

# 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, a property is sold and then replacement property is acquired. On occasion however, it may be advantageous to do the opposite; acquire property first and then sell.

Acquiring replacement property first in a 1031 Exchange presents a few difficulties. First of all, funds will need to be available for the down payment on the acquisition property (keep in mind nothing has been sold yet).

Second, the properties involved in an exchange can not be owned at the same time. In theory, an exchange is going from one property to another—so title to the new property and the old property can not be held at the same time. Luckily however, there is an option available that allows for the acquisition of the replacement property first; it's called the Reverse Exchange.

### Here's How It Works:

To properly structure a reverse exchange, an Exchange Accommodating Title Holder, or EAT (your Exchange Company), will go on title to either the property being acquired (replacement) or the property to be sold (relinquished).

If the EAT is to go on title to the replacement property, problems may arise if the investor is financing part of the acquisition costs. Many lenders balk at the idea of an EAT going on title to the property the investor is acquiring.

### The lender issues are as follows:

- The loan will be made to the EAT not to the Exchanger.
- The EAT will require the loan to be non-recourse.

- The EAT will require the Lender to waive its due on sale clause for transfer of the new property from the EAT to the Exchanger.
- The EAT will require the Lender to waive its requirement that the EAT sign any warranties or representations concerning the new property.
- The EAT will require the Lender to allow junior or subordinate financing on the new property.

If the lender decides not to loan on the property because of the constraints previously stated, the investor has two choices: find a new lender or structure the exchange with the EAT taking title to the relinquished property that is ultimately to be sold as a straw buyer. Challenges with the EAT acting as straw buyer include:

- The EAT will require cash to buy the property. The cash must come from the exchanger.
- The amount of cash advanced by the investor is the amount of estimated equity in the relinquished property
- There may be a due on sale clause on the debt of the relinquished property.
- A property tax re-assessment may be made at the time title transfers
- The exchanger may be burdened with an additional county transfer tax

Despite the complications, the reverse exchange can be a powerful tool for the investor provided they are aware of the obstacles and have plenty of time to work through the challenges.

*The subject matter in this newsletter is intended as general information only and not intended as tax or legal advice. Please always consult your tax or legal advisor for any specific tax or legal matters.*

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