

1031 Reverse Exchanges: How exactly do they work

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Up until the IRS approved Reverse 1031 Exchanges in a ruling (Rev. Procedure 2000-37) issued in September, 2000, many people, especially tax professionals, were skeptical of them. Now, however, even though there is lots of talk about them, many people really don't know exactly what a Reverse Exchange is and how it works.

Reverse Exchanges arise when you want to (or need to) buy your New Property before you've sold your Old Property. The problem is that the IRS will not let you be in title to both your Old Property and your New Property at the same time. This situation, then, gives rise to a Reverse Exchange.

In simple terms, what happens in a reverse exchange is that your Qualified Intermediary takes title to the New Property and holds, or "parks" it until you get your Old Property sold. Once your Old Property closes, the Intermediary then transfers title to you. And no, no one knows why the IRS issues a ruling telling you how to get around one of its other rules. It seems like it would be so much simpler to change the rule that says that you can't be in title to both properties at the same time.

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Until that happens, however, we are stuck with the reverse rules.

There are two speed bumps in a Reverse Exchange: the first is financing. When the Intermediary takes title to your New Property, they usually do so using a limited liability company (an LLC). The lender's loan, then, is to the LLC, secured by your New Property, and guaranteed by you. This makes the loan un-salable until you are finally in title to the property. If you are already working with a lender, ask them if they plan to sell your loan. If the answer is yes, they will not be able to finance your reverse exchange. You need a lender who will hold, or what they call "portfolio", the loan. Typically this will be a bank rather than a mortgage lender.

Your intermediary should be experienced enough to direct you to a good portfolio lender. Our experience is that portfolio lenders will not gouge you; their fees and rates are reasonable – but you won't be able to negotiate a deal like you usually can with a mortgage company.

Another benefit of dealing with a portfolio lender is that it is not uncommon for our clients to be able to finance most, if not all, of the purchase price of the New Property. Typically the lender will take a security interest in the Old Property as well as the new. Adding the values of both properties, and subtracting the debt of both properties will often times give our clients enough room for a very large loan for the purchase of the New Property.

Make sure that your loan does not have a “due on sale” clause. If it does, you need to have the lender modify it so that the loan is not called when ownership is transferred from the Intermediary to you.

If you plan on leaving the loan in place after you take title from the Intermediary, another adjustment you need to make in the loan documents is the addition of a “re-amortization” clause. For example, if your monthly loan payment is \$5,000 on a \$500,000 loan, don’t assume that it will automatically drop to \$1,000 a month when you sell the Old Property for \$400,000 and apply all of the proceeds against the loan. Without a re-amortization clause your monthly payment will still be \$5,000 a month.

The second speed bump in a Reverse Exchange is the cost. Because the Intermediary has to set up an LLC to take title to your property, and because they need to dissolve this LLC when the exchange is completed, and because they need to file tax returns on the LLC, they will incur heavy legal and accounting costs to handle the transaction. If your transaction is large, perhaps \$500,000 or more, the costs are not bad. The smaller your transaction is than that, the more prohibitive the cost will seem.

Gary Gorman, real estate tax specialist since 1972, is a founding partner of **The 1031 Exchange Experts, LLC**. Because he has written and lectured so extensively on IRC §1031, he is known among real estate investors as the QI who is Writing the Book on 1031 Exchanges.

The 1031 Exchange Experts are a team of CPAs and attorneys specializing in §1031, and are among the fastest growing independent Qualified Intermediaries in America. Headquartered in Denver, Colorado The Experts have additional offices in Connecticut, Arizona and Florida. Call toll-free 866-694-0204 for a free consultation, or visit their web site at www.expert1031.com