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.