COMMERCIAL INVESTMENT Real Estate

Exchanges

Park Your Reverse Exchange

These 1031 Strategies Help Investors Speed Past Exchange Roadblocks.

by Ronald L. Raitz, CCIM, and Bridgette M. Raitz, CPA

Once upon a time, a “reverse Starker” exchange was dreaded by most tax professionals and avoided at all costs, even by the most savvy investors. Today, time and experience have provided more comfort to people who deal with these unique transactions. As a result, this former strategy of last resort fast is becoming a preference for a growing number of real estate investors.

Today, most Internal Revenue Code Section 1031 tax-deferred exchanges are done on a delayed basis with the use of a qualified intermediary. The order of events is straightforward: Exchangers first sell their current property and then replace it with another.

But what happens when market forces turn the neat timing upside down? When the usual sequence of events is disrupted, many investors still may be able to reach their goals through a reverse exchange.

In a pure reverse Starker exchange (named for the taxpayer in the court case that allowed delayed exchanges), an investor completes the exchange in reverse order, taking title to the replacement property before transferring the relinquished property. However, with the advent of more refined strategies, this method seldom is used.

Most reverse exchanges today follow the traditional order of events by using a third party that is not related to the exchanger to “park” the replacement property until the original property can be sold. Once the relinquished property is sold, the exchanger takes title to the replacement by purchasing it from the third party. Because the sequence is in order, the reverse label no longer is accurate and the transaction might more aptly be called a warehouse or parking exchange.

Given the increasing acceptance of these types of transactions, commercial real estate professionals should understand the basics of parking exchanges when working with clients. A parking exchange could save a deal that otherwise might be lost due to timing problems.

IRS Issues

As the number of successfully completed parking exchanges has risen over the past five years, so has the all-around comfort level. Tax professionals and investors are becoming increasingly familiar with this structure and use it as a proactive investment strategy instead of as a last resort.

How did this complex exchange technique become more accepted? It likely is not due to any definitive guidelines from the Internal Revenue Service, which, historically, has issued little guidance on tax-deferred exchanges. In the preamble to its 1991 regulations, the IRS stated that the regulations did not apply to reverse exchanges — yet the same writings failed to exclude or validate reverse exchanges.

In fact, the IRS appears to be warming somewhat to these transactions. In a recent Private Letter Ruling, the IRS addressed whether two easements would be considered like-kind. In this case, the taxpayer received the replacement easement before disposing of the relinquished easement. The ruling simply acknowledged the reverse element of the exchange and did not voice any objection to it.

This is not uncommon: IRS letter rulings are case specific and normally focus on one particular issue. Although the lack of condemnation or question of the reverse aspect cannot be seen as a vote of confidence, it optimistically might be interpreted as a tacit nod from the IRS.

Recently, in a move that eventually may clarify the situation, the IRS informally requested input on reverse exchanges, asking for recommendations on ways to appropriately structure this type of exchange. This action may indicate that the IRS is planning to issue definitive guidelines governing reverse exchanges.

Using Parking Exchanges

The basics of a standard tax-deferred exchange are simple. An exchanger enters into a contract to sell a relinquished property and executes an exchange agreement with a qualified intermediary before closing. After the sale of the relinquished property, the exchanger has 45 days to identify a potential replacement property and another 135 days (for a total of 180 days from the sale) to purchase a replacement property.

While such time frames might work in a perfect world, the realities of dealing with these constraints may compel an investor to consider a more sophisticated exchange strategy. The following situations are examples of when a parking exchange might be a viable alternative to losing a deal altogether.

Finding the Replacement Property First. It increasingly is common for an investor to find the perfect replacement property before even offering the relinquished property for sale.
For example, John owns a small office building and a piece of raw land near an interstate. He decides the time is right to sell both investment properties and buy a prime piece of land he has located. Together, his relinquished properties are worth slightly less than the value of the land he wants.

He places both properties on the market and receives an acceptable offer on the land subject to re-zoning. Simultaneously, John quickly submits an offer for the desired replacement property. The owner agrees to John's offer but insists on a 30-day inspection period with another 30 days to close. Given the desirability of the property, the owner refuses to negotiate on any extensions or exchange contingencies.

Even if John can close one of his relinquished properties before he has to buy his replacement lot, he only will be able to do a partial exchange and cannot defer the full amount of taxes. If he doesn't contract for the desired property, however, he risks losing it and may have few options when the sale of his existing land is completed.

A parking exchange allows him to acquire the land he wants, sell the properties he owns, and defer all taxes from the transaction. An exchange company agrees to provide both the necessary qualified intermediary and parking entity services. The company establishes a separate parking entity, usually a corporation or limited liability corporation, that purchases the replacement lot. John arranges for outside financing and guarantees the loan. With the desired property warehoused, he can concentrate on effectively marketing his land and office building.

This is an example of an obvious situation in which a parking exchange makes sense. It allows the investor to put his relinquished property on the market, carefully evaluate all offers, and structure a more advantageous sale. Adding a level of complexity can beat having a fire sale to meet the time deadlines of a more standard exchange.

Building a Replacement Property. Bill owns and operates a growing carpet business from an overcrowded suburban store. Because he desperately needs to expand, he has located an attractive piece of land for a new, larger store. He conservatively estimates that once he closes on the lot, it could take more than 12 months to apply for the required zoning, get permits, and complete the new store. He wants to do a tax-deferred exchange, but he needs to stay in his old store until the new one is ready.
In addition, the price of the new lot is only half the value of his current property. He estimates it will take at least 10 months to have improvements in place that will equal the current relinquished value. Even if Bill successfully can negotiate a deal to sell his existing store and lease it back from the owner until his new store is ready, he will run afoul of a 1031 statutory time frame. He won't be able to get the maximum tax deferral from his exchange in 180 days. With a sizable tax liability riding on the sale of his current property, Bill needs a creative exchange strategy to accomplish his objectives.

In this situation, the lot must be acquired and construction started on the replacement property well before the sale of his relinquished property. Because the order of events is reversed, Bill should consider a parking exchange to accommodate his timing challenges.

Bill engages a firm to supply the necessary exchange services, which include establishing a parking entity to purchase and hold the lot with a loan provided by Bill. He enters into a construction-management agreement with the parking entity to supervise construction on the lot until completion. Once the improvements are in place and Bill's relinquished property is sold, the third party sells the new property to Bill, completing the exchange.

Although a replacement property can be transferred to an investor before ultimate completion, enough improvements must be in place to meet or exceed the replacement property target exchange value.

Finding a Replacement Property in Time. Another IRC deadline allows 45 days to identify a potential replacement property once the relinquished property has been sold. Although several rules govern the number of properties that can be identified, investors most commonly list three as potential replacements. After the 45-day identification period, the investor then must choose a property only from this list and close on it before the 180 days are up.
This deadline puts pressure on the exchanger to quickly identify properties that realistically can be obtained and financed if necessary. Under certain market conditions, finding properties that meet these criteria within a short amount of time can be a daunting challenge.

For example, Jenny has a piece of attractive land with a low basis. With a new road recently approved in her area, she feels the time is right to sell her property. She wants to do a tax-deferred exchange but fears that when the right offer comes, she won't be able to find an equally attractive replacement within 45 days. In her market area, new listings often are put under contract and close in a number of days. Sellers are less likely to consider contingency offers and more likely to dictate terms.

A parking exchange can solve Jenny's problem. If she feels that the timing is advantageous for selling the relinquished property, a search for an adequate replacement property can begin before listing the existing property. Once the property is found and a successful offer negotiated, Jenny can enter into a parking exchange. The amount of time that the parking entity holds the replacement property is structured to allow adequate time to sell the relinquished property.

Avoiding Exchange Delays. During a standard exchange, the timing of sales and acquisitions often is critical and delays or unexpected circumstances may jeopardize the entire transaction. What happens when the relinquished property sale falls apart just days before the replacement property is due to be closed? The best way to avoid this situation is to successfully negotiate the ability to extend any contracts. However, in today's market, it often is impossible to negotiate time extensions, let alone contingencies based on the buyer's ability to complete a tax-deferred exchange. The investor who was going to do a standard exchange still has the parking exchange as a potential alternative if a relinquished closing is delayed or aborted.

For example, Ian owns a small apartment building that is very time intensive to manage. When he is approached with an attractive offer for the property, he agrees to the contract that includes a standard financing contingency. In order to use an exchange and defer significant taxes that would be due on the sale, Ian quickly puts a triple-net leased property under contract. As the sale of his apartment building nears, the buyer unexpectedly voids the contract when his application for financing is turned down. Ian wants to move forward with his desired replacement property.

To successfully complete an exchange, Ian needs to modify his existing exchange agreement to a parking exchange. Once the required parking entity is included in the transaction, the new property can be purchased and the apartment building can be offered for sale. Once it sells, the parking entity can sell the replacement property to Ian, who can enjoy fewer management hassles.

Structuring a Parking Exchange

Two methods are used most often for a parking exchange: either the qualified intermediary warehouses the relinquished property or the parking entity warehouses the replacement property. Although warehousing the replacement property usually is preferred, both methods can be coordinated successfully based on individual needs.

Warehousing the Relinquished Property. This method is less common because of the additional uncertainties it adds to the transaction. An exchanger enters into an agreement with a qualified intermediary. Under this agreement, the intermediary acquires the replacement property and then transfers the replacement property to the exchanger. The down payment for the replacement property's acquisition is approximated to equal the equity of the relinquished property and is structured as a loan from the exchanger to the intermediary. At the same time, the exchanger transfers the relinquished property to the intermediary. A simultaneous exchange has been completed with an outstanding note to the exchanger. At a future date, the intermediary sells the relinquished property and uses the proceeds to repay this note.

This approach typically is more difficult for several reasons. First, the terms of any debt on the relinquished property must allow the intermediary to assume the obligation, which may not be permitted. Second, it also may prove more difficult for the exchanger to arrange financing on the replacement property without being able to use the proceeds from the relinquished property. Finally, the proceeds from the sale of the relinquished property may not equal the initial loan that the exchanger advanced. This variance can trigger a taxable event.

Warehousing the Replacement Property. Although more common than the previous method, this structure also presents some challenges. An exchange agreement is required between three parties: the exchanger, a qualified intermediary, and a parking entity. The parking entity first purchases the replacement property and holds it

until the exchanger is able to successfully sell the relinquished property. The exchanger then buys the property from the parking entity as the replacement, completing the exchange.
The first challenge is how to finance the purchase of the replacement property. If the exchanger has the necessary cash on hand, he can loan these funds to the parking entity under a separate bona fide loan agreement. But if an outside loan is needed, the transaction becomes more difficult. Many lenders don't feel comfortable with the structure and security of this kind of transaction. Increasingly, though, lenders are willing to grant the parking entity a nonrecourse loan secured by the property, but usually will require a guarantee from the exchanger.

Second, the parking entity could be held liable for any environmental problems or other issues related to the replacement property during the holding period. Double transfer taxes also would be incurred.

Finally, the issue of who manages the day-to-day operations of the replacement property must be resolved. This usually is arranged in one of two ways. If the replacement property is a parcel of raw land, the parking entity often will net lease the property to the exchanger, allowing him, as a tenant, to assume all costs and liabilities associated with the property. Alternatively, if the property has one or more tenants in place, the parking entity may enter into a management agreement with the exchanger allowing him to operate the property.

Burdens and Benefits
In most early reverse exchanges, only a qualified intermediary was used. The additional use of a separate parking entity in the exchange helps allay fears of a potential agency relationship. But even with the use of a parking entity, the question of whether there truly is an independent, arms-length transaction arises. In order for a valid transaction to exist, some experts argue that the parking entity must endure real burdens and reap real benefits. It is important to include enough of these risks and rewards when crafting the exchange agreement. Without any tangible burdens and benefits, some experts feel that the IRS could challenge the role of the third party in the exchange, ultimately invalidating the exchange.

Despite the fact that a parking exchange is complex and more expensive, the acceptance of this exchange strategy continues to grow. Due to the higher level of sophistication and risk, fees typically are three to five times the standard deferred exchange fee, and other charges for incorporation and tax returns may be incurred.

However, a parking exchange can work when the typical order of events in an exchange is reversed. With the additional flexibility it can offer in a fast-paced real estate market, its popularity should only continue to increase.

When considering any type of exchange, consult a real estate, tax, or legal professional.