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Reverse 1031 exchanges: Purchasing a replacement property - by Lynne Bagby

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In New England's fast-paced real estate market, finding suitable replacement property in a 1031 exchange can be very challenging. A reverse exchange is a variation of a parking arrangement transaction which provides an option for investors to take advantage of the current real estate market by acquiring desirable replacement property before closing on the sale of their relinquished property, deferring capital gains taxes.

Revenue Procedure 2000-37 ("Rev. Proc. 2000-37"), provides safe harbor guidelines for investors to acquire the replacement property before the sale of the relinquished property is completed. The reverse exchange can be the ideal solution if the investor is unable to delay the closing of the replacement property. The reverse exchange helps investors meet a number of objectives:

Seize the moment and do not miss out on an excellent purchase opportunity by being able to immediately acquire a desirable replacement property prior to selling the relinquished property;

Protect the exchange by eliminating the pressure-filled problems presented by the 45 day identification period; and

Improve the replacement property by using the parking arrangement format to increase the value of the replacement property by making capital improvements.

The safe harbor guidelines for a reverse exchange found in Rev. Proc. 2000-37 make it clear that the investor 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 of the replacement property is "parked" with a special purpose entity (generally a Limited Liability Company) called 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 investor owns one property and the EAT owns the other property.

There are several ways to proceed with a reverse exchange parking arrangement:

Parking the Replacement Property (also referred to as the “exchange last” format):

The EAT acquires title to the replacement property with funds the taxpayer loans to the EAT. Within 180 days, the investor sells the relinquished property through the “delayed exchange” format and the EAT transfers the replacement property to the investor.

- Positives of the Replacement Property Parked
- Not all exchange equity needs to be present
- A deferred exchange may follow this format
- Allows for multiple relinquished properties
- Negatives of the Replacement Property Parked
- Many lenders will have issues lending to an investor, if an EAT, not the investor is on title to the replacement property

Parking the Relinquished Property (also referred to as the “exchange first” format):

The investor conveys the relinquished property to the EAT and then the investor acquires the replacement property under a “simultaneous exchange” format. During the maximum 180 day exchange period, the EAT remains on title the relinquished property unit it is sold to a purchaser.

- Positives of the Relinquished Property Parked
- Loan and purchase of replacement property is easier since the loan is directly to the investor
- Negatives of the Relinquished Property Parked
- Equity and debt should match at the time of the replacement property purchase to avoid boot
- Transfer to the EAT may increase county property tax basis
- Lender issues on relinquished property (due on sale clause and prepayment penalties)

Reverse/Improvement Exchange: The EAT acquires the replacement property and makes improvements to this property. The improved property is later exchanged for the relinquished property within 180 days to complete the exchange.

All investors should thoroughly review any contemplated reverse exchange parking arrangement transactions with their legal and/or tax advisors.

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