

1031 Exchange

Reverse 1031 Exchanges

Internal Revenue Code Section 1031 allows deferral of capital gains taxes on real property used in trade or business or held for investment

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 last. 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 most commonly. 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 often not lend money to the EAT. Frequently, a reverse exchange requires the investor to purchase the replacement property all cash.

Third and finally, a reverse exchange will add thousands of dollars in additional exchange fees and closing costs to the exchange transaction, which makes it the most expensive method of exchanging. An average reverse exchange will generally cost an additional \$10,000, but that figure can vary depending on local transfer taxes.

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 replacement property out immediately.
- Reverse exchange also requires specific and unique tax reporting at year end. The Qualified intermediary will assist with such reporting.

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