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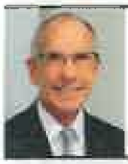
# The issues with doing a 1031 Exchange in a hot real estate market



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The problem in a hot real estate market is not selling the property you intend to relinquish. The challenge may very well be finding a suitable replacement property within the allotted identification period. The code requires identification of up to three potential replacement properties within 45 days of the closing date of the relinquished property. You have plenty of time to close, up to 180 days from that same date, but shopping for that replacement property when properties are selling within days of being listed for sale can be a real problem. Here's a possible solution. A reverse exchange allows a real estate investor to find and purchase the replacement property before selling the property to be relinquished. The IRS created "safe harbor" guidelines for reverse exchanges in Revenue Procedure 2000-37. These guidelines issued in 2000 removed many of the obstacles and extreme expense required for this type of exchange. The procedures allow the average investor to participate in this tax saving and wealth building procedure, that heretofore, only large corporations and the super wealthy investors had been able to take advantage of. Here's how it works:

First, as in a forward exchange, the investor must retain a qualified intermediary (QI), an unrelated third-party who, pursuant to an exchange agreement, acquires the relinquished property from the investor and sells it to the buyer; holds the proceeds from the sale of the relinquished property on behalf of the investor; and acquires and sells the replacement property to the investor to complete the exchange.

There are two ways a reverse exchange can be structured. Both involve a procedure called parking, in which title to property is vested in an "exchange accommodation titleholder" (EAT). Most commonly the EAT is a limited liability company created by the qualified intermediary solely for the purpose of parking property. One method of structuring a reverse exchange involves parking the replacement property this type of exchange is a "replacement property parked" reverse exchange. The deed and other closing documents are prepared in such a manner as to show the EAT as the buyer of the property. The EAT holds the replacement property on behalf of the investor until the relinquished property is sold and then the EAT transfers ownership of the replacement property to the investor. These parking arrangements permit the EAT to lease the property to the investor and also permit improvements to be constructed on the replacement property during the exchange period (these exchanges are called build to suit). Another method of structuring a reverse exchange involves parking the relinquished property with the EAT. In this "Relinquished Property Parked" reverse exchange, the investor deeds the property to be relinquished to the EAT and then purchases the replacement property in the investors own name. When the investor locates a purchaser for the relinquished property, the EAT then transfers it directly to the buyer and receives cash in return. This type of parking arrangement allows investors to receive loan proceeds to fund the purchase of the replacement property in their individual name rather than through the LLC as it would be done with the exchange last type of parking arrangement.

The potential risk to a reverse exchange should be considered before entering into such an agreement. The investor should be confident that the relinquished property can be sold within 180 days in order to keep the exchange within the safe harbor. The investor must also arrange for financing the replacement property purchase or pay cash, which may involve extended dealings with a lender in order to ensure that the lender understands that title to the collateral is vested in the EAT, not the investor/borrower, if the exchange is structured as a "Replacement Property Parked" exchange. Reverse exchanges and build-to-suit exchanges are more costly than forward exchanges, so a tax professional must be consulted in order for the investor to be certain that is it is financially advisable.

The possibilities from reverse exchanges, however, can more than outweigh the uncertainties. Reverse exchanges can insure that the perfect piece of replacement property does not slip through an investors hands because the investor is not ready to sell the relinquished property before the replacement property is purchased. This strategy can be beneficial because it allows investors time to locate their desired replacement property without the pressure of the 45-day identification period, and provides additional time to list and sell the relinquished property which may mean an increase in the sale price. A reverse exchange structure can also afford the investor the opportunity to complete improvements on the replacement property prior to giving up the relinquished property, which is often essential when relocating a business. In short it can be well worth the time and expense to preserve the investor's profits and help build wealth faster by finding that perfect replacement property.

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