

1031 EXCHANGE: Considerations When Transferring Real Estate in Reverse Exchanges

Under Revenue Procedure 2000-37, title to a relinquished or replacement property may be “parked” with an Exchange Accommodation Titleholder (EAT) until the taxpayer is able to sell the parked property to an unrelated party as part of a regular forward 1031 exchange.

When the reverse exchange involves the parking of a replacement property, the relinquished property needs to be sold as part of a regular forward exchange. After the sale of the relinquished property as part of a forward exchange, exchange funds are received, exchange funds are received by the qualified intermediary (QI), transferred to the EAT for the acquisition of the property being parked and then reimbursed to the taxpayer and/or lender from the EAT. The last step in a safe-harbor reverse or improvement exchange is for the EAT to convey ownership of the replacement property to the taxpayer.

The transfer of ownership can be accomplished either by:

- Issuance of a quit claim or special warranty deed; or
- Assignment of the membership interest in the LLC holding title to the property.

In the first option, the EAT can transfer the title for the parked replacement property to the taxpayer by way of a quit claim deed or special warranty deed. Many taxpayers are familiar with conveying real estate by way of a deed.

Nevertheless, several administrative and financial factors exist with issuing a deed. Notably, there are hard costs associated with preparing and recording a deed. At the onset, the title company handling the replacement property purchase closing should be made aware of the reverse or improvement exchange structure as it will need to issue a “hold open” policy or some other similar policy endorsement on the title commitment.

Further, the lender (if any) must acknowledge and agree that the conveyance of the replacement property from the EAT to the taxpayer is permissible and will not trigger an event of default or due on transfer clause which would accelerate payment of the entire indebtedness encumbering the real estate. Preparation and recording charges will be incurred by the taxpayer from the title company and lender for purposes of preparing and recording the subsequent deed. Moreover, there may be additional costs such as:

- Reissuance of a new loan package
- Release and recording of a new mortgage or deed of trust if there is debt encumbering the replacement property
- Potential real estate transfer tax or exemption forms to be completed and filed with the applicable state, county, and local authorities
- Other transactional fees related to the conveyance which can vary based on locality.

After the replacement property is conveyed to the taxpayer, the titleholder LLC is then dissolved by filing Articles of Dissolution with the applicable secretary of state.

The second potential option is that the membership interest in the titleholder LLC, which was formed at the beginning of the parking deal to step in the shoes of the taxpayer during the parking period, may be assigned to the taxpayer. The same taxpayer requirement exists for both the relinquished and replacement properties. The exchange takes place at the entity level; therefore, the assignee of the membership interest has to be the owner of record of the relinquished property. In certain circumstances, such as when the taxpayer is an individual,

grantor trust, corporation, or limited liability company, the assignment of the membership interest in the titleholder LLC may be utilized. This also applies when the taxpayer is a married couple, but only if they are in a community property state.

As of the effective date of the assignment of the membership interest, the EAT drops out and the taxpayer steps in as the sole member and manager of the titleholder LLC. The titleholder LLC then becomes the obligation of the taxpayer to maintain from and after the effective date of the assignment.

The taxpayer must inform the secretary of state of the state in which the titleholder LLC is organized, as well as any other applicable government agencies, of changes to the principal place of business and registered agent, and they must file an annual report going forward to keep the entity in good standing. If an EIN was obtained for purposes of the replacement property purchase, it will also be transferred to the taxpayer. The taxpayer will have limited liability protection under the state law governing LLCs but should also consider having an amended and restated operating agreement prepared by its own independent legal professional to reflect the new ownership and management organization. On limited occasions, there still may be local, county and state transfer tax considerations associated with assignment of the membership interest as well.

Depending on the facts and circumstances surrounding the parking arrangement, it may be more cost effective, efficient and desirable from a limited liability perspective to utilize an assignment of the membership interest on the back end to wrap up a parking deal instead of a deed.

As with all matters concerning 1031 exchanges, it is highly advisable to consult with an independent professional regarding the legal and tax consequences associated with either using a deed or an assignment of membership interest in the titleholder LLC for purposes of concluding a reverse or improvement exchange transaction.