REVERSE 1031 EXCHANGES

By now, most investors have heard of what's commonly referred to as a "1031 Exchange" – that is to say, a tax-deferred exchange of "like-kind" property performed under Section 1031 of the Internal Revenue Code. This regulation provides that no gain or loss is recognized on certain property exchanges, when certain criteria are met. The exchanged property or properties must be "like-kind", and the property or properties must be held for business or investment, not as inventory or a personal residence. There are additional requirements that must be met in terms of timing, structure, and mechanics of the transaction, however, the concept remains a simple one: if you sell a property and purchase a replacement property within 180 days and before your next tax return is due, you can attain significant tax savings with just a little bit of planning on the front end.

So, what if you've found a property you want to buy, and you have a "like-kind" property you intend to sell within the next few months, but, for any number of reasons, you aren't ready or able to sell the old property *before* you buy the new one? Can you still get the tax benefit of a 1031 exchange? The answer is YES, but properly structuring the transaction, commonly referred to as a "Reverse 1031 Exchange", becomes a bit more complex.

A typical 1031 exchange is channeled through a Qualified Intermediary. This intermediary, an independent entity that facilitates the exchange, does not actually take title to the property being exchanged. The rights to the sale contracts involved are assigned to the intermediary, and the intermediary holds the funds from the original sale until replacement properties are identified and ultimately purchased. In a reverse exchange scenario, a Qualified Intermediary is still utilized, but not until the time comes to sell.

In a reverse exchange, a new entity must be properly formed and registered with the Secretary of State. This new entity's purpose is to take title – that is, act as the buyer – of the new property at the outset of the transaction. This new entity is referred to as an Exchange Accommodation Titleholder, or sometimes is simply called a parking company. Note that you will still have the right to lease the new property while it's being parked, and the new entity can even delegate to you the right to complete construction or otherwise improve the new property during this time.

Once you're ready to sell the old property, the proceeds of the sale are channeled through the Qualified Intermediary. The intermediary then uses the proceeds to purchase the new property from the parking company. If everything was set up right from the front end, and the IRS regulations are observed throughout this process, you should incur no taxable gain on the sale of the old property and have the same tax basis in the new property. When contemplating a traditional or reverse 1031 exchange, you should seek the advice of your attorney and tax professional from the very beginning.

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