



“Standard” Reverse Exchange (Replacement Property Purchased)

What is one of the most common questions asked regarding a 1031 Exchange: "May I buy a property first, then sell my current property and still complete a 1031 exchange?" – Answer: Yes with the new reverse exchange procedure approved by the IRS.

Market – Because of favorable tax law changes, reverse exchanges have become increasingly prevalent during the last two years. A reverse exchange is typically used in the following situations. In the most common reverse exchange scenario, the owner of investment property listed for sale finds the *ideal replacement property* available before finding a buyer for the exchange property. After substantial real estate appreciation, the common complaint is lack of inventory; therefore the real estate investor needs to purchase prime real estate as it enters the market. Real estate sellers are confident in being able to sell their exchange property, but wish to avoid having to identify the replacement property in the required 45 days therefore they purchase model replacement property now.

New Tax Law - Effective 9/15/00, the IRS issued its Revenue Procedure 2000-37, for the first time sanctioning the reverse exchange with the "safe harbor" rule provided therein.

The IRS has finally issued regulations on reverse exchanges. While the regulations are not true reverse exchanges, there is now guidance on how a reverse exchange can be accomplished.

The IRS has approved a parking arrangement. If a real estate seller cannot sell their property in a timely enough fashion to perform a standard 1031 exchange, they can now use a qualified intermediary to hold title on the property they wish to acquire. The highlights of the Revenue Procedure are below:

**** There is a 180-day rule on reverse exchanges to be completed. The 180 days starts from date the intermediary purchases the replacement property for the taxpayer.**

Within 45 days of the purchased parked property, an identification form must be completed that identifies the relinquished property that is to be sold.

A new document called a “Qualified Exchange Accomodation Agreement” must be completed by the qualified intermediary and the taxpayer.

Financing – The first question and usually the most important is how the property will be paid for. It is necessary for the Exchangor to fund the first escrow for the replacement property from whatever source. The following are the most common options:

There might be a "swing loan" on the unsold exchange property payable upon its sale. Several exchangers with whom I have worked have refinanced their home, taking advantage of preferred loan terms on owner-occupied property.

The Exchangor will arrange a mortgage with a lending institution and make a typical 20-30% down payment; usually the loan is made to a single member LLC and guaranteed by the Exchangor.

Or the cash needed might come out of savings, etc.

Whatever the source and amount, it is advanced as a loan to the intermediary to acquire the replacement property. The intermediary gives the exchanger a nonrecourse promissory note in the amount of the advance, which, however, is repayable only to the extent of funds received on subsequent sale of the exchange property.

How a reverse exchange works

1031 Tax Free Strategies borrows funds from the client for the purchase and, if needed, may enter into a financing agreement, guaranteed by the client.

1031 Tax Free Strategies purchases the replacement property from a third party in a single member LLC (owned by the Qualified Intermediary).

1031 Tax Free Strategies leases the property back to you via a triple net lease until a future date when the relinquished property can be sold.

Client sells the relinquished property to a third party. The Exchangor's sale is structured in the delayed exchange format. The exchange proceeds are wired to 1031 Tax Free Strategies.

1031 Tax Free Strategies transfers ownership interest in the LLC to Client. This way documents stamps do not need to be paid twice and any existing mortgage would not have to be refinanced.

Reverse exchanges have become commonplace within the last few years and can provide necessary flexibility if structured by a competent professional. 1031 Tax Free Strategies provides expert assistance, with clients and their advisors actively involved in the structuring of reverse exchanges. The reverse exchange can provide great opportunities and advantages in managing your real or personal property investments.

Please feel free to call us if you have any questions regarding reverse exchanges or are ready to set up a reverse exchange.

