The Role of the Settlement Agent in Reverse and Improvement Exchanges

IPX 1031®

Neither the Qualified Intermediary (QI) nor the Exchange Accommodation Titleholder (EAT) takes the place of a settlement agent. In fact, because parking transactions involve multiple transfers of a parcel of real estate, the role of the settlement agent is often magnified.

Settlement agents should not be intimidated by the concept of a Reverse or Improvement Exchange. When a settlement agent works with IPX1031 on a parking transaction, the closings are not significantly different from a standard buy/sell closing. IPX1031 provides full instructions on how the deed should be drafted, what parties should be listed on the settlement statement, and how to handle the transfer of funds. IPX1031 handles Reverse Exchanges all over the country and closing procedures and terminology may differ by geographic region. If you are uncertain about a particular document or instruction IPX1031 encourages you to call the Exchange Coordinator handling the file.

Exchange methods and procedures vary from company to company. While there may be similarities between the procedures of IPX1031 and its competitors, it is not safe to assume all exchanges are processed the same way. It is important that the settlement agent, receive, review and understand the instructions issued by the exchange company for each deal. If there are any questions, the settlement agent should contact the exchange company for clarification.

The standard parking transaction (Reverse or Improvement Exchanges) typically involves three closings. The same settlement agent may handle all three transfers, but that is not always the case. The order of these closings and the parties involved will depend on the exchange structure, so coordination of the parties is essential. A brief summary of each structure's closing procedures is described below.

Delayed Improvement Exchange:

In a Delayed Improvement Exchange the first closing involves the Exchanger's transfer of the Relinquished Property through the QI to a third-party buyer. Often called the "down-leg" or "phase one" of a Deferred Exchange, this first closing for a Delayed Improvement Exchange is identical to a standard Deferred Exchange.

At the close of the Relinquished Property the Exchanger assigns his interest in the Relinquished Property to the QI. The settlement statement shows the QI as the seller. Proceeds from the sale are paid directly to the QI, and title to the Relinquished Property is transferred via direct deed from the Exchanger to the third-party buyer.

The QI will sign escrow instructions, amendments and the settlement statement, but these documents will need to be signed as "read and approved" by the Exchanger prior to submitting them for the QI's signature. Many ancillary documents (1099s, etc.) will not require the QI's signature.

The acquisition of the Replacement Property may occur in a simultaneous closing or it may be delayed by several days or even weeks. When the parties are ready to close on the Replacement Property, the EAT and Exchanger enter into a Qualified Exchange Accommodation Agreement (QEAA). The EAT will form a special purpose entity (usually a limited liability company) to hold title to the parked property. For purposes of simplification, this Brief Exchange will use the term "EAT" to collectively refer to both the EAT and the entity it uses to hold title.

The EAT is then assigned into the Exchanger's position as buyer under the Replacement Property purchase agreement. Since the EAT does not use its own funds, it borrows money from one or more of the following sources (1) the QI, (2) the Exchanger, or (3) a third-party lender arranged by Exchanger.

The EAT, as a "true" buyer is shown on the settlement statement and deed. The EAT will also sign all documents needing buyer's signature, but the settlement agent should make sure that the Exchanger has read and approved a copy of the closing documents prior to submitting them to the EAT for signature. Upon closing title vests in the EAT.

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The settlement agent will generally not be involved in the exchange again until the EAT is ready to transfer the Replacement Property to the Exchanger. This transfer must occur within 180 days of the day the Relinquished Property was transferred to the buyer.

To conclude the exchange, the Exchanger will assign its rights to acquire the improved Replacement Property to the QI. QI will advance the purchase price to the settlement agent (this amount will be off-set by any credits for any funds previously advanced to EAT by QI to acquire or improve the Replacement Property). QI should be shown as the buyer as the qualified intermediary for Exchange. Title to the improved Replacement Property is transferred via direct deeding with title running from the EAT to the Exchanger.

Relinquished Property Parked Reverse Exchange:

The Relinquished Property Parked, or the "Exchange First" Reverse Exchange generally requires the most set-up time and coordination for settlement agents. This is essentially the first leg of a "Forward" Exchange. The EAT will acquire title to the Relinquished Property and hold it until the EAT can sell it to a third-party buyer. As with all Reverse Exchanges, the transaction is governed by a QEAA between the Exchanger and EAT.

The exchange is often structured as a simultaneous exchange in which there are two contemporaneous closings. In the first closing the EAT acquires the Relinquished Property from the Exchanger. The QI is assigned into the Exchanger's position as seller under the purchase and sale agreement with the EAT. The settlement statement shows the QI as the seller and the Eat as the buyer. The EAT will generally finance its acquisition of the Relinquished Property by (1) taking the property subject to any existing debt and (2) receiving a purchase money loan from Exchanger for the balance of the purchase price. The Exchanger will generally deposit those loan proceeds directly into the closing for the EAT's benefit. The deed will be drawn transferring the Relinquished Property from the Exchanger to the EAT.

The Replacement Property closing, the second of the two closings, is completed as any standard deferred exchange "up-leg". The QI is assigned into the purchase contract and shows on the settlement statement as the buyer. The QI uses the proceeds from the Relinquished Property sale and has the Replacement Property deeded from seller directly to Exchanger.

With the Exchanger's disposition of the Relinquished Property and acquisition of the Replacement Property the exchange is technically completed under IRC Section 1031, even though the Relinquished Property has not been sold to a third-party buyer. This is why some refer to this exchange structure as the "exchange first" method.

The EAT will continue to hold the Relinquished Property until the Exchanger can locate a buyer. The EAT will execute the contract that the Exchanger has negotiated with the buyer. At closing, the EAT will instruct the settlement agent to disburse its proceeds to first pay-off any third-party financing taken "subject-to" and then to pay-off the purchase money loan from the Exchanger.

If the proceeds are not sufficient to satisfy both debt obligations the Exchanger will accept less than full pay-off for its loan. If the proceeds from the sale are more than the combined pay-offs the Exchanger and the settlement agent should discuss options with IPX1031, as any excess funds may be classified as "boot" by the IRS.

Although the Exchanger is not a party to this escrow IPX1031 will require that they sign any documents to be signed by the EAT as read and approved before closing. This ensures that the Exchanger is aware of all costs and terms of the closing.

Replacement Parked and Reverse Improvement Exchange:

Because these two exchange structures are very similar they are being combined for the purposes of this Brief Exchange. These exchanges begin with the Exchanger and EAT entering into a Qualified Exchange Accommodation Agreement (QEAA). Next the Exchanger assigns the EAT the Exchanger's rights to acquire the Replacement Property from the third-party seller. Since the EAT does not have its own funds it must borrow money from either the Exchanger or a third-party lender arranged by Exchanger. Often the EAT funding comes through a combination of two of these sources.

The settlement statement shows the EAT as the purchaser and the EAT executes all purchaser closing documents after the Exchanger has signed off as read and approved. Title is transferred from the seller to the EAT.

Title insurance options for the Replacement Property need to be addressed prior to the EAT LLC taking title. If, at the end of the exchange, the EAT transfers the property to the Exchanger by deed there will be a change in the legal titleholder, so any title insurance issued with the LLC as the insured will not offer protection to the Exchanger. There may be ways to mitigate the title insurance costs (i.e. binders, hold-opens, co-insurance, short-term reissue rates), but these options need to be discussed with the Exchanger and arranged in advance, otherwise the Exchanger may be faced with paying a second title insurance premium.

The EAT will continue holding title to the Replacement Property until the Exchanger is in a position to sell the Relinquished Property. If the transaction is an Improvement Exchange the process of constructing improvements on the Replacement Property can begin as soon as the EAT acquires title.

When the Relinquished Property sells the closing is identical to that of a standard ("forward") deferred exchange. The QI is assigned into the Exchanger's contract rights. The Exchanger deeds the property directly to the buyer, with the proceeds being sent to the QI by the settlement agent.

If the Exchange involves the construction of improvements the exchange funds can be used to pay the contractors. The EAT will typically remain on title to the Replacement Property through the 180-day Reverse Exchange period, or until the value of the improvements and the land are sufficient to fully defer the gain from the Relinquished Property sale.

A final, third closing file is scheduled to complete the exchange by having the EAT transfer the parked property to the Exchanger. This file is usually handled by the settlement agent who closed the transaction when the EAT acquired title. The QI is assigned into the Exchanger's rights to purchase the property from the EAT. The QI deposits the exchange funds needed to acquire the Replacement Property. If the exchange proceeds are not sufficient to satisfy the existing debt on the Replacement Property, the Exchanger must either deposit additional funds or assume the remaining debt.

The closing statement shows the QI as the buyer for the benefit of the Exchanger and the EAT as seller. Title is transferred via direct deeding from the EAT to the Exchanger, or by an assignment of the LLC membership interest.

Closing Reverse Exchanges can be a challenge at first. The mere addition of two new parties to the transaction can be a burden in of itself. Add to that the fact that settlement agents are often given short notice of the deal structure, and it's easy to see why Reverse Exchanges can be intimidating to some. We, at IPX1031, understand the value of the role played by settlement agents and make every effort to insure they are comfortable with the transaction. Please feel free to contact your local IPX1031 office or our National Reverse and Improvement Exchange Division – Structuring Department (888-475-2493) with any questions or for additional information on our services.