

REVERSE EXCHANGE GUIDE

Reverse exchanges are the most complex type of exchange. Such an exchange permits the investor to acquire their replacement property before the relinquished property is sold. Under no circumstance may an investor be on title to both the relinquished and replacement properties simultaneously. In September 2000, the IRS indicated a reverse exchange would be permitted if the transaction fell within the scope of “safe harbor” protection. The durational requirements of the “safe harbor” require the identification of the relinquished property within the 45-day identification period and the sale of the relinquished property within the 180-day exchange period. The trigger date for these periods is the “parking” of either the relinquished or replacement property with an Exchange Accommodation Titleholder (EAT). ERI arranges for one of its subsidiaries to function as the EAT. Reverse exchanges are effectuated under one of two structures depending on which property is to be “parked.” Under either structure, the parked property must be held by the EAT for federal and state income tax purposes.

Option A: Park Replacement Property — Exchange Last

Under this structure, title to the replacement property is transferred to the EAT, and not the investor, at close of escrow. The date of this transfer triggers the 45-day period to identify the property to be relinquished and the 180-day exchange period to sell identified relinquished property. Once the relinquished property escrow is ready to close, the EAT enters into a simultaneous exchange with the investor to transfer the title to the parked replacement property to the investor upon the transfer of the relinquished property to a third-party buyer.

Option B: Park Relinquished Property — Exchange First

This structure is generally used when financing is obtained for the acquisition of the replacement property. Prior to the replacement property close of escrow, the relinquished property must be transferred to the EAT. The transfer to the EAT triggers the 45-day period to identify the property to be relinquished and the 180-day exchange period to sell identified relinquished property. Accordingly, the transfer to the EAT ideally takes place shortly before the closing of the replacement property. ERI acquires the right to purchase the replacement property and causes it to be deeded directly from the seller to the investor in exchange for the investor’s transfer of the relinquished property to the EAT. The relinquished property is subsequently sold to a third-party buyer within the exchange period with the EAT acting as the titleholder.

Issues to Consider:

Funds brought in by the investor for the acquisition of the replacement property are permitted to be reimbursed to the investor from the proceeds of the relinquished property and are not subject to capital gains tax. To receive tax-deferral on funds that exceed the initial cash contribution, the excess funds are required to be sent as a principal reduction payment on any debt incurred for the acquisition of the replacement property. The investor bears any costs associated with the reverse exchange. For example, a voluntary transfer of title triggers property reassessment, which can result in the issuance of a supplemental property tax bill. Other common costs may include obtaining title insurance, a binder title insurance policy as well as adding the EAT on the liability insurance policy for the parked property. In addition, city and county documentary transfer taxes may apply.



QUESTIONS? SPEAK TO AN EXPERT!

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