Reverse 1031 Exchange

To understand a reverse 1031 exchange, you should first make sure you know the ins and outs of a 1031 exchange. There are some key differences between a standard 1031 exchange and a reverse 1031 exchange, both of which are designed to defer taxes while investing in real estate.

To learn more about what it is (and how it differs from a 1031 exchange), how to complete one, and how it can benefit you, read on.

What is a Reverse 1031 Exchange?

A reverse 1031 exchange is a tax deferment strategy that allows real estate investors to purchase a second investment property before selling their relinquished investment property—and importantly, defer capital gains taxes and other taxes that you would normally need to pay at sale of a property. Because a reverse 1031 exchange is more complicated than a standard 1031 exchange, it's important to understand it fully before going forward.

In a reverse 1031 exchange, the investor, also referred to as the taxpayer, first purchases a replacement property before selling the relinquished property (as opposed to a standard 1031 exchange where the order of operations is reversed).

After purchasing the replacement property, you, the investor, have 45 days to designate up to three properties to sell. You then have 135 days from that point to get under contract and close on the relinquished property. Reverse 1031 exchanges are executed under the IRS's safe harbor guidance of Revenue Procedure 2000-37, which states that you have a total of 180 days from the purchase of the replacement property to complete the full transaction.

That may seem straightforward enough, but there are some additional hoops to jump through. You cannot hold the title of the replacement property yourself upon purchasing. The title must instead be held by an Exchange Accommodation Titleholder (EAT) to hold onto, or park, the title throughout the 1031 exchange process for tax purposes.

You must also retain the services of a Qualified Intermediary. When the relinquished property is sold, only then can the Qualified Intermediary transfer the title of the relinquished property to the new buyer and the replacement property to you, the investor.

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Types of Reverse 1031 Exchanges

There are two variations of reverse 1031 exchanges and they both have their benefits and disadvantages.

Exchange Last

In an exchange last reverse 1031 exchange, the EAT acquires the replacement property and holds/parks it until you sell the relinquished property. This is the most common type of reverse 1031 exchange.

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It's preferred because it gives you more flexibility, but it can cause problems with your lender if they are concerned about the EAT holding the replacement property title. It's important to speak to different lenders to find their stance on this reverse 1031 exchange structure.

Exchange First

In an exchange first reverse 1031 exchange, you acquire your replacement property first, your lender lends directly to you, and simultaneously you hand the title over to the EAT.

While this will work for most lenders, you need to reinvest the total amount of equity in your relinquished property into your replacement property before the former sale closes; having this kind of cash on hand is rare.

Benefits of a Reverse 1031 Exchange

There's no arguing that a reverse 1031 exchange is more complicated than a straightforward, standard 1031 exchange. So why would an investor choose to go this route? There are a few reasons.

1. ***To secure a property.*** If you're in a competitive market, you may want to secure the replacement property you have your eye on before someone else grabs it.
2. ***To make sure you have a replacement property.*** If you have the means to purchase the replacement property first, that completely eliminates the risk of having to find a replacement property in just 45 days, as is the course of action in a 1031 exchange.
3. ***To minimize tax liability risk.*** If you don't sell the relinquished property within 180 days, then you shouldn't have any tax liability, say registered investment advisors CWS Capital Partners. However, if you choose to do a standard 1031 exchange and sell the relinquished property but can't close on a replacement property, then you would have a tax liability.

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8 Steps to Perform a Reverse 1031 Exchange

A reverse 1031 exchange is complicated, so while this will give you a solid overview of the process, it's best to speak with your investment advisor and chosen Qualified Intermediary and EAT about the specifics of your situation.

1. ***Find a replacement property.*** Make sure that your contract allows you to transfer the title to your chosen EAT, and let the title company know you're participating in a reverse 1031 exchange. The replacement property must be equal to or greater in value than the relinquished property.
2. ***Enter into a qualified exchange accommodation agreement.*** This is a written contract between you and your EAT laying out the terms of them holding title of your replacement property until you sell the relinquished property.
3. ***The EAT acquires the title.*** Once you arrange financing, the EAT will acquire the title of the replacement property and park it for you.
4. ***Designate the relinquished property.*** Once your EAT acquires the title of your replacement (now parked) property, you have 45 days to identify up to three properties to sell as the relinquished property.
   - ***Optional: Lease the parked property.*** The EAT can lease you the parked property that they're holding onto so you can control the property before the reverse 1031 exchange is completed.
5. ***Find a buyer.*** Within 135 days of identifying your relinquished property, you must find a buyer and enter into contract with them for the property and close that sale.
6. ***Enter into a new agreement with your Qualified Intermediary.*** This intermediary will transfer the title of the relinquished property to the new buyer and will gain the title to the replacement parked property.
7. ***Hand over the deed to the relinquished property.*** The Qualified Intermediary will make sure that you give the deed of the relinquished property to the new buyer who will transfer the funds to the Qualified Intermediary. The Qualified Intermediary will use that money to

acquire the parked property from your EAT. The EAT may use some of those funds to cover closing costs or other expenses.

8. ***Get your deed.*** Finally, the EAT will hand the deed of the parked, replacement property to you. You're done!

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Costs of a Reverse 1031 Exchange

There are several costs to be aware of when performing a reverse 1031 exchange. The EAT must report its ownership of the replacement property to the IRS, which will incur transaction costs. These costs include transfer fees, mortgage taxes, recording fees, lender charges, escrow and title fees, and legal fees, among others. Additionally, there will be an accommodation fee you must pay, which will vary based on the provider, the size and complexity of the exchange, and any other issues involved.

You can expect to pay around $3,500, but it's best to speak with a Qualified Intermediary about your specific situation to get an exact number.

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Risks and Considerations of a Reverse 1031 Exchange

While there are certainly benefits to a reverse 1031 exchange, there is, of course, some risk as well.

You may need to have liquid assets on hand.

If you have liquid assets on hand to purchase the replacement property before selling the relinquished property, then this may not be a worry for you. However, if you don't, you will need to get a loan for the replacement property. That itself can lead to risk if…

The lender doesn't approve the loan for your replacement property.

Some lenders will not participate in an exchange in which an EAT will hold the title. It's best to find this out before you begin the process.

You can't sell the relinquished property.

If your property is in a slow market or there is little interest, you may not be able to enter into contract and close the sale within 135 days from designation. If this is the case, the exchange will fail.

If you need to make improvements, you need to start right away.

If you already know which property you will designate as the relinquished property and that property needs physical improvements via construction, you need to start right away. There are commonly delays in construction work and if the work goes past the 180th day, the construction manager will apply the percentage complete to your tax deferral.

As with any big real estate investing decision, it's crucial to plan out every step of your reverse 1031 exchange before you start due to the many steps and considerations involved.