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'Parking' Investor Funds Are Key To Financing Reverse Exchange

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A reverse exchange, the flip side of a deferred exchange, is where the taxpayer directly or indirectly acquires the replacement property before disposing of the relinquished property.

Exchangers engage in a wide variety of so-called "parking" transactions to facilitate reverse exchanges. Such transactions "warehouse" the desired replacement property with an independent party, such as a qualified intermediary, until the exchanger arranges for the sale of the relinquished property.

Revenue Procedure 2000-37 describes a "safe harbor" for reverse exchanges. Non-safe harbor exchanges are also effective if the qualified intermediary has sufficient benefits and burdens of ownership, so that the qualified intermediary will be treated as the owner for federal income tax purposes.

The biggest hurdle facing an exchanger in a reverse exchange is how to provide the equity to purchase the property. The exchanger either loans the money to the qualified intermediary or arranges acquisition financing through a commercial lender. In either case, sufficient safeguards need to be in place to protect the exchanger, lender and the qualified intermediary. The structure of the financing depends on whether the parking arrangement falls under the safe harbor.

The Revenue Procedure requires that title to the replacement property must be held by "a person" who is not the exchanger or a disqualified person. This "person" is also known as an "exchange accommodation titleholder," typically a single-member limited liability corporation owned by a qualified intermediary. Since the EAT will own the replacement property, exchangers should be diligent in their choice of a qualified intermediary.

An exchanger with sufficient liquidity can simply lend the acquisition financing to the EAT. The loan can be interest free, and would be evidenced by promissory note and secured by a mortgage. The Revenue Procedure permits non-arm's length terms in financing arrangements, and the original issue discount rules of Section 1272 provide that no interest will be imputed on a debt instrument that has a fixed maturity date not more than one year from the date of issue.

If a commercial lender is involved, the requirement that the property be titled in the name of the EAT frequently causes consternation since the lender will have dealt with the exchanger in arranging financing, only to discover that an unrelated EAT will be taking title to the property. Adding to the consternation is the fact that the EAT will insist on non-recourse financing. If a mortgage is deemed insufficient security, which is typically the case, the Revenue Procedure does allow the exchanger to guaranty the obligations of the EAT. Furthermore, for the most conservative lenders, the guaranty can be secured by a mortgage on the relinquished property. Finally, the down payment for the purchase can be loaned by the exchanger to the EAT, secured by a second mortgage.

The Revenue Procedure requires that the EAT be treated as the beneficial owner of the replacement property for all federal income tax purposes and that both parties report the federal income tax attributes of the parked property on their federal income tax returns in a manner consistent with the qualified exchange agreement. All payments are typically matched up as deductible rent from the exchanger to the EAT, with the EAT recognizing the rent but paying it all out as deductible payments. For instance, interest owed on acquisition financing will be paid by the exchanger to the EAT as deductible rent, and the EAT will deduct its payments of the interest to the lender.

A problem may arise if the lender requires principal payments, since the EAT will not be able to deduct such payments. This problem can be avoided by having the principal payments advanced to the EAT by the exchanger.

The debt secured by the replacement property is paid off with the relinquished property sale proceeds. To the extent of deficiency in proceeds, the exchanger takes the replacement property subject to debt, assumes the debt, or provides it's own funds to retire the debt. To the extent of proceeds exceeding debt, further replacement properties may be purchased or the exchanger receives "boot."

The IRS acknowledges that parking arrangements can be accomplished outside the safe harbor. According to the Revenue Procedure, "determining the owner of property for federal income tax purposes requires an analysis of all of the facts and circumstances. As a general rule, the party that bears the economic burdens and benefits of ownership will be considered the owner of property for federal income tax purposes."

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The key to a successful non-safe harbor reverse exchange will remain careful structuring to meet the benefits and burdens test. The typical method of financing such an exchange is for the qualified intermediary to apply for and obtain funding from an institutional lender on a recourse basis with the equity portion provided by the qualified intermediary or loaned to the qualified intermediary from a third party (i.e. not the exchanger) on an arm's-length basis. Both loans should be secured by mortgages on the property, and both should bear a market rate of interest. If possible, the exchanger should avoid having to guaranty the loan, though this is typically easier said than done. If the lender requires the exchanger's guaranty, consider having the EAT pay the exchanger a guaranty fee.

These transactions vary considerably subject to the willingness of the lender and the qualified intermediary to accommodate the exchanger, but the more the exchanger bears the economic burden of the loan, the weaker the argument that the arrangement was entered into independently. Due to the complexities involved, an exchanger entering into a reverse exchange should contact a tax professional experienced in structuring and implementing these types of transactions. ■

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