

A Closer Look at How Financing Works in a Reverse 1031 Exchange

As Reverse 1031 Exchanges gain in popularity, the issue of financing becomes more and more critical. Reverse Exchange loans are not saleable by the lender, so as a result, most reverse loans are made by “portfolio lenders” which are usually banks. Still, most banks don’t understand them, and so they shy away from them.

First, let’s talk about how Reverse Exchanges work. A Reverse Exchange happens when you want, or need, to purchase your New Property



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before you’ve sold your Old Property. The IRS will not let you be in title to both the old property and the new property at the same time, so your exchange Qualified Intermediary steps in and buys (usually) your New Property and then holds it, or “parks” it until your Old Property is sold.

There are not many Qualified Intermediaries that have the technical know-how and trained personnel to do Reverse Exchanges, so before you start, make sure that they have the knowledge and experience to handle your exchange.

The IRS has a procedure for how Reverse Exchanges are to be handled by the Intermediary, and probably the first thing your Intermediary

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will do is set up a separate entity to handle your Reverse Exchange. This entity is called an Exchange Accommodation Titleholder (or “EAT”) by the IRS. The EAT will be the title holder of your new property until you’ve closed the sale of your Old Property.

The lender you choose will then make their loan to the EAT, which is usually a limited liability company (an “LLC”). This loan will be secured by your New Property, and guaranteed by you.

In addition to a security interest in your New Property, the lender will usually take a security interest in your Old Property as well. The lender does this to keep you committed to completing the exchange process. It usually acts to your benefit, however, because the lender will take the equity and loan values of both properties into consideration when they analyze the loan. For this reason, 100% financing for the purchase of the New Property is not uncommon.

If you are not blessed with a 100% loan from your lender, the balance of the purchase price, in other words, the equity must come from you. This amount is also treated as a loan to the EAT. For example, if the new property costs \$500,000, and the lender is willing to loan \$400,000 for the purchase, this loan will be in the form of a first mortgage or deed of trust, to the EAT. The balance of \$100,000 will come from you and will take the

form of a 2nd mortgage, or deed of trust, to the EAT.

You want to make two modifications to the lender's loan documents. The first is to remove any "due on sale" clause, or at least modify it, so that the lender does not call the loan when the exchange is completed, but instead, the loan will be transferred from the EAT to you.

The second modification we recommend is a "re-amortization clause". This clause will re-amortize the loan if there is a substantial pay down in the lender's loan when you take title. Using my example above, if your loan payment to the lender is \$4,000 per month, and upon completion of your exchange you pay down this loan by \$200,000 with the proceeds from the sale of your old property, your monthly payment will be the same, even though your loan amount has been cut in half. A re-amortization clause changes that and would reduce your payment accordingly.

When you close the sale of your Old Property, the proceeds from the sale will go to your intermediary who will set up a closing to transfer, or "flip" the New Property to you. The proceeds will be used to first pay back the equity that you put up. If there are funds remaining they will typically go to pay down the bank loan, since any funds that go to you in excess of the money that you put in, will be taxable. The bank loan will be transferred to you, the remaining balance will be re-amortized, and the EAT will be dissolved.