



# 1031 Reverse Exchange Topics

Reference Guide to 1031 Exchanges

**Patricia Flowers, CES®**  
Vice President  
patricia.flowers@ipx1031.com  
TF 877.781.1031  
Mobile 617.899.4718  
[www.ipx1031.com/flowers](http://www.ipx1031.com/flowers)

**§1031 Exchange Solutions Nationwide**

**Investment Property Exchange Services, Inc.**

a Fidelity National Financial Company FORTUNE 500



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**Offices Nationwide**  
[www.ipx1031.com](http://www.ipx1031.com)

# Introduction

Investment Property Exchange Services, Inc. (IPX1031) is a professional Qualified Intermediary for IRC §1031 Tax Deferred Exchange transactions.

IPX1031 has been assisting clients with their Tax Deferred Exchanges since 1988. Through our national network of regional offices and our knowledgeable, experienced staff, we have consistently demonstrated a commitment to unsurpassed service with integrity. We provide clients with an unparalleled professional team which has earned an outstanding reputation as the industry leader in IRC §1031 Qualified Intermediary services.

IPX1031 is a subsidiary of Fidelity National Financial, Inc. (NYSE:FNF), a Fortune 500 company and a leading provider of title insurance, mortgage services and diversified services. FNF is the nation's largest group of title companies and title underwriters – Fidelity National Title, Chicago Title, Commonwealth Land Title, Alamo Title, Lawyers Title and Ticor Title – that collectively issue more title insurance policies than any other title company in the United States. Our corporate strength permits IPX1031 to offer the highest level of financial security in the industry to ensure the safety of our clients' exchange funds. Exchange accounts held by IPX1031 are protected with a \$100 million fidelity bond, a \$50 million written third party corporate performance guarantee, and a \$30 million professional liability insurance policy.

IPX1031 facilitates thousands of Tax Deferred Exchange transactions every year. Our substantial expertise in facilitating exchanges, combined with the industry's most experienced team of exchange specialists, brings multidimensional insights to structuring even the most challenging exchanges. We handle all types of Section 1031 like-kind exchanges including simultaneous, delayed and exchange accommodation titleholder transactions for reverse and Build-to-Suit Exchanges.

Each of our regional offices is managed by staff experienced in handling all phases of exchange transactions. While we do not provide legal or tax advice in our role as Qualified Intermediary, we expertly guide our clients through the exchange process, providing information about exchange requirements, generating exchange documents, and safely handling exchange funds.

Our staff of trained professionals regularly conducts accredited continuing education courses throughout the country. Many of the country's most respected real estate companies, law firms and accounting firms consistently rely upon IPX1031 as a valuable educational resource. IPX1031 is active in the Federation of Exchange Accommodators (FEA), the national industry trade association representing Qualified Intermediary companies, serving on the Board of Directors for more than a decade. As a member of the FEA, IPX1031 continually participates in new industry developments and legislation regarding Tax Deferred Exchanges and tax related issues.

In our continuing effort to bring value to our clients, we provide this booklet that explains the key requirements and issues concerning IRC §1031 Tax Deferred Exchanges. These short chapters are intended to provide a technical overview and an understanding of the advantages of utilizing a Tax Deferred Exchange as an investment strategy for acquiring and disposing of investment or business-use assets. For recent updates and additional Exchange Topics, please visit our web site at [www.ipx1031.com](http://www.ipx1031.com).

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# The Safe Harbor Reverse Exchange

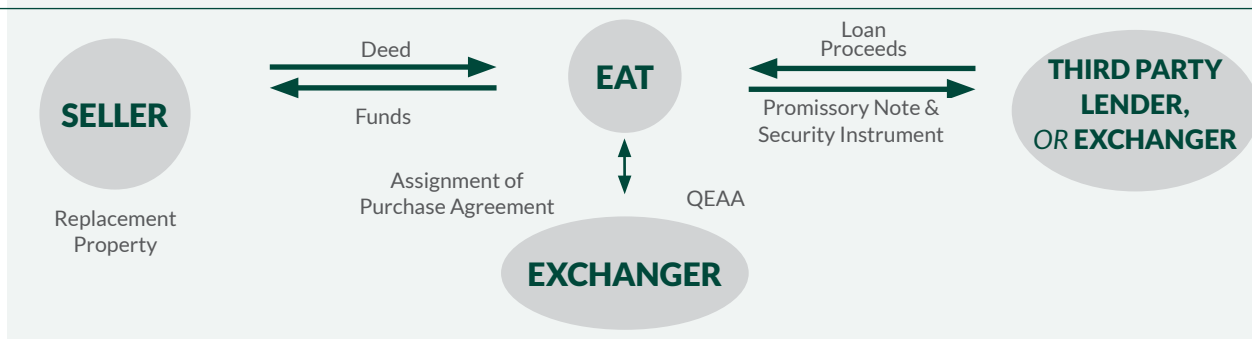
A “Reverse” Exchange occurs when the taxpayer acquires the Replacement Property before transferring the Relinquished Property. A “pure” Reverse Exchange, where the taxpayer owns both the Relinquished and Replacement Properties at the same time, is not permitted. The IRS has provided guidance on structuring a Reverse Exchange, offering a safe harbor under Rev. Proc. 2000-37. An Exchange Accommodation Titleholder (EAT), acquires and holds the target property (the parked property) in a separate special purpose entity, typically a single member LLC (the EAT and LLC are jointly referred to as “EAT”). To complete a Reverse Exchange, the EAT will take title to either the Relinquished Property or the Replacement Property under a “Qualified Exchange Accommodation Agreement” (QEAA).

**Time Periods:** The same 45 day Identification Period and 180 day Exchange Period deadlines of IRC §1031 apply to a safe harbor Reverse Exchange under Rev. Proc. 2000-37, with a slight tweak. If the EAT has begun the exchange by acquiring the Replacement Property, then the Exchanger must identify within 45 days after the EAT’s acquisition of the parked property, one or more Relinquished Properties to be exchanged for the Replacement Property. The identification rules require that written identification permitted under the three property or 200% rules be delivered to another party to the exchange, such as the EAT or the Qualified Intermediary. The identified Relinquished Property must be sold, and the parked Replacement Property transferred to the Exchanger to complete the exchange within 180 days of parking the Replacement Property with the EAT.

## Replacement Property Parked Reverse Exchange

**Replacement Property Parked - Phase I:** In the most common type of Reverse Exchange, the EAT acquires and parks legal title to the Replacement Property. The Exchanger or a third party lender loans the funds necessary for the EAT to purchase and take title to the Replacement Property. The EAT leases the property to the Exchanger under a triple net lease. This permits the Exchanger to receive the economic benefits and burdens of the property during the time that it is held by the EAT.

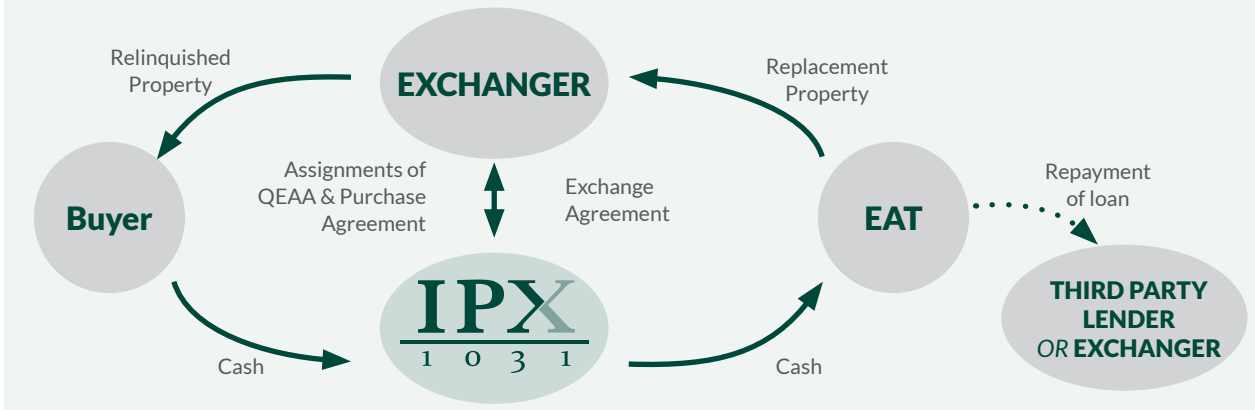
### Phase I - Holding Entity (EAT under Rev. Proc. 2000-37) Acquires Title to Replacement Property



**Replacement Property Parked - Phase II:** When the Exchanger sells the identified Relinquished Property, title is transferred directly to the buyer through direct deedling. The cash proceeds of the sale go to the Qualified Intermediary, which uses these Exchange Funds to acquire the Replacement Property from the EAT. Upon receipt, the EAT will first repay the loan from the Exchanger and then use remaining Exchange Funds to pay down the third-party loan on the Replacement Property prior to transferring the parked property to the Exchanger. If the Relinquished Property sale yields more Exchange Funds than necessary for the Qualified Intermediary to acquire the parked property, the Exchanger may identify additional Replacement Property within 45 days of the transfer of the Relinquished Property, and complete the additional acquisition within 180 days of the Relinquished Property transfer.

# The Safe Harbor Reverse Exchange (CONT.)

## Phase II - Simultaneous or Delayed Exchange



**Replacement Property Parked - Loans to EAT:** This type of Reverse Exchange works best when the Exchanger can pay all cash for the Replacement Property, or when the seller is providing the financing. If the Exchanger is working with a third-party institutional lender, the Exchanger should seek lender approval prior to beginning the Reverse Exchange. The EAT, as the titleholder of the property, may be required to be the borrower on the loan. Many lenders are not familiar with Reverse Exchanges, so involving them early in the process will ensure a smoother transaction. To protect the EAT from liability in the event of default by the Exchanger, the EAT will require the loan to be non-recourse as to itself. Lenders typically require the Exchanger to guarantee a loan made to the EAT.

## Relinquished Property Parked Reverse Exchange

An alternative to parking the Replacement Property is to park the Exchanger's Relinquished Property with the EAT.

### Phase I - Holding Entity (EAT under Rev. Proc. 2000-37) Agrees to Purchase Relinquished Property

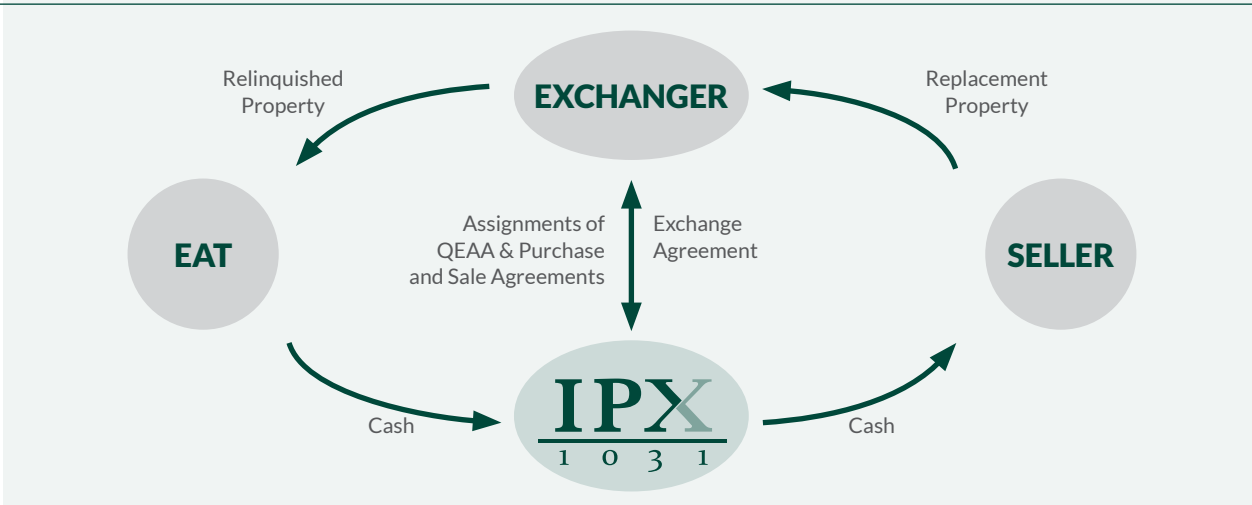


# The Safe Harbor Reverse Exchange (CONT.)

**Relinquished Property Parked - Loans to EAT - Phase I:** Since the EAT does not have its own funds to purchase the Relinquished Property, it must borrow the money. Typically the consideration consists of (1) the EAT taking the Relinquished Property “subject to” any existing third-party financing, and (2) a purchase money loan from the Exchanger for the balance. For a fully deferred exchange, the loan from the Exchanger should equal the equity the Exchanger has in the Relinquished Property.

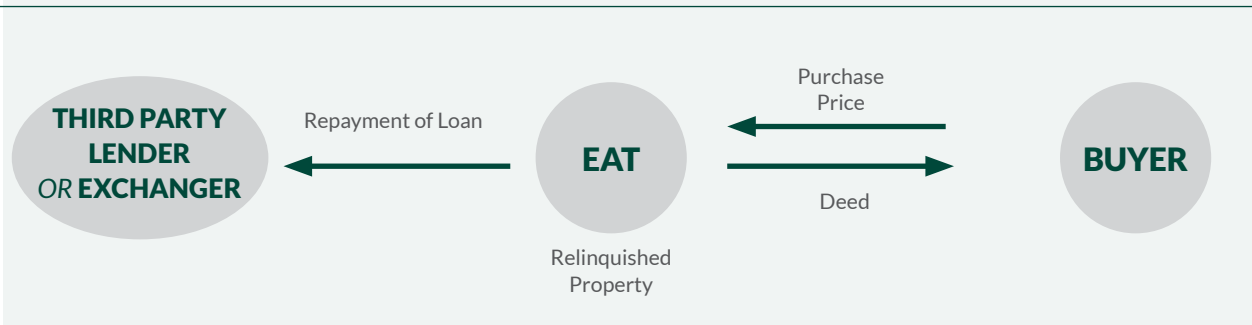
**Relinquished Property Parked - Phase II:** A Relinquished Property parked Reverse Exchange begins with a simultaneous exchange involving the Exchanger, the EAT, the seller of the Replacement Property, and the Qualified Intermediary. The Exchanger transfers the Relinquished Property to the EAT and simultaneously receives the Replacement Property from the seller. Both transfers occur through the Qualified Intermediary and the use of direct deeding. The funds the EAT borrowed from the Exchanger will be used to pay closing costs, with any balance flowing through the exchange and being applied toward the purchase of the Replacement Property.

## Phase II - Simultaneous Exchange



**Relinquished Property Parked - Phase III:** When the Relinquished Property is sold to the ultimate buyer, the cash proceeds from the sale go to the EAT and are used first to retire any existing third party debt the EAT took subject to, then to repay the Exchanger for the original loan to the EAT. If the price paid by the EAT for the parked property differs from the actual price paid by the ultimate buyer, the Exchanger and the EAT will enter into a purchase price adjustment agreement to increase or decrease the original purchase price and loan amount as necessary to reflect the final purchase price.

## Phase III - EAT Sells Relinquished Property



# The Build-To-Suit Exchange

The Build-to-Suit Exchange, also referred to as a construction or Improvement Exchange, gives the Exchanger the opportunity to use Exchange Funds for construction, renovations or new improvements, to the Replacement Property. In the most common type of Build-to-Suit Exchange, the Exchanger sells the Relinquished Property through a Qualified Intermediary in a delayed exchange, and then acquires the Replacement Property after it has been improved using the Exchange Funds from the Relinquished Property sale. Note that any improvements made to the Replacement Property after the Exchanger takes title are not considered “like-kind”. Treas. Reg. §1.1031(k)-1(e). To qualify for inclusion in the exchange, any improvements to the property must occur before the Exchanger takes title. *Bloomington Coca-Cola Bottling Company v. Commissioner*, 189 F.2d 14 (CA7 1951). Any unused Exchange Funds may be taxable as boot. Only funds disbursed for material actually in place and services actually performed will count toward the exchange value. Exchange Funds in an escrow “holdback” for post-closing improvements will not qualify even if the funds are deposited before the Exchanger takes title.

If the Exchanger wishes to include construction on the Replacement Property as part of the exchange, one option is to contract with the seller to have the construction completed before the transaction closes and the Exchanger takes title to the property. For a variety of reasons, this is often not a viable option. Rev. Proc. 2000-37 provides a “safe harbor” for structuring a Build-to-Suit Exchange using an Exchange Accommodation Titleholder (EAT) to hold title to the Replacement Property pending completion of the improvements. Time limitations and all other rules of IRC §1031 apply to Build-to-Suit Exchanges. The Identification Notice in a Build-to-Suit Exchange should include a description of the underlying real estate and as much detail regarding the improvements as is practical. To avoid boot, the Exchanger must ultimately acquire Replacement Property with a value equal to or greater than the value of the Relinquished Property, and use all of the exchange equity in the acquisition of the improved Replacement Property.

As in a typical Delayed Exchange, the Build-to-Suit Exchange involves a Qualified Intermediary and begins when the Exchanger sells the Relinquished Property. Prior to closing on the purchase of the Replacement Property, the Exchanger enters into a Qualified Exchange Accommodation Agreement (QEAA) with the EAT and assigns its rights in the purchase contract to the EAT. The EAT then acquires title to the Replacement Property. IPX1031 holds all parked properties in a separate special purpose holding entity (typically a single member LLC) for each exchange (the EAT and holding entity are jointly referred to as the EAT). The Exchanger or its designated representative is authorized by the EAT to act as its project manager to oversee all aspects of the construction. During the 180-day exchange period, the Exchanger, as project manager, sends construction invoices to the EAT for payment. The EAT must make payments directly to the vendors.

Build-to-Suit Exchanges are less complicated when the improvements can be paid for with cash loaned to the EAT by the Exchanger or with Exchange Funds advanced by the Qualified Intermediary. If a construction loan from an institutional lender is required, the Exchanger should seek lender approval prior to beginning the exchange, since the EAT, as titleholder to the Replacement Property, may be required to be the “borrower” on the loan. To protect the EAT from liability in the event of default by the Exchanger, the EAT will require the loan to be non-recourse as to itself. Lenders typically require the Exchanger to guarantee a loan made to the EAT.

On the earlier of the end of the 180-day Exchange Period or completion of construction on the Replacement Property, the EAT will transfer the Replacement Property to the Exchanger to complete the exchange. Depending upon the Exchanger’s preference, the Replacement Property is often transferred to the Exchanger by assignment of the sole membership interest in the holding entity rather than by a deed. Selecting the appropriate method for transfer of title should be determined after review of transfer tax and other legal issues by the Exchanger’s tax and legal advisors. If a third party lender is involved, the Exchanger typically will assume the construction loan upon the conclusion of the exchange. Any construction to be included in the exchange must be completed and paid for prior to the holding entity’s transfer of the Replacement Property to the Exchanger.

Rev. Proc. 2000-37 also permits the Exchanger to use an EAT to close on the purchase of the Replacement Property and commence construction of improvements, prior to the sale of the Relinquished Property. In Reverse Build-to-Suit Exchanges, since the Relinquished Property has not yet sold, the Exchanger or a third-party lender must loan funds to the holding entity to acquire and improve the Replacement Property.

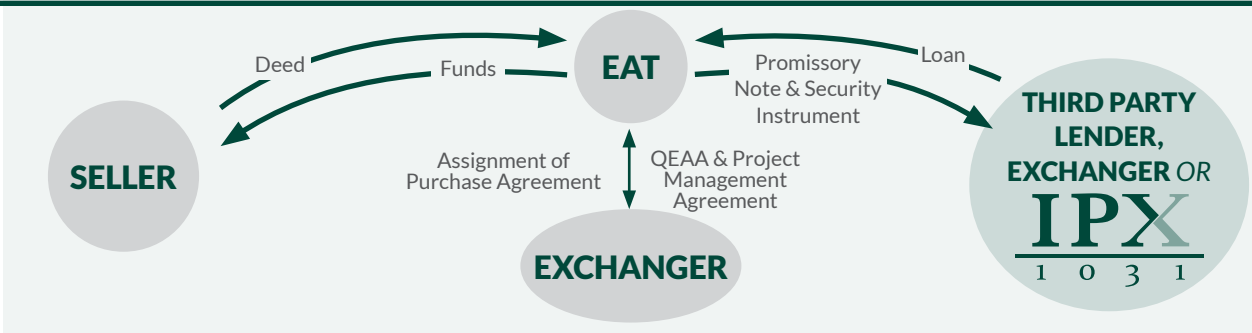


# The Build-To-Suit Exchange (CONT.)

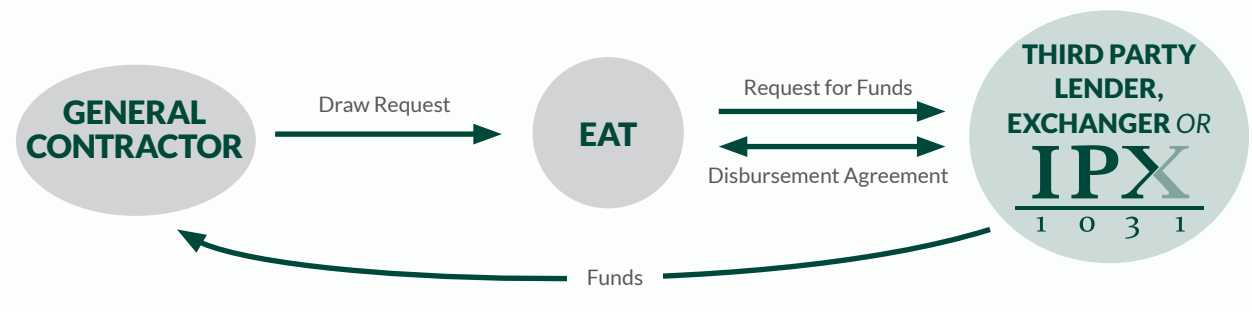
## Phase I - Qualified Intermediary Facilitates Disposition of Relinquished Property



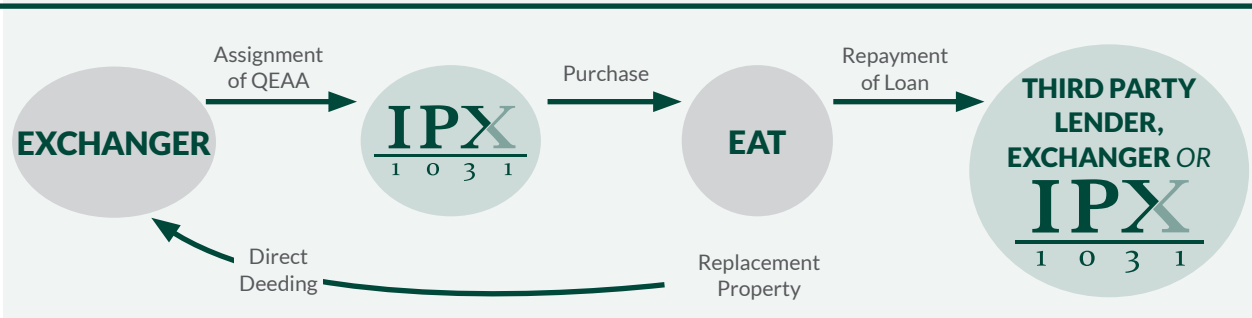
## Phase II - Holding Entity (EAT under Rev. Proc. 2000-37) Acquires Title to Replacement Property



## Phase III - Construction of Improvements



## Phase IV - Qualified Intermediary Facilitates Transfer of Improved Replacement Property to Exchanger



# Selecting an Accommodator for a Reverse or Improvement Exchange

The adage “you get what you pay for” is as true when selecting an Exchange Accommodation Titleholder (EAT) as it is when buying a car or booking a vacation. The key is to look for an Accommodator who will bring your exchange the best value, not necessarily the cheapest price.

The service, security and expertise of Accommodators vary tremendously from one company to another. To help our clients make sure they are doing an “apples-to-apples” comparison when selecting an EAT, we have prepared a list of due diligence questions and IPX1031’s answers. We are confident you will agree that when all the factors are considered, IPX1031 offers the best value for your exchange.

## Structure

Has the Accommodator verified that their documents comply with the “safe harbor” provided in Revenue Procedure 2000-37?

- IPX1031 has gone to great lengths and expense to ensure that we are providing exchange documents that comply with Revenue Procedure 2000-37.
- Our documents were developed by the top attorneys in the field, and have been used in transactions structured by the country’s largest accounting and law firms.

Does the Accommodator use a special purpose entity to hold title to the parked property?

- In its parking transactions, IPX1031 always uses special purpose entities to hold title to parked property, usually a single member, limited liability company (“SPE”).
  - › Each of our SPEs is used for only one exchange or one Exchanger, depending upon the circumstances.
  - › Unless taken over by our clients, our SPEs are dissolved after the exchange is concluded.
  - › The Exchanger can manage the SPE, and is given the choice of name and state of formation.

Is the Accommodator comfortable discussing the various issues and structures involved in Reverse and Improvement Exchanges?

- IPX1031 is the industry leader with the experience and expertise to assist the Exchanger and its tax advisors in structuring any transaction.
- We have created a separate “National Reverse and Improvement Exchange Division” to ensure that your transaction is handled by a specialist. The staff includes attorneys and Certified Exchange Specialists®.

## Expertise

How many Reverse Exchanges does the Accommodator handle each month?

- In recent years IPX1031 has averaged 50+ new Reverse or Improvement Exchanges per month.

Does the Accommodator have staff that specializes in Reverse Exchanges, or do they also have other responsibilities?

- IPX1031 has dedicated attorneys, Structuring Directors and Coordinators whose sole responsibility is handling Reverse and Improvement Exchanges.

How long has the Accommodator been facilitating Reverse Exchanges?

- IPX1031 had been facilitating Reverse and Improvement Exchanges since the company was founded in 1988.

Does the Accommodator have national experience or is their practice limited to certain geographic regions?

- IPX1031 handles Reverse and Improvement Exchanges nationwide.
- This broad national experience provides IPX1031 with the necessary expertise in real estate practices and closing procedures in all regions of the country.

# Selecting an Accommodator for a Reverse or Improvement Exchange (CONT.)

## Service

What type of service do you get for the fee? What documents are included? Are revisions possible? Is there any structuring consultation or issue spotting included in the Accommodator's service?

- IPX1031 strives to provide the highest level of customer service in the industry.
- Every parking transaction handled by IPX1031 begins in our highly trained Structuring Department. Our veteran staff reviews the details of each transaction, and with the involvement of the Exchanger's tax advisor, determines the best exchange structure for each transaction.
- The fees in a Reverse or Improvement Exchange are significantly higher than you will find in a Delayed/Forward Exchange. There is much more involved in the structuring stage, often requiring coordination with a third-party lender. The necessary documents are more sophisticated, and more numerous. Also, the everyday risks inherent in holding title to the parked property justify a higher fee. The typical documents in a "safe harbor" Reverse Exchange include:
  - › Qualified Exchange Accommodation Agreement
  - › Lease Agreement
  - › Loan Agreement (including Promissory Note and Pledge of SPE interest)
  - › Assignments
  - › Exchange Agreement (to complete the transaction)
- Although IPX1031 cannot take the place of a client's legal and tax advisors, IPX1031 will have in depth discussions with the Exchangers and their advisors on structuring the exchange. During the course of the transaction, IPX1031 will make every attempt to spot salient issues that may cause potential problems for the transaction and to suggest various strategies to overcome those issues.

Does the Accommodator meet the IRS tax filing requirements?

- IPX1031 fully complies with the requirements of Rev. Proc. 2000-37 regarding federal tax filing requirements.
- IPX1031 also reports ownership of parked properties for state purposes.

## Security

Who is the Accommodation company and who backs them up?

- IPX1031 and the affiliated entities used in Reverse and Improvement Exchanges are subsidiaries of Fidelity National Financial, Inc., a Fortune 500 company.
- Fidelity National Financial is a publicly traded company (NYSE "FNF").
- As a publicly traded company, information on the financial strength of the company is available in the Investor Info section of FNF's website at [www.investor.fnf.com](http://www.investor.fnf.com).

# Third-Party Loans with Accommodator on Title

One of the most challenging aspects of orchestrating a Reverse or Improvement Exchange is securing financing for the Replacement Property. Typically, Exchangers find the most success in obtaining a loan for this type of exchange by relying on their existing banking relationships. Some lenders may not be willing to comply with the non-recourse language required by IPX1031 when it acts as the titleholder. Early in the planning process IPX1031 may be able to provide an Exchanger with a list of local lenders who are willing to participate in Reverse or Improvement Exchanges.

Title to the property is held in a Special Purpose Entity (SPE), whose sole member is affiliated with IPX1031. The SPE should be the borrower under any acquisition or construction loans. It is a good idea to advise the lender of the involvement of the SPE and the structure of the transaction early in the process. In the initial discussions, the lender should also be supplied with the IPX1031 standard non-recourse language.

## Non-Recourse Requirement:

When a loan is “non-recourse” the lender agrees not to proceed personally against the borrower (i.e. the IPX1031 entity that is the sole member of the SPE) for liability under the loan. In other words, the lender agrees that its only remedies in the event of a default are to proceed against the property that secures the loan, as well as any guarantor.

Before the SPE will sign any loan documents, the loan must be entirely non-recourse as to our entities. (See Brief Exchange on Third Party Notes and Security Instruments for sample nonrecourse language.) This is a requirement for all loans the SPE signs, whether they are acquisition loans, assumption papers, or construction financing. Most lenders will require that the Exchanger personally guarantee the loan.

IPX1031 will review the loan documents for any affirmative actions or indemnity requirements the lender may place on the borrower. Often lenders will have a non-recourse provision in the loan agreement and then insert separate indemnifications from the borrower in other sections of the loan documents. Such responsibilities must be removed or transferred to the Lender’s guarantee agreement with the Exchanger.

## “Carve-Outs” to Non-recourse Provisions:

Many non-recourse loans will exempt or “carve-out” certain items or actions from the non-recourse limitation. The three most common carve-outs are for waste, environmental contamination, and borrower fraud. The loan must be entirely non-recourse as to the SPE and its sole member, with no carve-outs. IPX1031 will instruct the lender that the Exchanger, as guarantor under the loan, will need to have the liability for the “carve-outs”, not the SPE.

## Exchanger as Borrower or Co-Borrower:

On occasion lenders may be unwilling to list the SPE as the borrower. The lender may suggest that the Exchanger be the borrower under the Note and the SPE simply be the grantee on the deed of trust or mortgage. Another course of action is to have the Exchanger borrow the funds from the lender by signing a promissory note. The Exchanger then loans those funds to the SPE. The SPE gives the Exchanger a mortgage or deed of trust on the parked property. The Exchanger then assigns that deed of trust or mortgage to the lender as collateral for its original loan.

A more simple structure is to have the SPE and Exchanger as co-borrowers on the loan. Revenue Procedure 2000-37 permits Exchangers to enter into a variety of permissible agreements with regard to the financing of the parked property acquisition for a safe harbor Reverse Exchange. A co-borrower structure should qualify as a permissible agreement. (The same is not true for exchanges structured outside the safe harbor of Rev. Proc. 2000-37.)

# Third-Party Loans with Accommodator on Title (CONT.)

## Special Issues Regarding Financing in Relinquished Property Parked Reverse Exchanges:

When the SPE is holding the Relinquished Property, the Exchanger will most often have the SPE take title “subject to” the existing debt. That type of conveyance would likely constitute a transfer that could trigger a “due on sale” clause under the existing loan. The Exchanger should discuss the potential effect of triggering the due on sale clause with its tax advisors. Another option is to have the SPE assume the existing debt. Any assumption would require the lender’s consent. The documents must provide that the SPE is assuming the loan on a non-recourse basis.

If the Exchanger does not have sufficient cash for the down payment on the Replacement Property it may consider refinancing the Relinquished Property to obtain the necessary funds. A better course of action is for the Exchanger to discuss having the existing lender provide new financing for the SPE purchase of the Relinquished Property. The new financing would enable the Exchanger (through its Qualified Intermediary) to receive cash to put down on the Replacement Property while protecting against the concerns involved in refinancing prior to an exchange. There is a risk that the IRS may re-characterizing the equity pulled out of the Relinquished Property as cash boot, and taxable.

## Special Issues Regarding Cross Collateralized Financing in Replacement Property Parked Reverse Exchanges:

Sometimes the lender for the Replacement Property will require that the Relinquished Property also serve as collateral for its loan on the Replacement Property (“cross collateralization”). When the Relinquished Property sells the lender will need to release its lien so the buyer gets clear title. The lender may condition its release upon having the sales proceeds paid to the lender from escrow. Such a direct payment to the lender may trigger a “(g)(6) event”, i.e. an impermissible pledge of exchange funds by the Exchanger, which could disqualify the exchange. There are three alternatives that may avoid a (g)(6) event: (i) the Exchanger can pledge its rights under the Exchange Agreement to the lender, which includes the right to receive the proceeds upon a (g)(6) event; (ii) the Exchanger can enter into an “Irrevocable Direction to Disburse”, which requires the QI to pay any unused exchange funds to the lender; or (iii) the QI can receive the proceeds from escrow, then disburse them to the EAT as an irrevocable down payment on the Replacement Property. The EAT can then pay the funds to the lender to reduce the loan balance.

## Special Issues Regarding Construction Loans:

Occasionally in an Improvement Exchange there is a need to obtain a construction loan after the SPE has already taken title. This situation should be handled the same as an acquisition loan (discussed above). In most instances the SPE will be the borrower on a non-recourse basis, with the Exchanger guaranteeing the loan.

## Special Purpose Entities:

IPX1031 will form a SPE to hold title in all Reverse and Improvement Exchanges. The SPE is typically a single member limited liability company that holds the assets of one exchange transaction. The sole member of the SPE is an entity that is wholly owned by IPX1031. For safe harbor exchanges, the entity is “National Safe Harbor Exchanges, Inc.”. (See Brief Exchange on Special Purpose Entities for additional information.)

On occasion a third-party lender will require an opinion letter from the SPE’s outside legal counsel as to its formation and authorization. Opinion letters can be costly and also cause timing delays. If IPX1031 is required to engage counsel to issue an opinion letter, all costs will be passed on to the Exchanger. A minimum of ten (10) business days advance notice is necessary if an opinion letter will be required.

# Third Party Notes and Security Instruments

Title to the property being parked is held in a newly formed special purpose entity (SPE) with National Safe Harbor Exchanges, Inc., a California corporation (NSHE) as the sole member and/or manager. In the event the SPE is a party to a third-party note, security instrument, or other loan document; that loan must be assumable at least once by the Exchanger or NSHE must be permitted to assign its interest in the SPE to the Exchanger. In addition, all the loan documents SPE is party to must contain the following language:

**No Recourse to Exchange Accommodator.** National Safe Harbor Exchanges, Inc., a California corporation (“NSHE”), is acting as an exchange accommodation titleholder in connection with a like-kind exchange under IRC §1031 and Revenue Procedure 2000-37 for the benefit of \_\_\_\_\_ (“Exchanger”). NSHE is the sole member of \_\_\_\_\_, a \_\_\_\_\_ limited liability company (“SPE”). The general credit of NSHE is not obligated or available for the payment of the indebtedness created or secured by the loan agreement, promissory note, deed of trust / mortgage, environmental indemnities and any other documents executed by NSHE or SPE in connection with this loan (collectively referred to as the “Loan Documents”). Notwithstanding any provisions of the Loan Documents to the contrary, except in the event of fraud or willful misconduct by NSHE, Lender will not look to NSHE or its directors, officers, employees or shareholders (collectively, “NSHE Parties”) with respect to the indebtedness evidenced by the Loan Documents or any covenant, stipulation, promise, indemnity, agreement or obligation contained herein. In enforcing its rights and remedies under the Loan Documents, the Lender will look solely to any or all of the Property, SPE, Exchanger and guarantors for the payment of the indebtedness secured by these Loan Documents and for the performance of the provisions hereof. The Lender will not seek a deficiency or other money judgment against NSHE or NSHE Parties and will not institute any separate action against NSHE or NSHE Parties by reason of any default that may occur in the performance of any of the terms and conditions of the Loan Documents between SPE and Lender. This agreement on the part of the Lender shall not be construed in any way so as 1) to affect or impair the lien of the Loan Documents or the Lender’s right to foreclose as provided by law, or 2) to limit or restrict any of the rights or remedies of the Lender in any foreclosure proceedings or other action to enforce payment of the indebtedness secured by this instrument.

**Permitted Transfer:** Lender shall allow NSHE to transfer the Property to Exchanger pursuant to a Qualified Exchange Accommodation Agreement between said parties. This transfer shall not constitute an event that would permit Lender to declare the loan immediately due and payable, nor shall such transfer subject NSHE to payment of any Lender transfer fee. Upon such permitted transfer, NSHE shall be released from any and all liability. Lender consents to this transfer of the Property either by 1) deed from SPE to Exchanger or 2) NSHE’s assignment to Exchanger of the sole membership interest in SPE.

There can be no carve-outs. Any additional representations, warranties or indemnities contained in the loan documents must be specifically limited by the non-recourse clause but may be added with recourse to the Exchanger or other guarantor under a separate guaranty agreement.

**Please Note:** While NSHE is the sole member of SPE, the SPE is not permitted to open any demand deposit accounts or other financial products.

# Insurance Requirements

The responsibility of providing hazard and liability insurance coverage for a property held by IPX1031 lies with the Exchanger. Prior to taking title, IPX1031 will require proof of both liability and property coverage naming our holding entity.

The required coverage limits will be determined by the value and the nature of the use of the parked property. Property insurance coverage will need to be for the replacement value of the parked property. The minimum liability insurance limit for IPX1031 is \$1,000,000 and the minimum requirements generally increase according to the following table.

| <b>Property Value</b> | <b>Nature of Property Use</b> | <b>Required Minimum Liability Coverage</b> |
|-----------------------|-------------------------------|--|
| Any Value             | Residential (under 4 units)   | \$1,000,000                                |
| Under \$1,000,000     | Vacant Land                   | \$1,000,000                                |
| Under \$1,000,000     | Commercial/Multi Housing      | \$1,000,000                                |
| \$1M to \$5M          | Vacant Land                   | \$1,000,000                                |
| \$1M to \$5M          | Commercial/Multi Housing      | \$2,000,000                                |
| Over \$5M             | Commercial/Multi Housing      | \$5,000,000                                |

Owners of commercial liability insurance policies generally will not find adding the required coverage listing the holding entity a problem. Exchangers who do not own commercial liability insurance policies will want to confirm the available coverage limits with their agent.

Exchangers encountering problems obtaining the required minimum insurance coverage should speak with their IPX1031 representative regarding possible alternatives.

# Environmental Issues

The holder of record title to contaminated real estate may be subject to significant liability under federal and state “Superfund” or environmental protection laws. This liability, which can exceed several million dollars, can apply to the titleholder regardless of whether they caused the contamination or merely held title as an Accommodator for a short period of time to property that was already contaminated. Liability of the titleholder could also apply if a facility currently operating on the real estate is not in compliance with environmental regulatory requirements.

Since IPX1031 takes title to real property in Reverse and Improvement Exchanges, IPX1031 and its subsidiaries may be subject to potential environmental claims. It is important to keep in mind that unlike lenders, an entity acting as an Exchange Accommodation Titleholder (EAT) is not exempt from environmental liability under federal statute, and could be held responsible for the remediation costs associated with environmental contamination. Because the law will apply joint and several liability, an EAT could be held responsible for 100% of the clean-up costs associated with a property it held in a parking transaction. Even if an EAT was successful in avoiding ultimate liability in an environmental lawsuit, the costs of its defense will be many thousands of dollars. Such costs could be substantial enough to drive a small to moderately capitalized EAT into bankruptcy, and potentially jeopardize the EAT’s other exchange transactions.

Although IPX1031 makes use of special purpose entities (SPE) to hold title in Reverse and Improvement Exchanges, IPX1031 does not rely solely on SPEs to protect itself, and its Exchangers, from potential environmental claims. IPX1031 believes that a sound environmental policy that focuses on proper due diligence and risk analysis provides more security than thinly capitalized SPEs that might easily be “pierced”.

To prevent IPX1031 from ever facing an environmental challenge we have developed the following policy regarding environmental investigations. The only properties excluded from this policy are:

1. Residential property of less than four units, and
2. Vacant residential lots in residential neighborhoods.

For all properties for which we are asked to hold title (other than residential property), we require a current Phase I Environmental Site Assessment Report. This Report must meet the following criteria:

- a. The Report must be conducted in accordance with current ASTM standards (ASTM E-1527-13).
- b. The Report must be addressed to our SPE and its Member, or the consultant must issue a Reliance Letter in favor of the SPE and its Member.

If a known or potential release of a hazardous or regulated substance has been identified in the environmental reports, then in addition to providing the Phase I and subsequent reports, the Exchanger will need to provide IPX1031 with the proposed response plan. The response plan must include (1) who is responsible for the clean-up, (2) what is being done to remediate the problem and keep it from worsening, and (3) what funds have been set aside to conduct the response plan. After a review of the information, IPX1031 will, at its sole discretion, determine whether or not it will hold title to the property. Such review may include a review by outside counsel, at the Exchanger’s expense.

The environmental policy of IPX1031 is strict, and we acknowledge that many of our competitors do not go to such lengths in their investigations prior to taking title to property. We believe, however, that it is in our Exchanger’s best interest to use an EAT that understands the environmental implications of holding title and takes every reasonable measure to insure that the property it holds will not negatively affect its financial condition or the property it holds on behalf of its other Exchangers.



# The Lease Agreement in Reverse Exchanges

During the time the Special Purpose Entity (SPE) holds title in a Reverse or Improvement Exchange the parked property will be leased to the Exchanger or an affiliate of the Exchanger. This enables the Exchanger to use or sublease the parked property and enjoy the economic benefits, as well as the burdens, of operating the property.

In a Reverse or Improvement Exchange under the “safe harbor” guidelines of Revenue Procedure 2000-37 (“Rev. Proc. 2000-37”), the Lease Agreement will typically have a term of 180 days to coincide with the time periods set forth in the Qualified Exchange Accommodation Agreement.

Under the terms of the Lease Agreement, the Exchanger is required to pay rent to the SPE, consisting of all holding costs associated with the parked property. These holding costs include items such as mortgage payments, as well as local and state property taxes. The tenant will make these payments directly to the billing party. The Lease Agreement is structured so that the SPE does not derive any profit. Rev. Proc. 2000-37 does not require the Lease to be arms-length between the SPE and the Exchanger.

Holding costs do not include operating expenses. The tenant under the Lease Agreement is responsible for all operating expenses. The tenant is also entitled to all revenue generated by the property, including any rental income generated by any sub-leases of the parked property.

At the end of the exchange the Exchanger must provide the SPE with a schedule of the payments the Exchanger made on behalf of the SPE (the “Tax Accounting”). The Tax Accounting is needed so the SPE can file the applicable federal and state income tax returns required under Rev. Proc. 2000-37. The payment of expenses (other than operating expenses) should be reported by the Exchanger as rent payments made to the SPE. The SPE will report such items as rent and take the corresponding tax deductions, so the net income result for the SPE should be zero.

Rev. Proc. 2000-37 allows for the use of either a lease or a Property Management Agreement. In almost all cases a triple net lease is the preferred option. However, IPX1031 will agree to use a Property Management Agreement in the appropriate situation. A Property Management Agreement is typically used when the parked property is subject to an existing lease. The property manager will collect all the rent, pay all the expenses, and retain the balance as its management fee.

# Non-Safe Harbor Reverse Exchanges

A “Reverse” Exchange occurs when the taxpayer acquires the Replacement Property before transferring the Relinquished Property. A “pure” Reverse Exchange, where the taxpayer owns both the Relinquished and Replacement Properties at the same time, is not permitted. As a workaround, enterprising taxpayers structured “parking” transactions. An accommodation party (AP) would acquire and hold the Replacement Property until the taxpayer could transfer the Relinquished Property in a customary Forward Exchange. A major challenge of the parking arrangement was to give the AP enough benefits and burdens of the Parked Property to be treated as the owner for federal income tax purposes.

Revenue Procedure 2000-37 was issued by the IRS to provide taxpayers with a “safe harbor” to qualify their parking transactions under §1031. If the conditions of the safe harbor are met, the IRS will treat the AP as the beneficial owner of the Parked Property. Also, the IRS will not question whether the Parked Property qualifies as “Replacement” or “Relinquished” for purposes of §1031.

One condition of the safe harbor is that the AP can only hold the Parked Property for 180 days. That time requirement is an impediment to transactions where the Replacement Property needs improvements that will take more than 180 days to complete, or where the Relinquished Property takes longer to sell. As a result, some taxpayers choose to stay outside the safe harbor, in a “Non-Safe Harbor Exchange”. Outside the safe harbor the IRS has historically applied a benefits and burdens test to determine whether the true owner of the Parked Property is the AP or the taxpayer.

Whether inside or outside the safe harbor, the structure and documentation of the Reverse Exchange is very similar. The difference lies in the protections provided by the safe harbor.

| Safe Harbor  | Non-Safe Harbor                             |
|--|---|
| Accommodator Treated as the Owner                              | No Presumption as to Ownership              |
| 45 Days to Identify Relinquished Property                      | No Identification Requirement               |
| 180 Day Maximum Parking Period                                 | No Time Limit on Parking                    |
| Tax Reporting Required   | Tax Reporting Advisable                     |
| Accommodator Can Be Taxpayer’s Agent for Transfer Tax Purposes | Accommodator Should Not Be Taxpayer’s Agent |

The landscape changed for non-safe harbor transactions with the 9th Circuit Tax Court’s decision in *Estate of George H. Bartell, Jr. v. Commissioner*, 147 T.C. No. 5 (2016). In that case the AP held the property for 17 months. The AP had no appreciable benefits or burdens of ownership. The IRS argued that under a benefits and burdens test the taxpayer was the true owner, not the AP. The Court disagreed, holding that the AP may hold title solely for the purpose of an exchange. The AP was not required to have any benefits or burdens of ownership of the Parked Property to have a valid exchange. Also, the AP could be contractually insulated from risk by the taxpayer. An important factor in the Court’s decision was that the AP was not the agent of the taxpayer.

Bartell makes it easier for a taxpayer to structure a non-safe harbor exchange, since the AP no longer needs to have benefits and burdens of ownership. There is some tax risk, as the IRS may not follow Bartell outside the 9th Circuit. Some state courts may also be reluctant to adopt the Bartell opinion. Taxpayers should consult their tax professionals when contemplating a non-safe harbor exchange. For a better understanding of how this case may benefit you, please contact your IPX1031 representative. We will be happy to work with you and your tax professionals to craft a solution that will best fit your needs.

# General Contracting Issues in Improvement Exchanges

Revenue Procedure 2000-37 allows Exchangers great latitude in overseeing the construction of improvements on property being parked with an Exchange Accommodation Titleholder (EAT). These guidelines do not prevent Exchangers from acting as their own general contractor in parking transactions. Nor do they prevent an Exchanger from hiring a related party to act as the general contractor. However, before selecting a general contractor, the Exchanger should discuss the matter with its tax advisors to avoid the potentially improper receipt of exchange funds.

A Qualified Intermediary is used in a Delayed/Forward Exchange to prevent the Exchanger from being in actual or constructive receipt of the exchange funds generated from the sale of the relinquished property. Constructive receipt means that although the Exchanger does not actually have the funds, the party who did receive the funds is someone deemed to be under the Exchanger's control.

The most conservative approach is to hire a third-party general contractor to handle the project. Utilizing an unrelated general contractor lessens the Exchanger's appearance of control over the exchange funds. Unfortunately, it may not always be possible or desirable to hire independent general contractors. Sometimes the Exchanger is in the contracting business, and other times the value of the improvements is minimal, so the Exchanger chooses to act as its own general contractor.

In an Improvement Exchange the main concern with having the Exchanger act as the general contractor, or use a general contractor who is related to the Exchanger, is the potential for constructive receipt of the exchange funds. Although not to be used as legal precedent, the IRS has issued Private Letter Rulings which indicate that having a related general contractor receive exchange funds in the form of construction draws does not constitute the Exchanger's constructive receipt of proceeds. If the Exchanger does choose a related general contractor it should consider doing the following:

1. Have a written, arms-length construction agreement with the contractor.
2. The related general contractor should be in the contracting profession.
3. Fees paid to the contractor should be commercially reasonable.
4. Using a third-party disbursement agent (e.g. title company construction escrow) who would request funds from the exchange account and pay the vendors directly.

The Qualified Intermediary or EAT can also act as a disbursing agent. In that event, they would only disburse funds directly to the vendors. A direct disbursement to the Exchanger would result in the actual receipt of exchange funds, which could disqualify the exchange.

It is important not to confuse the roles of the "project manager" and the "general contractor". Although similar, the project manager typically oversees the project as a whole, while the general contractor deals directly with the subcontractors and the actual construction activity, including payments to vendors. The Exchanger can act as project manager without jeopardizing the exchange.

# “Soft Costs” in Improvement Exchanges

When constructing improvements, the first dollars out are most often spent on “soft” costs. Soft costs are expenses that do not relate to the direct construction of improvements. Some common examples of soft costs are architect and engineering fees, permits, surveys and environmental investigations.

While most tax advisors will agree that money spent on such items does increase the value of the property being improved and therefore increases the basis, it is an open question as to what treatment the funds spent on these items will receive in the course of a Section 1031 Tax Deferred Exchange. The main concern is the IRS may not consider plans and permits “like-kind” to real estate.

There are two main issues involving soft costs in an exchange. The first issue is one of constructive receipt and boot. If the soft cost improvements are not considered to be like-kind property, then the funds expended towards these types of improvements will be treated as boot and be potentially taxable. In addition, anytime exchange funds are spent on non-like-kind property in the course of an open exchange there is always a risk that the IRS will determine that the Exchanger had constructive receipt over the funds and, therefore, the entire exchange may be denied non-recognition treatment. Prior to the Holding Entity acquiring title to the parked property, the Exchanger should always check with his or her tax advisor as to the advisor’s preferred method for handling soft costs in an exchange.

The second issue arises when the Exchanger does not want the Holding Entity to remain on title through completion of the project. Often the value of the land plus the amount of funds spent on soft costs will equal or exceed the value the Exchanger needs for a complete deferral of the gain from the sale of the Relinquished Property. To get a full deferral, the Exchanger must go even or up in equity and value from the Relinquished to Replacement Property. Ideally, the Exchanger would leave the Holding Entity on title until the value of the actual physical improvements met or exceeded the value needed for a complete deferral.

On occasion, the 180-day deadline may prevent completing a project to the point where there is enough value in the Replacement Property to qualify for full tax deferral. In that event, please contact your IPX1031 representative to discuss the feasibility of a non-safe harbor exchange.

# Tax Accounting in Parking Transactions

Revenue Procedure 2000-37 (the “Safe Harbor”) provides great latitude to taxpayers and an Exchange Accommodation Titleholder (EAT) participating in parking transactions under its guidance. Taxpayers can have physical control of the parked property. They can loan the funds to the EAT to purchase the parked property. Taxpayers can even be given a “call” to acquire the parked property whenever they are ready to take title. That flexibility ends, however, when it comes to determining who is treated as the owner of the parked property for federal income tax purposes.

The Safe Harbor states:

*...the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in this revenue procedure. The [Qualified Exchange Accommodation] agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the [parked] property on their federal income tax returns in a manner consistent with this [Qualified Exchange Accommodation] agreement. (Rev. Proc. 2000-37 Section 4.02(3))*

If the requirements of the Safe Harbor are met, the EAT will be treated as the owner of the parked property for federal income tax purposes. The goal for both the EAT and the taxpayer is to establish the structure of the parking transaction in a manner that provides the greatest ability to recognize the economic attributes of the property. Since it is ultimately the taxpayer who is paying for expenses and receiving income from the parked property, we want to make sure the parking arrangement is documented and reported in a manner that allows the taxpayer to be in essentially the same position they would be in if they held title directly (with the exception of depreciation which is discussed below).

By using the triple net lease, the accounting of the EAT’s holding of the parked asset is simplified. All income and expenses associated with operating the parked property will be reported under the taxpayer (or to an affiliate of the taxpayer if the lease is set up with an affiliate as the tenant). Items such as rent received from a tenant, utility expenses, and minor (non-capital) repairs are all reported by the taxpayer without the involvement of the EAT.

Sometimes expenses are incurred that can only be deducted by the owner of the property. Real estate taxes may be the best example. Since the taxpayer is not the owner of the parked property, they are not allowed to take a deduction for any real estate taxes paid or accrued during the EAT’s ownership. Since the taxpayer is the one paying these items, the lease agreement classifies such payments as rent paid to the EAT, allowing the taxpayer to deduct the payment (labeling it as “rental expense”). The EAT will then report the “rental income” and take the off-setting deduction. This allows all parties to be in approximately the same place they would be in if the EAT was not on title.

The same is true for lender payments under notes to where the EAT or SPE are the borrower, and not the taxpayer. Since the taxpayer is not the borrower, they would generally not be in a position to deduct the interest payments. Principal payments are treated as additional advances on the loan from the taxpayer to the EAT. By classifying such payments as “rent” the deduction goes on the taxpayer’s return and creates a net-zero taxable result for the EAT.

Since all payments run directly from taxpayer to the appropriate payees, the EAT is not in a position to know what payments have been made. It is the taxpayer’s responsibility to provide the EAT with an accounting of the items to be considered “rent”, (i.e. the “Tax Accounting”).

# Tax Accounting in Parking Transactions (CONT.)

A form for providing the Tax Accounting information will be provided to the taxpayer with the documents circulated at the conclusion of the exchange. It is strongly encouraged that the taxpayer consult his/her accountant or tax advisor when completing this form. The EAT does not have an obligation to follow-up with the taxpayer for incomplete or missing Tax Accounting, so the taxpayer will want to make sure that the form is completed and returned to the EAT in a timely manner.

It is important that the taxpayer be consistent in reporting the parking transaction. If expenses are listed on the Tax Accounting, the taxpayer will need to be sure that they are reported as “rental expenses” on his/her return. Conversely, if an expense is not listed on the Tax Accounting the EAT will not be reporting it as rental income, so the taxpayer should not be reporting it as a rental expense.

One final note, since the taxpayer does not own the parked property, the taxpayer cannot claim depreciation (for tax purposes) during the period legal title is held by the EAT. (Neither can the EAT, as the property is inventory to the EAT.) Because the taxpayer claiming depreciation on a tax return is not consistent with the EAT being the owner for federal income tax purposes, to do so would take the transaction outside the Safe Harbor. The loss of the ability to claim depreciation during the EAT’s ownership is an opportunity cost that should be factored into the taxpayer’s evaluation of the overall costs of the exchange.

# Setting the Exchange Sales Price: Parking the Relinquished Property

One of the largest challenges to an “Exchange First” (i.e. Relinquished Property parked) Reverse Exchange is estimating the net sales price of a property that does not yet have a contract or may not even be listed for sale. In these situations the Exchanger will need to work with his or her advisors to estimate the value of the Relinquished Property. The price the Exchange Accommodation Titleholder (EAT) will pay for the Relinquished Property (the “Exchange Sales Price”) will need to be estimated prior to preparing exchange documents.

The goal in setting the Exchange Sales Price is to have the loan from the Exchanger to the EAT equal the expected cash proceeds that will be generated by the ultimate sale to a third-party. This will enable the Exchanger to put sufficient cash into the exchange to avoid or minimize boot.

To set the Exchange Sales Price, the Exchanger should estimate the purchase price a third-party buyer will pay for the Relinquished Property. The Exchanger should then subtract the estimated closing costs (the Settlement Agent may be of assistance in this matter). This net sales price will be what the EAT will pay for the Relinquished Property.

The Exchange Sales Price will also include taking the Relinquished Property “subject to” any existing third-party debt. (Please note that this transfer may trigger a due on sale clause under the existing loan. The Exchanger should discuss the potential ramifications of this with his or her tax advisors.) The difference between the Exchange Sales Price and the existing debt will be contributed in cash that the EAT borrows from the Exchanger. This loan will be evidenced by a Promissory Note which may be secured by the Relinquished Property and/or a pledge of the membership interest in the limited liability company the EAT uses to hold title.

Upon closing the sale of the Relinquished Property to the EAT, the cash EAT borrows from Exchanger will be transferred by IPX1031, as the Qualified Intermediary, to the Exchanger’s Replacement Property account, to be used toward the acquisition of that property.

When the EAT sells the Relinquished Property to the ultimate buyer, the proceeds of that sale will be used first to payoff the existing third-party lender and then the balance paid to Exchanger to payoff or pay down the Exchanger’s Note.

If the ultimate sales price differs from Exchange Sales Price, the Exchanger and the EAT will enter into a purchase price adjustment agreement to modify the original sales price and promissory note amount to accurately reflect the true value of the property.

The purchase price adjustment will alleviate any concerns over the EAT having gain or loss on the sale and provide a mechanism to return the accurate amount of proceeds to Exchanger. However, it may not resolve a boot issue if the equity the Exchanger has in the Relinquished Property ends up being greater than the resulting equity in the Replacement Property. Therefore, if the Exchanger is not sure of the exact Exchange Sales Price it may be best to err on the “high side” to make sure sufficient cash is flowing through the exchange. The Exchanger should discuss this issue with his or her tax advisors.

# Off Title Options in Parking Transactions

All parking transactions end with the Exchange Accommodation Titleholder (EAT) transferring the parked property to the Exchanger. This “off title” transfer is accomplished by one of two methods: (1) a deed from the limited liability company (“LLC”) or (2) a transfer of the LLC membership interest. The method used will depend on a number of factors, so it is very important that the Exchanger discuss the options with its tax advisor.

## Deed Transfer:

When concluding a parking transaction by deed transfer, the LLC holding title will sign a deed transferring the parked property to the Exchanger (or to the third-party buyer in an “Exchange First” Reverse Exchange). Some items to consider when considering a transfer by deed:

- **Transfer Taxes** – In jurisdictions that assess transfer taxes, the deed from the LLC to the Exchanger may trigger a tax. Some states/counties/cities have exemptions under which the transfer may qualify (i.e. transfers between agents and principals), but that is not always the case. It is advisable for the Exchanger to determine the application of any transfer tax laws before entering into the exchange.
- **Title Insurance** – Because the deed transfer method results in a change in the legal titleholder, the title insurance issued for the benefit of the LLC 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 arranged in advance of wrapping up the exchange. If prior arrangements were not made, the Exchanger may be faced with paying a second title insurance premium.
- **Loan Assumptions** – Since the legal titleholder is changing from the LLC to the Exchanger, a third-party lender will generally require a formal loan assumption, often at an additional cost.
- **Tenant Issues** – For some parked assets, for example shopping centers and apartment complexes, a second change in the legal title holder may necessitate coordination and cooperation from the tenants (i.e. estoppel letters). While such items are generally obtainable, many investors would prefer to avoid the administrative inconvenience and not go to their tenants for such matters.
- **Timing** – IPX1031 will rely on the Exchanger’s attorney or the settlement agent who handled the initial purchase of the parked property to prepare the deed and coordinate the recording. Because of the involvement of third-party settlement agents, title insurance and loan assumption issues, to transfer by deed will often require significantly more lead time than a transfer by limited liability company interest. IPX1031 suggests a minimum of 10 business days.

## LLC Membership Interest Transfer:

Because of the speed and relative ease of concluding a parking transaction by the EAT’s assignment of the sole membership interest in the LLC holding title, this transfer method is generally preferred. Although it has significant benefits, there are also some issues with transfers of membership interest that an Exchanger needs to fully explore before selecting this option:

- **Transfer Taxes** – Although legal title does not change, some states and municipalities will view the assignment of membership interest as a change in ownership of the assets of the LLC, and will impose a real estate transfer tax. Some jurisdictions will assess an entity transfer tax in addition to, or instead of, a real estate transfer tax. An Exchanger should be sure to evaluate potential taxes with its CPA or tax advisor.



# Off Title Options in Parking Transactions (CONT.)

- **Franchise Taxes** – Ownership of an LLC will frequently carry with it a responsibility to pay annual franchise taxes or entity registration fees to the state of formation and any state in which it is authorized to do business. In some states this amount is nominal, but in others (California for example), the taxes on the limited liability company can be hundreds of dollars.
- **Same Taxpayer Requirement** –Some Exchangers like to keep things simple and have all their real estate held in the same entity. However, Section 1031 requires that the same Taxpayer that held title to the Relinquished Property must take title to the Replacement Property. For that reason, at the end of the parking transaction the Exchanger should acquire the LLC membership, rather than having the membership assigned to their existing entity. However, concluding an exchange via an assignment of LLC interest does not mandate that the Exchanger permanently hold the asset in that entity. The Exchanger should consult with its tax advisors about transferring the property at a later date.
- **More Than One Taxpayer** – The IRS treats the acquisition of the sole membership interest in a limited liability company as the equivalent of acquiring the underlying asset (PLR200118023). Challenges arise when more than one Taxpayer holds title to the Relinquished Property. Separate Taxpayers acquiring an interest in the same LLC creates a partnership, and partnership interests are not eligible for like-kind exchange treatment under Section 1031. If an exchange involves multiple Taxpayers, and the Taxpayers want to acquire the parked property via membership assignment, the EAT must hold title in multiple LLCs, each as a tenant in common.

In the end, the decision to conclude the parking transaction by deed or assignment of LLC interest comes down to the Exchanger and its tax advisors reviewing all factors, including discussing the options with any third-party lender, then deciding on the best course of action.

# The Role of the Settlement Agent in Reverse and Improvement Exchanges

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.

# The Role of the Settlement Agent in Reverse and Improvement Exchanges (CONT.)

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 deed 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.

# The Role of the Settlement Agent in Reverse and Improvement Exchanges (CONT.)

## 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.

# Third Party Leases

As an accommodating party, IPX1031 prefers not to enter into agreements with third parties. The Exchanger's lease of the parked property to the ultimate third-party tenant should be structured as a sub-lease under our lease of the parked property to the Exchanger.

If a sublease is not possible IPX1031 may agree to have our SPE enter into the lease as landlord in a lease to a third party provided the following language is included in the lease:

Notwithstanding any provisions this Lease to the contrary, National Safe Harbor Exchanges, Inc., a California corporation ("NSHE") is acting as an exchange accommodation titleholder in connection with a like-kind exchange under IRC Section 1031 and Revenue Procedure 2000-37 for the benefit of \_\_\_\_\_ ("Exchanger"). As an accommodation party Tenant agrees not to look to NSHE or NSHE's directors, officers, and employees with respect to the Lease or any covenant, stipulation, promise, indemnity, agreement or obligation contained herein. In enforcing its rights and remedies under the Lease, the Tenant will look solely to the Exchanger for the performance of the provisions herein. Tenant will not seek another money judgment against NSHE or NSHE's directors, officers, and employees and will not institute any separate action against NSHE by reason of any default that may occur in the performance of any of the terms and conditions of the Lease between Landlord and Tenant. This agreement on the part of Tenant shall not be construed in any way so as to effect or impair the Tenant's rights hereunder as provided by law or construed in any way so as to limit or restrict any of the rights or remedies of the Tenant in any proceedings or other enforcement of this Lease.

# The Delayed Improvement Exchange on Ground Lease – Structure

Although Revenue Procedure 2000-37 (Rev. Proc. 2000-37) is usually associated with Reverse Exchanges, all parking arrangements can benefit from the safe harbor provisions. In addition to the Exchange Agreement with IPX1031 as the Qualified Intermediary, Delayed Improvement Exchanges involve the use of a Qualified Exchange Accommodation Agreement (QEAA) and an Exchange Accommodation Titleholder (EAT). In situations where the Replacement Property is a leasehold interest, the EAT will form a special purpose entity (SPE) to acquire and hold the ground lease interest.

## Phase I: Qualified Intermediary Facilitates Transfer of Relinquished Property:

The exchange begins with IPX1031 entering into an Exchange Agreement with the Exchanger in which IPX1031 agrees to acquire the Relinquished Property and transfer it to the buyer. The proceeds from the sale are deposited into the Exchange Account, then used to acquire the Replacement Property from the seller. Ultimately, the property will be transferred to the Exchanger to complete the exchange. The Exchange Agreement provides that if improvements are to be constructed on the Replacement Property prior to its acquisition by the Exchanger, an affiliate of IPX1031 will acquire and hold title to the property during the construction period.

The acquisition of the Replacement Property may occur simultaneously with sale of the Relinquished Property or thereafter. Pursuant to the IRS regulations, the Exchanger must not only identify the Replacement Property, but the improvements as well. The intended improvements should be identified with as much detail as is practicable. The identification should also include the legal description of the underlying land. The identification must be made within 45 days of the transfer of the Relinquished Property.

## Phase II: SPE Acquires Newly Created Leasehold Interest:

The SPE becomes the lessee under a newly created ground lease. The ground lease must have a term in excess of 30 years to qualify the leasehold interest as a like-kind to real estate. The Replacement Property will be the leasehold interest, plus the improvements that will be added during the period the SPE is the lessee.

The SPE and the EAT will enter into a Qualified Exchange Accommodation Agreement (QEAA) with the Exchanger under which the SPE agrees to hold the Replacement Property for a period of time not to exceed 180 days following the transfer of the Relinquished Property. The SPE may also sublease the Replacement Property to Exchanger.

## Phase III: Construction of Improvements:

The SPE will engage the Exchanger as the Project Manager to oversee the construction activities on the Replacement Property. Although the Project Management Agreement gives the Exchanger broad powers when dealing with the improvements, including contracting with the contractors and consultants involved in the improvements process, any documents requiring the approval or signature of the legal owner of the Replacement Property must be delivered to the SPE, as the legal owner, for execution.

The Exchanger, as Project Manager, will present draw requests to the SPE. The SPE will fund those draws with funds advanced by IPX1031 under the QEAA or borrowed from the Exchanger or a third-party construction loan.

# The Delayed Improvement Exchange on Ground Lease – Structure (CONT.)

## Phase IV: Qualified Intermediary Facilitates Transfer of Improved Replacement Property to Exchanger:

When the improvements are complete or on the 180th day after the Relinquished Property was closed, whichever occurs first, IPX1031 will facilitate a transfer of the Replacement Property from the EAT to the Exchanger. This off title transfer can be accomplished by the EAT causing the SPE to assign the ground lease to Exchanger, or by the EAT assigning its membership interest in SPE to Exchanger.

There is no requirement that the improvements be completed at the time the Replacement Property is transferred to the Exchanger, however, the value of the leasehold plus the improvements at the time of the transfer must be sufficient to successfully complete the exchange (i.e. even or up in value from that of the Relinquished Property). In addition, any debt from the Relinquished Property must be replaced and all proceeds from the sale of the Relinquished Property must be spent. Pre-payments to contractors will not qualify for exchange treatment. Such payments are for goods and services, which are not like kind to real property. The Exchanger must refer to state law to determine if materials not yet incorporated or affixed in the property will be considered real property. In most states building materials which are not actually in place will not be considered real property.

It is well settled that a long-term leasehold, plus improvements, qualifies as Replacement Property in an exchange when the underlying land is owned by a party unrelated to the Exchanger. Recent rulings have even approved exchanges where the underlying land is owned by a related party. However, some taxpayers seek to use exchange funds to improve a leasehold on land already owned by the taxpayer. Although such exchange structures have been consistently disallowed by the IRS, some taxpayers insist on proceeding anyway. Such a structure is very aggressive. It is critical that that taxpayer's intent on using exchange funds to improve land they already own discuss their proposed transaction with a tax and/or legal advisor before proceeding. IPX1031 is available to discuss the pros and cons with the taxpayer and their advisors. Please refer to Brief Exchange: The Safe Harbor Reverse Exchange for further detail and flow charts.

# Third Party Ground Leases

Often the acquisition of a Replacement Property takes the form of a ground lease interest. In such circumstances, before we will agree to have our special purpose entity (SPE) become the tenant under the ground lease the following language must be included in the lease or the assignment of the lease (depending on whether the lease is newly created or existing):

Notwithstanding any provisions this Lease to the contrary, National Safe Harbor Exchanges, Inc., a California corporation (“NSHE”) is acting as an exchange accommodation titleholder in connection with a like-kind exchange under IRC Section 1031 and Revenue Procedure 2000-37 for the benefit of \_\_\_\_\_ (“Exchanger”). As an accommodation party Landlord agrees not to look to NSHE or NSHE’s directors, officers, and employees with respect to the Lease or any covenant, stipulation, promise, indemnity, agreement or obligation contained herein. In enforcing its rights and remedies under the Lease, the Landlord will look solely to Tenant and/or the Exchanger for the performance of the provisions herein. Landlord will not seek a money judgment against NSHE or NSHE’s directors, officers, and employees and will not institute any separate action against NSHE by reason of any default that may occur in the performance of any of the terms and conditions of the Lease between Landlord and Tenant. This agreement on the part of Landlord shall not be construed in any way so as to effect or impair the lien of the Lease or Landlord’s rights hereunder as provided by law or construed in any way so as to limit or restrict any of the rights or remedies of the Landlord in any proceedings or other enforcement of this Lease.



A low-angle photograph of several modern skyscrapers with glass facades, reaching towards a cloudy sky. A large, dark green diamond-shaped graphic is overlaid on the image, containing the main text.

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SECURITY.  
EXPERTISE.**

Patricia Flowers, CES®  
Vice President  
patricia.flowers@ipx1031.com  
TF 877.781.1031  
Mobile 617.899.4718  
[www.ipx1031.com/flowers](http://www.ipx1031.com/flowers)

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