FINANCIAL ADVISORY

Deferring Taxes with a Reverse 1031 Exchange

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This month, we'll talk about a tax deferral vehicle that I haven't written about previously – the Reverse 1031 Exchange. In a Traditional Exchange, you sell your Downleg property, then have 45 days to identify and 180 days total to close on your replacement Upleg property. In a Reverse Exchange, you will buy your Upleg property first, then "pay yourself back" with the proceeds from the later sale of your Downleg.

Although I don't remember completing a Reverse Exchange for a client, I have done them for my personal investments. In my case, I found the perfect replacement property before the property I wanted to sell was even listed. (After the tenants vacated, it needed some updates to get the price I wanted for it.) The property's seller wasn't willing to wait for me, and I wanted to buy the building when I could. I discovered that a Reverse 1031 Exchange could be the solution to my problem.

FIND A WAY TO FUND YOUR DOWN PAYMENT

In a Traditional 1031 Exchange, I will sell a property first then use those proceeds as a down payment on a new one. This step is missing from Reverse 1031 Exchanges, so how do I fund my down payment? The easiest way is to write a check from your savings. Many investors don't have that kind of cash lying around or, if you're like me, want to keep as much cash as possible on hand during purchases or sales to take care of any unexpected costs that may arise. (Such as re-tenanting the new property if they all move out after you raise the rents immediately.) If this isn't an option – what other solutions are there?

A home equity line of credit, or HELOC, could be a good source for this funding. Many are available with low or no closing costs, and at attractive rates. These loans are meant to be temporary – those attractive rates won't stay that way forever – but your plan is to repay them with the tax-deferred proceeds for the property you sell.

A cash-out second mortgage or a cash out refinance on another of your investment properties is another potential source for your down payment. In this case, I would prefer a cash out second because I plan it to be a temporary loan. Borrowing $500,000 at 4% for 30 years will give me a monthly payment of $2,387. Borrowing $1,000,000 will cost $4,774 / mo. However, after I sell my Downleg property and repay the $500,000

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that I temporarily borrowed, my monthly payment will still be $4,774. Your loan will be paid off earlier, but you'll still have 10 years of that higher payment.

ONE PLACE YOUR DOWN PAYMENT SHOULDN'T COME FROM

When doing my Exchange, my original plan was to take a second mortgage on the property I planned to sell. I would use those funds for a down payment on my new property, then sell the Downleg property and use the proceeds to pay off the permanent loan and the second mortgage. Since I do 1031 Exchanges for a living, I remembered that the IRS takes a dim view of cash-out refinances close to the sale of a property for 1031 Exchange. Did this rule apply to Reverse Exchanges, as well? I asked my accommodator, and was told "It's a grey area – the 1031 rules here don't differentiate between Traditional and Reverse Exchanges with regards to the cash-out prohibition. We feel that you won't have a problem as long as you spend ALL of the refinance proceeds on the down payment for your Upleg purchase and document everything very carefully." I then called my CPA to ask for his opinion. He has a lot of experience in reporting real estate and 1031 Exchange taxes, and he didn't agree. He said that he would want to "report those proceeds as a gain." No matter how good you feel about your plan, you can't use it if the guy signing your tax return doesn't agree. I modified my plan by doing a temporary 2nd loan on another (not related with that Exchange) property that I own.

ADDITIONAL COST

A Reverse Exchange will cost more. With the accommodator I used, it cost $6,000 vs. $750 for a Traditional 1031 Exchange. In the grand scheme of things, I don't feel that the extra $5,250 is a big deal for an investor looking to defer taxes on a $1,000,000 gain.

THE RISK

With a Traditional Exchange, you sell your property and need to buy a replacement. Your risk is that you cannot identify a replacement property in 45 days or close on the purchase in 180, and you then owe taxes on your capital gain and accumulated depreciation. With a Reverse Exchange, If I bought a property at first, then don't sell my Downleg property within 180 days, I've lost the ability to pay myself back with tax deferred money. I can still use the sales proceeds to repay my temporary loan – but I'd have to pay taxes first.

BUT YOUR ABILITY TO DEFER TAXES MAY NOT BE LOST

If I were faced with the above scenario of not selling my Downleg property within the 180-day deadline, I would instead defer those taxes anyways by completing a Traditional 1031 Exchange. The temporary loan that I used to fund the initial acquisition would remain, which I would probably repay with a partial refinance and by using some of that cash I like to keep on hand for unexpected expenses.

A Reverse 1031 Exchange could be worth considering if you are intimidated by the 45-day identification rule or if you find a property that you want to buy before selling your Downleg. If you have any questions, call my office toll-free at (877) 313-1868.

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1031 Risk Disclosure:

- There is no guarantee that any strategy will be successful or achieve investment objectives;
- Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;
- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 Exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;
- Impact of fees/expenses – Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits