EQUITY EXCHANGE LLC

DEVOTED EXCLUSIVELY TO THE FACILITATION OF 1031 TAX DEFERRED EXCHANGES SINCE 1994

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At Equity Exchange LLC we act exclusively as a *Qualified Intermediary (Intermediary)* handling tax deferred exchanges throughout the United States. *Starker*, *like-kind*, and §1031 *exchanges* all refer to §1031 of the Internal Revenue Code, which, since the 1920's has allowed investors in income producing or investment property to exchange properties and defer capital gains tax. IRC §1031 provides that *no gain or loss shall be recognized if property held for productive use in a trade or business or for investment purposes is exchanged solely for property of a like kind.* In order to completely defer the capital gains tax, an Exchanger must acquire like kind property and cannot receive cash or other benefits. Because the Code requires the properties be *exchanged*, the necessity for the Intermediary arises.

The Intermediary, also historically known as *Facilitator*, *Accommodator* or *Strawman*, is an independent, third party to a property sale or purchase transaction. Its participation converts a taxpayer's (*Exchanger's*) unrelated sale and purchase of property into an exchange. It does so by assuming Exchanger's position in both the sale and purchase of the Exchanger's property.

The Intermediary's role is not that of tax or legal advisor. Exchanger's are encouraged to consult with their legal and tax counsel when contemplating a §1031 exchange.

The Exchange begins at (not after) the close on the sale of Exchanger's Relinquished Property, at which time the Exchanger enters into an *Exchange Agreement* with the Intermediary. Every 1031 Exchange Agreement requires that:

- ✓ The Intermediary acquire Exchanger's right to sell the Relinquished Property (*equitable title);*
- ✓ Exchanger deed the property directly to its Buyer;
- ✓ The Intermediary receives the net proceeds from the sale and holds or immediately transfers them for the benefit of Exchanger; and,
- ✓ The Intermediary uses the funds to purchase the Replacement Property from its Seller, who deeds the Replacement Property directly to the Exchanger to complete the exchange.

Prior to exchanging, every Exchanger should become familiar with the following basic, but extremely important principles:

- ✓ §1031 tax deferred exchanges are not *tax-free* exchanges. The capital gains tax does not *disappear* after an exchange, rather it is *deferred* until a Replacement Property is sold outright, rather than exchanged into something else.
- ✓ Both the Relinquished and the Replacement Exchange Properties must be *like-kind, i.e., property held for investment* or *income producing property*.
- ✓ Property an Exchanger already owns will not qualify as Replacement Property, therefore, the Intermediary cannot use the proceeds from the sale of the Relinquished Property to acquire or pay down debt on other property that Exchanger already owns.
- ✓ Exchanges must be completed within strict timelines. First, from the date the Relinquished Property closes, the Exchanger has 45 days in which to *identify* a small number of potential Replacement Properties. The identification is made to the Intermediary, in writing, and must include specific addresses or legal descriptions. Even if none of the identified properties end up being acceptable or available, once the 45 days has elapsed the Exchanger cannot change identified properties. The exchange will fail if none of the listed properties are acquired. Second, Exchanger and Intermediary must complete the closing on the Replacement Property within 180 days of the close of the Relinquished Property.
- ✓ In order to be completely deferred on taxes an Exchanger must roll all of the equity out of the Relinquished Property into the Replacement Property, and the Replacement Property must be of equal or greater value to the sale price (minus closing costs) of the Relinquished Property. Therefore, if an Exchanger has debt on the Relinquished Property, then the Exchanger will need to have debt on the Replacement Property. The only way to reduce or eliminate debt on the Replacement Property is for the Exchanger to add additional cash from other sources for the purchase of the Replacement Property. An exchange does not fail if an Exchanger buys a less expensive Replacement Property, but the difference between the sale price (minus closing

costs) of the Relinquished Property and the purchase price of the Replacement Property will be subject to capital gains tax, and any cash an Exchanger receives either at the Relinquished Property or the Replacement Property closings will be subject to capital gains tax, regardless of how much the Exchanger invested in the Relinquished Property or how much the adjusted basis is in the Relinquished Property.

PARTIES DISQUALIFIED FROM ACTING AS INTERMEDIARY

The Internal Revenue Treasury Regulations issued June of 1991 specified in Reg. 1.§1031 (k)-1(g)(4)(iii) that a disqualified person could not function as an Intermediary, and then defined a *disqualified person* as:

1. Any person who is an agent of the taxpayer at the time of the transaction or any person who has acted as the taxpayer's employee, attorney, accountant, investment banker, real estate agent or broker within the two year period ending on the date of the transfer of the first of the Relinquished Properties;

2. Any person who is related to the taxpayer including any family members;

3. Any individual, partner or corporation where a related party owns more than 10% of capital or profit interest or stock value, or;

4. Two corporations in a controlled group, a grantor and fiduciary in a trust, or any entity that would appear to be an agent under local law.

An exchange will fail if an Exchanger has actual or constructive receipt of 1031 exchange proceeds. A disqualified person is considered the agent of an Exchanger, therefore if an Exchanger's agent receives the 1031 exchange proceeds, then the IRS may interpret that as the Exchanger having received the 1031 exchange proceeds.

LIKE-KIND PROPERTY

In order for a 1031 exchange to qualify, an Exchanger's Relinquished Property must be exchanged for Replacement Property that is *like-kind property.* In real property exchanges, like-kind refers to the nature or character of the property, not its grade or quality. Therefore, for example, it does not matter whether a property is vacant or improved, because that goes to the grade or quality of the property, not to its kind or class. Whether properties are like-kind is determined by the manner in which the Exchanger treats the properties; both Relinquished and Replacement Properties must be either *investment* or *income-producing* to qualify. Any property held for use in a trade or business (income producing) or for investment purposes is like-kind. The following are examples of properties that could all be considered interchangeably, like-kind, pursuant to IRC §1031:

- Hotel or motel
- Development and zoning rights
- Apartment complex
- Tenant in common interests (TICs)
- Single-family rental
- Mineral rights and water rights
- Office building
- Vacant land
- Camping resort
- 30-year leasehold interest

- Vineyard and winery
- Conservation or scenic easements
- Gas station
- Rental recreation property
- Duplex
- Single Tenant Retail
- Vacation and second homes (but see the next section titled *Vacation and Second Homes*)
- Farm (non personal residence portion can be exchanged; Exchanger may be able to take the portion of the sale price allocated to personal residence tax-free.)
- Partnership interests, LLC membership interests (with one exception), stocks, bonds, notes, securities, certificates of trust, good will and property held primarily for resale, or as stock-in-trade are not considered like-kind under the code and are therefore not exchangeable.

Generally, most properties sold by developers, builders and individuals who acquire, renovate and sell, will be considered *held primarily for resale*, and therefore, not allowed exchange treatment. When the courts analyze whether a property qualifies as like-kind, the test they apply is that of *intent*; the intent of the Exchanger at the date of the exchange of the property. The courts have primarily focused on three factors to determine intent. The first factor is the number, the frequency, and the extent of real estate transactions entered into by the Exchanger. No specific number of transactions has been cited by the courts, but certainly the more the sales the more likely the courts will find the Exchanger did not have the requisite intent. The second factor is the extent of an Exchanger's development activities, for example, rezoning, dividing a large parcel into many, installing streets, utilities and sewers. These are activities attributable to the Exchanger's own efforts that increase the value of the property, as opposed to gain that is due to outside factors, for example, the fortuitous proximity to a new highway or shopping mall. The third main analysis point is sales efforts by the Exchanger. The more involved the Exchanger is in the advertisement and the sales effort associated with the property, the more likely the courts will deem it not like-kind property.

VACATION AND SECOND HOMES

Whether or not *vacation homes*, or *second homes*, qualify for 1031 exchanges is a hotly contested issue within the 1031 exchange community. Some CPAs argue that vacation homes are not investment property, but rather *personal use property*, and thus cannot be exchanged. Other CPAs take the position that if an Exchanger has an expectation that a vacation home will create a greater return if it is <u>not</u> rented out, because of the wear and tear caused by tenants, it nevertheless qualifies as like-kind property, which may be exchanged under IRC §1031. The question boils down to whether an Exchanger must rent out a vacation home in order for it to qualify for a 1031 exchange.

In 1981 the IRS issued a Letter Ruling (Ltr Rule 8103117), which allowed a 1031 exchange on a vacation home that was sold and replaced with another vacation home. The Relinquished Property had not been rented for the six or seven years prior to the exchange, however the IRS concluded that the property had been held for both *personal enjoyment* and as a *sound real estate investment*. The Replacement Property was also intended to be held for the same personal enjoyment and investment intent. It appears that the IRS was persuaded in this instance to accept as controlling, that part of the taxpayer's intent was to hold the property as an investment.

In the U.S. Tax Court case Rivera v. Commissioner, the Exchanger owned a vacation home that had had very little rental activity; most use was personal, by the owners themselves. While the issues in the case did not involve Section 1031 directly, the question of whether or not the property was investment property was addressed by the Court. The court determined that the property was held primarily for investment purposes based solely upon the testimony of the Exchangers, who had stated that the property had been purchased *with the expectation that it would increase in value*.

Given the case law, **Equity Exchange LLC** will not refuse to assist Exchangers who wish to exchange property that has been, or will be, strictly second home or vacation property. However, we highly recommend that every Exchanger considering exchanging improved property that they have not rented, or will not rent, discuss the proposed exchange fully with their CPA. We believe it is best for Exchangers to speak with their accountants before beginning the exchange, in order to determine their accountant's personal opinion in the matter. This will prevent severe disappointment and frustration on the part of the Exchanger at tax time. CPA's that support this type of exchange will most likely suggest that the Exchanger take some action to document investment intent. This might be as simple as writing a letter to the Exchanger's CPA or attorney, and stating that it is the Exchanger's intent to hold the property as an investment, for future appreciation.

FOREIGN PROPERTY

Property located within the United States (including, it appears, the U.S. Virgin Islands) can be exchanged for like-kind property located within the United States. It cannot be exchanged for property that is located outside the United States. However, an Exchanger who is subject to U.S. taxes can exchange property located outside the United States for other like-kind property located outside the United States.

ANCILLARY BENEFITS TO EXCHANGING AND OBJECTIVES COMPATIBLE WITH EXCHANGING

There are countless reasons people decide to sell property; virtually the only reason they exchange is in order to defer the capital gains tax. Fortunately, many of the reasons people decide to sell are compatible with exchanging. Some common motivating factors for selling, which work well with exchanging, are:

- Simplify management; exchange many properties into fewer or more manageable properties.
- Estate planning. An Exchanger can exchange out of one or more Relinquished Properties into one or more Replacement Properties, and then establish, through wills or trusts, which heirs the Exchanger would like to receive which properties. Later, when the heirs inherit, their basis in their inherited property is *stepped up* to the fair market value of the property at the time it is inherited, effectively <u>eliminating</u> the Exchanger's gain. (One of only two instances where the capital gains taxes are actually *eliminated* rather than *deferred*. The other instance is when the Exchanger converts to a primary residence. (See *§1031 Exchanges and the $500,000 Exclusion for the Sale of Personal Residences-The Ultimate Exchange*)
- Spread the risk; exchange a larger property into different types or locations.
- Move investments to areas offering better economic conditions, better appreciation.
- Accommodate Exchanger's relocation to a new residence; managing from a distance can be difficult.
- Trade low or no income producing property, such as unimproved land, for income producing property.
- Trade property with little or no basis for new property in which there is basis, which can be depreciated. When properties are exchanged, the old basis in a Relinquished Property, which may be little or nothing, *transfers* to the Replacement Property. If the Replacement Property is more expensive than the Relinquished Property, that difference is added to the basis amount that transferred over from the Relinquished Property. Both figures are combined, becoming the new basis in the Replacement Property, which can then be depreciated by the Exchanger.
- Exchange into a property that will function as a location for Exchanger's business (or perhaps for Exchanger's children's business.)

- Exchange into a rental property where Exchanger's children are attending college; collect rent from their children's roommates and enjoy appreciation on the property rather than paying rent. After college, sell and exchange again.

OBJECTIVES WHICH ARE INCOMPATIBLE OR SEMI-COMPATIBLE WITH EXCHANGING

If an individual's objective is simply to *not* acquire any Replacement Property, an exchange will provide no benefit. If the objective is to acquire a Replacement Property that carries a lesser purchase price than the Relinquished Property, the difference in value will be subject to capital gains tax. (If that difference is less than the gain, there will be no benefit to exchanging. The IRS takes the tax off the top.)

If an individual's objective is to relinquish a property encumbered by a mortgage and to acquire a Replacement Property without a mortgage, if the new Replacement Property is less expensive than the Relinquished Property, the difference in value will be subject to capital gains tax. (In order to be completely deferred, all of the cash out of the sale must be rolled into the Replacement Property and the Exchanger must undertake at least the same amount of debt as was on the Relinquished Property. An Exchanger may reduce the amount of debt on a Replacement Property by adding cash toward the purchase of the Replacement Property.)

If an individual's objective is to acquire a new personal residence an exchange will not work. An Exchanger's personal residence is not like-kind property.

If, at the closing on Exchanger's Replacement Property, an Exchanger arranges for a mortgage amount greater than what is needed to close on the Replacement Property thus resulting in the Exchanger receiving cash, the cash received will be subject to capital gains tax. This holds true even if the Exchanger intends to use the funds to make improvements to the Replacement Property after close. If at all possible, a more desirable result can be achieved by increasing the amount of the mortgage on the Replacement Property in a separate transaction <u>after</u> the Exchanger takes title to the Replacement Property.

If an Exchanger, as part of the sale of the Relinquished Property receives an instrument such as a note, land contract or mortgage from the Buyer (Seller financing), the instrument will be subject to capital gains tax. The instrument is, in effect, proceeds from the sale and is not like-kind to the Relinquished Property given up and is therefore subject to capital gains tax. Installment sales rule will apply and the capital gains tax gain can be paid on an installment basis pursuant to IRC §453. However, see *Seller Financing and Exchanges* for additional information and options where Seller financing is part of the sale portion of the transaction.

§1031 EXCHANGES AND THE $500,000 EXCLUSION FOR THE SALE OF PERSONAL RESIDENCES - OR THE ULTIMATE EXCHANGE

Exchangers frequently exchange into Replacement Property that they intend to eventually convert (tax-free) into a personal residence. (Taxpayers generally may exclude up to $250,000 in gain realized on the sale of a personal residence for individuals, and $500,000 for married couples filing a joint return, if they have owned the residence and resided in it for periods adding up to two years, of the five year period ending on the date of sale (IRC §121). Typically, the conversion occurs two years or so after the residence was acquired as 1031 Replacement Property and held for the required investment purposes. The Exchanger must own the residence for five years from the acquisition date as a Replacement Property and reside in it for periods of time adding up to two years during the five year period for the full gain exclusion. The Exchangers converts to a personal residence simply by moving into the residence, living there for three more years, thus making the residence eligible for the exclusion for sale of a personal residence.

The *American Jobs Creation Act of 2004* imposes the five year ownership requirement for the tax-free sale of a personal residence originally received as Replacement Property in a 1031 exchange. Under the 2004 Act, the exclusion of gain on the sale of a personal residence does not apply if a sale occurs within five years of the acquisition date of the property, if the property was received as Replacement Property in a 1031 exchange. (Also see *Combining The Benefits Of IRC §121 and IRC §1031.)*

THE SIMULTANEOUS §1031 EXCHANGE

In a simultaneous exchange, the Relinquished Property and the Replacement Property are transferred concurrently. The Intermediary transfers ownership to the proper entities and insulates the Exchanger from constructive receipt of funds issues. Although the Intermediary does not hold the 1031 Exchange Proceeds in a simultaneous exchange, the Intermediary does *control the flow* of the 1031 Exchange Proceeds. The Intermediary also assists in creating a reciprocal trade and provides a paper trail for the entire transaction.

THE DELAYED §1031 EXCHANGE

The delayed exchange begins when an Exchanger's Relinquished Property is sold and is completed when the Replacement Property is acquired within the 180-day exchange period. An Intermediary, as an independent party to the exchange transaction, creates the reciprocal trade of properties for the exchange, holds the 1031 Exchange Proceeds, and supplies the necessary exchange documents, such as the *Exchange Agreement*, *Assignments* and *Exchange Closing Instructions*.

THE STEPS CLOSING TO A DELAYED §1031 EXCHANGE

1. Exchanger enters into a Purchase and Sale Agreement (*the contract*) to sell the Relinquished Property to its Buyer. Exchanger includes an *Exchange Cooperation Clause*, in, or as an addendum, to the contract. A sample Exchange Cooperation Clause for the Relinquished Property contract is as follows:

   > *Seller reserves the right to convert this transaction to a tax deferred exchange pursuant to IRC Section 1031, and agrees to hold Buyer harmless from any and all claims, liabilities or delays in time resulting from such an exchange. Buyer acknowledges Seller's intent and agrees to cooperate with Seller and to execute all documents reasonably requested by Seller, including an assignment of this agreement, at no additional cost to Buyer.*

2. Exchanger provides **Equity Exchange LLC** (several days before closing) with the date and location of the closing. (See *Exchange Information Form-Appendix A-4 through A-5*)

3. Also prior to closing, **Equity Exchange LLC** forwards the *Phase I Exchange Closing Instructions*, *Notice of Assignment*, *Assignment Agreement*, and *1031 Exchange Agreement* to the title company, attorney or other individual who will prepare the closing documentation.

4. At closing, Exchanger assigns his or her position as Seller of the Relinquished Property to **Equity Exchange LLC** (as Exchanger's Intermediary). **Equity Exchange LLC** sells the Relinquished Property (although the deed goes directly from the Exchanger to the Buyer) and the net sale proceeds (the *1031 Exchange Proceeds*) are forwarded to **Equity Exchange LLC** for deposit into a *Qualified Escrow Account* for Exchanger. The standard closing documents which must be modified for a 1031 exchange include:

a. The closing or settlement statement: **Equity Exchange LLC** is included as Qualified Intermediary for the Exchanger; and,

b. The IRS Form 1099S: the form is issued in the Exchanger's name, using Exchanger's social security or tax ID number. Box number is marked, indicating that the Exchanger *will receive other property as part or all of the consideration*.

5. After closing, **Equity Exchange LLC** sends the Exchanger a letter confirming the date the Relinquished Property closed, the 45-day and 180-day deadlines, and the 1031 Exchange Proceeds amount held in the Qualified Escrow Account. (See *Sample Identification Letter-Appendix A-1 through A-3)*

6. Within 45 days of the Replacement Property closing, the Exchanger identifies Replacement Properties to **Equity Exchange LLC**. (See *Identification of Replacement Properties*)

7. The Exchanger enters into a Purchase and Sale Agreement (*Contract*) with the Seller of Exchanger's chosen Replacement Property. (Exchanger can actually enter into the agreement at any time, even several months prior to initiating the first steps of the exchange, as long as no closing occurs until after the Relinquished Property sells.) Exchanger includes an *Exchange Cooperation Clause*, in, or as an addendum, to the contract. A sample Exchange Cooperation Clause for the Replacement Property contract is as follows:

   Buyer reserves the right to convert this transaction to a tax deferred exchange pursuant to IRC Section 1031, and agrees to hold Seller harmless from any and all claims, liabilities or delays in time resulting from such an exchange. Seller acknowledges Buyer's intent and agrees to cooperate with Buyer and to execute all documents reasonably requested by Buyer, including an assignment of this agreement, at no additional cost to Seller.

8. The Exchanger provides **Equity Exchange LLC** (several days before closing) with the date and location for the Replacement Property closing. (See *Exchange Information Form-Appendix A-4 through A-5*) **Equity Exchange LLC** forwards the *Phase II Exchange Closing Instructions, Notice of Assignment*, and *Assignment Agreement*, and wires the 1031 Exchange Proceeds to the title company, attorney or other individual who will prepare the Replacement Property closing documentation. The standard closing documents which must be modified for a 1031 exchange include:

   a. The closing or settlement statement: **Equity Exchange LLC** is included as Qualified Intermediary for the Exchanger; and,

   b. The dollar amount of the 1031 Exchange Proceeds being used for each Replacement Property must show on the closing or settlement statement as *1031 Exchange Proceeds*, a credit to the Buyer.

9. At closing, the Exchanger assigns the Replacement Property Purchase and Sale Agreement to **Equity Exchange LLC**, and **Equity Exchange LLC** uses the 1031 Exchange Proceeds to pay for the property. (Exchanger provides any additional funds necessary to close, either in the form of a mortgage or cash.) The Seller deeds the Replacement Property directly to the Exchanger and the Exchanger's 1031 exchange is complete.

REPLACEMENT PROPERTY IDENTIFICATION RULES

EXCHANGE PERIOD: An Exchanger must receive title to the Replacement Property during the *Exchange Period*, which is a 180-day window that begins on the date the Exchanger conveys the Relinquished Property to its Buyer and ends 180 days later. (If an exchange begins in the last few months of a given year, then the 180th day may fall after Exchanger's next tax return is due. If so, the exchange must be completed by the date the tax return is due or the Exchanger must file for an extension of the due date of the tax return. This will allow the Exchanger to use the entire 180-day window, but will not extend the window beyond a total of 180 days. In addition, within the first 45 days of the date the Exchanger conveys the Relinquished Property to its Buyer, (the *Identification Period*) the Exchanger must *identify* the Exchanger's intended Replacement Property, pursuant to the following:

1. ***IDENTIFICATION PERIOD***: The property Exchanger intends to use as Replacement Property must be identified in writing, within 45 days of the closing on the Relinquished Property. The 45-day rule is firm, and cannot be extended for any reason. The 45-day period includes Saturdays, Sundays, and legal holidays.

2. If the Exchanger identifies potential replacement properties within the 45-day period, the Exchange proceeds cannot be refunded until the expiration of the 180-day Exchange period. If no Replacement Properties are identified within the 45-day period, the Exchanger may request his proceeds to be refunded as of the 46th day.

MANNER OF IDENTIFICATION: The Exchanger must properly identify Replacement Property by doing at least one of the following:

3. Completing the purchase of all of Exchanger's Replacement Property within the 180-day Exchange Period; or

4. Identifying Exchanger's intended Replacement Property in writing to the Intermediary by midnight of the 45th day of the Identification Period. Every identification must contain an unambiguous description of each potential Replacement Property, including either street addresses or legal descriptions, and must be signed by the Exchanger. Identifications must be hand-delivered, mailed (U.S. Mail postmarked), faxed or otherwise delivered via UPS or Fed Ex or other similar service, by midnight of the 45th day of the Identification Period. If the Exchanger intends to make improvements to the Replacement Property (see *Improvement or Build-to Suit Exchanges*) during the Exchange Period, then the Exchanger must include a detailed description of both the land and the proposed improvements.

CHOICE OF PROPERTY IDENTIFICATION RULES: In addition to abiding by the rules discussed immediately above under *Manner of Identification*, the Exchanger must also select and abide by **one** of the following rules, which were presumably drafted by the IRS to limit the number of properties an Exchanger can identify. (They are technically not supposed to limit how many Replacement Properties an Exchanger can actually acquire, rather, just limit how many an Exchanger can identify.) Exchangers must choose and follow **one** of the following three rules when identifying Replacement Property:

1. ***THE THREE PROPERTY RULE:*** Exchanger may identify up to three Replacement Properties of any value. If the Exchanger selects this rule, then the Exchanger must submit a signed and dated list of up to three unambiguously described properties to the Intermediary within the 45 days. The Exchanger need not submit the fair market value of the properties and need not acquire all of the Replacement Properties submitted.

2. ***THE 200% RULE:*** Exchanger may identify any number of Replacement Properties as long as the aggregate (total) fair market value of the Replacement Properties does not exceed 200% of (or 2 x) the aggregate fair market value of the Relinquished Property sold. If the Exchanger selects this rule, then the Exchanger must submit a signed and dated list of unambiguously described properties to the Intermediary within the 45 days. In addition, the Exchanger must list the fair market value of each of the potential Replacement Properties. The Exchanger need not acquire all of the Replacement Properties submitted.

3. ***THE 95% RULE:*** Exchanger may identify any number of Replacement Properties without regard to their aggregate fair market value, as long as the Exchanger ultimately acquires 95% of the fair market value of the identified Replacement Properties. If the Exchanger selects this rule, then the Exchanger must submit a signed and dated list of unambiguously described properties to the Intermediary within the 45 days. The Exchanger need not submit the fair market value of the potential Replacement Properties but the Exchanger must acquire 95% of the Replacement Properties submitted to the Intermediary.

CHANGING PREVIOUSLY IDENTIFIED PROPERTIES: During the 45 Day Identification period only, an Exchanger may change properties previously identified by submitting (in writing to the Intermediary) revocations of previous identifications and substituting new identifications, all pursuant to the rules discussed above.

PRESIDENTIALLY DECLARED DISASTERS (EXTENSIONS): Revenue Procedure 2005-27 provides that taxpayers who are in the process of an exchange and who are covered by a published IRS Notice or News Release following a Presidentially declared disaster or a terroristic or military action may extend the following periods by 120 days or to the last day of the extension period authorized by the IRS, whichever is later:

(1) The last day of the 45-day Identification Period and the last day of the 180-day Exchange Period for Delayed Exchanges under the IRC 1031, and

(2) The 5-business day period to enter into a QEAA, the 45-day Identification Period and the 180-day Exchange Period for Reverse Exchanges pursuant to Rev Proc 2000-307, 2002 Cum Bull 308.

In order to qualify, the Relinquished Property must have been transferred on or before the date of the Presidentially declared disaster and the taxpayer must be an *affected taxpayer* as defined in the IRS News Release or other guidance announcing tax relief for the victims of the specific disaster and have difficulty meeting a deadline for one of the following reasons:

(A) The Relinquished Property or the Replacement Property is located in a covered disaster area;

(B) The principal place of business of any party to the transaction is located in the covered disaster area;

(C) Any party to the transaction or an employee of such party is killed, injured, or missing as a result of the disaster;

(D) A document prepared in connection with the exchange or a relevant land record is destroyed, damaged, or lost as a result of the disaster;

(E) A lender decides not to fund a real estate closing, either permanently or temporarily, due to the disaster, or refuses to fund a loan to the taxpayer because title insurance or flood, disaster or other hazard insurance is not available because of the disaster.

EXCHANGES BETWEEN RELATED PARTIES; SPECIAL PROVISIONS

Back in 1989, in IRC §1031 (f), Congress enacted a two-year holding period for like-kind exchanges between related parties. The purpose of the rule was to eliminate the benefit related parties receive when they exchange a low-basis property for high-basis property in anticipation of a profitable sale of the low-basis property. IRC §1031 (f) requires a two-year holding period after an exchange between related parties. If <u>either</u> the taxpayer <u>or</u> the related party disposes of the exchanged property within two years, then the gain or loss is triggered for <u>both</u> parties. Furthermore, *suspension* provisions, IRC

§1031 (g) can extend that two-year holding period. The two-year holding period is *suspended* if either the taxpayer's or the related party's risk of loss is substantially decreased, for example, due to an option, put on either exchanged property. (Should the risk of loss *increase* again, the two-year period would resume from the point where it had stopped.)

There are three exceptions to the related party two-year holding period rule. If the taxpayer or related party dies and the property is disposed of within the two-year holding period, gain will not be triggered to the second party. The two-year limitation does not apply if the property is transferred because an involuntary conversion, and the original exchange occurred before the imminence of the conversion. Finally, if the taxpayer can establish that neither the original exchange nor the subsequent disposition within the two-year period was undertaken for the purpose of avoiding tax, then the original exchange may not fail.

In 2002, the IRS further restricted related party like-kind exchanges through a Intermediary. Revenue Ruling 2002-83 (2002-49 IRS 927) eliminated the opportunity for related parties to exchange property using an Intermediary if one of the related parties receives cash out of the exchange. The IRS looks beyond the closing transactions to determine whether a related party *cashed out*. If a related party does indeed cash out, then the transaction will not qualify for non-recognition treatment under IRC §1031.

***Example*:** Exchanger owns Blackacre. An unrelated party buys Blackacre from Exchanger through Intermediary, at a standard §1031 exchange closing. Intermediary then uses the 1031 Exchange Proceeds out of Blackacre to purchase Greenacre from Exchanger's Brother, and Brother deeds Greenacre directly to Exchanger. (If Greenacre were acquired from someone other than a related party, the transaction would work.) Under Revenue Ruling 2002-83 however, Exchanger cannot receive non-recognition treatment, because, in a transaction using an Intermediary, Brother is receiving cash for the property that Exchanger is receiving as Replacement Property. Because, in this example Brother receives cash for Greenacre, the provisions of §1031 will not apply to Taxpayer's exchange, and Taxpayer must recognize the gain on his or her transfer of Blackacre to the unrelated party.

The related parties definition has evolved into a blend, defined under IRC section 267(b) and section 707(b). Related parties include the following:
Family members (siblings, spouses, ancestors, and lineal descendants);

An individual and an entity (corporation or partnership) where the individual owns either directly or indirectly more than 50% in value of the entity;

Two entities in which the same individual owns directly or indirectly more than 50% of each;

An estate in which the taxpayer is either the executor or beneficiary of the estate; and,

A trust in which the taxpayer is the fiduciary and the related party is a beneficiary either of that same trust or a related trust or a fiduciary of a related trust.

One should note that Field Service Advice (FSA) Memorandum 2001-37003 does allow related parties to exchange (actually swap) properties, and non-recognition treatment of the gain is permitted as long as neither related party sells their Replacement Property for at least two years after the initial exchange.

While the restrictions to related-party exchanges seem to limit the tax benefits, in some situations, tax deferral and estate planning can still make related-party like-kind exchanges useful. For example:

A taxpayer who previously did a 1031 exchange subsequently dies and leaves the property to heirs. The inherited property is revalued and the old capital gains that were never recognized are wiped clean. If the heirs then sell the inherited property, their basis will be the value as of the day they inherited. This is true for all exchanges, not just related party exchanges.

A parent owns investment property that is appreciating quickly and a child owns income-producing property that is not appreciating as rapidly. The parties swap. The parents enjoy the income and the tax on the child's ultimate sale will be lower because of the child's higher basis.

When related parties exchange property, the IRS requires additional information, including the name, address, identifying number, and relationship of the related party. In addition, Form 8824 must be filed for the year of exchange and also for the two years following the exchange to *assure* the IRS the two-year holding requirement is satisfied.

PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

Exchanges of *partnership interests* are specifically excluded from non-recognition treatment under IRC §1031, regardless of whether the interests are general or limited partnership interests. A partnership, nevertheless, may exchange real property that it owns, as long as the entire partnership itself is the Exchanger and remains a partnership throughout the exchange. In addition, the partnership must acquire the Replacement Property as the exact same entity it was when it exchanged out of the Relinquished Property.

However, more often than not, one or more of the partners does not wish to exchange and would rather receive the cash from the sale. More conservative practitioners believe that the best route then is to distribute the partnership interest to the partner not exchanging by deeding an undivided interest in the Relinquished Property to the non-exchanging partner prior to the closing of the sale. Then, as long as there are still at least two remaining partners, the partnership can still exchange and the non-exchanging partner gets cash.

Other possible solutions are to liquidate the partnership either prior to or after the exchange and distribute to each *partner* a tenancy-in-common interest in the real property with the other former partners. There are no recent cases directly on point, however it is preferable to transfer ownership to the individual Exchangers as far in advance of the exchange as possible. The lurking concern is that if a di7stribution or dissolution occurs shortly prior to the sale, the IRS might take the position that the Relinquished Property was not *held for productive use in a trade or business or for investment purposes*, because the exchanging former partners had received title to the Relinquished Property just prior to the beginning of the exchange. (Distributing cash to non-exchanging partners prior to sale, which allows the partnership to then exchange avoids the qualified use issue in its entirety.)

Relevant case law:

Bolker v. Commissioner, 81 TC 782 (1983), aff'd 760 F2d 1039 (CA9 1985). Taxpayer entered into an exchange agreement on Relinquished Property on the same day that he received a liquidating distribution of the property from his wholly-owned corporation. He then acquired a Replacement Property three months later to complete his exchange. The Tax Court held that the qualified use requirement was met as long as the taxpayer did not intend to liquidate the Relinquished Property or use it for personal pursuits.

Magneson v. C.I.R., 753 F.2d 1490 (9th Cir.1985). The court allowed tax deferred exchange treatment because the contribution to or from a partnership is an allowable change in the form of ownership rather than a disposition that would disqualify the property from exchange treatment.

One major exception to the general rule that the same taxpayer entity that relinquishes title to the Relinquished Property has to acquire title to the Replacement Property is found in Treas. Reg. §301.701-(3)(b)(1), which provides that single-member LLC's that acquire property may be ignored for tax purposes and treated as the direct owners of the property. The use of single member LLC's allows an individual, for example, to start an exchange as an individual, and complete the exchange with the purchase of the Replacement Property in the name of a single member LLC as long as the LLC has not elected to be treated as a corporation for federal tax purposes. Under federal tax law, a single member limited liability company is a disregarded entity and its assets are treated as owned by the sole member of the company. Thus, if Mr. Smith exchanges out of property that was titled in his name, he could acquire property in ABC LLC provided that he is the sole member and the company is a disregarded entity. The same result would follow where ABC LLC exchanges out of the Relinquished Property and Mr. Smith acquires Replacement Property in his individual name. Via Private Letter Ruling, the IRS approved of a Replacement Property acquired by a two member LLC in which the taxpayer and the taxpayer's wholly-owned corporation were the members of the LLC. The IRS acknowledged that the taxpayer's corporation had no rights or risk regarding profits, losses or management of the LLC, and agreed to disregard the two member LLC as an entity separate from the taxpayer, similar to the treatment of a single membership LLC. (LTR 199911033). Additionally very helpful, was LTR 200131014, whereby an individual Exchanger who acquired a Replacement Property in his own name, was subsequently allowed to deed the Replacement Property into a single member LLC in which he was the sole member, without violating the held for requirement imposed by IRC §1031.

REVERSE §1031 EXCHANGES

In simultaneous and delayed exchanges an Exchanger first conveys the Relinquished Property to its Buyer, and subsequently receives the Replacement Property from its Seller. In fact, IRS rules forbid an Exchanger from acquiring Replacement Property without first transferring out of title to the Relinquished Property. Thus, *reverse exchanges* are used where, for various compelling reasons, an Exchanger must first acquire the Replacement Property from its Seller and subsequently convey the Relinquished Property to its Buyer.

In a reverse exchange structured pursuant to Rev. Proc. 2000-37, a separate entity, the *Exchange Accommodation Titleholder* (*EAT*), is established to facilitate the transaction. The EAT actually holds title either to the Relinquished Property or to the Replacement Property pursuant to an agreement between the parties, the *Qualified Exchange Accommodation Agreement* (QEAA). The QEAA must be signed within 5 business days after title is transferred to EAT.

A safe harbor reverse exchange must be completed with 180 days from the day the EAT acquires title to a property. This durational limit is taken from those of a delayed exchange, which by statue must be completed within the lesser of 180 days or the due date of the Exchanger's tax return for the year in which the Relinquished Property is transferred. Additionally, the Exchanger must identify one or more Relinquished Properties within 45 days after the EAT acquires title to a Replacement Property. The same identification rules apply as in delayed exchanges; written identification be delivered to another party to the exchange, such as the EAT or the Intermediary, and the number of alternative and multiple properties that can be identified are limited.

Rev. Proc. 2000-37 specifically states that, *the Service recognizes that parking transactions can be accomplished outside of the safe harbor provided in this revenue procedure*, and leaves open the option for Exchangers to structure reverse exchanges that do not comply with all of the provisions of Rev. Proc. 2000-37. Thus, Exchangers may elect to pursue reverse exchanges that will take longer than 180 days. There is still very little regulatory authority to assist in structuring a reverse exchange outside the safe harbor, so non-safe harbor reverse exchanges should only be used if there is an absolute need to proceed outside of Rev. Proc. 2000-37.

The basic consensus in the industry is that, unlike Rev. Proc. 2000-37, a valid non-safe harbor exchange will require the EAT to undertake more responsibility for ownership of the property than just bare tax ownership. Most tax experts believe that EATs operating outside of the safe harbor will need to be the owner of the parked property for both tax and financial reporting purposes, thus showing the assets and liabilities associated with the parked property on its books for GAAP purposes.

The most common type of safe harbor reverse exchange is what is commonly called a *Reverse A*, which is where the Exchanger contracts with the EAT to purchase and retain title to the Exchanger's intended Replacement Property. In the first phase of the Reverse A exchange the Exchanger loans funds to the EAT, who in turn uses the funds either to pay for the Replacement Property in full or as a down payment in conjunction with other funds provided by a third party lender. The EAT takes title in the EAT's name. Under the terms of the QEAA, the EAT leases the property to the Exchanger under a triple net lease. In this way the Exchanger can begin to using the property or renting the property out while the EAT is on title. Within 180 days, when the Exchanger sells the Relinquished Property it is deeded directly to its Buyer through the Intermediary. The cash proceeds from the sale go to the Intermediary, who uses the proceeds to acquire the Replacement Property from the EAT. The EAT uses the proceeds to pay off or pay down any loans it received to acquire the Replacement Property, including loans from the Exchanger. The EAT then deeds the Replacement Property to the Exchanger to complete the exchange. If the proceeds from the Relinquished Property sale exceed what was paid to purchase Replacement Property, the Intermediary can use the excess proceeds to purchase additional Replacement Property. Additional Replacement Property must be properly identified by the Exchanger within 45 days and transferred to the Exchanger within 180 days of Exchanger's transfer out of the Relinquished Property. This type of reverse exchange works well when the Exchanger can pay all cash for the Replacement Property, when the Seller is providing the financing, or when an Exchanger is working with a sophisticated third-party lender. If a loan from an institutional lender is a necessity, the Exchanger must be very firm in establishing with the lender that the EAT (not the Exchanger) will be the temporary titleholder of the property. Many, if not most lenders are not familiar with reverse exchanges, and many types of loans are not available when pursuing a reverse exchange. Loan costs may even be increased to cover the lender's document preparation and legal fees. Lenders are usually relieved to learn that the lenders' security interest is protected because the Exchanger signs the note guaranteeing the loan and the EAT pledges the Replacement Property as security, on a non-recourse basis. In other words, the EAT pledges the property by signing the mortgage, and the Exchanger signs the note. If the Exchanger should default, the EAT's obligations to the lender are limited to tendering the Replacement Property to the Lender.

An alternative to *parking* the Replacement Property with the EAT is to park the Exchanger's Relinquished Property with the EAT. This type of reverse exchange commonly known as the *Reverse B*, starts with a simultaneous exchange. Here the Exchanger transfers title to the Relinquished Property to the EAT and simultaneously receives title to the Replacement Property from the Seller. Since the Relinquished Property has not yet been sold to its *ultimate* Buyer thus providing exchange proceeds for the acquisition of the Replacement Property, the Exchanger must loan the cash to the EAT to acquire to the Replacement Property from the Seller. This cash loan should be equivalent to the equity the Exchanger has in the Relinquished Property. The EAT then leases the Relinquished Property to the Exchanger under a triple net lease. When a Buyer is ready to close on the Relinquished Property, the property is sold and deeded from the EAT to the Buyer. The net cash proceeds from the sale go to the EAT and are used to repay the Exchanger for the original loan to the EAT. If the price paid by the ultimate Buyer ends up being greater than the amount the Exchanger estimated as the equity in the Relinquished Property and loaned to the EAT, then that difference may be subject to capital gains tax. In order to prevent payment of capital gain tax on excess proceeds from the sale of the Relinquished Property, the equity from the Relinquished Property must be reinvested in the Replacement Property prior to the Exchanger taking title. If the estimated proceeds from the Relinquished Property are greater than the funds available for the down payment on the Replacement Property, the Exchanger will need to have the EAT take title to the Replacement Property. That way the EAT can use the excess proceeds from the sale of the Relinquished Property to pay down the debt on the Replacement Property prior to transferring title to the Exchanger. Otherwise the Exchanger can acquire additional Replacement Property after the Relinquished Property is sold. The 45-day identification period and the 180-day exchange period begin when the Relinquished Property closes.

Exchangers should consider that when completing a reverse or an improvement exchange, there may be additional state, county, or local transfer taxes that could be assessed twice, such as when the Replacement Property is deeded from the Seller to the EAT to hold while the construction is completed and then later, when the improved Replacement Property is deeded to the Exchanger to complete the exchange. Fortunately, in a Private Letter Ruling, the IRS conceded that the use of language in the QEAA stating the EAT is the *agent* of the Exchanger for the purpose of avoiding transfer taxes would not invalidate the safe harbor. Unfortunately, not all states and municipalities recognize an agent/principal transfer tax exemption and, therefore, the Exchanger should be aware that double transfer taxes could be a factor. Also, the accounting, legal, Intermediary and EAT fees will almost certainly be significantly higher than on simultaneous or delayed exchanges, where the deeding is direct and the EAT is not required to hold title to property.

During the time the EAT is on title to the EAT will require hazard and commercial general liability insurance, along with an indemnity from the Exchanger from liability.

IMPROVEMENT OR BUILD-TO-SUIT §1031 EXCHANGES

Exchangers often wonder whether they can use the funds from their Relinquished Property to buy their Replacement Property and then build on or make improvements to that Replacement Property. While an Exchanger will not derive any tax benefit for improvements added <u>after</u> closing on the Replacement Property, *improvement exchanges* make it possible to incorporate the value of the improvements into the exchange. The key is to increase the value of the Replacement Property <u>before</u> the Exchanger receives it. In an exchange structured as an improvement exchange under the safe harbor protection of Rev. Proc. 2000-37, the entity used to facilitate an improvement exchange is referred to as the *Exchange Accommodation Titleholder* (*EAT*). The agreement between the Exchanger, and the EAT is the *Qualified Exchange Accommodation Agreement (QEAA).* The QEAA must be signed within 5 business days after title is transferred to EAT.

The improvement exchange begins with the Exchanger's sale of the Relinquished Property through the Intermediary. The Intermediary and the EAT enter into an agreement that allows the EAT to use the exchange proceeds to acquire the Replacement Property in its name and to complete the Exchanger's desired improvements. The Exchanger arranges for the construction to be completed on the Replacement Property and acts as project manager overseeing all aspects of the construction on behalf of the EAT. The Exchanger approves and forwards construction invoices to the EAT for payment. Construction contracts should be in the name of the EAT, and if construction contracts were executed prior to the EAT acquiring title, the construction contracts should be transferred to the EAT by an assignment.

During the time the EAT is on title to the property and while the contractor completes the construction, the EAT will require hazard and commercial general liability insurance, along with an indemnity from the Exchanger from liability.

The usual time requirements apply; the Exchanger must identify the Replacement Property (and the intended improvements) within 45 days of closing on the Relinquished Property. For new construction on bare land, the identification must include a specific description of the land and include a drawing or detailed summary of the new construction to be done on the land. Where the Replacement Property is an existing structure in need of remodeling, an address of the building and a summary of the remodeling project should be adequate. The improved Replacement Property must be transferred to Exchanger within 180 days of the closing on the Relinquished Property. While all improvements need not be completed within the 180 days, the goal is to complete and pay for enough improvements so that the value of the improved Replacement Property is of equal value of that of the Relinquished Property. There is no requirement in improvement exchanges, reverse or otherwise, that construction be *completed* within the 180-day exchange period; improvements do not need to be suitable for occupancy or use. An Exchanger is credited with receiving Replacement Property valued as of the date it is transferred to the Exchanger as long as the improvements in place on that date are considered real property in the same state where the Replacement Property is located. The value of the Replacement Property is comprised of the amount paid out for the purchase of the land plus the amount paid out for completed construction.

Prepaid construction contracts for delivered but not constructed materials do not qualify.

Improvement exchanges are less complicated when, once exchange proceeds from the sale of the Relinquished Property are exhausted, the Exchanger can pay cash for improvements that are to be made to the Replacement Property. If a construction loan from an institutional lender is required, the Exchanger should seek lender approval early on. Even if an Exchanger is working with a sophisticated third-party lender, the Exchanger must be very firm in establishing with the lender that the EAT (not the Exchanger) will be the temporary titleholder of the property. Many, if not most lenders are not familiar with improvement exchanges, and many standard types of loans will not be available when pursuing an improvement exchange. Loan costs may even be increased to cover the lender's document preparation and legal fees. Lenders are usually relieved to learn that the lenders' security interest is protected because the Exchanger signs the note guaranteeing the loan and the EAT pledges the Replacement Property as security, on a non-recourse basis. In other words, the EAT pledges the property by signing the mortgage, and the Exchanger signs the note. If the Exchanger should default, the EAT's obligations to the lender are limited to tendering the Replacement Property to the Lender. On the earlier of the end of the 180 day exchange period, or upon the completion of the construction on the Replacement Property, the EAT will transfer title to the Replacement Property to the Exchanger to complete the exchange. If a third party lender is involved the Exchanger will assume the construction loan upon conclusion of the exchange. Any construction to be included in the exchange must be built and paid for prior to the EAT's transfer of the Replacement Property to the Exchanger.

Variations to improvement exchanges include combining a reverse exchange with an improvement exchange. In a reverse improvement exchange the Relinquished Property does not close until sometime after the EAT has acquired the Replacement Property and improvements are either underway or are completed. Reverse improvement exchanges must be completed within 180 days of the date the EAT takes title to the Replacement Property.

Exchanges into improvements on property an Exchanger already owns are a developing area in the world of §1031 exchanges. They arise when an Exchanger wishes to use the proceeds from a Relinquished Property to build on property the Exchanger already owns. Once the Relinquished Property sells, the EAT enters into a ground lease on the Replacement Property with Exchanger. The lease must be for at least 30 and one-half years. EAT pays for improvements from the exchange proceeds, or Exchanger can arrange for a construction loan guaranteed by Exchanger. Exchanger manages the construction. Upon the completion of the construction or at the end of the 180 days the Intermediary transfers the leasehold interest and newly constructed improvements from EAT to Exchanger. The Exchanger now owns the fee simple in the land along with the lease on the land and improvements. The lease should stay in place for at least 4 years. After that most Exchangers will elect to extinguish the lease and merge ownership of the property to a single interest. All Exchangers contemplating such an exchange should consider that in 2004, Rev. Proc. 2000-37 was modified by Revenue Procedure 2004-51 to provide that the *safe harbor or Rev. Proc. 00-37 does not apply to Replacement Property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder.*

Exchangers should consider that when completing a reverse or an improvement exchange there may be additional state, county, or local transfer taxes that could be assessed twice, such as when the Replacement Property is deeded from the Seller to the EAT to hold while the construction is completed and then later, when the improved Replacement Property is deeded to the Exchanger to complete the exchange. Fortunately, in a Private Letter Ruling, the IRS conceded that the use of language in the QEAA stating the EAT is the *agent* of the Exchanger for the purpose of avoiding transfer taxes would not invalidate the safe harbor. Unfortunately, not all states and municipalities recognize an agent/principal transfer tax exemption and, therefore, the Exchanger should be aware that double transfer taxes could be a factor. Also, the accounting, legal and Intermediary and EAT fees will almost certainly be significantly higher than on simultaneous or delayed exchanges where the deeding is direct and the EAT is not required to hold title to property.

INSTALLMENT SALES AND INSTALLMENT SALE TREATMENT

If an Exchanger exchanges out of a Relinquished Property and at closing takes back a mortgage or land contract (*note*) so that the net cash goes to the Intermediary and the balance of the purchase price is to be paid by the Buyer to the Exchanger over time, the value of the note is taxable because it is not like-kind property. The Exchanger can elect to report the taxes on the note on an installment basis, as the payments come in, but only the cash that the Buyer provides at closing is available to exchange into Replacement Property. Generally in this situation, all of the basis out of the Relinquished Property will be allocated to the Replacement Property, and the note will have no basis, which means that all of the Buyer's payments will be fully taxable to the Exchanger. (IRC §453) As such, the Exchanger will only be able to defer capital gains tax on the cash the Buyer provides at close. Sometimes that is perfectly acceptable to an Exchanger. However, there are other options an Exchanger might wish to consider. Each of the options requires that the Intermediary receive the note at the close on the Relinquished Property. The note must be made payable to the Intermediary and thus becomes part of the 1031 Exchange Proceeds held by the Intermediary for the benefit of the Exchanger. The note can subsequently be used as follows:

1. If the note is short-term and will mature within the 180-day exchange period, the Intermediary will receive the payoff and then use it to purchase the Exchanger's Replacement Property.

2. The Exchanger may offer the Seller of the intended Replacement Property the note as all, or part, of the consideration due to the Seller for the purchase of the Replacement Property. At the closing on the Replacement Property, the Intermediary will endorse the note over to the Seller of the Replacement Property. The Seller of the Replacement Property, unfortunately, will not be able to take installment sale treatment.

3. The Exchanger may arrange for a third-party to buy the note for cash from the Intermediary, who will then use the cash to purchase the Exchanger's Replacement Property.

4. The Exchanger can buy the note for cash from the Intermediary. The Exchanger then holds the note and receives the payments. In this instance the Exchanger *wears two hats.* Under one hat the Exchanger is a lender who lends funds to the Buyer of the Relinquished Property to purchase the Relinquished Property. Under the other hat the Exchanger is simply the Exchanger selling the Relinquished Property through the Intermediary, who in turn will take the net proceeds (the 1031 Exchange Proceeds) and uses the funds to purchase the Exchanger's Replacement Property. The Exchanger can take installment treatment on the note commencing on the date that the Exchanger receives the note from the Intermediary.

If it should turn out that none of the options discussed above will work, or if the Exchanger cannot, or chooses not, to close on a Replacement Property, then the Intermediary will assign the note over to the Exchanger. The Exchanger can take installment treatment on the note commencing on the date that the Exchanger receives the note from the Intermediary.

If an Exchanger sells a Relinquished Property through a Intermediary in the latter part of one year, and despite having the bona fide intent to complete the exchange, elects either not to purchase Replacement Property or not to spend all of the 1031 Exchange Proceeds on Replacement Property and thus receives the funds in the following year, the gain due will be reported for the tax year in which the Exchanger actually receives the cash. (See more under *Reporting Option for Failed or Cancelled 1031 Exchanges.*)

PLANNING A §1031 EXCHANGE

When a Relinquished Property is purchased by a Buyer, the IRS considers the funds from the Buyer as *realized*. If the Exchanger rolls all of the net proceeds out of the sale into a Replacement Property and replaces the debt on the Relinquished Property with an equivalent amount of debt (or cash out of the Exchanger's pocket) on the Replacement Property, then the IRS will not *recognize* the funds from the Buyer, and no capital gains tax will be due. If, however, the Exchanger receives money or other non-qualifying property, commonly known as *boot*, the boot amount is subject to capital gains tax. Boot is anything that an Exchanger receives pursuant to the transfer out of a Relinquished Property that is other than like-kind Replacement Property. *Cash boot* refers to cash, cash equivalents (*e.g*., bank cd's or treasury notes), or a promissory note executed by the Buyer of the Relinquished Property in favor of the Exchanger (Seller financing). *Mortgage boot* consists of any liabilities the Exchanger has on the Relinquished Property that the Buyer assumes or takes the Relinquished Property subject to, or debt on the Relinquished Property that is not replaced with an equivalent amount of debt on the Replacement Property. In the eyes of the IRS, the Exchanger is receiving *debt relief*, and debt relief is taxable. Anytime an Exchanger receives cash or the benefit of cash during an exchange, for example a home equity loan on the Exchanger's personal residence is paid off with the proceeds from the Relinquished Property, or the Exchanger receives cash at the close on the Replacement Property because a larger mortgage is placed on the Replacement Property than is necessary to close, the cash is boot, and will be subject to capital gains tax. It does not matter that, as in the first example, the Exchanger had used the home equity line to make repairs or improvements to the Relinquished Property. Nor does it matter that the Exchanger intends to use the excess loan proceeds in the second example to make improvements or repairs to the Replacement Property.

Proper groundwork is essential to a successful exchange. You should carefully review the following points:

- Both the Relinquished Property, and the Replacement Property must be investment or income-producing properties. (See *Like-Kind Property*)

- Title to the Replacement Property must be held in the same manner as title is held in the Relinquished Property. (For example, in a trust, in a partnership, in an LLC, in an individual, in husband and wife etc.) Now is the time to confirm that your lender for the Replacement Property understands that you need to take title to the Replacement Property exactly the same way you deeded out of the Relinquished Property.

- Do you wish to use proceeds from the Relinquished Property to make improvements to the Replacement Property? If so, improvements must be made <u>before</u> you take title to the Replacement Property. (See *Improvement or Build-to-Suit Exchanges*)

- Are you planning on using part of the proceeds in cash or for personal debts? If so, those amounts may be subject to capital gains tax.

- Are you intending to sell to or buy property from a related party? If so, see *Exchanges Between Related Parties; Special Provisions.*

- Will you be financing your Buyer on the sale of your Relinquished Property? If so, please see *Installment Sales and Installment Sale Treatment.*

Equity Exchange LLC can be very helpful to you in the crucial exchange planning stage. We can explain the various types of exchanges, and the benefits and downsides to each type. We have seen endless variations to thousands of exchanges, and we are happy to draw upon that knowledge. Of course, Exchangers should always seek tax and/or legal advice prior to starting their exchange.

COMPLETE TAX DEFERMENT IN A NUTSHELL

In order to defer all of the capital gains tax on the disposition of a Relinquished Property, an exchange transaction must satisfy all of the following:

1. The Exchanger must acquire Replacement Property that is equal to or greater than the value of the Exchanger's Relinquished Property; and,

2. The Exchanger must reinvest all of the net equity from the Relinquished Property in the Replacement Property; and,

3. The Exchanger must assume debt on the Exchanger's Replacement Property that is equal to or greater than the debt on the Exchanger's Relinquished Property. If the debt on the Exchanger's Replacement Property is less than the debt on the Exchanger's Relinquished Property, then the Exchanger may contribute additional cash to balance the exchange; and,

4. The Exchanger must not obtain a mortgage that is greater than the exact amount required to close on the Replacement Property.

Partial tax deferment does not by any means mean that a 1031 exchange will fail. Any excess cash or non-like-kind property that an Exchanger receives; any net reduction in debt (mortgage relief) on the Replacement Property or any net reduction in the purchase price of the Replacement Property vs. the sale price of the Relinquished Property are considered *boot* and may be subject to capital gains tax.

TAX TIME – DOCUMENTATION OF §1031 EXCHANGES

A like-kind exchange is reported to the IRS by the Exchanger as part of the Exchanger's regular tax return for the tax year in which the Exchanger transfers out of a Relinquished Property. The deadline for completing an exchange is the earlier of either 180 days from the date on which the Exchanger transfers out of the Relinquished Property or the due date, including extensions filed by the Exchanger, for the Exchanger's tax return for the year of the transfer of the Relinquished Property. Therefore, if an Exchanger transfers out of Relinquished Property after October 18th of a given year, then the Exchanger will actually have less than 180 days in which to complete the exchange, unless the Exchanger files for an extension. An extension will give the Exchanger the full 180-day Exchange Period, but it will not extend the Exchange Period beyond 180 days.

Generally, exchanges of non-depreciable investment property are reported on IRS Form 1041 Schedule D (*Capital Gains and Losses*) and IRS Form 4797, *Sale of Business Property Capital Gains and Losses*, for trade or business property. In addition, IRS Form 8824, *Like-Kind Exchanges* is a supplemental form that is usually included with IRS Form 1120 Schedule D or IRS Form 4797. (For exchanges involving related persons, IRS Form 8824 must be filed for two additional years following the year of the exchange.)

IRS Form 8824 functions as a supporting statement for like-kind exchanges reported on other forms as discussed above. A separate 8824 Form is used for each separate exchange. Among other things, Form 8824 calls for the following information:

- Descriptions of both the Relinquished and the Replacement Properties.

- The date the Exchanger originally acquired the Relinquished Property.

- The date the Exchanger transferred out of title to the Relinquished Property.

- The date the Exchanger identified the Replacement Property.

- The date the Exchanger acquired title to the Replacement Property.

- Related party (if applicable) information.

- The fair market value and the adjusted basis of the Relinquished Property.
- Any cash received (subject to tax).
- The fair market value of the Replacement Property.

A substantial amount of the information required for Form 8824 can be found right on the closing statements from the closings of the Relinquished and the Replacement Properties. Always save your closing statements for tax time.

TAX TIME - CLOSING COSTS AND §1031 EXCHANGES

There is little actual authority in the Internal Revenue Code or Treasury Regulations as to how to treat the closing cost items commonly seen on closing or settlement statements. The following is based on current existing authority:

Payment of *non-recurring* costs of sale or purchase from the exchange proceeds should not create taxable boot. For example:

Real estate commissions
Recording fees
Direct legal fees
Title insurance premiums
Intermediary fees
Closing agent fees
Documentary transfer taxes

Other costs may create taxable boot, because they are viewed by the IRS as *expenditures or benefits for purposes other than for acquiring the Replacement Property*. For example loan fees, points and prorated mortgage insurance are considered *costs to obtain a new loan* and prorated property taxes, insurance payments and rents are usually considered *ongoing operating expenses* and not part of the exchange. (Note that payment of these items will not interfere with the safe harbor, but could result in taxable boot.)

Still other costs, such as appraisal fees, inspections, surveys and environmental studies are also typically considered taxable boot if they are used to obtain a new loan for the Replacement Property. However, if a Purchase and Sale agreement for a Replacement Property is specifically made contingent upon the satisfactory completion of these items, it may be possible to argue that these expenditures were really for *the purchase of the property* and not to obtain a new loan.

TAX TIME – DEPRECIATION RECAPTURE

Depreciation is extremely important in calculating the adjusted basis of property. The purpose of depreciation is to allow taxpayers to deduct for wear and tear of business use property. When depreciated property is sold, depreciation previously taken by a taxpayer is *recaptured*. (All business use property is subject to depreciation recapture, however, provisions are different depending on whether the asset being sold or exchanged is real or personal property.)

Improved commercial real estate is real property subject to a depreciation deduction on the taxpayer's return (*IRC §1250 property*). The recapture provisions applicable to IRC §1250 property are complex, but distinguish between property placed on service by the taxpayer before 12-31-86 (*pre 87 property*) and property placed in service after the date (*post 86 property*). Pre 87 property is IRC §1250 property that was probably depreciated using an accelerated cost recovery method of depreciation. For IRC §1250 property, any depreciation taken under ACRS in excess of the depreciation that would be allowed under a straight-line cost recovery method is taxed as ordinary income, and any gain attributable to un-recaptured deprecation under straight-line depreciation (*un-recaptured §1250 gain*) is taxed at a rate of 25%.

The *Tax Reform Act of 1986* eliminated accelerated depreciation and required that all real property use straight-line depreciation under the modified accelerated cost recovery system (MACRS). Accordingly, most 1250 property is Post 86 property, thus, when it is sold or exchanged it is not subject to excess depreciation recapture, which is at ordinary income tax rates. As with Pre 87 IRC §1250 property, un-recaptured IRC §1250 property gain on Post 86 property is taxed at 25% federal tax rate, and any gain in excess of the deprecation taken is at the current 15% federal capital gains tax rate.

EXAMPLE: Taxpayer sells (or exchanges) a Post 86 property with an adjusted basis of $200,000 for $1,200,000. The Taxpayer has taken $400,000 in depreciation. Upon a sale the Taxpayer will recognize a total gain of $1,000,000 ($1,200,000 - $200,000). $400,000 will be un-recaptured IRC §1250 property gain taxed at 25% and $600,000 will be considered capital gain taxed at 15%. (If, however, the Taxpayer exchanges the building into like-kind real estate with a purchase price of $1,200,000, the Exchanger will defer all of the gain arising form the disposition of the Relinquished Property.)

EXAMPLE: Taxpayer sells (or exchanges) a Pre 87 property and $200,000 of the depreciation was subject to recapture as *excess depreciation*. The Taxpayer will recognize $200,000 of depreciation recapture taxed as ordinary income at the Taxpayer's marginal tax rate. The remaining $200,000 of depreciation will be un-recaptured IRC §1250 property gain taxed at 25% and the remaining $600,000 of gain will be considered capital gain taxed at 15%. (Again, however, if the Taxpayer exchanges the building into like-kind real estate with a purchase price of $1,200,000 the Exchanger will defer all of the gain arising form the disposition of the Relinquished Property.)

TAX TIME – REPORTING OPTION FOR FAILED OR CANCELLED 1031 EXCHANGES

A failed or cancelled exchange results in full recognition of gain from the disposition of the Relinquished Property as if the property were sold. However, under Reg. §1.1031 (k)-l (j) and pursuant to the general rules of installment sales, taxpayers may postpone the recognition of gain in a failed or cancelled exchange to the extent of the exchange funds received in the year after the transfer of the Relinquished Property if the taxpayer had a bona fide intent to enter into an exchange. An issue arises, however, if the amount of gain to be recognized exceeds the amount of the exchange funds, usually when the taxpayer's Relinquished Property was subject to a mortgage in excess of basis. In that situation it is unclear whether the gain from the debt relief is postponed to the subsequent year or recognized in the year of disposition of the Relinquished Property. If the exchange had been completed as intended, the debt relief would be entirely avoided by a taxpayer who had acquired new debt on the Replacement Property to offset the debt that was relieved on the Relinquished Property.

SAFE HARBORS, RECEIPT OF FUNDS AND §1031 EXCHANGES

In 1991 the IRS published Treasury Regulations for tax deferred exchanges, establishing four safe harbors allowing taxpayers to avoid actual or constructive receipt of money or other property thus disqualifying a transaction as a 1031 exchange. The four safe harbors are:

1. Qualified Intermediaries
2. Interest and growth factors
3. Qualified escrow accounts and qualified trusts
4. Security or guaranty arrangements

The safe harbors may be used alone, or in any combination, as long as the terms and conditions of each sale transaction complies. The first three safe harbors require an *exchange agreement* between the Exchanger and the Intermediary to expressly limit the Exchanger's right to *receive, pledge, borrow or otherwise obtain the benefits of money or other property* before the end of the 180-day exchange period, except as permitted by the Treasury Regulations. The safe harbors are not satisfied if these restrictions are not placed upon the Exchanger, even if the Exchanger never actually receives the exchange proceeds. *Cash out* provisions in the Regulations allow the exchange agreement to remove these restrictions and grant the Exchanger access to the exchange proceeds before the end of the exchange period, but only under the following circumstances.

1. If the Exchanger has not identified Replacement Property by the end of the 45-day period, then the exchange can be terminated and the Exchanger has the right to the exchange proceeds at any time thereafter.
2. If, after the end of the identification period, the Exchanger has identified Replacement Property and receives all of the identified Replacement Property to which the Exchanger is entitled under the exchange agreement, then the Exchanger has the right to receive any remaining exchange proceeds even if it is prior to the end of the 180-day exchange period.
3. If, after the end of the identification period a material and substantial contingency occurs that: relates to the deferred exchange, is provided for in writing; and is beyond the control of the Exchanger and of any *disqualified person* other than the person obligated to transfer the Replacement Property to the Exchanger, then the Exchanger has the right to the proceeds.

CLOSING OUT A §1031 EXCHANGE

Pursuant to the 1031 Exchange Agreement, which is drafted to comply with IRC §1031, (*see Safe Harbors, Receipt of Funds and §1031 Exchanges above*) an Exchanger, other then for a closing on Replacement Property, may have access to excess or unused exchange funds once one of the following conditions has been met:

1. The Exchanger has closed on all of the identified Replacement Property and the 45-day identification period has expired; or,

2. The Exchanger has not identified any Replacement Property and the 45-day identification period has expired; or,

3. The Exchanger's 180-day exchange period has expired; or,

4. A material and substantial contingency has occurred after the end of the 45-day identification period that:
    a. Relates to the exchange; and,
    b. Is provided for in writing; and,
    c. Is beyond the control of the Exchanger or a disqualified person.

COMMON FICTIONS REGARDING §1031 EXCHANGES

- *Fiction:* My property really has not appreciated enough to incur any significant gain.
  Fact: Depreciation on investment property reduces your basis and can lead to capital gains tax on the difference between you adjusted basis and your sales price.

- *Fiction:* I must have a property available to swap.
  Fact: You can sell to any unrelated, willing Buyer and buy from any unrelated, willing Seller as long as you use the services of an Intermediary.

- *Fiction:* The property I am exchanging into has to be exactly like the property I am selling.
  Fact: Your sale and purchase properties must simply be investment or income producing property and need not be the same exact type of property.

- *Fiction:* The Intermediary will take title to my property at some point in the exchange.
  Fact: Direct deeding is used for most exchanges; the deed goes directly from you to your Buyer and from your Seller directly to you.

- *Fiction:* I can have my attorney or brother act as my Intermediary.
  Fact T: Your relative, tax or legal advisor, employee, and real estate agent are all related parties and cannot function as your Intermediary.

- *Fiction:* I will not be able to pay off my old mortgage or get a new mortgage if I do an exchange.
  Fact: Your mortgage is paid off at closing and you can arrange for a new mortgage just like you normally would in a regular sale and purchase.

- *Fiction:* The sale price of my Relinquished Property is $100,000 and out of that my gain is $30,000. Therefore, I need to spend $30,000 on Replacement Property.
  Fact: In order to be completely deferred you need to spend $100,000 (less your Relinquished Property closing costs) on your Replacement Property.

- *Fiction:* The sale price of my Relinquished Property is $100,000. Therefore, I need to spend $100,001 on my Replacement Property.
  Fact: In order to be completely deferred you need to spend $100,000 (less your Relinquished Property closing costs) on your Replacement Property. If you buy Replacement Property for less, the difference will be subject to capital gains tax, but it does not mean that your exchange will fail.

CAPITAL GAINS TAX – §1031 EXCHANGE EXAMPLE OF COMPLETE DEFERMENT

Sophie, a calendar year taxpayer, bought an office building for $100,000 in 1989. She depreciated the building by $15,000 over the years, and has added $10,000 worth of permanent improvements:

Original Purchase Price	$100,000
Depreciation	- 15,000
Improvements	+10,000
Adjusted Basis	95,000

Original Purchase Price – Depreciation + Capital Improvements = Adjusted Basis

Sophie agrees to sell the office building for $300,000; her closing costs will be $5,000.

Sales Price	$300,000
Closing Costs	- 5,000
Adjusted Basis	- 95,000
Sophie's Capital Gain	$200,000

Sales Price – Closing Costs - Adjusted Basis = Capital Gain

Sophie closes on the sale of her office building as a 1031 exchange through an Intermediary. After her mortgage of $65,000, and her closing costs of $5,000 are satisfied, 1031 Exchange Proceeds in the amount of $230,000 are forwarded to Sophie's Intermediary:

Sales Price	$300,000

Settlement Costs	- 5,000
Mortgage Balance	- 65,000
Net Exchange Proceeds	$230,000

She wants to be completely deferred on capital gains taxes, so Sophie uses two different formulas to calculate how much she needs to reinvest in order to be completely deferred. In order to be completely deferred, Sophie must spend at least $295,000 on her Replacement Property:

Sales Price	$300,000	(Net Equity) Exchange Proceeds	$230,000
Closing Costs	- 5,000	(Debt Relief) Mortgage Balance	+ 65,000
Required Reinvestment	$295,000	Required Reinvestment	$295,000

Sales Price – Closing Costs = Reinvestment or Net Equity + Debt Relief = Reinvestment

If Sophie decides not buy any Replacement Property and to pay the capital gains tax, it will be approximately $38,900:

$15,000 gain resulting from recaptured depreciation would be taxed at 25% ($3,750), plus $185,000 gain resulting from appreciation, in Sophie's bracket, would be taxed at 15%, and her state tax would be an additional, approximately, 4% (27,750 + 7,400 = 35,150)

PLEASE SEE OTHER IMPORTANT EXAMPLES UNDER: *Tax Time – Depreciation Recapture*

CONTRACT CLAUSES REFLECTING TAXPAYER'S INTENT TO COMPLETE TRANSACTION AS AN EXCHANGE

When entering into the Purchase and Sale Agreements for both the sale of Exchanger's Relinquished Property and the purchase of Exchanger's Replacement Property, the Exchanger must include an *Exchange Cooperation Clause*, either within the Purchase and Sale Agreements, in, or as an addendum, to the Purchase and Sale Agreements. Sample Exchange Cooperation Clauses are as follows:

1. ***WHERE THE EXCHANGER IS SELLING THE RELINQUISHED PROPERTY***: *Seller reserves the right to convert this transaction to a tax deferred exchange pursuant to IRC Section 1031, and agrees to hold Buyer harmless from any and all claims, liabilities or delays in time resulting from such an exchange. Buyer acknowledges Seller's intent and agrees to cooperate with Seller and to execute all documents reasonably requested by Seller, including an assignment of this agreement, at no additional cost to Buyer.*

2. ***WHERE THE EXCHANGER IS BUYING THE REPLACEMENT PROPERTY***: *Buyer reserves the right to convert this transaction to a tax deferred exchange pursuant to IRC Section 1031, and agrees to hold Seller harmless from any and all claims, liabilities or delays in time resulting from such an exchange. Seller acknowledges Buyer's intent and agrees to cooperate with Buyer and to execute all documents reasonably requested by Buyer, including an assignment of this agreement, at no additional cost to Seller.*

COMBINING THE BENEFITS OF IRC §121 AND IRC §1031

At sale time, homeowners, particularly those who own farms or who own adjacent vacant land, can find themselves faced with capital gains that exceed their $250,000/$500,000 principal residence exclusion. Oftentimes these individuals can take advantage of two separate tax code sections in order to better minimize their capital gain tax liabilities i.e. the tax **exclusion** under IRC §121 **and** the tax **deferral** under IRC §1031.

BENEFITS OF IRC §121: IRC §121, allows homeowners to exclude the capital gains tax on the sale of their principal residence up to $250,000 for individual taxpayers and $500,000 for taxpayer couples filing jointly. The property must have been the principal residence for 24 months out of the last 60 months. Taxpayers can even exclude gain on the sale of vacant land adjacent to the principal residence if it was used as part of the principal residence and the taxpayer sells the principal residence within 2 years before or after the date of the sale of the vacant land.

BENEFITS OF IRC §1031: IRC §1031 allows the owners of *property held for productive use in a trade or business* or *held for investment* to exchange it for other *like-kind property* and defer capital gain taxes. The definition of like-kind property is very broad. For example, a property owner can exchange out of a farm and acquire a single family rental, a duplex or a triplex, a commercial property another farm or ranch property or a vacation home primarily *held for investment.*

EXAMPLE 1: A developer offered Mary, who is single, $650,000 to purchase her home and her adjacent, vacant ten acres. Because Mary had originally purchased it all for $66,000 (i.e. her *cost basis*) even after subtracting her $250,000 exclusion under IRC §121, Mary would still have owed the IRS as much as $50,000 in federal capital gains tax ($650,000 - $66,000 = $584,000 - $250,000 = $334,000 x 15% = $50,100). However, before she closed on her sale to the Developer, Mary set up a 1031 Exchange with **Equity Exchange LLC**. She told Equity Exchange LLC that she and her accountant had allocated 40% of the $650,000 sale price to her home ($260,000) and 60% to the vacant 10 acres, as an investment ($390,000). At close, Mary received a check for $260,000 and $390,000 went to **Equity Exchange LLC** where it was placed in a Qualified Escrow Account. Through **Equity Exchange LLC**, Mary exchanged into an income-producing rental property for $400,000. Later, in a separate transaction, Mary bought a new home for herself for $205,000. Mary was able to pocket $45,000 and did not have to pay any capital gains taxes. (Even if Mary had decided not to purchase a new home and had only exchanged into the rental property, she would not have had to pay any capital gains tax on the $260,000 she received in cash, $10,000 of which she used to exchange into her rental property.)

EXAMPLE 2: A casino offered Edward and Amelia, who are married, $850,000 for their modest farm home, which included a 100-acre dairy farm. Since the property had been in Edward's family for generations, they had virtually no basis. Edward and Amelia's accountant did not feel they could possibly allocate any more than $300,000 to the home, with the balance being allocated to the dairy farm. Through an exchange set up by **Equity Exchange LLC**, Edward and Amelia sold to the casino. At close, Edward and Amelia received a check for $300,000 and $550,000 went to **Equity Exchange LLC** where it was placed in a Qualified Escrow Account. Edward and Amelia entered into a purchase agreement on a new farm, which included a farmhouse, dairy barns and 240 acres for $760,000. At closing, **Equity Exchange LLC** provided the $550,000 it was holding, and Edward and Amelia provided $210,000 balance required to close. Edward and Amelia were able to account for everything on their tax return by using their (up to) $500,000 IRC §121 primary residence exemption on the $300,000 they received in cash, $210,000 of which they later used for their new home. The remaining $550,000 was allocated to the new dairy barn and 140 acres.

Your accountant or real estate attorney can help you determine the value of your residence portion (IRC §121) of the transaction versus the portion used for investment or income-production purposes (IRC §1031).

SETTING UP YOUR §1031 EXCHANGE WITH EQUITY EXCHANGE LLC

Equity Exchange LLC will be happy to set up your §1031 exchange and forward the documentation to your attorney's office, title insurance agency, bank, or real estate company, even on short notice. Just be sure to call us **before** you close on any property, and be prepared to provide us with detailed information on your upcoming closing(s). (See *Exchange Information Form-AppendixA-4 through A-5)*

§1031 EXCHANGE TERMINOLOGY

Accommodator — *Qualified Intermediary* or *Intermediary*, *Facilitator* or *Strawman*.
The entity that facilitates an exchange for an individual or entity.

Boot — The cash amount or the fair market value of non-qualifying (not like-kind property) received by an Exchanger. Examples: cash, notes, land contracts purchase money mortgages, services, stocks, an interest in a partnership or a membership interest in a single member LLC which does not own property or membership interest in a multiple member LLC. Boot is subject to capital gains tax.

Constructive Receipt — Control over §1031 Exchange Proceeds by the Exchanger, without actual physical possession. (Example: Exchanger's agent holds the funds.)

Deferred Exchange — Transfer is of Relinquished Property for Replacement Property.

Delayed Exchange — Same as Deferred Exchange except there is a time span between the sale and purchase transfers (up to 180 days are permissible, pursuant to IRC §1031).

Exchange Identification — Rules pursuant to IRC §1031, which spell out the format and the time frame for specifying Exchanger's potential Replacement Property in a delayed exchange.

Exchange Period — The 180 day period, which, in a delayed exchange, begins at the closing on the sale of Exchanger's Relinquished Property, and in which time the Exchanger must take title to Replacement Property. In a reverse exchange the 180-day period begins at the closing on the initial acquisition of Exchanger's Replacement Property. Exchanger must transfer out of title to the Relinquished Property and take title to the Replacement Property within the 180 day Exchange Period.

Exchanger — The owner of property endeavoring to defer capital gains tax pursuant to IRC §1031.

Identification Period — The 45-day period, which, in a delayed exchange, begins at the closing on the sale of Exchanger's Relinquished Property, and in which time the Exchanger must identify to Intermediary (in writing) Exchanger's potential Replacement Property. In a reverse exchange the 45-day period begins at the closing on the initial acquisition of Exchanger's Replacement Property. Exchanger must identify to Intermediary (in writing) Exchanger's potential Relinquished Property within the 45-day period.

Improvement Exchange — Allows Exchangers to build on or improve a Replacement property (thereby increasing the value) before the Exchanger receives the Replacement Property.

Like-kind — Property that qualifies for non-recognition pursuant to IRC §1031. Refers to the nature or character of the property, not its grade or quality. Most real property qualifies as long as the Exchanger's intent is to hold the property as in investment or income producing property. Like-kind in personal property is <u>not</u> exchangeable under the pursuant to IRC §1031.

Qualified — (*Intermediary*) Independent third party principal to a real estate transaction,

Intermediary	whose participation converts an unrelated sale and purchase of property into an exchange, thereby qualifying the transaction for capital gains tax deferment pursuant to IRC §1031.
Qualifying Property	More commonly known as Like-Kind Property; property that meets the criteria established in IRC §1031(a). Like-kind does not refer to the nature, character, or type of property. Rather, like-kind addresses the intended use of the property and is defined as property acquired and held for business or investment purposes.
Relinquished Property	Exchanger's old, sale, saleside or down-leg property. The property sold in the first phase of a deferred or delayed exchange transaction and a later phase in a reverse exchange.
Replacement Property	Exchanger's new, acquisition, buy, buyside, target or up-leg property. The property purchased in the second phase of a deferred or delayed exchange transaction and the first phase of a reverse exchange transaction.
Reverse Exchange	Exchange transaction in which Exchanger's Replacement Property is acquired from its Seller prior to the closing on the sale of Exchanger's Relinquished Property.
Safe Harbors	IRC §1031 prescribes four separate methods for safeguarding delayed exchanges, proper use of any one will create a qualifying exchange. The simplest way enjoy the confidence of a safe harbor is to have an Intermediary facilitate the exchange. (NOTE: 1991 IRS Regulations provide that the onlysafe harbor available for a simultaneous exchange is through the use of an Intermediary's services.)
Simultaneous Exchange	Both exchange phases, the sale and purchase, occur on the same or virtually the same day. May also be referred to as a deferred exchange.

EQUITY EXCHANGE LLC'S 1031 EXCHANGE SERVICE FEE SCHEDULE

Simultaneous 1031 Exchanges:

Fee: $750
Covers the entire exchange of one Relinquished Property for one Replacement Property. The fee for each additional Replacement Property closing is $350.

Delayed 1031 Exchanges:

Fee: $750
Covers the entire exchange of one Relinquished Property for one Replacement Property. Any interest earned on the 1031 Exchange Proceeds during the exchange period is retained by Equity Exchange LLC. The fee for each additional Replacement Property closing is $350.

Reverse and Improvement 1031 Exchanges:

Reverse Exchange: $4000 / Improvement Exchange: $4500: Covers the entire exchange of one Relinquished Property for one Replacement Property. As part of the 1031 Exchange Service Fee, Equity Exchange LLC retains any interest earned on the 1031 Exchange Proceeds and any construction loan proceeds held in escrow during the exchange period. The fee for each additional Relinquished or Replacement Property is $350.

<u>Exchanger's Bank of Choice Option</u>:
We normally use a national bank with whom we have a long-standing working relationship, however any Exchanger may elect that Equity Exchange LLC hold the 1031 Exchange Proceeds held in Exchanger's bank of choice however, Equity Exchange LLC will charge a $175 additional fee for this option.

1031 closing documentation needed with less than 2 business days notice, will incur an additional $100 Service Fee.

Intermediary will retain any interest earned on the 1031 Exchange Proceeds while held in the qualified escrow.

EQUITY EXCHANGE LLC
4866 KITTERY SY NW
COMSTOCK PARK, MI 49321
616-942-6017 ❖ PHONE & FACSIMILE
exchanges@equityexchangellc.com

August 14, 2019

William and Ellen Exchanger
408 Washington AVE
Midstate, MI 49999

Re: Relinquished Property: Exchanger's one-half interest in 100 Park Avenue, Harbor Springs, Michigan

Dear Mr. and Mrs. Exchanger:

Congratulations on completing the first phase of your 1031 exchange. We are holding $188,750.86 in 1031 Exchange Proceeds at Fifth Third Bank. When it is time to close on your Replacement Property, we will wire the $188,750.86 (less the $30.00 wire/transfer fee) to the closing.

Your Relinquished Property closed on August 13, 2019 therefore you must identify your Replacement Properties within 45 days of that date, Friday, September 26, 2019. You may use the enclosed form to mail, email or by fax us your ID properties. Your IDs must be signed, dated and either reflect a postmark or fax receipt at Equity Exchange LLC by midnight of your 45th day. (Our fax is always on.) Your Replacement Property must close by midnight, Sunday, February 8, 2020. We need approximately 10 days notice of your closing(s) so we can provide your closer with both the 1031 Exchange Documentation and your 1031 Exchange Proceeds. We need the address (or legal description) of the property you are acquiring, the title company preparing the closing, the closing date, and, if you plan to acquire multiple Replacement Properties, exactly how much you want us to send for each closing. Please call anytime with any questions.

Sincerely,

Monica Downer
Member

To: Equity Exchange LLC, a Michigan limited liability company (*Qualified Intermediary*4866 Kittery ST NW, Comstock Park, Michigan 49321; Facsimile Number: 616-942-6017

From: William and Ellen Exchanger (*Exchanger*), 408 Washington AVE, Midstate, MI 49999

Exchanger's Relinquished Property: Exchanger's one-half interest in 100 Park Avenue, Harbor Springs, Michigan

Pursuant to Section 1031 of the Internal Revenue Code, William and Ellen Exchanger hereby submit the following properties as potential Replacement Properties for Exchanger's Relinquished Property:

Address or ☐ Check here if legal description is attached (if address is not available). ____ Street   City or Township   State   County Approximate Fair Market Value: $

Address or ☐ Check here if legal description is attached (if address is not available). ____ Street   City or Township   State   County Approximate Fair Market Value: $

Address or ☐ Check here if legal description is attached (if address is not available). ____ Street   City or Township   State   County Approximate Fair Market Value: $

45-DAY ID DEADLINE: Friday, September 26, 2019; 180-DAY PURCHASE DEADLINE: Sunday, February 8, 2020

EXCHANGER; WILLIAM AND ELLEN EXCHANGER:

By:____________________________________Date:________________________
William Exchanger

By:____________________________________Date:________________________
Ellen Exchanger

RECEIVED AT EQUITY EXCHANGE LLC BY:

By:____________________________________Date:________________________

Sample Reminders A-3

IMPORTANT REMINDERS ON IDENTIFYING AND CLOSING ON YOUR REPLACEMENT PROPERTY:

1. **Once your 45-day identification period is up (Friday, September 26, 2014), you cannot substitute other potential Replacement Property, even if all of the properties become unavailable or all simply turn out to be unacceptable to you as Replacement Property. The IRS allows no exceptions and gives no extensions on identifying or closing on Replacement Property.**

2. **In order to be completely deferred on capital gains taxes you need to buy Replacement Property of equal or greater value to your Relinquished Property sale price (minus non-recurring closing costs), <u>and</u>, all of the cash (equity) out of the sale must be invested into the Replacement Property at the closing on the Replacement Property. If you buy a less expensive Replacement Property, the difference may be subject to capital gains taxes. If you arrange for a mortgage on your Replacement Property, which results in your getting cash back at closing, the cash may be subject to capital gains taxes.**

3. **You must provide Equity Exchange LLC with timely notice of your Replacement Property closing(s). Equity Exchange needs time to prepare and forward 1031**

4. **Exchange documents to the office preparing the closing, and, Equity Exchange LLC must also arrange to have the 1031 Exchange Proceeds wired for closing. You should provide Equity Exchange LLC with <u>at least</u> five-business days notice before any closing.**

5. **Always take title to your Replacement Property the same way you exchanged out of your Relinquished Property. For example, if you sold as husband and wife, buy as husband wife. If you sold in your trust, buy in your trust etc.**

6. **If the Exchanger identifies potential replacement properties within the 45-day period, the Exchange proceeds cannot be refunded until the expiration of the 180-day Exchange period. If no Replacement Properties are identified within the 45-day period, the Exchanger may request his proceeds to be refunded as of the 46th day.**
7. **The following (or very similar) clause reflecting your intent to complete the acquisition of your Replacement Property as a 1031 Exchange is required in your Buy/Sell Agreement, either in the body of the agreement or as an addendum:**

   Buyer reserves the right to convert this transaction to a tax deferred exchange pursuant to IRC Section 1031, and agrees to hold Seller harmless from any and all claims, liabilities or delays in time resulting from such an exchange. Seller acknowledges Buyer's intent and agrees to cooperate with Buyer and to execute all documents reasonably requested by Buyer, including an assignment of this agreement, at no additional cost to Seller.

EQUITY EXCHANGE LLC
4866 KITTERY ST NW
COMSTOCK PARK, MI 49321
616-942-6017 ❖ FACSIMILE
exchanges@equityexchangellc.com

Exchange Set-up Information; please provide the following via fax or email five days prior to any closings:

Exchanger's Name (how the person doing the exchange holds title to the Relinquished Property (the property being sold by Exchanger,) for example, in individual name(s), in a trust, in an LLC, or as a corporation):

1. ______________________________
2. ______________________________
3. ______________________________
4. ______________________________

If Exchanger is an entity such as a trust, LLC, partnership or corporation, what are the full names and titles of the individuals who will sign on behalf of the entity?

1. **Name:** ______________________ **Title:** ______________
2. **Name:** ______________________ **Title:** ______________
3. **Name:** ______________________ **Title:** ______________

Exchanger's contact information:

____

Street **City** **State** **ZIP**

____

Work Phone **Cell Phone** **Home Phone** **Email**

Relinquished Property:

Anticipated closing date:______________ **Sale Price:**______________

Complete address or description of the Relinquished Property (include the percentage each Exchanger owns if other than 100%.) Attach legal description if no street address is available:

____

Street Address **Condo/Unit Number**

____

City or Township (specify) **County** **State**

Is Exchanger related in any way to the Purchaser of Exchanger's Relinquished Property or the Seller of Exchanger's Replacement Property? _________. If yes, what is their relationship?____

Contact information for the title company, or attorney's office where the Relinquished Property closing will take place:

____

Company Name **Contact Name** **File #** **Closer's Email**

____

Street **City** **State** **ZIP** **Phone** **Fax**

Do you wish to receive any funds from the closing on your Relinquished Property?

☐**YES** ☐**NO** **If yes, how much? $_________________________________ NOTE: any funds you elect to receive may be subject to capital gains tax. Once we receive the funds, Equity Exchange LLC cannot disburse funds during the 180-day exchange period except for the acquisition of Replacement Property.**

Replacement Property (the property being purchased; if known at this time):

Anticipated closing date:_____________________ Price:______________________________

Complete address or description of the Replacement Property (include the percentage each Exchanger will acquire, if other than 100%.) Attach legal description if no street address is available:

____

Street Address **Condo/Unit Number**

City or Township (specify) **County** **State**

Complete contact information for the title company, or attorney's office where the Replacement Property closing will take place:

Company Name **Contact Name** **File #** **Closer's Email**

Street **City** **State** **ZIP** **Phone** **Fax**

<u>1031 Exchange Service Fee Schedule for Delayed: $750</u>

The $750 1031 Exchange Service Fee covers the entire exchange of one Relinquished Property for one Replacement Property. The service fee for each additional Replacement Property is $450.

<u>Simultaneous 1031 Exchanges:</u>
Same Title Company for both closings: $750
Different Title Cmpanies for closings:$850

<u>1031 Exchange Service Fee Schedule for Reverse 1031 Exchanges</u>: <u>$4000</u>

The 1031 Exchange Service Fee covers the entire exchange of one Replacement Property for one Relinquished Property. The fee for each additional Relinquished or Replacement Property is $450.

<u>1031 Exchange Service Fee Schedule for Improvement Exchanges</u>: <u>$4500</u>

<u>Exchanger's Bank of Choice Option</u>:
We normally use a national bank with whom we have a long-standing working relationship, however any Exchanger may elect that Equity Exchange LLC hold the 1031 Exchange Proceeds held in Exchanger's bank of choice however, Equity Exchange LLC will charge a $175 additional fee for this option.

Intermediary shall also charge a $50 fee each time Exchanger requests exchange proceeds for anything other than at closing.

1031 closing documentation needed with less than 2 business days notice, will incur an additional $100 Service Fee.

Intermediary will retain any interest earned on the 1031 Exchange Proceeds while held in the qualified escrow.

Contract Notice of Exchange Language for Buyers and Sellers:

The following (or similarly worded clauses) must be added to Exchanger's purchase & sale agreements. (Notices may be as addendums, and may be added as late as closing day.)

Where Exchanger is selling a Relinquished Property:
Seller reserves the right to convert this transaction to an exchange pursuant to Internal Revenue Code section 1031. Buyer agrees to cooperate with Seller and shall execute an Assignment Agreement and any other documents reasonably requested by Seller at no additional cost or liability to Buyer.

Where Exchanger is buying a Replacement Property:
Buyer reserves the right to convert this transaction to an exchange pursuant to Internal Revenue Code section 1031. Seller agrees to cooperate with Buyer and shall execute an Assignment Agreement and any other documents reasonably requested by Buyer at no additional cost or liability to Seller.

Exchanger's Acknowledgement of Equity Exchange LLC's 1031 Exchange Service Fee:

I, the Exchanger, hereby request that Equity Exchange LLC prepare and deliver my 1031 exchange documentation for my closing, and act as my Qualified Intermediary for my 1031 Exchange. I understand that my 1031 Exchange Service fee is in accordance with the fee schedule above, and that once Equity Exchange LLC emails my exchange documentation to the party or parties closing my transaction, my 1031 Exchange Service fee is due to Equity Exchange LLC. If I find that I am either unable or I do not wish to complete my 1031 exchange, I understand that Equity Exchange LLC's 1031 Exchange Service Fee must nevertheless be paid in full and that the entire 1031 Exchange Service Fee amount is non-refundable.

Exchanger Signature: ____Date______________

Exchanger Signature: ____Date______________