

Tell It To The Bank - Clear Communications with Mortgage Lenders are Critical in Reverse 1031 Exchanges

A *Reverse 1031 Exchange* is a strategy that allows a taxpayer to make a tax-deferred exchange of property where the replacement property is purchased *before* the relinquished property is sold. This strategy is helpful when the taxpayer's sale of relinquished property has been held up or the seller of the replacement property demands a quick closing or when the taxpayer doesn't know yet which of several potential relinquished properties will be sold.

The basic problem in a Reverse Exchange is that the taxpayer cannot hold title to both the relinquished property and the replacement property at the same time. Once the taxpayer owns both properties, it is impossible to exchange them. In order to resolve this difficulty, the IRS has provided a safe-harbor method to "park" either the replacement property or the relinquished property with an *Exchange Accommodation Titleholder* (an "EAT"). The EAT holds legal title to the parked property from the time the replacement property is acquired until the relinquished property is sold (up to 180 days). Although the EAT is the legal owner of the parked property, the taxpayer can operate, improve, use and profit from both properties during the exchange period.

It is possible to park either the replacement property or the relinquished property. However, there are some good reasons why the *replacement* property is usually the one that is parked: (a) Parking the relinquished property would trigger a default in the taxpayer's existing mortgage unless the lender's permission is obtained. Obtaining that permission can take time and can be expensive. (b) If the relinquished property is parked, it is not possible for the taxpayer to change his/her mind and to decide to sell some other property. (c) Parking the relinquished property starts the clock on the 45-day identification period and 180-day exchange period for that property. (d) It is usually convenient to get the taxpayer's mortgage lender on board with a parking arrangement affecting the replacement property, as long as the process is well understood by everyone.

H2: The Reverse Exchange Process

This is how the reverse exchange process typically works.

A new *single purpose entity* (an "SPE") is formed. Usually, the SPE is a limited liability company. It is disregarded for federal income tax purposes because it has only one owner. During the parking period, the SPE is owned by the EAT. The SPE acquires legal title to the replacement property. Because the owner of the SPE is the EAT and because there is a "parking arrangement" between the taxpayer and the EAT, the EAT is considered to be the owner of the replacement property for federal income tax purposes during the parking period. The taxpayer lends SPE and EAT all of the cash needed to acquire the replacement property. The mortgage lender makes a normal mortgage loan to the SPE. The SPE signs all the normal closing documents. The lender may or may not require the taxpayer to guaranty the mortgage note. If there is a guaranty, it may be either a general guaranty or a so-called "bad boy" limited guaranty. If there is mezzanine financing or certain bankruptcy remote protections for the lender, there can be as many layers of LLCs as needed, so long as they are all single member LLCs that are ultimately owned by the EAT and that are disregarded for federal income tax purposes. The loan documents need a

special carve-out to permit or to require that ownership of the SPE will be transferred by the EAT to the taxpayer within 180 days of the date that the replacement property was acquired.

While the property is "parked", although the taxpayer has its full use and benefit, the taxpayer cannot depreciate it. The taxpayer and the EAT report taxes relating to the parking period essentially as if the taxpayer were the master tenant on the parked property, and the EAT were the landlord under a triple net lease. Sometimes a formal lease to that effect is part of the parking arrangement.

Usually, the EAT transfers the SPE to the taxpayer when it is time for the taxpayer to acquire legal ownership of the parked replacement property. Transfer of the replacement property by the EAT to the taxpayer, together with transfer of the net proceeds from the sale of the relinquished property by the QI to the taxpayer discharges any outstanding debts owed by the EAT to the taxpayer for money that it "borrowed" to buy the replacement property.

All of this works well and goes smoothly as long as all the parties, including the lender and the lender's counsel, understand the process.

When the process is thoroughly explained, nearly all lenders can become comfortable with the reverse exchange process. However, there are a few exceptions. Therefore, the taxpayer should look for a relatively sophisticated mortgage lender whenever a reverse exchange is contemplated, and the taxpayer should ask the lender if they have handled reverse exchange transactions in the past or if they are willing to learn how to do it. Be careful to review the loan documents to make sure that they meet the requirements of the parking arrangement. In particular, make sure there is no recourse to the EAT and there is a carve-out permitting the eventual transfer of the SPE to the taxpayer.