

When the Exchanger finally closes on the sale of the relinquished property, title is transferred directly to the buyer through a simultaneous exchange while the funds go to the Intermediary. Then the Qualified Intermediary uses the cash proceeds to acquire the replacement property from the Holding Entity. The

er and then to reduce the principal balance of the third party financing.

Practical Considerations

Before the IRS issued Revenue Procedure 2000-37 on September 15th 2000 it was unclear whether reverse exchanges would be accorded non recognition treatment. This revenue procedure now provides that tax deferral on reverse exchanges will be recognized if the transaction falls within the scope of the announced IRC 1031 "safe harbor" provisions. Also an Exchanger must:

Plan to comply with all the exchange deadlines, however unlike a delayed exchange there are no adverse tax consequences to a failed reverse exchange.

Be prepared to provide the Qualified Intermediary with hazard and commercial liability insurance and a current Phase I environmental assessment.

Expect fees for a reverse exchange to run as much as \$6,000-\$12,000 dollars compensating the Exchange Accommodation Titleholder for both the time and risk of being on title as well as customary documentation preparation fees.

The Reverse Exchange can be a creative way to structure an exchange to best fit the Exchanger's investment goals and objectives. It is essential, however, that the exchanger seek the service

es of an experienced Qualified Intermediary, like Investment Property Exchange Services (IPX1031), and the advice of their tax and legal advisors before entering into a reverse exchange.

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services. Rather than merely focusing on the fee to be charged, it is prudent to understand what you are getting for this fee and whether there would be any add-ons. In addition, you should consider the rate of interest, if any, that the taxpayer/exchanger will receive while the funds are held with the qualified intermediary. These rates are negotiable and fungible and should be studied carefully. Regulations have been proposed which could adversely affect certain qualified intermediaries that pay a lower rate on the funds held by the intermediary than the intermediary may earn on those funds. Lastly, there are mechanisms such as qualified trusts, standby letters of credit and mortgages which could secure the intermediary's promise to acquire (and improve, if part of the transac-

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tion) suitable replacement property or return the funds to the taxpayer in the event that all of the exchange proceeds are not used to acquire replacement property.

While many qualified intermediaries, exchange accommodation titleholders and sponsors of tenant in common programs have diligently drafted agreements to make certain that the transaction complies with the provisions of Section 1031, and provide the occasional piece of advice as to the tax effects of the transaction, there is no substitute for having your legal and tax advisors review the economics of the transaction and the documents to make certain that the taxpayer/exchanger achieves the tax-deferral that it is seeking in the exchange.

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