Case Study: A Reverse Exchange of Real Estate – Parking the Replacement Property

The Facts

On May 7, 2014, an attorney from central Illinois contacted us on behalf of his client, Mr. Lodo, who wished to do 1031 Exchange. Mr. Lodo needed to acquire, or risk losing, his desired replacement property, however, he did not have a buyer in place for the sale of his relinquished property. The purchase price for the replacement property was $1,512,000 and the closing was scheduled for June 6, 2014. In a typical tax deferred exchange, the taxpayer sells the relinquished property first and uses the exchange proceeds to acquire the replacement property. When the situation requires the taxpayer to take ownership of the new property prior to the sale of the old property, in a reverse fashion of a standard 1031 Exchange, this is referred to as a Reverse Exchange.

The Problem

Mr. Lodo wanted to do an exchange of his old property for the new property but was unable to find a buyer for his old property prior to the scheduled closing of the new property. Unfortunately, the IRS does not recognize the validity of a "pure reverse exchange" where the taxpayer acquires the new property before the sale of the old property.

The Solution

This is a common conundrum - the inability to sell the old property prior to the date of acquisition of the new property. To address this situation, the IRS issued Revenue Procedure 2000-37 to effectively enable taxpayers to buy before selling. There are several approved solutions, the most common being to arrange for the exchange company to hold title to the new property on behalf of the taxpayer. When the exchange company services a routine exchange, it acts as a Qualified Intermediary (QI); when an exchange company services a reverse exchange, in which it has to take title to a property, it is referred to as an Exchange Accommodation Titleholder (EAT).

The EAT takes title to the new property and "parks," or holds, that title until the taxpayer sells the relinquished property as part of a conventional forward exchange. In this type of reverse exchange, the taxpayer will ultimately acquire the replacement property from the EAT, who acquired it from the original seller.

In Mr. Lodo's transaction, a financial institution made a loan of $1,100,000 towards the acquisition price of the new property. The loan was made to a new LLC, established specifically to take title to the new property, with the EAT as its sole member. This loan was documented by a note and secured by a mortgage on the property. Mr. Lodo, rather than the EAT, was asked to guaranty the loan. In addition, Mr. Lodo made his own loan to the LLC in the approximate amount of $412,000 to help finance the EAT's acquisition of the replacement property. The loan was documented with a note and secured with a pledge of the EAT's membership interest in the LLC. The acquisition of the new property was closed on June 6, 2014 resulting in a maximum safe harbor deadline to complete the Reverse Exchange as of December 2, 2014.

While the replacement property was held by the EAT, Mr. Lodo entered into a contract to sell the relinquished property with a closing date of October 31, 2014. The sale price was $1,425,000. The debt on the old property was $700,000 and that loan was paid directly from the closing, so the net equity amounted to roughly $725,000. Upon closing, the remaining sale proceeds were deposited directly into Mr. Lodo's Forward Exchange account.
Mr. Lodo then directed the QI to transfer the funds from the exchange account to the EAT in order to pay down the two loans that were originally made to the EAT to acquire the new property. The EAT paid off the $412,000 loan from Mr. Lodo and paid down the loan from the financial institution with the remainder of the funds in the exchange account. Mr. Lodo then took ownership of the replacement property subject to the remaining debt.

The Result

Mr. Lodo used the Reverse Exchange safe harbor to manage the purchase of the replacement property before the sale of the relinquished property, deferring taxes on the sale of his relinquished property.

Reverse Exchanges, such as Mr. Lodo's transaction detailed above, are typically documented by the following:

- An exchanger information form
- A qualified exchange accommodation agreement (the reverse exchange agreement)
- Assignment to the EAT of the purchase agreement between the client and the seller to buy the replacement property
- Limited liability company sale agreement to sell the EAT's membership interest to the client
- Non-recourse promissory note documenting taxpayer's loan to the EAT to purchase the replacement property
- Pledge of the exchange company's membership interest in the title-holding LLC as security for the note
- Master lease allowing for the client to enter into tenant leases directly with the tenants
- Environmental indemnity agreement