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Reverse the curse of taxes? Why a reverse exchange should be in your tax arsenal

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Many people know that they can defer paying taxes on the gain from the sale of their property if they later purchase other like-kind property and reinvest the sale proceeds as part of a so-called 1031 exchange. But did you know that an exchange can be done in reverse, too?

Unlike a typical "forward" exchange in which an owner first sells its property and then buys another, in a "reverse" exchange, the owner buys first and sells later. When might a "reverse" exchange make sense? Have you found a great purchase opportunity that must close quickly? Did you intend a "forward" exchange, but either lose your buyer or extend the buyer's closing date until after the date scheduled for your purchase to keep from losing your buyer? Did you decide not to sell your property unless you are sure you can buy a suitable replacement property on satisfactory terms? In these and other circumstances, a "reverse" exchange might be the best course of action.

Reverse exchanges are more complex and document intensive than forward exchanges in part due to parking agreements. Because you cannot exchange properties with yourself, anyone intending a "reverse" exchange must avoid taking title to the new property while it still holds title to the old one. To do that, title to one of the properties is often "parked" with an accommodator, someone who agrees to hold it for you until you find a real buyer for your old property. In addition to a parking agreement, the exchangor (i.e., property owner exchanging properties) and the accommodator historically entered into a number of other agreements to address other concerns common to reverse exchanges including (i) the accommodator's need for funds to purchase the new property (in part because no old property sale proceeds will be available because the old property will not have been sold yet); (ii) the exchangor's desire to control the economic benefits and burdens of the "parked" property (either because it is the current owner or soon will be); and (iii) the accommodator's exposure to environmental and other property-related claims. To address these concerns, the parties' agreements might require the exchangor to indemnify the accommodator for any claims arising from its services, provide cash and financing for the new property's purchase and provide any loan guarantees that are required by the new lender. The agreements also might require the accommodator to either hire the exchangor as property manager or lease the parked property to the exchangor on favorable terms. The IRS historically took the position that as more parked property rights were transferred back to the exchangor, the accommodator became less the owner of the parked property and more the exchangor's agent. If the IRS decided that the accommodator was the exchangor's agent, the IRS disallowed the exchange.

Thankfully, however, the IRS changed its position. In 2000, the IRS adopted a revenue procedure that created a safe harbor for "reverse" exchanges that includes the IRS's agreement not to dispute the accommodator's ownership of the parked property if the accommodator meets the safe harbor standards for an "exchange accommodation titleholder" and the parties' various arrangements meet the safe harbor standards for a "qualified exchange accommodation arrangement." More importantly, however, the safe harbor not only authorizes the parties to use various guarantees, indemnities, management agreements and other contractual arrangements that were historically required by exchangors and accommodators, they confirm that their use will not void the exchange, even if the contracts are not on arm's length terms.

Anyone considering a "reverse" exchange should engage a good team of tax and legal advisors at the very outset of the exchange to help structure it and allocate the economic benefits and burdens of the parked property. Expect a number of questions to help fine tune the exchange's structure and agreements. For example, three questions may help determine whether you should park the old property or the new one: Do the loan documents that encumber the old property prohibit parking it with the accommodator because they prohibit all transfers? Does your new lender really understand that when its loan closes, the accommodator will hold title to the new property rather than its ultimate borrower? Is there any adverse condition associated with either the old or new property that would dissuade the accommodator from taking title to it? Clearly a "reverse" exchange is more complex than the typical "forward" exchange, but it may be your most attractive option to complete a transaction in a cost effective and efficient manner that also defers the payment of taxes.

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