The 1031 Exchange Hybrid Solution: Combining Forward and Reverse Exchanges

Most Section 1031 Like-Kind Exchange transactions involve a taxpayer who sells a relinquished property and then acquires a replacement property within the appropriate guidelines. An increasing number of exchangers are structuring their transactions as 1031 reverse exchanges, wherein the taxpayer first arranges for the acquisition of the replacement property and later sells their relinquished property. But there is a hybrid solution that often is overlooked – this is a combination forward-reverse exchange.

The Situation

Karen currently owns a small strip center and has received an attractive offer to sell the property for $500,000. She also has a small office building she is trying to sell, also worth about $500,000. She was planning to sell both properties and combine the proceeds to acquire replacement property worth at least $1,000,000.

The Problem

Karen's small strip center will close in about 45 days, but she has not yet received any offers on the office building. The fact that she has identified a suitable replacement property for which the seller has agreed to accept $1,000,000 if she can close in 60 days further complicates matters. With the office building being not under contract, she is worried about how to accomplish her 1031 exchange goals.

The Solution: A Combination Forward-Reverse Hybrid 1031 Exchange

Karen will structure the sale of her small strip center as part of a Section 1031 Like-Kind Exchange. After consultation with her attorney and Real 1031 as the Qualified Intermediary ("QI"), Karen understands both the forward 1031 exchange and reverse 1031 exchanges process.

The sale of the strip center took place on March 1, 2021, and the exchange proceeds were sent directly to Real 1031, the qualified intermediary, to be held on her behalf until the purchase of her replacement property. This is necessary because a taxpayer participating in a like-kind exchange cannot be in actual or constructive receipt of the net sale proceeds while the exchange is pending.

Within 45 days after the closing on the sale, Karen identified a one-half interest, in the event she never sells the office building never sells, and also identifies a 100% interest, assuming the office building will sell, in her target replacement property using Identification Rules in 1031 Exchanges. Karen also worked closely with the qualified intermediary, Real 1031, to begin the reverse exchange component of her transaction. Real 1031, through its affiliate, referred to in the rules as an Exchange Accommodation Titleholder ("EAT") will take title to the other one-half interest in Karen's target replacement property. The EAT used for reverse exchanges is similar to the QI used for conventinal forward exchanges.

Specifically, Karen will lend the additional $500,000 to a new LLC (let us call it Newco LLC), with the EAT as its sole member, which was established specifically for the purpose of facilitating the reverse 1031 exchange. The loan from Karen to Newco LLC will be documented by a note and secured with a pledge of the EAT's membership interest in favor of Karen in Newco LLC.

Karen ultimately closes on the acquisition of the target replacement property on April 30, 2021, with title vested 50% in her personal name and 50% in Newco LLC, as tenants in common. Learn more about Tenants in Common. On June 1, 2021, while the replacement property is held by Karen and Newco, Karen enters a contract to sell the small office building, her second relinquished property, for $540,000, with a closing date of August 20, 2021. At closing, after all closing costs are paid, the net proceeds of $500,000 will be deposited into Karen's exchange account with Real 1031 and the QI will transfer the funds to the EAT as "purchase" price prior for the acquisition by Karen of the remaining 50% tenancy in common interest from the EAT. Immediately upon receipt of those funds the EAT will remit that sum to Karen to pay off the loan that was made to the EAT to acquire the one-half interest in the new property. Upon payoff of the $500,000 loan owed to Karen, Karen receives full ownership of the replacement property. In this manner it is the same as if Karen had acquired the replacement property outright from seller.

The Result

Karen used the forward exchange for the sale of the strip center and the reverse exchange for the sale of the office building to ultimately acquire 100% of the new building, deferring the taxes on both sales in the process. In doing so, Karen exchanged from two properties worth approximately $1,000,000 into a single, more desirable building worth about the same.