

# Introduction to Reverse 1031 Exchanges

## Revenue Ruling 2000-37

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By structuring a Reverse 1031 Exchange transaction, you can acquire your like kind replacement property before you sell your relinquished property. This tax planning strategy is particularly beneficial in markets where property demand is high and inventory is low.

Entering into a forward 1031 exchange transaction can create a lot of anxiety because the Taxpayer (Exchangor) must identify his or her like kind replacement property within 45 *calendar* days after the close of escrow on the relinquished property. Reverse 1031 Exchanges give the Exchangor the flexibility to take all the time they need to locate the ideal replacement property, without the pressure of the forward 1031 exchange deadlines.

Reverse 1031 exchanges have been structured by legal and tax advisors for years, but there was no guidance from the Department of the Treasury or Internal Revenue Service and only little guidance from certain court decisions that were handed down. Exchangors had to rely on the educated guesses of their legal and tax advisors on how to properly structure a Reverse 1031 exchange transaction, until 2000.

### **Department of the Treasury Issues Reverse 1031 Exchange Guidance**

The Department of the Treasury finally issued Revenue Procedure 2000-37 on September 15, 2000, which provides a number of safe harbor rules, or guidelines, for structuring Reverse 1031 Exchange transactions. Revenue Procedure 2000-37 has significantly increased the number of Reverse 1031 Exchange transactions since that time. Prior to this, taxpayers completed Reverse 1031 Exchanges with little guidance from the Internal Revenue Service. While these guidelines have clarified issues surrounding Reverse 1031 Exchanges and provided a much higher comfort level than before, they also leave a lot of unanswered questions and create a more complex and costly transactional structure.

The taxpayer should always seek competent legal, financial and tax counsel prior to entering into any 1031 tax-deferred, like-kind exchange.

### **Replacement or Relinquished Property Parking with the EAT**

In a Reverse 1031 Exchange, an Exchange Accommodation Titleholder (EAT) acquires and holds legal title to the taxpayer's property on behalf of the taxpayer. A Qualified Intermediary (Accommodator or QI) facilitates the 1031 tax-deferred, like-kind exchange. The EAT and the Qualified Intermediary may be the same entity, although it is not advisable. Diversified Reverse Exchange Corporation was established specifically to function as an

Exchange Accommodation Titleholder or EAT, while Diversified Exchange Corporation fulfills the role of the Qualified Intermediary or Accommodator.

The best way to visualize the structure of a Reverse 1031 Exchange is to view it as two separate component parts – each separate of the other and yet fully and contractually integrated to complete the Reverse 1031 Exchange.

In fact, the Reverse 1031 Exchange is actually a misnomer because it consists of a parking transaction where legal title to either the relinquished or replacement property is acquired and held (parked) by the EAT and then a simultaneous 1031 exchange (not a true Reverse 1031 Exchange) occurs either at the beginning (Exchange First) or at the end (Exchange Last) of the Reverse 1031 Exchange process. Revenue Procedure 2000-37 is not a Reverse 1031 Exchange Revenue Procedure. It really provides guidelines for utilizing the “parking” method in structuring Reverse 1031 Exchange transactions. It is commonly called a Reverse 1031 Exchange because, as previously mentioned, it allows the taxpayer to acquire his or her like kind replacement property first and then dispose of the relinquished property at a later date.

This article will discuss the various structures, including the positives and negatives of each. First, let's review the agreements, parties and requirements that are required to properly structure and complete a Reverse 1031 Exchange pursuant to Revenue Procedure 2000-37.

### **Exchange Accommodation Titleholder (EAT)**

In order for an entity to qualify and serve as the EAT it must meet all of the following requirements:

- Hold Qualified Indicia of Ownership, customarily the legal title, at all times from the date of acquisition of the property until the property is transferred.
- Cannot be a disqualified entity or the taxpayer.
- Must be subject to federal, and if applicable, state income tax. If the EAT is treated as a partnership or S corporation, more than 90% of its partnership interests or shareholders must be owned by partners or shareholders who are subject to federal income tax.

### **Qualified Indicia of Ownership**

Qualified Indicia of Ownership are defined as any of the following:

- Legal title to the property.
- Other indicia of ownership of the property that are treated as beneficial ownership of the property under principles of commercial law (i.e. a contract for deed).

- Interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes, such as a single-member LLC; this entity must hold either legal title to the property or other Qualified Indicia of Ownership.

### **Qualified Exchange Accommodation Agreement**

The EAT and the taxpayer must enter into a written Qualified Exchange Accommodation Agreement (QEAA). The terms of the QEAA must include the following:

- The EAT is holding the property for the taxpayer's benefit in order to facilitate an exchange pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations and Revenue Procedure 2000-37.
- The EAT and the taxpayer agree to report the acquisition, holding and disposition of the property on each of their respective income tax returns in a manner consistent with the agreement.
- The EAT will be treated as the beneficial owner of the property for all federal and state income tax purposes.

### **Legal and Contractual Arrangements**

Revenue Procedure 2000-37 allows the EAT and the Exchangor to enter into a number of non-arms length agreements and legal arrangements in order to complete a successful Reverse 1031 Exchange transaction utilizing the parking structure while eliminating certain risks for both the EAT and the Exchangor.

The taxpayer is responsible for any capital gains or losses and will receive any net operating profits or losses generated from the property during the parking or holding period. The Exchangor will retain control of the parked property either by leasing the property from the EAT pursuant to a triple-net lease or by entering into a property management agreement. The taxpayer assumes all management responsibilities of the property, including the retention of an outside property management firm if they so desire.

### **Time Limits for Identifying and Transferring the Parked Property**

Transferring and identification requirements are consistent with those in a forward (delayed) 1031 tax-deferred, like-kind exchange.

In an Exchange Last parking arrangement (explained below), you must identify the relinquished property within 45 *calendar* days after the transfer of the replacement property to the EAT in a manner consistent with the principles of identifying property in a forward (delayed) 1031 tax-deferred, like-kind exchange.

In an Exchange First parking arrangement (explained below), no identification is required since the actual 1031 exchange is completed at the beginning of the transaction as a simultaneous exchange.

The relinquished property must be sold and transferred to the buyer within 180 *calendar* days after the transfer of the parked property to the EAT in either an Exchange First or Exchange Last structure.

### **Reverse 1031 Exchange Structures**

The EAT can hold (park) title to either the replacement property or relinquished property, depending on a number of complicated factors within each individual transaction.

The preferred and most common method is to have the EAT acquire and hold title to the Exchangor's replacement property pursuant to an Exchange Last structure. However, there are times when parking title to the replacement property with the EAT is not practical and title to the relinquished property must be held by the EAT pursuant to an Exchange First structure.

### **Exchange Last Structure – EAT Holds Title to Replacement Property**

The "Exchange Last" structure is the most common form of Reverse 1031 Exchange. In the "Exchange Last" structure, the taxpayer enters into a Qualified Exchange Accommodation Agreement with the EAT. The EAT forms an LLC or other special purpose entity ("SPE"). The taxpayer assigns the Purchase Contract and/or the Escrow Instructions for the replacement property to the SPE.

The taxpayer will either loan funds to the EAT and/or arrange for third-party financing to the EAT for the acquisition of the replacement property. The EAT acquires and holds (parks) title to the replacement property. The EAT will typically lease the replacement property to the taxpayer pursuant to an absolute triple net lease or enter into a property management agreement with the Exchangor, as authorized by the Qualified Exchange Accommodation Agreement. The lease payments to the EAT are offset by the loan payments due from the EAT. The lease payments may cover any debt service owed on outside financing. This structure is designed to be tax neutral for the EAT.

The taxpayer must identify the relinquished property or properties they intend to sell within 45 *calendar* days after the EAT acquires title to the replacement property. The taxpayer will then assign the Purchase Contract and/or Escrow Instructions for their relinquished property to the Qualified Intermediary. When the relinquished property closes and title is transferred to the buyer, the taxpayer will acquire and receive title to the replacement property or the membership interest in the SPE/LLC that holds title to the replacement property from the EAT by completing a simultaneous exchange. The EAT uses the net proceeds received from the sale of the relinquished property to pay down the loan to the third-party lender and/or the Exchangor.

The taxpayer should obtain their lender's approval prior to entering into an "Exchange Last" Reverse 1031 Exchange transaction if he or she needs to secure conventional financing. The SPE/LLC will be the borrower on the loan since the SPE/LLC holds title to the property. The EAT will typically sign the loan documents on a non-recourse basis and the taxpayer can

guarantee the loan on a recourse basis. The financing issues are one of the more difficult aspects when structuring a Reverse 1031 Exchange.

### **Reverse and Build-To-Suit (Improvement) 1031 Exchange Combination**

The "Exchange Last" Reverse 1031 Exchange structure can be combined with a Build-To-Suit (Improvement) 1031 Exchange structure as well. In this type of 1031 exchange, the taxpayer can build a new structure, improve an existing structure or retrofit the parked replacement property before selling their relinquished property and receiving title to the replacement property.

### **When to Use Exchange Last Parking Structure**

Taxpayers typically select the "Exchange Last" Reverse 1031 Exchange structure when they are purchasing the replacement property for cash or the seller is providing short-term financing (seller-carry back). It is the easier of the Reverse 1031 Exchange structures to administer and put in place, especially when there is little lead time prior to the close of the replacement property transaction.

### **Issues and Problems with the Exchange Last Structure**

**Cash Boot Potential:** If the amount of the down payment (which is the money loaned to the EAT) used to acquire the replacement property is less than the equity generated from the sale of the relinquished property, you could be liable for taxable boot. (*Note:* To qualify for 100% tax deferral in a 1031 exchange, the equity in the replacement property must be equal to or greater than the equity in the relinquished property.) If the equity from the relinquished property is more than the down payment on the replacement property, the EAT can contribute additional cash to avoid a tax liability.

**Financing:** If seller financing is not available, then you must pay cash for the replacement property or arrange conventional or other financing. Obtaining outside financing is often difficult with this structure because the lender is not always willing to lend to the EAT. If outside financing is available, the EAT will be required to execute a non-recourse loan guaranteed by you.

### **Exchange First Structure – EAT Holds Title to Relinquished Property**

In the case of a parked relinquished property, the taxpayer completes a simultaneous exchange up front by "selling" (transferring) his or her relinquished property to the EAT and acquiring his or her replacement property. The relinquished property may not be transferred to a disqualified entity. When the taxpayer locates a buyer for the relinquished property, the EAT direct deeds the property to the buyer and transfers any net sales proceeds to the taxpayer in full and complete satisfaction of the note executed by the EAT.

In the "Exchange First" structure, the taxpayer assigns the Purchase Contract and/or Escrow Instructions for the relinquished property to the Qualified Intermediary. The taxpayer

enters into a Qualified Exchange Accommodation Agreement with the EAT. The EAT sets up an LLC or other special purpose entity to take title to the relinquished property. The taxpayer "sells" the relinquished property to the EAT. The taxpayer and/or a third party lender loan money to the EAT and the EAT executes a non-recourse note in favor of the lender or the taxpayer. The EAT uses the "loan proceeds" to acquire the relinquished property from the Qualified Intermediary. The Qualified Intermediary uses the funds from the EAT ("loan proceeds") to purchase the replacement property on behalf of the taxpayer. The replacement property is direct deeded to the taxpayer and the exchange is completed. Once a buyer for the relinquished property is found, the net proceeds from the sale of the relinquished property are used to payoff any notes due to an outside lender or the taxpayer.

### **When to Use Exchange First Parking**

An "Exchange First" may be a more viable option than an "Exchange Last" when you need to obtain conventional financing on the replacement property. Lenders may have difficulty lending on a property that is held by an EAT.

### **Issues and Problems with the Exchange First Structure**

***Cash Boot Potential:*** If the equity in the relinquished property is greater than the cash invested in the replacement property, then you may incur capital gain tax liability. Since you have already purchased your replacement property, you will not have the opportunity to balance your exchange. For this reason, having the EAT hold the replacement property ("Exchange Last") may be a more desirable option than the "Exchange First" structure.

***Relinquished Property Loan:*** By transferring your relinquished property to the EAT, you risk triggering the due-on-sale clause in your relinquished property loan. This is one of the reasons that many EATs will not hold qualified indicia of ownership to the relinquished property.

***Choosing the Relinquished Property:*** It may be difficult for you to determine which relinquished property is most suitable for your Reverse Exchange.

### **Pre-Exchange Due Diligence**

Before setting up your exchange, the EAT will require you to submit the following:

- 1) Financial statement or tax returns for the last two years;
- 2) Grant deed for the relinquished property;
- 3) Binder providing proof of property, casualty and liability insurance and naming the LLC as the insured and the EAT and taxpayer as additional insureds;
- 4) Phase I Environmental Assessment report issued within the last 6 months; the report must indicate that the property is free of contamination and be certified to the EAT (commercial and industrial real property and vacant land); and
- 5) Title insurance binder naming the EAT as the insured (real property).

## Issues with Reverse 1031 Exchanges

The costs surrounding Reverse 1031 Exchanges are considerably more substantial than those for a traditional, forward delayed exchange.

Fees for Reverse Exchanges are higher than fees for Forward, Delayed Exchanges due to documentation and the risk the EAT assumes by taking title to the "parked" property. The taxpayer will also incur additional title insurance, environmental, loan, legal, property, casualty and liability insurance, and escrow/closing costs.

The potential of incurring double taxation of state, county or local transfer taxes when a property is transferred to the EAT and then transferred to the buyer ("Exchange First") or to the taxpayer ("Exchange Last") initially caused concern among investors and their advisors. However, in a recent Private Letter Ruling (PLR 200148042), the Internal Revenue Service approved an express declaration of agency for all purposes except federal income tax purposes in an EAT's Qualified Exchange Accommodation Agreement. Transferring property from an agent to a principal is not a taxable event in most jurisdictions. While a Private Letter Ruling only pertains to a ruling on one particular case, this nonetheless provides insight into the Internal Revenue Services's views on the subject.

**Depreciation:** The ability to depreciate the property is not available until the taxpayer actually acquires title to the replacement property or once the taxpayer has transferred the relinquished property to the EAT and the Reverse 1031 Exchange has been complete.

## Alternative Strategies

After reviewing the costs involved in a Reverse 1031 Exchange, the taxpayer may want to find a way to delay the closing of the replacement property until he or she finds a buyer for his or her relinquished property and can complete a Forward 1031 Exchange.

Solutions that allow the taxpayer to delay the close of escrow and secure your replacement property include using conditional or non-refundable earnest money deposits or an option or lease/option agreement.

## About the Author

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