1031 EXCHANGE FOCUS

Section 1031 of the internal revenue code is one of the greatest wealth building tools available to the investor.

THE REVERSE EXCHANGE

Internal Revenue Code Section 1031 allows investors to defer the payment of capital gains taxes when selling investment property and exchanging into other like- kind investment property.

In a typical 1031 Exchange, relinquished property is sold and then replacement property is purchased. On occasion, it may be advantageous to do the reverse; purchase replacement property first and then sell relinquished property. Such a process is aptly named "Reverse Exchange" and is an accepted method of exchanging under current tax law (Revenue Procedure 2000-37).

A reverse exchange presents three notable challenges. First, the relinquished and replacement properties cannot be owned by the investor at the same time. Therefore, an Exchange Accommodating Titleholder (EAT) will take title to the replacement property. The qualified intermediary working on the exchange will generally set up the EAT. After the EAT takes title to the replacement property, the investor will have the normal 180 days to complete the exchange by selling the relinquished property.

The second challenge is financing the replacement property. Funds need to be available for the purchase of the replacement property prior to the sale of the relinquished property. An investor contemplating a reverse exchange will need to have cash available to spend out of pocket. Since the EAT will acquire title to the replacement property, a lender will generally not lend money to the EAT. Almost always, a reverse exchange requires the investor to purchase the replacement property all cash.

Third and finally, a reverse exchange will add several thousand dollars in additional exchange fees and closing costs to the exchange transaction which makes it the most expensive method of exchanging.

The preferred method of completing a reverse exchange is for the EAT to take title to the replacement property in an all cash purchase. However, it is sometimes possible for the EAT to take title to the relinquished property. It is also possible for the EAT to take title to the replacement property and for a loan to be part of the purchase price. Such alternative structures are rare and often difficult to accomplish.

- The funds used to acquire the replacement property must be advanced by the investor as a loan to the EAT. The EAT will pay back the loan after the relinquished property is sold.
- The investor will have full access to the replacement property during the EAT ownership and can rent the property immediately.
- In order for the EAT to take title and then transfer ownership to the investor, a single member LLC will usually be used. At the completion of the exchange, the EAT will generally transfer the LLC to the investor rather than recording a deed. Transferring the LLC to complete the exchange will likely save on transfer taxes but will require the investor to manage the LLC after the completion of the exchange.
- Reverse exchange also requires specific and unique tax reporting at year end and the Qualified Intermediary will assist with such reporting.

ONE ASSET EXCHANGE

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