

# Reverse Exchanges – Now is the Time

By Nace Cohen, CPA

It's no wonder in today's market the astute real estate investor sees countless opportunities to invest. Generous seller incentives, short sales and foreclosures unheard of during the boom indicate the market continues its path down the bell curve, and many are wondering have we hit bottom or are further price declines imminent? To the experienced investor though, price declines trigger opportunity. If you've ever wondered how some folks get wealthy in real estate when others sit on the side lines, read on.



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In a normal or forward 1031 Exchange, the investor sells his old property and rolls the gain forward to the new one, deferring the capital gains tax due on the sale and preserving it as equity in the new property, a wealth builder. You have 45 days from the date of sale to identify the new property and 180 days to close on what you identified, no extensions! In this market, investors would like to take advantage of falling prices and seller incentives on the purchase of new investment property by exchanging they're highly appreciated old property without paying tax; the problem is buyers are in short supply. So what do you do when you want to buy the new property ahead of the sale of the old? It's called a **Reverse Exchange**.

The Reverse Exchange arises when you want (or need) to buy your New Property before you've sold your Old Property. The problem is the IRS will not let you be in title to both your Old Property and the New Property at the same time. To resolve this, the IRS issued a ruling (Rev. Procedure 2000-37) which in simple terms requires your Qualified Intermediary (QI) take title to the New Property for you and holds, or "parks" it until you get your Old Property sold. Once your Old Property closes, the QI transfers title to you and the exchange is completed. In a Reverse exchange, from the time the QI takes title to the New Property, you'll have 45 days to identify the Old Property you want to "sell", and 180 days to get that Old Property sold, closed, and in title to the New Property.

Reverse exchanges have two hurdles to get through. The first is financing. When the QI takes title to the 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 New Property. If you are 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 term "portfolio", the loan. Typically this will be a bank rather than a mortgage broker.

Your QI 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 finance most, if not all, of the purchase of the New Property. Typically the lender takes a security interest in the Old and New Properties. Adding the value of both and subtracting the debt often yields enough room for a very large loan for the purchase of New Property.

Make sure the loan does not have a “due on sale” clause. If it does, you need to have the lender modify it so the loan is not called when ownership is transferred from the QI to you. Also, if you plan on leaving the loan in place after you take title from the QI, make sure there is a “re-amortization” clause. This will help modify the payment when the loan is paid down from the sale of the Old Property.

The second hurdle in a Reverse Exchange is the fee to the QI. The QI has to set up an LLC to take title to the New Property and dissolve it when the exchange is completed. They also need to keep a set of “books” for it and file tax returns. In addition, there should be a whole set of legal documents over and above the straight or forward exchange that need to be prepared. Don’t forget they own the property not you! Therefore, an experienced QI should give you the comfort level you need to make sure the New Property is safe while in their control, and when they eventually transfer title to you. For example, the reverse exchange documents should contain an “option” for you to buy the New Property from the QI at cost, not some inflated figure due to the passage of time. In addition, those docs need to specify the QI cannot “encumber” the New Property during the time they hold it.

Fees to the QI to do a reverse will not seem that bad if your transaction is large, say \$500,000 or more. The smaller your transaction is than that, the more prohibitive the cost will seem. Bear in mind it’s the savings on the capital gains tax you’re after, so get with your CPA to figure that out prior to doing a 1031 exchange.

Utilizing the reverse exchange has many benefits. As noted above, in a buyer’s market where replacement property inventory is plentiful, it allows you to go ahead and secure the New Property at advantageous terms. In addition, buying the New Property first locks in the price now as opposed to taking the chance the cost may rise. This strategy also enables you to not “fire sale” the Old Property, and you can take more time selling your Old Property and get the right price if not more. This may help offset some of the extra cost to the QI.

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