

Reverse 1031 Exchanges: Avoiding Capital Gains Taxes in a Seller's Market

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1031 exchanges are wonderful *if* everything goes according to plan. But, when you're in a seller's market, finding and closing a deal on a new investment property in 180 days or less can be quite a challenge. Miss the deadline, and you're liable for capital gains taxes. Let's take the case of one investor, John, and see how a \$1 million profit turned into a \$150,000 federal tax bill. Here's his story.

The clock was ticking, and John was really starting to sweat. It had been four and a half months since he sold his 124-unit apartment building, and he had planned to roll up the \$1 million profit into another property through a 1031 exchange. He thought he did everything right. He thoroughly researched the Accommodator (the third party who holds the proceeds of the sale of the apartment building until the close of the purchase of the next property) *before* putting his property on the market. He consulted his lawyer and his accountant to make sure the deal made sense. He figured out where he wanted the Accommodator to put the proceeds of the sale. After all, with

well over the FDIC limit of \$100,000 on the line, this was an important issue. He even identified three likely prospects for the purchase end of the transaction within the first month.

What he didn't account for was the fact that he was working in a seller's market. As a result, all three of the potential purchase deals fell through. And now, in a seller's market, he had one and a half months to find and close a deal on a similar investment property before the 1031 time limit ran out. But, he didn't succeed. In fact, he had to write a fat capital gains check to Uncle Sam. So, how could John have avoided this gut-wrenching situation and saved himself a \$150,000 tax bill? He could have done a "reverse" 1031 exchange instead of a "regular" 1031 exchange!

What Is a 1031 Exchange?

A 1031 exchange is a method for avoiding the capital gains tax on the sale of an investment property by transferring the equity to a "like" property. The tax code has some very specific requirements for these transactions, including a 45-day deadline for identifying the property to be purchased, a 180-day time limit on the entire transaction and a clause that the taxpayer (e.g., the seller) cannot physically take possession of nor have control over the proceeds of the sale during these 180 days.

In a 1031 exchange the original

property, which is called the "relinquished" or "downleg" property, is sold. The proceeds of the sale are then transferred to a third party, called an Accommodator, who holds the funds on the seller's behalf. After the sale is complete, the seller then identifies up to three possible "like" properties (i.e., other investment properties), which are called the "replacement" or "upleg" properties. Upon the close of the purchase of the replacement property (or properties), which must take place within 180 days of the close of sale of the relinquished property, the Accommodator relinquishes control of the funds to the replacement property escrow.

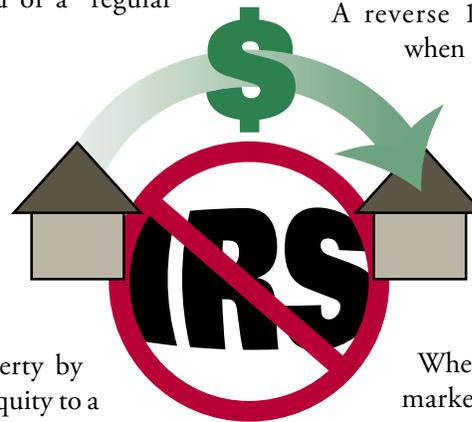
What Is a Reverse 1031 Exchange?

A reverse 1031 exchange is when everything is done in reverse. First, the replacement property is purchased. Then, within 180 days, the relinquished property is sold.

When you're in a seller's market, this can be the way to go. However, things can get pretty tricky when you factor in the details of financing and the fact that the title to the replacement property must be held by the Accommodator until the relinquished property sells.

How Do You Implement a Reverse 1031 Exchange?

So, exactly how does this work?



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Doing a reverse 1031 exchange involves five basic steps:

1. **Research everything.** Before any properties are purchased or sold, you and the property owner should start by doing your research. This includes finding the replacement property, determining the value of the relinquished property, finding and researching the background of the Accommodator, reviewing the Accommodator's standard contractual documents, finding a lender who will do these types of transactions and running everything by an accountant and lawyer.
2. **Arrange funding for purchasing the replacement property.** To finance this purchase, the buyer initially takes out a short-term loan that is secured by both the replacement property and the equity in the relinquished property. Because the title to the replacement property will be temporarily held by the Accommodator, you need to verify that the Accommodator is willing to allow debt against the transaction and that the lender will approve a nonrecourse loan (as most Accommodators will not sign recourse loans). Now is also a good time to line up the long-term financing for the purchase (e.g., when the relinquished property is sold and the title to the replacement property is transferred from the Accommodator to the buyer).
3. **Purchase the replacement property.** The title is held by the Accommodator. In a "regular" 1031 exchange, the seller of the relinquished property cannot touch the proceeds of the sale. In a reverse 1031 exchange, however, the buyer of the replacement property cannot hold the title to the replacement property until

the entire transaction is complete.

4. **Sell the relinquished property.** The transaction must be completed within 180 days of the purchase of the replacement property.
5. **Complete all transactions.** Simultaneously with the sale of the relinquished property, the Accommodator transfers the title of the replacement property, pays off any existing loans on the relinquished property, pays off the short-term loan on the replacement property (i.e., the one that is secured by both properties) and finalizes the new, long-term financing for the replacement property.

Can You Show Me an Example of a Reverse 1031 Exchange?

The following hypothetical example illustrates a typical reverse 1031 exchange transaction:

Phillip Jones owns an investment property worth \$2 million. The property has an existing loan of \$250,000. Phillip would like to sell this property (aka, the "relinquished" property) and purchase a different investment property (aka, the "replacement" property) for \$3 million. Because the properties are located in what is currently a seller's market, Phillip has decided to do a reverse 1031 exchange. He does his research, finds an Accommodator with whom he is comfortable (i.e., ABC Accommodators), talks to his lawyer and accountant, and gets ready to proceed.

To purchase the replacement property, Phillip will need \$3 million of secured financing. Most banks will lend \$1.5 million (50 percent of the property's value) without blinking, and ABC Accommodator is willing to allow this debt against the transaction. But, this still leaves a funding deficit of \$1.5 million. To obtain the remaining fund-

ing, Phillip pledges the relinquished property as additional collateral. Next, Phillip purchases the replacement property for \$3 million, with the property title held by ABC Accommodators and the loan in Phillip's name. Within 180 days of the close of this purchase, Phillip sells the relinquished property for \$2 million.

At the close of escrow on the relinquished property, a number of things simultaneously take place:

- The \$250,000 loan on the relinquished property is paid off.
- The \$3 million loan on the replacement property is paid off.
- The title to the replacement property is transferred from ABC Accommodators to Phillip Jones.
- The \$1.75 million gain from the sale of the relinquished property is rolled up into the replacement property.
- The \$1.25 million of long-term financing for the replacement property is put into Phillip's name and secured by the replacement property.

What Are the Advantages of Reverse 1031 Exchanges?

In a seller's market, a "reverse" exchange can have a number of advantages over a "regular" exchange. Some benefits include:

- **Having more time to find a good deal on the replacement property.** With a reverse 1031 exchange, the property owner can take his/her time locating and negotiating a deal for the replacement property, without trying to beat an arbitrary time limit.
- **Becoming a more desirable buyer.** Because the buyer has already arranged for financing and the purchase would be made without any contingencies, the individual is at an advantage in the negotiating process.

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- **Experiencing less stress.** In a seller's market, selling a property within the prescribed 180-day time limit is much easier than buying one.

What Are Some Potential Problems?

There are a number of potential hazards of which to be aware when initiating a reverse 1031 exchange. First and foremost, there is the risk that all of the transactions will not be completed within the 180-day time frame. This time limit doesn't change, regardless of any buyer or lender (aka, Accommodator) delays and regardless of any contingencies on the sale of the relinquished property. Second, there is the possibility of unscrupulous or even fraudulent behavior by the Accommodator. After all, the buyer has taken out a loan on a property whose title is held by a third party. What if the Accommodator refuses to relinquish the title of the property when the deal closes? Third, there is the difficulty of finding a lender who will perform these types of transactions, especially since reverse 1031 exchanges do not conform to the standard requirements of many lenders. Finally, there is the danger that the market will change from a seller's market to a buyer's market after the replacement property has been purchased, thereby making it extremely difficult to meet the 180-day limit.

Because of these risks, the property owner should conduct a reality check *before* beginning the transaction. For instance, are you comfortable with the value of the replacement property? Are you confident that you can sell the relinquished property at a given price within the 180-day time limit? What if the sale of the relinquished property does not take place? Will you still be happy with the purchase of the replacement property? If so, how will you obtain financing for it?

What Do You Need to Know about the Accommodator?

You need to have absolute faith in the integrity of the Accommodator. To find a good Accommodator, ask for referrals from your banker, title company and escrow officer. Then, do your homework! Be sure to ask the following questions:

- How long has the Accommodator been in business?
- How much experience does the Accommodator have in doing reverse 1031 exchanges?
- Is the Accommodator familiar with the IRS rules governing these transactions?
- Who are the principals?
- What do their references have to say about them?
- Are they well-known in the industry?

Before the replacement property is purchased, you also need to take a good look at the Accommodator's standard contractual documents. These documents are the only legal guarantee that the title to the property will be relinquished at the close of the deal and that the property will be properly managed and maintained in the interim. In addition, if the replacement property is an income-producing property, there are a number of other details that should be documented in writing as part of the transaction, including:

- Who will collect the proceeds of the income-producing property?
- Where will these proceeds go? (Although the Accommodator must retain control over these proceeds, the agreement should stipulate that these funds be used toward the mortgage payments or for other expenses of the property.)
- Who will contend with the tenants?
- Who will pay the property's bills?
- Who will be responsible for all other aspects of managing the property?

Regardless of the type of property involved, you will want to know the Accommodator's fees up-front. Most Accommodators' fees are negotiable and are based on documentation/legal costs and on the size of the transaction. Make sure the fees make sense for the transaction.

What Do Lenders Look for When Processing Reverse 1031 Exchanges?

As with any commercial loan, lenders want to see that there is sufficient equity to accommodate the transaction throughout the entire process. What is the value of the replacement property? What is the value of the relinquished property? What are the market conditions?

Summary

Reverse 1031 exchanges are a means for avoiding capital gains taxes on the sale of an investment property by rolling up the gains into another "like" property. When you're in a seller's market, selling your existing property within a 180-day time frame is easier than buying the next property on this time schedule. Consequently, doing a "reverse" 1031 exchange often makes more sense than doing a "regular" 1031 exchange.

Note: This article is written for general information only. The information presented in this article should not be construed as formal legal or tax advice. You should contact your personal tax advisers regarding the particular facts of your potential exchange.

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