

BOSTON BUSINESS JOURNAL

Consider Your Options: Reverse 1031

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Recently, my colleague, James Friedman, wrote about like-kind exchanges in the article “Advantages of the single credit alternative in a Section 1031 exchange.”

In a typical 1031 exchange, the owner sells its property, then buys a new one. But what if you cannot sell first? What if you have a great purchase opportunity that falls in your lap that must close quickly? What if a typical exchange is in progress, but your buyer defaults, or needs their closing date extended beyond the scheduled closing date for your purchase? What if you would simply rather not commit to sell your property until you have a suitable replacement property under contract on satisfactory terms?

In these and other circumstances, a “reverse” exchange might help.

In a reverse exchange, you buy and then sell, but it’s not quite that simple. Because you cannot exchange properties with yourself, title to the new property and old one cannot be held by the same party at the same time. To keep the title holders separate, the new property is often “parked” with someone who agrees to hold it for you until you sell your old property – an accommodator – and the owner and accommodator will enter into a number of other agreements to allocating rights and obligations between the owner and



accommodator to address concerns common to reverse exchanges, including: the owner’s desire to control the economic benefits and burdens of the “parked” property, and any improvements made to it, pending completion of the exchange; and the accommodator’s need for funds to purchase and maintain the new property and for protection from environmental and other property-related claims.

Historically, the IRS took the position that as these agreements transferred more parked property rights to the owner, the accommodator looked less like an independent title holder of the parked property and more like the owner’s agent, and if the IRS decided that the accommodator was the owner’s agent, the IRS disallowed the exchange.

Thankfully the IRS changed its position, created a safe harbor, and agreed it would not dispute the accommodator’s ownership of the parked property if certain safe harbor standards were met. Perhaps most importantly, those standards not only authorize the parties to use various guarantees, indemnities, management agreements and other contractual arrangements historically desired, the

standards confirm that their use will not void the exchange, even if the contractual arrangements 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.

- Should you park the old property or the new one?
- Does your new lender understand the accommodator will hold title to the new property rather than its ultimate borrower?
- Do the loan documents that encumber the old property prohibit parking it with the accommodator because they prohibit all transfers?

Clearly a “reverse” exchange is more complex than the typical exchange, but it may prove to be your most attractive option to complete a transaction in a cost effective, tax deferring manner.

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