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Set up an IRC Section 1031 Reverse Exchange before buying that property!

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It was a surprise to receive several phone calls within one week where a taxpayer had recently purchased an investment property and then wanted to sell an investment property to execute an IRC Section 1031 Reverse Exchange. Sad to say, but it was too late. Any kind of a 1031 exchange using a Qualified Intermediary (QI) must be set up prior to closing on either a sale or a purchase. Let's remember that in the event of a Reverse 1031 exchange the taxpayer is able to purchase replacement property first, and then sell relinquished property utilizing the same designated 180 day exchange period. Since there is no cash or short term note for the QI to hold from a sale, the QI needs to hold something; or there is no exchange-basically the taxpayer would own the replacement property & the relinquished property simultaneously. In the case of Reverse Exchanges, theoretically, the QI takes title to the property to be purchased or the property to be sold, at the time if the closing of the replacement & the other property is either purchased by or retained by the Exchanger.

Here in New England, one of the repetitive comments both in print and from potential exchangers is that the inventory continues to be low and properties for sale are getting multiple offers. That being said, investors are entertaining a Reverse Exchange in order to acquire something desirable when they see it. This type of an exchange structure allows an investor to "seize the moment," protect their exchange by eliminating the pressure-filled problems presented by the 45-day identification period, and can allow them to use the parking arrangement to increase the value of the replacement property by making capital improvements.

Revenue Procedure 2000-37 makes it clear that the exchanger cannot own both properties at the same time. It describes the ownership process as a "parking arrangement" because either ownership of the relinquished property or the replacement property is "parked" with an Exchange Accommodation Titleholder (EAT). To "park the ownership" actually means that a deed is recorded to transfer the ownership to the EAT so that the Exchanger owns one property and the EAT owns the other property.

When the replacement property is "parked," the EAT acquires title to the property being purchased with funds the exchanger cause to be loaned to the EAT. Within 180 days, the exchanger sells the relinquished property through the "delayed exchange" format and the EAT transfers the replacement property to the exchanger.

Positives of the "Replacement Property Parked" include: full exchange equity need not be present; a deferred exchange may follow this format; it allows for multiple replacement properties. Negatives of this format are that the Lender may have issues lending to the EAT; there are high costs-such as potential double transfer taxes and title insurance fees.

The alternative is to "park" the Relinquished Property where the Exchanger conveys the

relinquished property to the EAT and then the exchanger acquires the replacement property under a "simultaneous exchange" format. During the 180 days, the EAT remains on title to the property being sold until it is bought by a purchaser.

The positives of the "Relinquished Property Parked" are that the loan and purchase of replacement property is easier since the loan is directly to the exchanger; it is possibly less expensive on transfer tax on the relinquished property. Negative issues are that the equity and debt should match to avoid "boot;" the transfer to the EAT may increase county property tax basis; and a potential lender issue on the relinquished property (due on sale clause and prepayment penalties).

Proper planning is a must; reverse exchanges take more time for a Qualified Intermediary to set up although they can produce the intended result: acquisition of the desired replacement property and tax deferral. All investors should thoroughly review any contemplated reverse exchange transactions with their tax or legal advisor.

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