Brief Exchanges

Investment Property Exchange Services, Inc.

Tax Deferred Exchange Solutions Nationwide

National Toll Free Number

(888) 771-1031

Offices Nationwide

www.ipx1031.com

QUALIFIED INTERMEDIARY

Introduction

Investment Property Exchange Services, Inc. (IPX1031) is a professional Qualified Intermediary for IRC Section 1031 tax deferred exchange transactions.

IPX1031 has been assisting clients with their real and personal property tax deferred exchanges since 1988. Through our national network of regional sales and processing offices and our experienced staff we have earned an outstanding reputation throughout the industry as the leader in IRC §1031 Qualified Intermediary services. Our knowledgeable staff, combined with our commitment to service with integrity, provides investors with an unparalleled professional team.

IPX1031 is able to offer the highest level of safety and security in the industry for our clients' exchange proceeds. IPX1031 is a subsidiary of Fidelity National Financial, Inc., which is listed on the prestigious NYSE as "FNF". FNF, a Fortune 500 provider of products and outsourced services and solutions to financial institutions and the real estate industry and the nation's largest title insurance company, offers the size and financial strength necessary to ensure the security of our clients' exchange proceeds. Exchange accounts are secured by a written third party guarantee and a $100 million dollar fidelity bond. IPX1031 also maintains $30 million dollars in professional liability insurance.

Everyone at IPX1031 is committed to providing unsurpassed service to our clients. Our substantial expertise in facilitating exchanges, combined with the industry's most experienced and specialized team of exchange specialists, brings multidimensional insights to structuring even the most challenging exchanges. We handle all types of real and personal property exchange variations, including: simultaneous, delayed, safe harbor reverse and build-to-suit exchanges and foreclosure and work-out exchanges.

IPX1031 facilitates thousands of tax deferred exchange transactions every year. An attorney who is experienced in handling all phases of exchange transactions manages each of our regional processing offices. Although we do not replace the role of the client's legal and tax advisors, we do guide investors through the exchange process by discussing the specific exchange requirements, generating the appropriate exchange documentation, managing the exchange process and safely handling the client's exchange proceeds.

In addition to being utilized as a valuable educational resource for many of the most respected real estate and related associations and firms throughout the country, our staff of trained professionals regularly conducts accredited exchange courses in most states. As a long-standing member of the Federation of Exchange Accommodators, the trade association representing over 250 Qualified Intermediaries throughout the nation, we continually participate in the new developments and legislation regarding tax deferred exchanges and tax related issues.

In our continuing effort to maintain the highest level of customer service, we have developed these Brief Exchange Communications topics to highlight and explain some of the important requirements and issues concerning IRC §1031 tax deferred exchanges. The Brief Exchanges Communications are an overview of the elements necessary for a successful tax deferred exchange and are meant to provide the client with a better understanding of the advantages of utilizing an exchange as an alternative investment strategy for acquiring and disposing of investment or business property. We have taken the liberty in these Brief Exchanges of emphasizing real estate due to the more straightforward nature of real property exchanges. While the general requirements of IRC §1031 apply equally to exchanges of real or personal property, there are additional rules and regulations that are specific to personal property exchanges. We have outlined the differences between real property and personal property exchanges in the applicable Personal Property Brief Exchange material contained in this booklet. As with any tax deferred exchange, whether it is an exchange of real or personal property, clients are strongly encouraged to contact their tax and legal advisors for professional and legal advice regarding their specific transaction prior to entering into an exchange.

Table of Contents

Exchange Manual Categories 1
The Tax Deferred Exchange 2
Non-Tax Reasons to Exchange 3
The Role of the Qualified Intermediary. 4
Assurances 5
How to Initiate an Exchange 6
Tax Deferred Exchange Terminology. 7
What Property Qualifies for IRC §1031 Treatment 8
Like-Kind Property and Exchanges of Foreign Property 9
Delayed Exchange Deadlines and Identification Requirements 10
Boot 11
IRC §1031 Do's and Don'ts 12
Tax Season Issues 13
Disaster Relief Extensions for Exchange Deadlines 13
Vesting Issues 14
Exchanging with a Related Party 15
Closing Costs and the Tax Deferred Exchange. 16
Limitations on The Safe Harbors: The (G)(6) Provisions 17
The Simultaneous Exchange 18
The Delayed Exchange. 19
The Build-To-Suit Exchange. 20-24
How to Initiate a Build-To-Suit Exchange 25-26
The Reverse Exchange 27-30
How to Initiate a Reverse Exchange. 31-34
Property Held for Resale Purposes 35
Other Interests in Real Property and Mixed Use Exchanges 36
Personal Property Exchanges 37-38
Multiple Asset Exchanges 39
Combining Seller Financing with Tax Deferred Exchanges 40
Refinancing Before and After Exchanges. 41
Partnership, LLC and REIT Issues. 42-44
Installment Land Sales Contracts 45
Disqualified Parties and Your Attorney as Accommodator 46
Helping the Client Plan for the Exchange 47
The Impact of Depreciation Recapture on Exchanges 48-49
Master Like-Kind Exchange Programs 50
Tenancy in Common Interests - A Replacement
Property Solution for Exchanges 51
Estimating the Capital Gain Tax on the Sale of Investment Property 52
Exchange Addendum 53

Exchange Manual Categories

Exchange Basics

- ❏ The Tax Deferred Exchange
- ❏ Exchange Terminology
- ❏ §1031 Do's and Don'ts
- ❏ §1031 Qualified Property
- ❏ Like-Kind Property
- ❏ Delayed Exchange Deadlines
- ❏ Vesting Issues
- ❏ Tax Season Issues
- ❏ Boot
- ❏ Safe Harbor Limitations
- ❏ Foreign Property
- ❏ Exchange Closing Costs
- ❏ Disqualified Party Issues
- ❏ Related Party Issues

Exchange Elements

- ❏ Role of the Qualified Intermediary
- ❏ Assurances of IPX1031
- ❏ Non-Tax Reasons to Exchange
- ❏ Your Attorney as Accommodator
- ❏ Initiating an Exchange
- ❏ Helping the Client Plan for the Exchange
- ❏ Exchange Addendum
- ❏ Estimating the Capital Gain Tax

Exchange Essentials

- ❏ Simultaneous Exchanges
- ❏ Delayed Exchanges
- ❏ Build-to-Suit Exchanges
- ❏ "Reverse" Exchanges
- ❏ Mixed Property Exchanges
- ❏ Personal Property Exchanges
- ❏ Other Interests in Real Property
- ❏ Installment Land Sales Contracts
- ❏ Seller Financing and Exchanges
- ❏ Refinancing Issues
- ❏ Partnership, LLC & REIT Issues
- ❏ Property Held for Resale
- ❏ Multi-Asset Exchanges
- ❏ Depreciation and Exchanges
- ❏ Master Exchange Programs
- ❏ Tenancy In Common Interests

IPX1031 Information Services

- ❏ Training Seminars
- ❏ In-Office Staff Training
- ❏ Investor Seminars
- ❏ Accredited Continuing Education Programs for Real Estate, Legal, Escrow and Tax Professionals
- ❏ Customized Marketing Materials

The Tax Deferred Exchange

The tax deferred exchange, as defined in Section 1031 of the Internal Revenue Code of 1986, as amended, offers investors one of the last great opportunities to build wealth and save taxes. By completing an exchange, the investor (Exchanger) can dispose of their investment property, use all of the equity to acquire replacement investment property, defer the capital gain tax that would ordinarily be paid, and leverage all of their equity into the replacement property. Two requirements must be met to defer the capital gain tax: (a) the Exchanger must acquire "like kind" replacement property and (b) the Exchanger cannot receive cash or other benefits (unless the Exchanger pays capital gain taxes on this money).

In any exchange the Exchanger must enter into the exchange transaction prior to the close of the relinquished property. The Exchanger and the Qualified Intermediary enter into an Exchange Agreement, which essentially requires that (a) the Qualified Intermediary acquires the relinquished property from the Exchanger and transfers it to the buyer by direct deed from the Exchanger and (b) the Qualified Intermediary acquires the replacement property from the seller and transfers it to the Exchanger by direct deed from the seller. The cash or other proceeds from the relinquished property are assigned to the Qualified Intermediary and are held by the Qualified Intermediary in a separate, secure account. The exchange funds are used by the Qualified Intermediary to purchase the replacement property for the Exchanger.

Important Considerations for an Exchange

- Exchanges must be completed within strict time limits. The Exchanger has 45 days from the date the relinquished property closes to "Identify" potential replacement properties. This involves a written notification to the Qualified Intermediary listing the addresses or legal descriptions of the potential replacement properties. The purchase of the replacement property must be completed within 180 days after of the close of the relinquished property. After the 45 days has passed, the Exchanger may not change their Property Identification list and must purchase one of the listed replacement properties or the exchange fails!
- To avoid the payment of capital gain taxes the Exchanger should follow three general rules: (a) purchase a replacement property that is the same or greater value as the relinquished property, (b) reinvest all of the exchange equity into the replacement property and (c) obtain the same or greater debt on the replacement property as on the relinquished property. The Exchanger can offset the amount of debt obtained on the replacement property by putting the equivalent amount of additional cash into the exchange.
- The Exchanger must sell property that is held for **income** or **investment** purposes and acquire replacement property that will be held for **income** or **investment** purposes.
- IRC Section 1031 does not apply to exchanges of stock in trade, inventory, property held for sale, stocks, bonds, notes, securities, evidences of indebtedness, certificates of trust or beneficial interests, or interests in a partnership.

Investment Property Exchange Services, Inc. is available to assist Exchangers and their advisors with their exchange strategies. **The Exchanger is always advised to discuss the intended exchange with their legal or tax advisor.**

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

NON-TAX REASONS TO EXCHANGE

Generally, investors complete tax deferred exchanges to defer the capital gains tax on the disposition of their investment properties. However, there are many additional underlying reasons an investor might want to exchange one property for another. The motives often fall along standard risk—reward or cash flow—appreciation scales. These are some of the typical non-tax motives to exchange:

- Exchange from fully depreciated property to a higher value property that can be depreciated.
- Exchange from property that cannot be refinanced. For example, moving from vacant land to improved property, which can support a new refinance loan, and will thereby give the client the ability to obtain cash after the acquisition of the replacement property.
- Exchange from non-income producing raw land to improved property to create a positive cash flow from the rental income.
- Exchange from a property with maximized or minimal cash flow (an apartment building) to a higher cash flow property (a retail shopping center) to generate a larger cash flow.
- Exchange from a stagnant or slowly appreciating property to a property in an area with faster appreciation.
- Exchange for a property or properties that may be easier to sell in the coming years.
- Exchange to meet the client's location requirements. For example, the client moves to another state and wants to have their investment property nearby for management purposes.
- Exchange to fit the lifestyle of a client. For example, a retiree may exchange for a property requiring reduced management responsibility so they can do more traveling.
- Exchange from several smaller properties to one larger property to consolidate the benefits of ownership and reduce management responsibilities.
- Exchange from a larger property to several smaller properties. Exchanges can be used to divide an estate among several children or for retirement reasons.
- Exchange to a property the client can use in his or her own profession. For example, a doctor may exchange from a rental house to a medical building to use for his/her practice.
- Exchange from a partial interest in one property to a fee interest in another property.
- Exchange from a management intensive fee interest in real estate to a professionally managed triple net leased property where the lease, including options, has 30 or more years remaining.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

The Role of the Qualified Intermediary

The use of a Qualified Intermediary is essential to completing a successful IRC §1031 tax deferred exchange. Investment Property Exchange Services, Inc., (IPX1031) as a professional Qualified Intermediary, performs several vital functions in an exchange.

Creates the Exchange of Properties

The IRS stipulates that a reciprocal trade or actual exchange must take place in each exchange transaction. This means the Exchanger must assign to the Qualified Intermediary (1) their interest as seller of the relinquished property and (2) their interest as buyer of the replacement property. Because the Qualified Intermediary becomes an actual principal in the transaction, a reciprocal trade is created, even when there are three or more parties involved in the exchange (i.e. when the Exchanger is purchasing the replacement property from someone other than the buyer of their relinquished property).

Holds Exchange Proceeds

If the Exchanger actually or constructively receives any of the proceeds from the sale of their relinquished property, those proceeds will be taxable as boot. IPX1031, as the Qualified Intermediary, will hold the proceeds from the sale in a separate exchange account until the funds are used to purchase the Exchanger's replacement property. All exchange proceeds held by IPX1031 are covered by a written guarantee and $100 million in fidelity bond insurance coverage.

Prepares Legal Documentation

Several legal documents are necessary in order to properly complete an exchange. The Qualified Intermediary will prepare an Exchange Agreement, Assignment Agreements and Exchange Closing Instructions for each settlement officer handling the transaction.

Provides Quality Service

Although the process of completing an exchange is relatively simple, the rules are complicated and filled with potential pitfalls. IPX1031 has developed a reputation as the industry leader due to our substantial exchange experience and our unyielding commitment to our clients. We work closely with all parties involved to ensure a smooth transaction.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Assurances

When selecting a Qualified Intermediary, the Exchanger must feel confident that their Qualified Intermediary is a professional company with the requisite expertise, skill and commitment to provide quality service and security of the exchange funds. **Investment Property Exchange Services, Inc. (IPX1031) is sensitive to these concerns.** Through its national network of offices IPX1031 has developed a reputation throughout the industry as the leader in IRC §1031 Qualified Intermediary services.

Security

Exchangers must feel confident that exchange funds will be safe and available for the successful conclusion of their exchange. **IPX1031** is able to offer the highest level of safety and security of the exchange funds.

- IPX1031 is a subsidiary of Fidelity National Financial, Inc. (NYSE:FNF) the largest provider of title insurance and diversified real estate-related services
- A written guarantee for the exchange funds
- $100 million in Fidelity Bond Coverage
- $30 million in Professional Liability Insurance
- Employee Theft and Dishonesty Coverage

Service

Our innovative techniques in structuring exchanges, combined with the expertise of our professionals, allow us to provide Exchangers with superior service.

- As a member of the Federation of Exchange Accommodators, IPX1031 is informed of any new developments in the field and participates in proposing new legislation for tax deferred exchanges and the Qualified Intermediary industry.
- We have an unflagging commitment to the Exchanger to provide quality service and superior documentation.

Expertise

We have exceptional technical expertise and practical experience gleaned from many years of helping Exchangers defer capital gain taxes.

- Our regional attorney managers and experienced processing staff have the expertise to structure and manage the most challenging real and personal property exchange transactions, including delayed, simultaneous, improvement, reverse, foreclosure and workout exchanges.
- IPX1031 facilitates thousands of tax deferred exchange transactions each year.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

HOW TO INITIATE AN EXCHANGE

STEP 1...

Find an experienced professional QUALIFIED INTERMEDIARY to assist you with the exchange as early in the sale process as possible. Key points to consider in selecting a Qualified Intermediary are: the **knowledgeable and experienced staff**; the **local assistance** for your real estate agent, CPA and attorney; **and of especially critical importance: the safety of your funds** while held by the Qualified Intermediary. At a minimum, you should require the Qualified Intermediary to provide fidelity bond insurance coverage. Investment Property Exchange Services, Inc. has a written guarantee and a $100 million fidelity bond to secure the exchange funds.

STEP 2...

Instruct your real estate agent to include an "Exchange Cooperation Clause" as an addendum to the purchase and sale agreement on the relinquished property (the property the Exchanger is selling to the buyer).

An example Exchange Cooperation Clause is:

> *"Buyer hereby acknowledges that it is the intent of the Seller to effect an IRC §1031 tax deferred exchange which will not delay the closing or cause additional expense to the Buyer. The Seller's rights under this agreement may be assigned to Investment Property Exchange Services, Inc., a Qualified Intermediary, for the purpose of completing such an exchange. Buyer agrees to cooperate with the Seller and Investment Property Exchange Services, Inc. in a manner necessary to complete the exchange."*

STEP 3...

Contact your Qualified Intermediary as soon as possible after escrow is opened or after entering into the purchase and sale agreement and advise them of your intent to do an exchange well in advance of the closing date. The Qualified Intermediary will draft the appropriate Exchange Agreement, Assignments and Exchange Closing Instructions that must be executed prior to closing on the property being sold.

STEP 4...

Start searching for acceptable replacement property immediately to insure that you can meet the strict time frame for the 45-day Identification Period.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Tax Deferred Exchange Terminology

As with any other specific area of real estate law, tax deferred exchanges under IRC §1031 have their own language, which may be confusing to those who are unfamiliar with these transactions. The following are some of the exchange terms and phrases that are often used with their "plain-English" interpretations.

1. **Boot**—Fair Market Value of non-qualified (not "like-kind") property received in an exchange. (Examples: cash, notes, seller financing, furniture, supplies, reduction in debt obligations.) Receipt of boot will not disqualify an exchange, but the boot will be taxed to the Exchanger to the extent of the recognized gain.

2. **Constructive Receipt**—A term referring to the control of proceeds by an Exchanger even though funds may not be directly in their possession.

3. **Exchanger**—The property owner(s) seeking to defer capital gain tax by utilizing a IRC §1031 exchange. (The Internal Revenue Code uses the term "Taxpayer.")

4. **Like-Kind Property**—This term refers to the nature or character of the property, not its grade or quality. Generally, real property is "like-kind" as to all other real property as long as the Exchanger's intent is to hold the properties as an investment or for productive use in a trade or business. With regards to personal property, the definition of "like-kind" is much more restrictive. (See Brief Exchange, Like-Kind Property.)

5. **Qualified Intermediary**—The entity that facilitates the exchange for the Exchanger. Although the Treasury Regulations use the term "Qualified Intermediary," some companies use the term "facilitator" or "accommodator".

6. **Relinquished Property**—The property "sold" by the Exchanger. This is also sometimes referred to as the "exchange" property or the "downleg" property.

7. **Replacement Property** —The property acquired by the Exchanger. This is sometimes referred to as the "acquisition" property or the "upleg" property.

8. **Identification Period**—The period during which the Exchanger must identify Replacement Property in the exchange. The Identification Period starts on the day the Exchanger transfers the first Relinquished Property and ends at midnight on the 45th day thereafter.

9. **Exchange Period**—The period during which the Exchanger must acquire Replacement Property in the exchange. The Exchange Period starts on the date the Exchanger transfers the first Relinquished Property and ends on the earlier of the 180th day thereafter or the due date (including extensions) of the Exchanger's tax return for the year of the transfer of the Relinquished Property.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

WHAT PROPERTY QUALIFIES FOR IRC §1031 TREATMENT?

To qualify for a tax deferred exchange under IRC §1031 both the relinquished and the replacement properties must be held by the Exchanger for investment purposes or for "productive use in their trade or business". The Exchanger's purpose and intent in holding the property, rather than the type of property, is the critical issue. The use of the property by the other parties to the exchange (buyer and/or seller) is irrelevant. The following are examples of qualifying properties:

Bare land	Farmer's farm
Commercial rental	Residential rental
Industrial property	Doctor's own office
30-year leasehold interest	Percentage interest in investment property

Under IRC §1031 the following properties do not qualify for exchange purposes:

- Stock in trade or other property held primarily for sale (Note: this includes property held by a developer or other dealers in property);
- Securities or other evidences of indebtedness or interest;
- Stocks, bonds, or notes;
- Certificates of trust or beneficial interests;
- Interests in a partnership (Note: the partnership can elect out of partnership status under IRC §761(a));
- Choses in action (this is a right to receive money or other personal property by judicial proceeding).

It is important to note that the intent by the Exchanger to hold the property for personal use will prevent the property from qualifying for exchange treatment. Therefore, second homes will not qualify for tax deferred exchange treatment unless the taxpayer changes how they treat or use the second home. For example, a taxpayer could "convert" their second home to a valid exchange property and establish this intent by properly renting the property and holding it as a legitimate rental property. See Rev. Rul. 57-244, 1957-1 C.B. 247. However, the taxpayer cannot just simply rent the taxpayer's residence and expect it to automatically qualify for exchange treatment. Bolaris v. C.I.R., 776 F.2d 1428 (9th Cir. 1985). Many taxpayers own vacation homes, which are rented out during the time when the taxpayer is not using the home. Even though under IRC §280A a vacation home may have a portion of its deductions disallowed if it is used for personal purposes under the "14-day rule", an Exchanger can argue that if the vacation home is partially used in a trade or business (renting it), the vacation home should be eligible for tax deferred exchange treatment upon it sale. However, there may need to be a bifurcation of uses as is also required for a home office use in a personal residence. Rev. Rul. 82-26, 1982-1 C.B. 115.

In many instances taxpayers use a part of their personal residence for a home office for business purposes. In this case when the taxpayer sells the personal residence, the transaction must be split such that the portion used for business purposes is treated separately for tax purposes from the portion used for a personal residence. Rev. Rul. 82-26, 1982-1 C.B. 115. The taxpayer could then qualify the entire transfer for tax-free treatment; the business portion could qualify for a tax deferred exchange under IRC §1031 and the personal residence portion could qualify for a tax-free sale under IRC §121 provided the transaction otherwise met the exemption requirements of IRC §121. Naturally, consultation with a tax advisor is important whenever a taxpayer changes how they intend to hold property.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

"Like-Kind" Property

To qualify for tax deferred exchange treatment under IRC §1031, the relinquished property must be exchanged for replacement property that is of "like-kind". For real property exchanges the term "like-kind" refers to the nature or character of the property and not to its grade or quality. For example, it does not matter whether the real property involved is improved or unimproved because that fact only relates to the grade or quality of the property and not to its kind or class. See Treas. Reg. §1.1031(a)-1(b). In essence, all real property is "like-kind" with all other real property. Generally, however, for personal property exchanges the relinquished and replacement property must both be in either the same General Asset Class or the same Product Class. To qualify for an exchange the Exchanger must have held the relinquished property for investment, or for "productive use in their trade or business," and must intend to do the same with the replacement property. The following are examples of "like-kind" properties:

- Residential for commercial
- Fee simple interest for 30-year leasehold
- Non-income producing raw land for income producing rental property
- Corporate twin-engine aircraft for a corporate jet
- Buses for buses
- Livestock of the same sex (Note: livestock of different sexes are not of "like kind")
- Bare land for rental property
- Single family rental for multi-family rental
- Rental mountain cabin for a dental office in which the Exchanger intends to practice
- Mitigation credits for restoring wetlands for other mitigation credits
- Garbage routes for garbage routes

Exchanges of Foreign Property

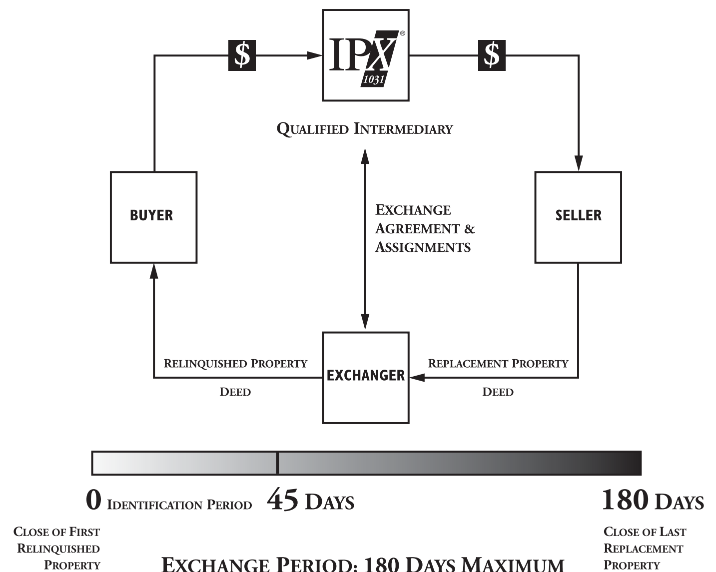
Exchangers may exchange properties throughout the United States. When taxpayers relocate within the United States they can essentially "take" their investment properties with them by completing an exchange. For example, the Exchanger who is moving from California to Montana may relinquish in California and acquire near their new home in Montana.

Prior to 1989, however, Exchangers were able to perform an exchange of a United States property for a foreign investment property, such as a rental house in Los Angeles for a rental villa in France. After the Revenue Reconciliation Act of 1989, IRC §1031 was amended such that real property located in the United States and real property located outside the United States are not like-kind. See Treas. Reg. §1.1031(h). Prior to April 2005, it was unclear by what "property located in the United States" meant, but there was some indication in Private Letter Ruling 9038030 (June 1990) that property located in the United States Virgin Islands might qualify as "property located within the United States" and therefore like-kind to property located in one of the 50 states. In April 2005 the IRS issued final and temporary regulations regarding various aspects of residence and source rules involving U.S. Possessions, which include American Samoa, Guam, the Northern Mariana Islands, Puerto Rico and the United States Virgin Islands, such that property located within one of these U.S. Possessions is like-kind with property located within the United States for purposes of qualifying for a tax deferred exchange. Moreover, a taxpayer who sells foreign property and buys foreign property, and who is subject to capital gains tax on their U.S. tax return, may want to consider an exchange since foreign property is considered to be of like-kind to other foreign property. For example, the taxpayer who relinquishes a rental property in Canada and acquires another like-kind property in Canada, or relinquishes a rental apartment in Singapore and acquires a rental condominium in Hong Kong, may benefit from a tax deferred exchange. It is important to note that in exchanges involving personal property the determining factor as to whether the personal property is foreign or domestic is the location of the predominant use of the property because personal property used predominantly within the United States and personal property used predominantly outside the United States are not of a like-kind. The tax code generally requires a two year holding period for both the relinquished and replacement properties in determining the predominant use for the "like-kind" requirement for personal property exchanges.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Delayed Exchange Deadlines and Identification Requirements

The most common exchange variation is the delayed exchange format. One of the central requirements in a delayed exchange is that the replacement property is properly identified within the identification period and acquired by the end of the exchange period. The Treasury Department issued Regulations in 1991 that clarified the acceptable methods to properly identify replacement property. See Treas. Regs. §1.1031(k)-1(b) through (e). It is essential in a delayed exchange to adhere to these rules and deadlines established for identifying and acquiring the replacement property. Failure to comply with these rules may result in a failed exchange.



There are two key deadlines that the Exchanger must meet to have a valid exchange:

- Exchange Period: The Exchanger must receive the Replacement Property within the earlier of 180 days after the date on which the Exchanger transferred the first Relinquished Property, or the due date (including extensions) for the Exchanger's tax return for the tax year in which the transfer of the first Relinquished Property occurs.
- Identification Period: The Exchanger must identify the Replacement Property to be acquired by the end of the Exchange Period within 45 days of the transfer of the first Relinquished Property.
- The time periods for the 45-day Identification Period and the 180-day Exchange Period are very strict and cannot be extended even if the 45th day or 180th day falls on a Saturday, Sunday or legal holiday.

Replacement Property must be properly identified within the Identification Period by at least one of the following methods:

- Completing the purchase of the Replacement Property within the Identification Period; or
- Identified in a written document ("Identification Notice") signed by the Exchanger and hand delivered, mailed, telecopied, or otherwise sent by midnight of the 45th day, which is the end of the Identification Period.

The written Identification Notice should be made to:

- The person obligated to transfer the Replacement Property to the Exchanger, even if that person is a disqualified party. Examples of persons obligated to transfer the Replacement Property to the Exchanger are the seller of the Replacement Property or the Exchanger's Qualified Intermediary; or
- To any other person involved in the exchange other than the Exchanger or a disqualified party. Examples of persons who are involved in the exchange and who are not considered disqualified parties are an escrow, settlement or title officer or a person who is providing the Exchanger with services solely relating to the exchange of property.

The Identification Notice must contain an unambiguous description of the Replacement Property and must be signed by the Exchanger. A fully executed purchase and sale agreement specifying the Replacement Property may satisfy these requirements. Otherwise, in the case of real property, the Identification Notice must include the legal description, a street address or a distinguishable name. In addition, when the Exchanger intends to improve the Replacement Property during the Exchange Period the Exchanger must include an adequate description of the underlying land and a description in as much detail as is practicable at the time of the identification of the proposed construction or improvements. When identifying Replacement Property in a real property exchange, any personal property included in the purchase that has a value of less than 15% of the total value of the Replacement Property is considered incidental and does not need to be separately identified. An identification of Replacement Property may be revoked prior to the end of the Identification Period. The revocation must be done in a writing signed by the Exchanger and made to the same person to whom the original identification notice was sent.

Exchangers have the flexibility of identifying more than one property as Replacement Property for their exchange. The options for identification are:

- Three Property Rule: The Exchanger may identify as potential Replacement Property any three properties, without regard to their fair market value.
- 200% Rule: The Exchanger may identify as potential Replacement Property any number of properties provided the aggregate fair market value of all of the identified properties does not exceed 200% of the aggregate fair market value as of the date of the transfer of all of the Relinquished Properties.
- 95% Exception: If the Exchanger identifies more potential Replacement Properties than allowed under either the Three Property or the 200% Rules, the Exchanger must receive Replacement Property by the end of the Exchange Period that has a fair market value of at least 95% of the aggregate fair market value of all of the identified Replacement Properties. The fair market value of property is determined as of the earlier of the date the property is received by the Exchanger or the last day of the Exchange Period and without regard to any liabilities secured by the property.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Boot

Having nothing at all to do with footwear, "Boot" is a term which refers to the items of personal property and/or cash that is necessary to even out an exchange. Boot is property which is received in an exchange and that is not "like kind" as to other property acquired in an exchange transaction. Boot is defined as the "fair market value" of the non-qualified property received in an exchange.

While the receipt of boot will not disqualify the exchange, an Exchanger who receives boot in an exchange transaction generally recognizes gain to the extent of the value of the boot received. Some common examples of Boot are:

- Cash proceeds an Exchanger receives from the Qualified Intermediary during or after the exchange;
- Nonqualified property, such as stocks, bonds, notes or partnership interests;
- Proceeds taken from the exchange in the form of a note or contract for sale of the property. An Exchanger can utilize IRC §453 to recognize the gain (boot) of a seller carry-back note received in an exchange transaction under the *installment sale* rules;
- Relief from debt on the Relinquished Property caused by the assumption of a mortgage, trust deed, contract, or an agreement to pay other debt that is not replaced on the Replacement Property;
- Personal Property received in the exchange. Personal Property is never "like-kind" to real property; and
- Property that is intended for personal use and not for use by the Exchanger as either his/her investment or business use property.

To avoid the receipt of Boot the Exchanger should:

- Purchase "like-kind" Replacement Property of equal or greater net sales price than the Relinquished Property;
- Reinvest all of the net equity (exchange funds) from the sale of the Relinquished Property in the purchase of the Replacement Property; and
- Obtain equal or greater debt on the Replacement Property than was paid off, assumed, or taken subject to on the Relinquished Property. *Exception:* A reduction in debt on the Replacement Property can be offset with additional cash from the Exchanger, but increasing the debt on the Replacement Property cannot offset a reduction in the exchange equity, thereby resulting in excess exchange funds upon the completion of the exchange. Any excess exchange funds will be Boot and the capital gain tax will be recognized to the extent of the Boot received.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

IRC §1031 DO'S AND DON'TS

DO advanced planning for the exchange. Talk to your accountant, attorney, broker, lender and Qualified Intermediary.

DO NOT miss your identification and exchange deadlines. Failure to identify within the 45-day identification period or failure to acquire replacement property within the 180 day exchange period will disqualify the entire exchange. Reputable Qualified Intermediaries will not act on backdated or late identifications.

DO keep in mind these three basic rules to qualify for complete tax deferral:

- Use all proceeds from the relinquished property for purchasing the replacement property.
- Make sure the debt on the replacement property is equal to or greater than the debt on the relinquished property. (Exception: A reduction in debt can be offset with additional cash; however, a reduction in equity cannot be offset by increasing debt.)
- Receive only "like-kind" replacement property.

DO NOT plan to sell and invest the proceeds in property you already own. Funds applied toward property already owned purchase "goods and services," not "like-kind" property.

DO attempt to sell before you purchase. Occasionally Exchangers find the ideal replacement property before a buyer is found for the relinquished property. If this situation occurs, a reverse exchange (buying before selling) may be necessary. While the IRS has recently provided guidance for reverse exchanges in Revenue Procedure 2000-37, Exchangers should be aware that reverse exchanges are considered a more aggressive exchange variation because some other entity must hold title to either the Exchanger's relinquished or replacement property for up to 180 days pending the completion of the exchange transaction.

DO NOT dissolve partnerships or change the manner of holding title during the exchange. A change in the Exchanger's legal relationship with the property may jeopardize the exchange.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Tax Season Issues

Exchangers must report their exchange on the tax return for the year in which the exchange begins. The exchange is reported on Form 8824, "Like-Kind Exchanges." This form requests the date of the exchange transaction, the date properties were "identified" and financial information obtained from the closing/settlement statement. For the sale of depreciable rental or business property the Exchanger will also need Form 4797, "Sale of Business Property." For the sale of non-depreciable investment property, the Exchanger will need Form 1041 Schedule D, "Capital Gains and Losses." Rev. Rul. 72-456 and Treas. Reg. §1.1031(k)-1(g)(7)(ii) provide information on the tax treatment of closing costs in an exchange. Rev. Rul. 72-456 deals specifically with broker commissions but is considered a guideline for treatment of other closing costs. The basic rule is that closing costs reduce realized gain on the relinquished property, reduce boot received and are added to the basis of the replacement property.

If the Exchanger relinquished property after October 18th, then they actually have less than 180 days in which to complete their exchange unless they file for an extension. The actual deadline for completing an exchange ("the Exchange Period") is the earlier of either 180 days from the date on which the Exchanger transfers 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. The IRS generally has three years in which to audit a tax return. However, this statute of limitations is extended if a taxpayer fails to report more than 25% of their gross income. Often the tax savings generated by an exchange will be significant enough to activate this extension of the three year audit period.

Disaster Relief Extensions for Exchange Deadlines

In early 2004, the IRS issued Revenue Procedure 2004-13 that provided for the extension of certain tax deadlines, including tax deferred exchange deadlines, in those regions that were declared disaster areas by the President, but only upon the issuance of a "news release" for such disasters from the IRS. Rev. Proc. 2004-13 was then clarified by the IRS in Notice 2005-3 (issued January 13, 2005), to provide additional guidance for the application of disaster extensions to exchanges. Notice 2005-3 is applicable to acts that may be performed on or after January 26, 2005. The rules of Notice 2005-3 are highly technical and anyone seeking to utilize it should obtain the counsel of their tax or legal advisor. In general, Notice 2005-3 provides:

- The 45-day Identification Period and the 180-day Exchange Period for delayed exchanges and the times deadlines for safe harbor parking transactions specified in Rev. Proc. 2000-37 are "time sensitive acts" eligible for extension.
- A 120-day postponement (or the ending date announced in the Presidential disaster declaration if later) is allowed if the Exchanger has difficulty meeting the deadlines for any of these "time sensitive acts", but only if (a) the relinquished property was transferred to a buyer, or the qualified indicia of ownership was transferred to the Exchange Accommodation Titleholder, on or before the disaster declaration date and (b) the Exchanger is either an "affected taxpayer" or has "difficulty meeting the time deadlines due to the disaster". "Affected Taxpayers" include relief workers and individuals and businesses who are located in the disaster area, or whose tax records are located in the disaster area. Reasons the taxpayer may have "difficulty meeting the time deadlines due to the disaster" include (a) the relinquished or replacement property or the principal place of business of one of the parties involved in the exchange is located in the disaster area (this includes the QI, EAT, settlement agent/attorney, lender, title insurer), (b) any party to the transaction is killed, injured or missing, (c) a land record document or a document prepared in connection with the exchange is destroyed, damaged or lost, and (d) title insurance, loans, or flood, hazard or other such insurance is unavailable for property located in the disaster area.
- A 120-day postponement is allowed for the 180-day Exchange Deadline if, after the end of the 45-day Identification Period, the identified replacement property in a delayed exchange, or the identified relinquished property in a safe harbor parking transaction is "substantially damaged".

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Vesting Issues

To qualify as an exchange under IRC Section 1031 title to the replacement property must be held in the same manner as title to the relinquished property. Therefore, the entity beginning the exchange must be the entity concluding the exchange. The Qualified Intermediary will prepare the exchange documents to reflect the vesting information as shown on the title commitment or preliminary report for the Exchanger's relinquished property. For example:

- Husband relinquishes, then Husband must acquire
- Husband and Wife, as Trustees relinquish, then Husband and Wife, as Trustees must acquire
- ACME Corporation relinquishes, then ACME Corporation must acquire
- Johnson LLC relinquishes, then Johnson LLC must acquire
- Les Mis Partnership relinquishes, then Les Mis Partnership must acquire

Exchangers must anticipate these vesting issues as part of their advanced planning for the exchange. These vesting issues are easier to resolve before loan documents are sitting on the closing table. However, business considerations, liability issues and lender requirements may make it difficult for the Exchanger to keep the same vesting on the replacement property. For example:

- If a husband as the only Exchanger is relying on the wife's income to qualify for replacement property financing, then the lender will require the wife to appear on the deed, which may violate the husband's exchange requirements.
- Lenders seldom loan to trustees; they loan to individuals, thereby creating difficulties for a trust as an Exchanger to acquire the replacement property in the same trust entity that started the exchange.
- Exchanger's who dispose of relinquished property in one entity, such as a corporation, partnership or multi-member LLC and who want to acquire the replacement property in a different corporation or multi-member LLC for each replacement property may not do so within the exchange format.

The following changes in vesting usually do not destroy the integrity of the exchange:

- The Exchanger's revocable living trust may acquire the replacement property in the Exchanger as an individual, as long as the trust entity is disregarded for Federal tax purposes.
- The Exchanger's estate may complete the exchange after the Exchanger dies following the close of the sale of relinquished property.
- The Exchanger may transfer relinquished property held as an individual and acquire replacement property titled in a single-member LLC or acquire multiple replacement properties in different single-member LLC's. Single-member LLC's are disregarded for Federal tax purposes under the "check-the-box" rules.
- In community property states, a husband and wife may exchange relinquished property held by them individually as community property, for replacement property titled in a two-member LLC in which the husband and wife own 100% of the membership as community property, but only if they treat the business entity as a disregarded entity. (Rev.Proc.2002-69)
- A corporation that merges out of existence in a tax-free reorganization after the disposition of the relinquished property may complete the exchange and acquire the replacement property as the new corporate entity.
- An Illinois land trust is a disregarded entity for IRC §1031 purposes, so an Illinois land trust beneficiary may exchange his beneficial interest in relinquished property held by the trust for replacement property titled in the name of the beneficiary, individually, or in a different Illinois land trust, as long as the Exchanger is the beneficiary. (Rev.Rul.92-105)

To avoid what the IRS may consider as a "step transaction," thereby disqualifying the exchange, the Exchanger should not make any changes in the vesting of the relinquished or replacement properties prior to, or during the exchange. Exchangers are cautioned to consult with their tax or legal advisors regarding how their vesting issues will impact the structure of their exchange before they transfer the relinquished property. Proper planning and negotiation can make the difference between a successful exchange and a taxable problem.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Exchanging with a Related Party

Exchanges between related parties are allowed but the Exchanger must follow specific rules before the exchange will qualify for tax deferral. Related parties are defined in IRC §267(b) and §707(b)(1) as any person or entity bearing a relationship to the Exchanger, such as members of a family (brothers, sisters, spouse, ancestors and lineal descendants); a grantor or fiduciary of any trust; two corporations which are members of the same controlled group or individuals; and corporations and partnerships with more than 50% direct or indirect ownership of the stock, capital or profits in these entities. Under IRC §1031(f) it is clear that two related parties, owning separate properties, may "swap" those properties with one another and defer the recognition of gain as long as both parties hold onto their replacement properties for two years following the exchange. This rule was imposed to prevent taxpayers from using exchanges to shift the tax basis between the properties with the intended purpose of avoiding paying taxes.

The more typical related party exchange scenarios have the Exchanger using a Qualified Intermediary to create the exchange with either a related party buyer who purchases the Exchanger's relinquished property or a related party seller from whom the Exchanger acquires the replacement property. Most tax advisors agree that exchanges in which the Exchanger sells relinquished property to a related party buyer will have better success in qualifying for tax deferral, but only if both the buyer and the Exchanger hold onto the properties they receive in the exchange for the two-year holding period. Exchanges in which the seller of replacement property is the related party are less likely to qualify for tax deferral unless the related party seller also does an exchange. Under Rev. Rul. 2002-83, exchange treatment will be denied to an Exchanger who, through a Qualified Intermediary, acquires replacement property from a related party seller, if the related party seller receives cash or other non-like-kind property, regardless of whether the Exchanger holds the replacement property for the requisite two years. The IRS will generally view this latter transaction as yielding the same result as if the Exchanger swapped properties with a related party, and then the related party immediately sold the property acquired, violating the two-year holding requirement. Exceptions to the two-year holding period are allowed only if the subsequent disposition of the property is due to (a) the death of the Exchanger or related person, (b) the compulsory or involuntary conversion of one of the properties under IRC §1033 (if the exchange occurred before the threat of conversion), or (c) the Exchanger can establish that neither the exchange nor the disposition of the property was designed to avoid the payment of federal income tax as one of its principal purposes. In fact, under IRC §1031(f)(4) a related party exchange will be disallowed if it "is a part of a transaction (or series of transactions) structured to avoid the purposes of the related party provisions." It is also important to note that under IRC §1031(g) the two-year holding period is "tolled" for the period of time that (a) either party's risk of loss with respect to their respective property is substantially diminished because either party holds a *put right* to sell their property, (b) either property is subject to a *call right* to be purchased by another party, or (c) either party engages in a *short sale* or any other transaction.

In an October 2004 Private Letter Ruling (PLR 200440002) the IRS ruled that §1031(f) would not trigger gain recognition in a series of exchanges involving two related partnerships that used an unrelated Qualified Intermediary since neither related party was cashing out of their investment in real estate and each related party represented that they would hold their replacement property for the required two years following their exchange. In the transaction, Partnership A sold their relinquished property to an unrelated third party buyer and purchased their replacement property from Partnership B, a related party. Partnership B then completed their exchange by purchasing replacement property from an unrelated third party seller. Upon completion of the two exchanges each party owned like-kind property and neither party received cash or other non-like kind property (other than boot received in the exchange) in return for the relinquished property. In the IRS analysis §1031(f)(1) did not apply because the Qualified Intermediary was an unrelated party, and §1031(f)(4) and Rev. Rul. 2002-83 also did not apply because the series of transactions were not set up to avoid the purposes of §1031(f). In contrast to this PLR, the Tax Court confirmed the IRS position in Rev. Rul. 2002-83 that the related party rules of §1031(f) cannot be avoided by interposing an unrelated Qualified Intermediary. The Tax Court also confirmed that these types of related party transactions are within the re-characterization rule of §1031(f)(4) and that since the principal purpose of the transaction was the avoidance of income taxes the parties failed to meet the "no tax avoidance" exception of §1031(f)(2)(C). *Teruya Brothers, Ltd.*, 124 T.C. No. 4 (2005).

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Closing Costs and the Tax Deferred Exchange

Exchangers, closing agents, escrow officers and tax advisors have struggled with the many issues presented by the variety of expenses and cash payments associated with closing the properties in an exchange transaction. To make matters less certain, there is little authority in the Internal Revenue Code or Treasury Regulations as to how to treat the closing cost items commonly seen on settlement statements. The following are answers based on existing authority to typical issues seen on settlement statements.

Given the general rule that an Exchanger must transfer all equity in the relinquished property to the replacement property, the issue is whether the Exchanger will be taxed on the amount of the sale proceeds used to pay typical sale and purchase settlement expenses.

- Revenue Ruling 72-456 that specifies that real estate sale commissions paid are offset against the sale proceeds received provides some guidance. The purchase commissions paid are added to the basis of the replacement property. Therefore, payment of brokerage commissions from exchange proceeds does not create taxable boot.
- Based on this rationale, the same favorable treatment may be accorded other sale and purchase expenses. Payment of the following "non-recurring" costs of sale or purchase from the exchange proceeds should not create taxable boot:

Real estate commissions	Recording fees	Direct legal fees
Title insurance premiums	Qualified Intermediary fees	Agreed property inspections
Escrow or closing agent fees	Documentary transfer taxes	

- However, certain costs may create taxable boot because they are seen as expenditures for benefits other than acquiring the replacement property. Loan fees, points and prorated mortgage insurance are really costs to obtain a new loan. Prorated property taxes, insurance payments and rents are usually considered deductible ongoing operating expenses and not part of the exchange, but the payment of these items will not interfere with the safe harbor.
- Payment of 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. If, however, the Purchase and Sale Agreement for the replacement property was specifically made contingent upon the satisfactory completion of these items, the Exchanger could argue that these expenditures were really for the purchase of the property and not to obtain a new loan.
- The Exchanger may wish to consider prorated property tax payments or security deposits paid to the buyer of the relinquished property as the equivalent of non-recourse debt from which the Exchanger was relieved. While this treatment initially creates mortgage boot received, this payment can be netted against liabilities assumed (mortgage boot paid) on the purchase of the replacement property. See TAM 8328011 regarding prorated rent payments.
- There is an open issue as to whether the Qualified Intermediary's use of exchange funds to pay for the costs and expenses to close on the replacement property affect the safe harbor restrictions of Treas. Reg. §1.1031(k)-1(g)(6). The Treasury Regulations provide that the payment of normal costs of sale or purchase, including prorations, commissions, transfer taxes, property taxes and title company fees may be paid from the exchange proceeds and will be disregarded and will not be construed as constructive receipt of funds by the Exchanger. See Treas. Reg. §1.1031(k)-1(g)(7). Even though these types of prorations and closing costs will not interfere with the use of the Qualified Intermediary safe harbor, they may still constitute boot to the Exchanger. However, using exchange proceeds for closing expenses unrelated to the direct purchase of the replacement property must only be made at the time of closing on the replacement property when the Qualified Intermediary pays out all of the exchange funds it is holding in accordance with the restrictions for completing the exchange set forth in Treas. Reg. §1.1031 (k)-1(g)(6).

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Limitations on The Safe Harbors: The (G)(6) Provisions

The 1991 Treasury Regulations for tax deferred exchanges under IRC §1031 establishes four "safe harbors," the use of which allow a taxpayer (Exchanger) to avoid actual or constructive receipt of money or other property for purposes of completing a §1031 exchange. Although an Exchanger will not automatically be deemed to have constructive receipt of relinquished property sale proceeds if the safe harbor requirements are not met, compliance with the safe harbors should satisfy even a conservative tax advisor. The four safe harbors include (1) qualified intermediaries, (2) interest and growth factors, (3) qualified escrow accounts and qualified trusts and (4) security or guaranty arrangements. These safe harbors may be used singularly or in any combination as long as the terms and conditions of each can be separately satisfied.

The first three of the safe harbors require the exchange agreement between the Exchanger and the Qualified 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 Treasury Regulation §1.1031(k)-1(g)(6)(ii)-(iii). and Treas. Reg. §1.1031(k)-1(g)(6)(i). 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. Treas. Reg. §1.1031(k)-1(g)(8), Example 2(ii). The "cash out" provisions found 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:

(A) If the Exchanger has not identified replacement property by the end of the 45-day identification period, then the exchange can be terminated and the Exchanger has the right to the exchange proceeds at any time. For example: On April 1, Exchanger "E" transfers the relinquished property to a buyer. If the Exchanger fails to identify any replacement property on or before May 16, then E may have access to the funds in the exchange account at any time after May 16.

(B) 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.

For example, if E identified a single replacement property on May 15 and acquired that replacement property on May 25, then E could demand the balance of the remaining exchange proceeds at any time after that date since E had acquired ***all of the identified replacement property to which it is entitled under the exchange agreement.*** This provision is more problematic when the Exchanger identifies multiple replacement properties. For example: On April 1, E transfers the relinquished property to a buyer and the Qualified Intermediary "QI" receives $500,000 in exchange proceeds. On or before May 16, E properly identifies a ranch and two vacant lots as replacement property ***although E only intends to acquire the ranch.*** The 180-day period expires on September 28. On August 28, QI uses $300,000 to acquire the ranch for E as replacement property. The answer is unclear as to whether E has an immediate right to the $200,000 balance of the exchange proceeds. Some commentators believe that the QI should be allowed to pay any excess exchange funds to the Exchanger without having to wait for the expiration of the 180-day period. Other commentators argue that since the Exchanger has properly identified other properties, which he/she has not acquired, the Exchanger has not acquired ***all of the properties to which it is entitled.*** Therefore, the receipt of the remaining exchange funds prior to the expiration of the 180-day period could constitute constructive receipt of the exchange funds and possibly jeopardize the tax-deferred nature of the entire transaction.

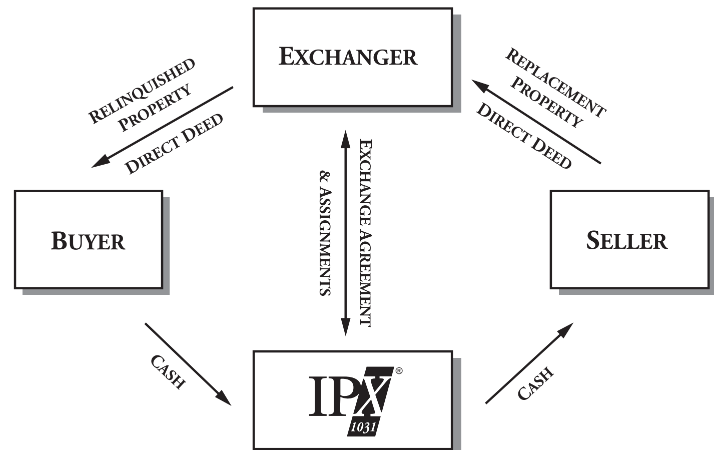
(C) If, after the end of the identification period a material and substantial contingency occurs that: relates to the deferred exchange, is provided for in writing; and is beyond the control of the Exchanger and of any "disqualified person" other than the person obligated to transfer the replacement property to the Exchanger, then the Exchanger has the right to the exchange proceeds. Although the Treasury Regulations provide very few examples, zoning problems or unsatisfactory structural inspections may rise to the level of a "material and substantial contingency." To avoid the possibility of constructive receipt of the exchange funds, the Exchanger should always consult with their tax advisor as to whether the occurrence of a particular contingency in their purchase contract could be considered a "material and substantial contingency" to qualify under this provision.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

The Simultaneous Exchange

In a simultaneous (also called concurrent) exchange, the old ("relinquished") property and the new ("replacement") property are transferred concurrently. Investors performing such an exchange without the benefit of a Qualified Intermediary may risk losing the tax deferred status of the transaction, especially if there are three parties involved.

Simultaneous Exchange with Intermediary



The Tax Court in *Keith K. Klein v. Commissioner,* 66 T.C.M. 1115 (1993), has determined one simultaneous three party exchange as a fully taxable sale. Mr. Klein's closing escrow instructions simply assigned his rights to the proceeds from the sale of his property directly to the second closing for the purchase of his replacement property. The Tax Court stated that Mr. Klein had unrestricted control over, and thus the receipt of the funds in his transaction. Klein argued that the provision in his earnest money agreement stated that the buyer would cooperate in structuring a tax deferred exchange. He felt that the funds in escrow were already assigned to the seller of the replacement property and thus he had no control over the funds. The Court indicated that the cooperation clause would not control the constructive receipt issue. **Unwary investors who do not utilize a Qualified Intermediary may be surprised to discover their transaction does not qualify for tax deferral.**

The use of a Qualified Intermediary involves the insertion of a fourth party who transfers ownership to the proper entities and insulates the exchanger from constructive receipt issues on the proceeds. The Qualified Intermediary becomes the accommodating party, thus protecting the Exchanger, buyer and seller. Although the Qualified Intermediary does not hold any proceeds in a simultaneous exchange, they function in the important capacity of creating a reciprocal trade; since they receive the relinquished property and acquire the replacement property for the exchange. The Qualified Intermediary also **controls** the flow of the exchange funds.

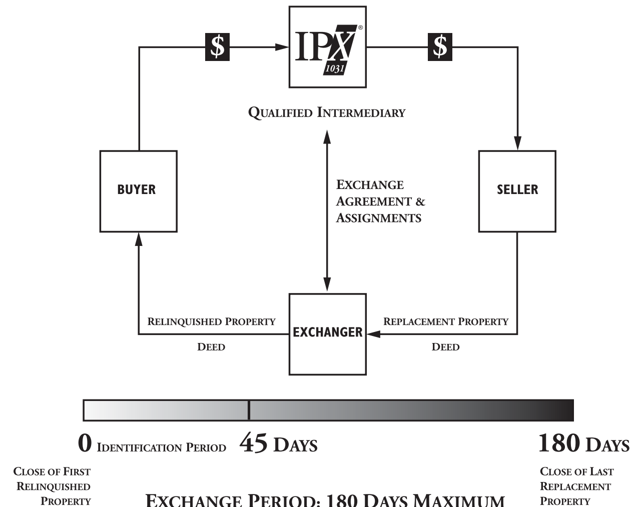
The Qualified Intermediary provides the following important services:

- Shields parties (Exchanger, buyer and seller) from certain liabilities;
- Ensures the preservation of safe harbor treatment under the 1991 Treasury Regulations;
- Provides a paper trail validating the flow and structure of the transaction; and
- Reduces the agent and closing officer's liability for the exchange structure.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

THE DELAYED EXCHANGE

There is a common misconception that all tax deferred exchanges are complicated and require all properties, relinquished and replacement, to close concurrently. Fortunately, the most common exchange variation, the delayed exchange (also referred to as a deferred or *"Starker"* exchange, *Starker v. U.S.*, 602 F.2d 1341), provides Exchangers with more flexibility and options in acquiring the replacement property than the simultaneous exchange. The delayed exchange begins when the Exchanger's first relinquished property is sold and is completed when the last replacement property is acquired within the prescribed exchange period. To provide the required notice to the relinquished property buyer(s) and the replacement property seller(s) the Purchase and Sale Contract for each property should include an "exchange cooperation".



The use of a Qualified Intermediary (also known as an "Accommodator" or "Facilitator") is the most common method used to complete a valid delayed exchange quickly and easily. The Qualified Intermediary is an independent party to the exchange transaction, who performs the function of creating the reciprocal trade of properties for the exchange, holds the exchange funds and supplies the necessary exchange documents, such as the Exchange Agreement, Assignments and Closing Instructions. The Exchanger assigns the rights in the Sale Contract for the relinquished property and in the Purchase Contract for the replacement property to the Qualified Intermediary, who essentially becomes the "seller" of the relinquished property and the "buyer" of the replacement property. To avoid actual or constructive receipt of the exchange funds by the Exchanger the proceeds from the sale of the relinquished property are held by the Qualified Intermediary until they are needed for the acquisition of the replacement property. In both simultaneous and delayed exchanges in which a Qualified Intermediary is used to create the reciprocal exchange of properties the IRS allows "direct deeding" of the relinquished property from the Exchanger to the buyer and of the replacement property from the seller to the Exchanger, thereby avoiding the necessity of the Qualified Intermediary holding title to any property. Revenue Procedure 90-34, 1990-16 C.B. 552 Treas. Reg.§1.1031(k)-1(g)(4)(v). Direct deeding avoids the assessment of double state, county, or local documentary transfer taxes and any liability on the part of the Qualified Intermediary for environmental hazards that may exist on the property.

The Treasury Department issued Regulations in 1991 that clarified the acceptable methods to properly identify replacement property. See Treas. Regs. §1.1031(k)-1(b)-(e). First, the Exchanger must receive all replacement property within the earlier of 180 days after the date on which the Exchanger transferred the first relinquished property, or the due date (including extensions) for the Exchanger's tax return for the tax year in which the transfer of the first relinquished property occurs. Second, the Exchanger must identify the replacement property to be acquired by the end of the Exchange Period within 45 days of the transfer of the first relinquished property. These time periods are very strict and cannot be extended even if the 45th day or 180th day falls on a Saturday, Sunday or legal holiday. The proper identification of replacement property is critical and if not made in a timely manner the exchange fails and the entire transaction is taxable. The rules are as follows: (a) the replacement property identification must be in writing and signed by the Exchanger, (b) it must be delivered by mail, fax or hand delivery to a party to the exchange transaction (usually the Qualified Intermediary) by midnight of the 45th day, (c) the replacement properties must be unambiguously described, such as by a street address, tax lot number, legal description or the like, and (d) the Exchanger may list up to three properties of unlimited value, but if more than three properties are listed, their total aggregate fair market value may not exceed 200% of the aggregate fair market value of the relinquished property. It is essential in a delayed exchange to adhere to these rules and deadlines established for identifying and acquiring the replacement property. **Failure to comply with these rules may result in a failed exchange.**

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

The Build-To-Suit Exchange

The build-to-suit exchange, also referred to as a construction or improvement exchange, gives the Exchanger the opportunity to use all or part of the exchange funds for construction of the replacement property and still accomplish a tax deferred exchange. This is a variation of the delayed or reverse exchange that allows the Exchanger more flexibility and provides the Exchanger with the opportunity to either renovate an existing improved property or even construct a new improvement on raw land. In the most common type of build-to-suit exchange the Exchanger sells the relinquished property in a delayed exchange and then acquires the replacement property after it has been improved with the exchange funds from the relinquished property. It is important to note that any improvements made to the replacement property after the Exchanger takes title are considered to be "goods and services". These goods and services are not considered "like-kind" property and are taxable as boot as are any remaining exchange funds. Treasury Regulations §1.1031(k)-1(e). Consequently, to be included in the exchange any improvements to the property must occur before the Exchanger takes title. *Bloomington Coca Cola Bottling Co. v. Commissioner,* 189 F.2d 14 (CA7 1951).

If the Exchanger wishes to include construction on the replacement property as part of the exchange, one option is to contract with the seller to have the construction completed by the seller or a contractor before the transaction closes and the Exchanger takes title to the property. Escrow holdback accounts do not work for build-to-suit exchanges. Another option for the Exchanger is to negotiate with a builder to purchase the replacement property for the purpose of completing the construction, and then when the replacement property is finished the Exchanger can sell the relinquished property in an exchange and buy the improved property from the builder to complete the exchange. If neither of these options will work, or when the Exchanger desires to structure the transaction under the "safe harbor" guidelines of Revenue Procedure 2000-37 ("Rev. Proc. 2000-37") as discussed below, the build-to-suit exchange is accomplished by using an Exchange Accommodation Titleholder to hold title to the Exchanger's replacement property pending the completion of the improvements. In all cases it is important to remember that all applicable rules of IRC §1031 apply equally to build-to-suit exchanges, such that the Exchanger has 45 days to properly identify the replacement property, and no more than 180 days to acquire the identified improved replacement property. Also, to have a totally tax deferred exchange, the Exchanger must ultimately acquire replacement property that is of the same or greater value as the relinquished property, and use all of the exchange equity in the acquisition price of the replacement property and the construction of the improvements.

Until recently it had been unclear whether the validity and nonrecognition status of the build-to-suit exchange would be upheld by the IRS if the replacement property that was to be improved was acquired by either the Qualified Intermediary or an entity created by the Qualified Intermediary to park the property pending the construction of the improvements. However, on September 15, 2000, that question was answered by the IRS in the form of Rev. Proc. 2000-37, which provides that nonrecognition treatment on exchanges in which either the replacement property or relinquished property is parked with an exchange accommodation titleholder pursuant to the terms of the Revenue Procedure will be recognized if the transaction falls within the scope of this announced IRC § 1031 "safe harbor."

The "Safe Harbor" Build-To-Suit Exchange

In an exchange structured as a build-to-suit exchange under the safe harbor protection of Rev. Proc. 2000-37 the entity used to facilitate a build-to-suit exchange is referred to as the Exchange Accommodation Titleholder ("EAT"), and the replacement property held by the EAT is commonly called the "parked property". The EAT will generally form a disregarded special purpose entity (the "Holding Entity") to take title to the parked property. The document governing the relationship between the Exchanger, EAT and the Holding Entity is termed the "Qualified Exchange Accommodation Agreement" ("QEAA").

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

THE BUILD-TO-SUIT EXCHANGE *(Continued)*

Under Rev. Proc. 2000-37, just as in the delayed exchange requirements, a build-to-suit exchange must be completed within 180 days after either the day the Exchanger closes on the sale of the Relinquished Property or the day the Holding Entity acquires the parked property whichever first occurs. The durational limit on delayed build-to-suit exchanges is taken from those of a delayed exchange, which by statute 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. Although the Holding Entity is on title, the Exchanger must still properly identify the replacement property and any improvements to be completed on the property within 45 days following the sale of the relinquished property. The identification rules require written identification of the replacement property, including any improvements to be made to the replacement property, to be delivered to another party to the exchange, such as the Qualified Intermediary or the Holding Entity, and limits the number of alternative and multiple replacement properties that can be identified. If the built-to-suit exchange is conducted as a reverse build-to-suit, the relinquished property identification rules of Rev. Proc. 2000-37 will also apply.

THE PROCEDURE

As in a typical delayed exchange, the delayed build-to-suit exchange begins when the Exchanger sells the relinquished property. Prior to closing on the purchase of the replacement property, the Exchanger will enter into the QEAA with the Holding Entity and will assign the rights in the purchase contract to the Holding Entity. The Qualified Intermediary and the Holding Entity will enter into an agreement that will allow the Holding Entity to use the exchange funds to acquire a fee or fee-equivalent interest in the replacement property and to complete the identified improvements. On behalf of the Holding Entity, the Exchanger arranges for the construction to be completed on the replacement property. The Exchanger, or its designated representative, is retained by the Holding Entity to act as its project manager overseeing all aspects of the construction on behalf of the Holding Entity. During the 180-day exchange period, the Exchanger, as Project Manager, sends construction invoices to the Holding Entity for payment. Build-to-suit exchanges are less complicated when the Exchanger can pay all cash for the 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 for this type of exchange prior to beginning the exchange since the Holding Entity may be required to be the borrower on the loan as the titleholder of the property. To protect the Holding Entity from liability in the event of a default by the Exchanger, the Holding Entity will only be the borrower on a non-recourse loan and deed of trust or mortgage. On the earlier of the end of the 180-day exchange period or the completion of the construction on the replacement property the terms of the QEAA are satisfied and the Holding Entity will then 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 the conclusion of the exchange. Any construction to be included in the exchange must be built and paid for prior to the Holding Entity's transfer of the replacement property to the Exchanger.

In the light of Rev. Proc. 2000-37, it is not necessary that the Exchanger close on the sale of the relinquished property prior to the closing of the replacement property. In a reverse build-to-suit exchange the relinquished property does not close until sometime after the Holding Entity has acquired the replacement property and improvements are either underway or are completed. In reverse build-to-suit exchanges since the relinquished property has not yet sold the Exchanger or a third-party lender must make funds available to the Holding Entity to acquire and improve the replacement property, otherwise the procedure is the same as discussed in this Brief Exchange.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

THE BUILD-TO-SUIT EXCHANGE *(Continued)*

IMPORTANT ISSUES

To have a valid exchange the Exchanger must properly identify the replacement property to be acquired within the 45-day identification period. In a delayed build-to-suit exchange the replacement property does not exist in the form that it is to be later acquired and so the property identification rules for property "to be constructed" are satisfied by the Exchanger "if a legal description is provided for the underlying land and as much detail is provided regarding the construction of the improvements as is practicable at the time identification is made." Treasury Regulations §1.1031(k)-1(e)(2).

- For new construction on bare land the identification requires a specific description of the land (legal description or tax lot) and a drawing or detailed summary of the new construction to be done to 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 will probably suffice.
- For purposes of the 200% rule, the fair market value of the identified property is the estimated fair market value of the improved property at the time the Exchanger expects to receive it.

The exchange requirement that the Exchanger take title to the replacement property within the 180-day exchange period applies to delayed build-to-suit exchanges. If the improvement exchange is structured as a "reverse" exchange, the Exchanger must acquire the replacement property within 180-days following the date the Holding Entity took title. After the Exchanger takes title to the replacement property construction may continue but the value of the additional construction will not be considered as part of the exchange. The improved replacement property eventually received by the Exchanger to complete the exchange must be "substantially the same property as identified." Normal "course of construction" changes may meet this test, however, "substantial changes" to the construction of the improvements probably do not meet this test. Treasury Regulations §1.1031(k)-1(e)(3). The Exchanger should keep in mind the following:

- For real property there is no requirement that construction be completed within 180 days when the Exchanger receives the replacement property, which means often that the improvement does not need to be suitable for occupancy or use. The Exchanger will be credited with receiving replacement property valued as of the date it is deeded to the Exchanger provided the improvements in place on that date are considered real property in the state in which the replacement property is located. For most exchanges, that value of the replacement property is comprised of the amount of the completed construction contract and the value of the land.
- The tax rules specifically prohibit the inclusion in the exchange value of a prepaid, but not completed, construction contract for delivered, but not constructed, materials since these delivered materials are considered prepaid services, which are not "like-kind" to real property.

PRACTICAL CONSIDERATIONS

Build-to-suit exchanges are definitely more complex than the more typical delayed exchange and require that the Exchanger plan the exchange carefully before either (1) selling the relinquished property or (2) having the Holding Entity acquire the replacement property and starting the strict delayed or "safe harbor" exchange deadlines. The Exchanger should always consider the following issues:

- In delayed build-to-suit exchanges, since the exchange period is limited to 180 days, which is often too short for many types of construction, it is critical that the build-to-suit exchange be well planned so that the purchase of the replacement property and the construction can begin shortly after the close of the relinquished property.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

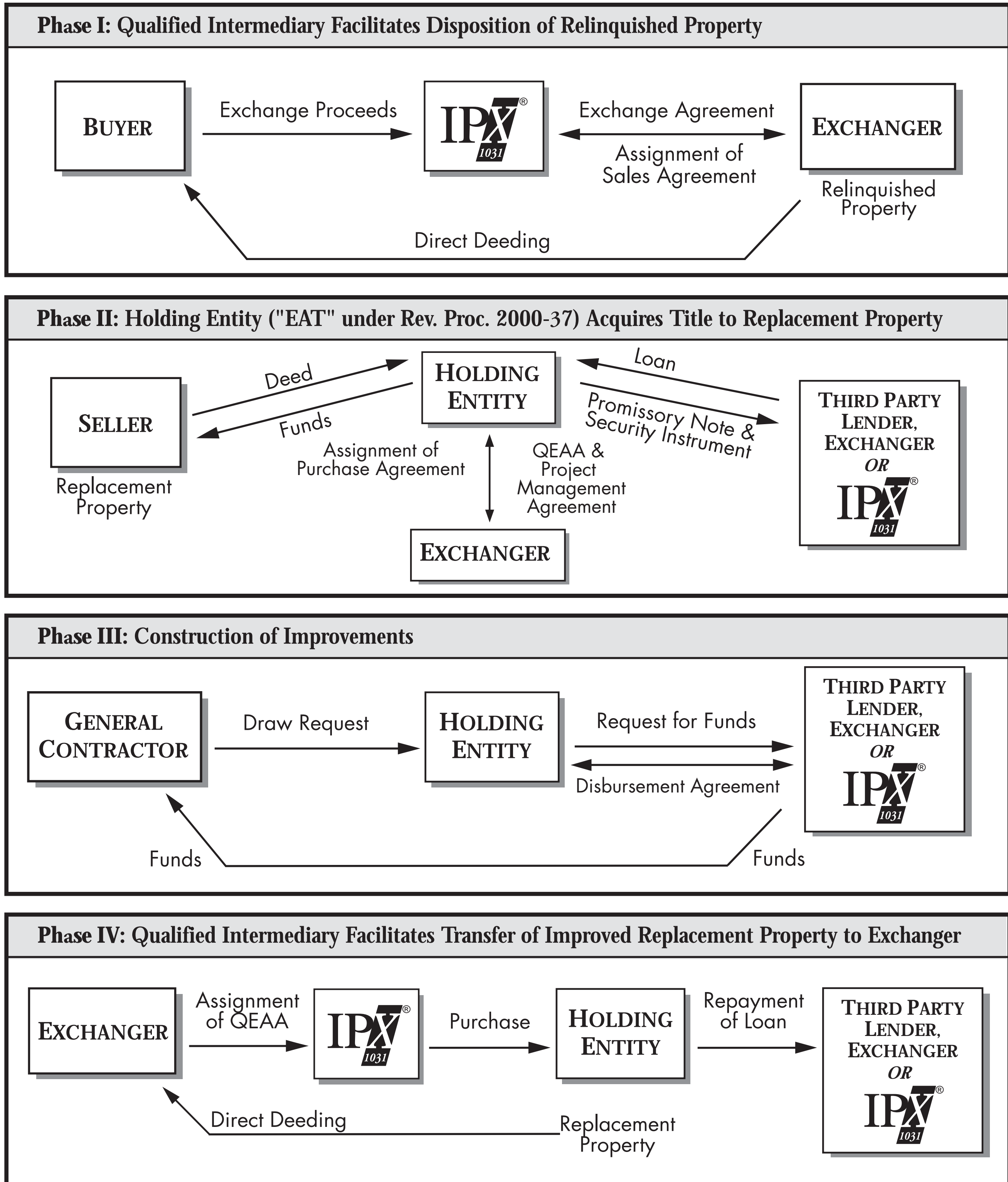
The Build-To-Suit Exchange *(Continued)*

- If a construction loan is required for the build-to-suit exchange, the Exchanger should consult with the lender prior to beginning the exchange to resolve and eliminate any problems the lender may have in making the construction loan to the Holding Entity. The lender will usually require the Holding Entity to sign the promissory note and the Deed of Trust or Mortgage to protect the lender's security interest while the Holding Entity holds title. All loan documents to which the Holding Entity is a party must be non-recourse to the Holding Entity.
- During the time the Holding Entity is on title to the parked property and while the contractor completes the construction the Holding Entity will require hazard and commercial general liability insurance, an acceptable recent Phase I Environmental Assessment Report and an indemnity from the Exchanger from any liability .
- The construction contract should be in the name of the Holding Entity with a construction management agreement with the Exchanger, or the Exchanger's designated representative, to provide the Exchanger with control of the construction while the Holding Entity is on title. If the construction contract was executed prior to the Holding Entity acquiring title, the construction contract should be transferred to the Holding Entity by an assignment.
- Despite the provisions of Rev. Proc. 2000-37, there may be additional state, county, or local transfer taxes that may be assessed twice: (1) when the replacement property is deeded from the seller to the Holding Entity to hold while the construction is completed and (2) when the improved replacement property is deeded to the Exchanger to complete the exchange. In a recent Private Letter Ruling (PLR 200148042), the IRS held that the use of language in the QEAA stating that the Holding Entity 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 may be an additional cost of the transaction in those jurisdictions. Also, the accounting, legal and Qualified Intermediary and/or Holding Entity fees will almost certainly be significantly higher than on simultaneous or delayed exchanges where the deeding is direct and the Qualified Intermediary is not required to hold title to property.
- Based on current legal authority, an Exchanger may not do a build-to-suit exchange where the construction to take place is on land owned by the Exchanger. *DeCleene v. Commissioner*, 115 T.C. No. 34 (2000) and *Bloomington Coca Cola Bottling Co. v. Commissioner*, 189 F.2nd 14 (CA7 1951). Creative practitioners had attempted to avoid this negative authority by structuring the build-to-suit exchange as construction on a newly created, long-term leasehold interest granted to the Holding Entity. The Holding Entity would construct improvements on the leasehold interest and then transfer the improved leasehold to the Exchanger to complete the exchange. Recently, however, Rev. Proc. 2000-37 was modified by Revenue Procedure 2004-51 to provide that the "safe harbor" of Rev. Proc. 2000-37 "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" (Revenue Procedure 2004-51 Section 4). Although opinions are split as to whether the technical language of Rev. Proc. 2004-51 directly impacts the newly created leasehold structure, verbal indications from the IRS indicate that this new modification was intended to take transaction structures in which the improvements are made on newly created leasehold interests outside of the safe harbor when the Exchanger is the lessor under the newly created lease.
- There are, however, several Private Letter Rulings (200251008 and 200329021) that appear to reach a different conclusion when an affiliate or related party, as opposed to the Exchanger itself, owns the land on which the improvements are to be constructed. Taxpayers should be cautioned that in Rev. Proc. 2004-51 the IRS announced that "[t]he Service and Treasury Department are continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party and the accommodation party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate."

Build-to-suit exchanges can be a creative way to structure an exchange to best fit the Exchanger's investment goals. However, it is essential that Exchangers seek adequate legal and tax counsel in planning a build-to-suit exchange prior to entering into the exchange.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

"Delayed Build-To-Suit" Exchange



Brief Exchange Communications

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

How to Initiate a Build-To-Suit Exchange

STEP 1 …

Select a QUALIFIED INTERMEDIARY to assist you with the build-to-suit exchange as early in the process as possible. Key points to consider in selecting a Qualified Intermediary are: the **knowledge and experience** of the staff; the **professional assistance** provided by the Qualified Intermediary to your real estate agent, CPA and attorney; the **security of the property** while it is being held by the Qualified Intermediary, and the **security of the exchange funds** held by the Qualified Intermediary, which are of especially critical importance. **Investment Property Exchange Services, Inc. (IPX1031)** is a subsidiary of Fidelity National Financial, Inc., the largest provider of title insurance and real estate related services and the parent company of Fidelity National Title Insurance Company, Chicago Title Insurance Company, Ticor Title Insurance Company, Alamo Title Insurance Company and Security Union Title Insurance Company.

STEP 2 …

In all types of exchange transactions always instruct your real estate agent to include an "Exchange Cooperation Clause" as an addendum to the purchase and sale agreement on both the relinquished property(ies) and the replacement property(ies) used in the exchange. IPX1031 has sample exchange cooperation addendums available for this purpose.

STEP 3 …

Contact your tax and/or legal advisor as early in the build-to-suit exchange process as possible to consult with them to determine the advisability and feasibility of completing a build-to-suit exchange and whether the build-to-suit exchange should be structured as a "delayed" or "reverse" exchange. Build-to-suit exchanges are significantly more expensive than delayed or simultaneous exchanges because they are more complex and require additional time and effort by the Qualified Intermediary to set up and administer. In addition, since the Qualified Intermediary or its affiliated Holding Entity must hold title to the replacement property to complete the exchange, the Qualified Intermediary has increased risk and liability that is not present in delayed or simultaneous exchanges, which significantly adds to the cost of the exchange.

STEP 4 …

Contact your Qualified Intermediary as soon as possible **after entering into the purchase and sale agreements** for the sale of the relinquished property and purchase of the replacement property and advise the Qualified Intermediary of the timing and close of these transactions. **IPX1031 must have two weeks prior notice to review the details of the build-to-suit exchange and to prepare the applicable exchange documents.** Both your attorney or accountant and IPX1031 must approve the transaction before IPX1031 will finalize the exchange documents. IPX1031 will work closely with your tax and legal advisors during every step of the transaction. IPX1031 has a National Reverse and Improvement Exchange Division located in Phoenix, Arizona that specializes exclusively in these types of transactions. IPX1031 will draft the appropriate Exchange Agreement (if the relinquished property has already closed under a delayed Exchange Agreement the appropriate Exchange Agreement Amendment will be prepared), Assignment, Qualified Exchange Accommodation Agreement, Project Management Agreement, Exchange Closing Instructions and other documents for execution prior to the close of the property being acquired as replacement property. IPX1031 will also assign into the Construction Contract as the owner. In either a delayed or "safe harbor" reverse build-to-suit exchange the construction work must be completed prior to the end of the 180 day exchange period. Also, in any build-to-suit exchange the replacement property must be identified to the Qualified Intermediary with a description of the underlying land plus a description, in as much detail as practicable at the time of the identification, of the improvements to be completed by the end of the exchange. **REMEMBER, DO NOT CLOSE ON THE RELINQUISHED PROPERTY WITHOUT A QUALIFIED INTERMEDIARY IN PLACE, AND DEFINITELY DO NOT CLOSE ON THE REPLACEMENT PROPERTY WITHOUT ALL OF THE APPROPRIATE BUILD-TO-SUIT EXCHANGE DOCUMENTS IN PLACE!**

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

HOW TO INITIATE A BUILD-TO-SUIT EXCHANGE *(Continued)*

STEP 5 …

Prior to IPX1031 or a subsidiary of IPX1031that is used as the Holding Entity taking title to the replacement property in the build-to-suit exchange, you must have hazard and commercial general liability insurance coverage naming the Holding Entity as an insured or additional insured for the amount of liability coverage specified by IPX1031. In addition, prior to taking title to commercial, industrial or raw land IPX1031 must be provided with a copy of the Phase 1 Environmental Site Assessment report or other comparable environmental evaluation that is no more than six months old for review and approval. IPX1031 will require that the Phase I be certified to the Holding Entity and the Phase I must state that the property is free of contamination. Finally, each contractor or subcontractor that will work on the construction project must be licensed and have the appropriate insurance and a bond satisfactory to IPX1031.

STEP 6 …

If IPX1031 or its Holding Entity is taking title to the replacement property and if there is a third party lender, you must contact your lender, whether it is a financial institution or the seller of the replacement property, and instruct your lender that you will be completing a build-to-suit exchange and that IPX1031 or its Holding Entity will be the borrower on the loan until such time as the replacement property is deeded to you. The loan will need to be non-recourse to IPX1031 and its Holding Entity. For both delayed build-to-suit exchanges and "safe harbor" build-to-suit exchanges your lender can require that you be a guarantor on the loan and that you offer other collateral (other than the relinquished property), if necessary, to meet the lender's underwriting guidelines. IPX1031 will work closely with your lender to assist them in understanding the build-to-suit exchange process.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

THE REVERSE EXCHANGE

A reverse exchange is the "flip side" of a deferred (delayed) exchange. In a reverse exchange the Exchanger for various reasons must acquire their like-kind replacement property before disposing of a relinquished property. Until recently it was unclear whether reverse exchanges would be given nonrecognition treatment by the IRS. However, on September 15, 2000, that question was answered by the IRS in the form of Revenue Procedure 2000-37 ("Rev. Proc. 2000-37"). This Revenue Procedure provides that tax deferral on reverse exchanges will be recognized if the transactions fall within the scope of an announced IRC §1031 "safe harbor." The new reverse exchange rules can be expected to lead to two categories of reverse exchanges, those that fit neatly within the safe harbor guidelines and those that do not fit within the safe harbor rules.

THE "SAFE HARBOR" REVERSE EXCHANGE

In a reverse exchange structured under the safe harbor protection of Rev. Proc. 2000-37 the entity used to facilitate a reverse exchange is referred to as the Exchange Accommodation Titleholder ("EAT"), and the property held by the EAT is commonly called the "parked property". The EAT will usually form a special purpose entity (the "Holding Entity") to take title to the parked property. To complete a reverse exchange the Holding Entity can take title to either the relinquished property or the replacement property under a "Qualified Exchange Accommodation Arrangement". The document between the Exchanger, EAT and the Holding Entity is termed the "Qualified Exchange Accommodation Agreement" ("QEAA").

Under Rev. Proc. 2000-37, a safe harbor reverse exchange must be completed within 180 days after the Holding Entity acquires the parked property. The durational limit on safe harbor transactions is taken from those of a delayed exchange, which by statute 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, under a safe harbor reverse exchange the Exchanger must identify one or more relinquished properties within 45 days after the Holding Entity acquires the replacement property. Rev. Proc. 2000-37 adopts the same identification rules that apply in delayed exchanges, which require written identification be delivered to another party to the exchange, such as the Holding Entity, EAT or the Qualified Intermediary, and limits the number of alternative and multiple properties that can be identified.

THE "NON-SAFE HARBOR" REVERSE EXCHANGE

Under Section 3.02 of Rev. Proc. 2000-37 which specifically states, "the Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in this revenue procedure", Rev. Proc. 2000-37 leaves open the option for some aggressive Exchangers to structure a reverse exchange that does not comply with all of the provisions of the Revenue Procedure and, therefore, Exchangers may elect to pursue reverse exchange structures that will take longer than 180 days or which will not have identified relinquished property. Since there is no regulatory authority to assist in structuring a reverse exchange outside the parameters of the safe harbor there is a much higher risk associated with such exchanges and, therefore, non-safe harbor reverse exchanges should be attempted only if there is an absolute need to proceed outside of Rev. Proc. 2000-37.

Experts in the field agree that unlike under Rev. Proc. 2000-37, a valid non-safe harbor exchange will require the Holding Entity to undertake more responsibility for ownership of the parked property than just bare tax ownership. Most tax experts believe that Holding Entities operating outside of the safe harbor of Rev. Proc. 2000-37 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. As a result of this potentially adverse impact on the financial statements of the publicly traded parent corporation of most large Qualified Intermediaries, these Qualified Intermediaries, including IPX1031, will not be allowed to participate in non-safe reverse exchanges. While IPX1031 cannot assist clients with non-safe harbor reverse exchanges by acting as the Holding Entity, IPX1031 can still participate in the exchange as the Qualified Intermediary working in conjunction with the Exchanger's tax counsel and non-safe harbor Holding Entity.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

THE REVERSE EXCHANGE *(Continued)*

THE PROCEDURE - PARKING THE REPLACEMENT PROPERTY

In the most common type of reverse exchange the Exchanger contracts with the Holding Entity to have it purchase and retain title to the replacement property. In the first phase of the reverse exchange the Exchanger loans the necessary down payment funds to the Holding Entity, who in turn uses these funds along with funds provided by a third-party lender, if any, to close on the replacement property and take title in the Holding Entity's name. Under the terms of the parking agreement or the QEAA, the Holding Entity leases the property to the Exchanger under a triple net lease. In this way the Exchanger can begin to use the property or sublet the property while the Holding Entity is on title. On the rare occasion that a lease agreement is not possible the Holding Entity may be willing to retain the Exchanger or a third party designated by the Exchanger as the property manager. The use of a property management agreement instead of a triple net lease adds substantial tax reporting obligations to the reverse exchange structure and, therefore, this type of arrangement should not be used unless other more suitable options are unavailable.

When the Exchanger sells the relinquished property identified in the exchange it is transferred directly to the buyer through a simultaneous exchange with the Qualified Intermediary and the use of direct deeding. The cash proceeds of the sale go to the Qualified Intermediary, who uses the proceeds to acquire the replacement property from the Holding Entity. The Holding Entity uses these proceeds from the sale to first repay the loan from the Exchanger and then any additional proceeds are used to pay down the third-party loan on the replacement property prior to deeding the replacement property to the Exchanger. If there are more proceeds from the relinquished property sale than the Qualified Intermediary needs to acquire the replacement property, the Qualified Intermediary can use the excess proceeds to purchase additional replacement property within 180 days of the transfer of the relinquished property, provided that such additional replacement property can be properly identified by the Exchanger within 45 days of the close 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 required, the Exchanger should seek lender approval for this type of exchange prior to beginning the exchange because the Holding Entity (not the Exchanger) may be required to be the borrower on the loan as the titleholder of the property. Exchangers should be aware that despite Rev. Proc. 2000-37 many lenders are not familiar with reverse exchanges, many types of loans are not available when pursuing a reverse exchange and the loan costs may be increased to cover the lender's document preparation and legal fees. In a safe harbor exchange to protect the lender's security interest and to protect the Holding Entity from liability in the event of a default by the Exchanger, the Exchanger will guarantee the loan and the Holding Entity will only be the borrower on a non-recourse loan and deed of trust or mortgage.

THE PROCEDURE - PARKING THE RELINQUISHED PROPERTY

An alternative to parking the replacement property is to have the Holding Entity park the Exchanger's relinquished property. This type of reverse exchange begins with a simultaneous exchange involving the Exchanger, the Holding Entity, the seller of the replacement property and the Qualified Intermediary. Here, with the assistance of the Qualified Intermediary, the Exchanger transfers the relinquished property to the Holding Entity and then simultaneously receives the replacement property from the seller. Both transfers occur through the Qualified Intermediary and the use of direct deeding. Since the relinquished property has not yet been sold to a true buyer to provide exchange funds for the acquisition of the replacement property, the Exchanger must loan the funds to the Holding Entity. The funds are then put into the exchange through the Qualified Intermediary to be used to acquire the replacement property from the seller. This loan should equal the equity the Exchanger

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

THE REVERSE EXCHANGE *(Continued)*

has in the Relinquished Property. As in the replacement-parking alternative, the Holding Entity leases the relinquished property to the Exchanger under a triple net lease agreement. In the second half of the transaction when the Exchanger has located a suitable buyer for the relinquished property, the relinquished property is sold and deeded from the Holding Entity to the buyer. The cash proceeds from the sale go to the Holding Entity and are used first to retire any existing third-party debt the Holding Entity took subject to, and then to repay the Exchanger for the original loan to the Holding Entity. If the price paid by the Holding Entity for the parked property differs from the actual price paid by the ultimate buyer, the Exchanger and the Holding Entity will enter into a purchase price adjustment agreement to increase or decrease the original purchase price and loan amount from the Exchanger as necessary to reflect the final purchase price.

PARKING REPLACEMENT VERSUS RELINQUISHED PROPERTY

- When dealing with replacement property of a residential nature quite often institutional lenders will not make the acquisition loan to the Holding Entity even if guaranteed by the Exchanger so the only alternative is to have the Holding Entity take title to the relinquished property so that the Exchanger can take direct title to the replacement property with a new loan from the institutional lender.
- To prevent a boot issue and the payment of capital gain taxes 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 may wish to have the Holding Entity take title to the replacement property so that the Holding Entity has an opportunity to use the excess funds from the sale of the relinquished property to pay down the debt on the replacement property prior to transferring title to the Exchanger, or the Exchanger can try to acquire additional replacement property at the time the relinquished property is sold and the 45-day identification period and 180-day exchange period start to run. If the Holding Entity is taking title to the relinquished property the down payment on the replacement property should equal or exceed the estimated equity in the relinquished property to avoid boot.
- Parking the relinquished property can be risky since the Exchanger must be careful not to trigger a due-on sale clause in the relinquished property loan when the relinquished property is deeded to the Holding Entity.
- Often the Exchanger does not know which relinquished property will be used in the exchange, or which relinquished property will sell first. In this situation, it is advisable for the replacement property to be parked with the Holding Entity to allow the Exchanger the opportunity to tie up the replacement property until the Exchanger knows which relinquished property to use in the exchange or which one will sell first.

PRACTICAL CONSIDERATIONS

- To fall within the safe harbor protection of Rev. Proc. 2000-37, the Exchanger must identify the relinquished property to be exchanged within 45 days of the Holding Entity taking title to the parked replacement property, and the Holding Entity cannot remain on title for longer than 180 days.
- During the time the Holding Entity is on title to the property the Holding Entity will require hazard and commercial general liability insurance, an acceptable recent Phase I Environmental Site Assessment Report and an indemnity from any liability from the Exchanger.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

The Reverse Exchange *(Continued)*

- Additional costs incurred by the Exchanger for a reverse exchange may be substantial. Additional title insurance may be required when the Holding Entity deeds the replacement property to the Exchanger; additional state, county, or local documentary transfer taxes may be assessed when property is deeded first to the Holding Entity and then to the Exchanger or the buyer; and the accounting, legal and Holding Entity's fees will almost certainly be significantly higher than the costs of a simultaneous or delayed exchange.

- If the Exchanger's transaction requires improvements be completed on the replacement property prior to the Exchanger acquiring title, the replacement property can be parked with the Holding Entity. The Holding Entity will enter into a construction agreement with the general contractor and will borrow funds from the Exchanger or a third-party lender to finance the construction.

- In the light of the practical difficulties and associated costs for all types of reverse exchanges, the Exchanger may wish to consider other available alternatives to delay the close of the purchase of the replacement property until the relinquished property sells to allow the Exchanger to complete a regular simultaneous or delayed exchange. For example, the Exchanger could apply an additional or non-refundable earnest money deposit for the benefit of the seller as consideration for the seller delaying the close of the replacement property, or the Exchanger could enter into an option to purchase the replacement property at a later date thereby providing enough time to sell the relinquished property.

- Recently Rev. Proc. 2000-37 was modified by Revenue Procedure 2004-51 to provide that the "safe harbor" of Rev. Proc. 2000-37 "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" (Revenue Procedure 2004-51 Section 4). This new ruling has a potential impact on reverse improvement exchanges where the Exchanger is attempting to construct improvements on property it currently owns and provides a "warning" for reverse improvement exchange structures where the replacement property is currently owned by an affiliate or related party.

Reverse and reverse build-to-suit exchanges can be a creative way to structure an exchange to best fit the Exchanger's investment goals. However, it is essential that Exchangers seek adequate legal and tax counsel in planning a reverse or reverse build-to-suit exchange prior to entering into the exchange.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

How to Initiate a Reverse Exchange

STEP 1—Select a QUALIFIED INTERMEDIARY to assist you with the reverse exchange as early in the process as possible. Key points to consider in selecting a Qualified Intermediary are: the **knowledge and experience** of the staff; the **professional assistance** provided by the Qualified Intermediary to your real estate agent, CPA and attorney; and the **security of the property** while it is being held by the Qualified Intermediary, which is of especially critical importance. It is highly recommended that you work with a Qualified Intermediary with significant financial strength and stability to insure that the Qualified Intermediary will be in business and able to transfer your property to you when you are ready to complete your exchange. **Investment Property Exchange Services, Inc. (IPX1031)** is a subsidiary of Fidelity National Financial, Inc., the largest provider of title insurance and real estate related services and the parent company of Fidelity National Title Insurance Company, Chicago Title Insurance Company, Ticor Title Insurance Company, Alamo Title Insurance Company and Security Union Title Insurance Company.

STEP 2—In all types of exchange transactions always instruct your real estate agent to include an "Exchange Cooperation Clause" as an addendum to the purchase and sale agreement on both the relinquished property(ies) and the replacement property(ies) used in the exchange. IPX1031 has sample exchange cooperation addendums available for this purpose.

STEP 3— Contact your tax and/or legal advisor as early in the reverse exchange process as possible to consult with them to determine the advisability and feasibility of completing a reverse exchange. Your Qualified Intermediary will consult with your tax and/or legal advisor to determine which property, the replacement or the relinquished, will be used in the reverse exchange. This determination will depend upon such variables as the type of property in the exchange, the lender on the property to be purchased, environmental issues, tenant issues, construction plans, vesting and entity title issues and numerous tax considerations. Reverse exchanges are significantly more expensive than delayed or simultaneous exchanges because they are more complex and require additional time and effort by the Qualified Intermediary to set up and administer. In addition, since the Qualified Intermediary or its affiliated Holding Entity must hold title to either the relinquished or replacement properties to complete the exchange, the Qualified Intermediary has increased risk and liability in reverse exchanges that is not present in delayed or simultaneous exchanges, which significantly adds to the cost of the exchange.

STEP 4— Contact your Qualified Intermediary as soon as possible **after entering into the purchase and sale agreement** for the purchase of the replacement property and advise the Qualified Intermediary of the timing and close of the transaction. **IPX1031 should have two weeks prior notice to review the details of the reverse exchange and to prepare the applicable exchange documents.** Both your attorney or accountant and IPX1031 must approve the transaction before IPX1031 will finalize the exchange documents. IPX1031 will work closely with your tax and legal advisors during every step of the transaction. IPX1031 has a National Reverse and Improvement Exchange Division located in Phoenix, Arizona that specializes exclusively in these types of transactions. IPX1031 will draft the appropriate Qualified Exchange Accommodation Agreement (or Parking Agreement), Assignment, Project Management Agreement (for reverse build-to-suit exchange), Exchange Agreement, Exchange Closing Instructions and other documents for execution prior to the close of the property being acquired in the reverse exchange. In a reverse build-to-suit exchange IPX1031 will also assign into the Construction Contract as the owner, and may require a third party inspector to determine the progress of the work and the disbursement of the funds from the exchange account. In a "safe harbor" reverse build-to-suit exchange the construction must be completed prior to the end of the 180 day exchange period. **REMEMBER, DO NOT CLOSE ON THE REPLACEMENT PROPERTY WITHOUT A QUALIFIED INTERMEDIARY AND ALL OF THE REVERSE EXCHANGE DOCUMENTS IN PLACE!**

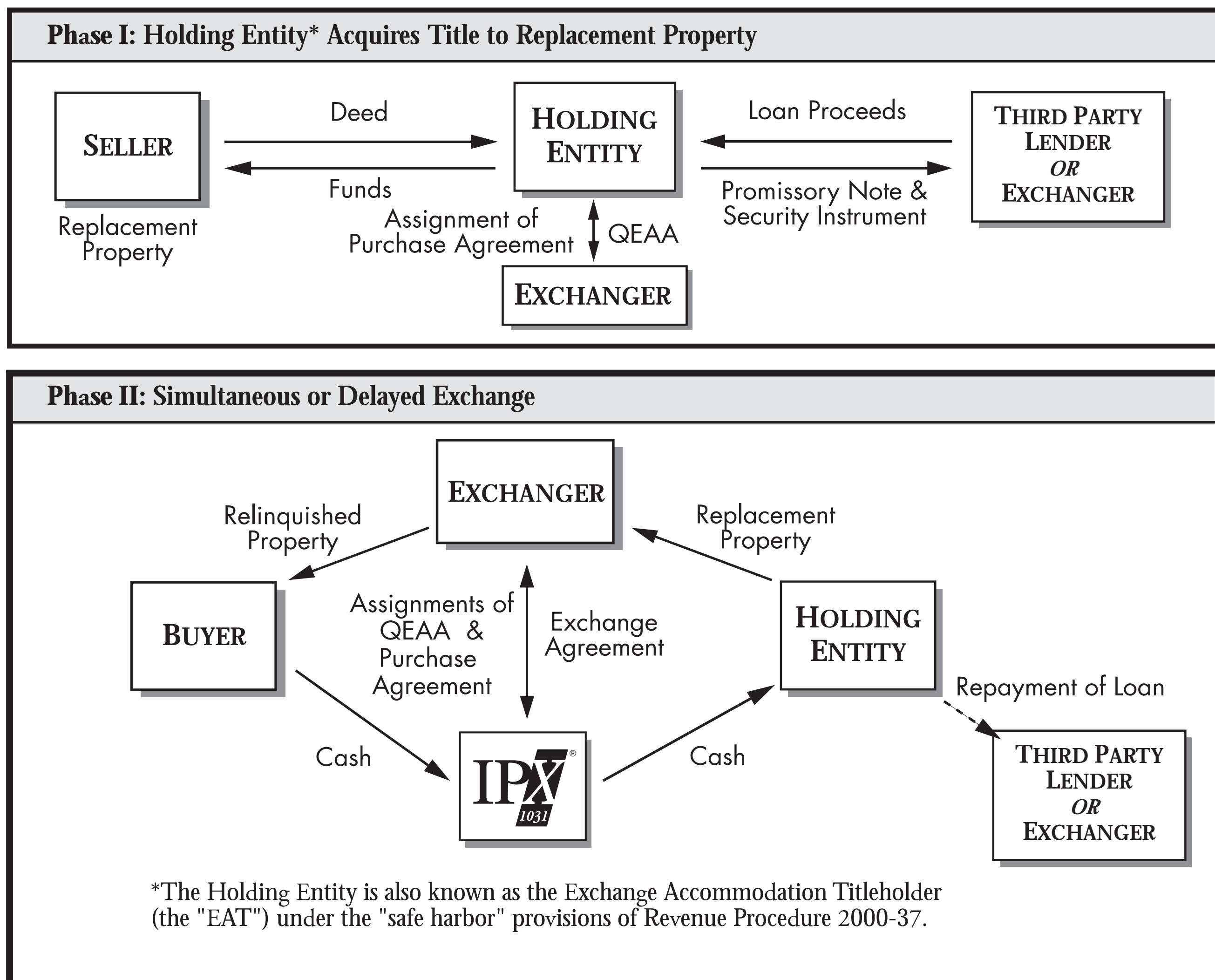
STEP 5—Prior to IPX1031 or a subsidiary of IPX1031 that is the Holding Entity used to take title in the reverse exchange to either the replacement or relinquished property, you must have hazard and liability insurance coverage naming the Holding Entity as an insured or additional insured for the amount of liability coverage specified by IPX1031. In reverse build-to-suit exchanges each contractor or subcontractor that will work on the construction project must be licensed and have the appropriate insurance and a bond satisfactory to IPX1031. In addition, prior to IPX1031 or its Holding Entity taking title to commercial, industrial or non-residential raw land IPX1031 must be provided with a copy of the Phase 1 Environmental Site Assessment report or other comparable environmental evaluation that is no more than six months old for review and approval. IPX1031 will require that the Phase I be certified to the Holding Entity and the Phase I must state that the property is free of contamination.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

How to Initiate a Reverse Exchange *(Continued)*

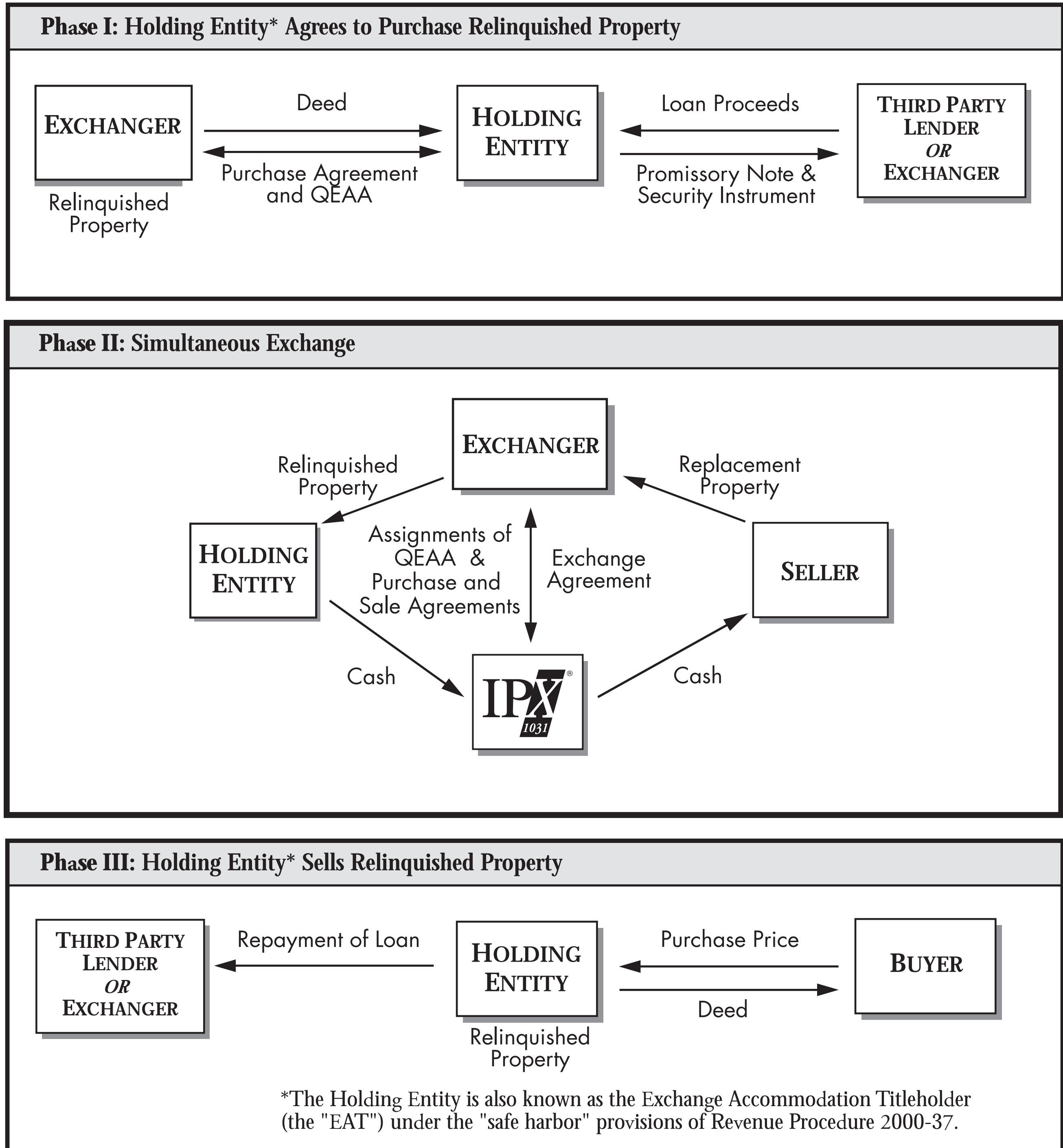
STEP 6 — If IPX1031 or its Holding Entity is taking title to the replacement property and if there is a third party lender, you must contact your lender, whether it is a financial institution or the seller of the replacement property, and instruct your lender that you will be completing a reverse exchange and that IPX1031 or its Holding Entity will be the borrower on the loan until such time as the replacement property is deeded to you. The loan will need to be non-recourse to IPX1031 and its Holding Entity. Your lender may also require that you be a guarantor on the loan and that you offer other collateral (other than the relinquished property), if necessary, to meet the lender's underwriting guidelines. IPX1031 will work closely with your lender to assist them in understanding the reverse exchange process.

"Replacement Property Parked" Reverse Exchange



Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

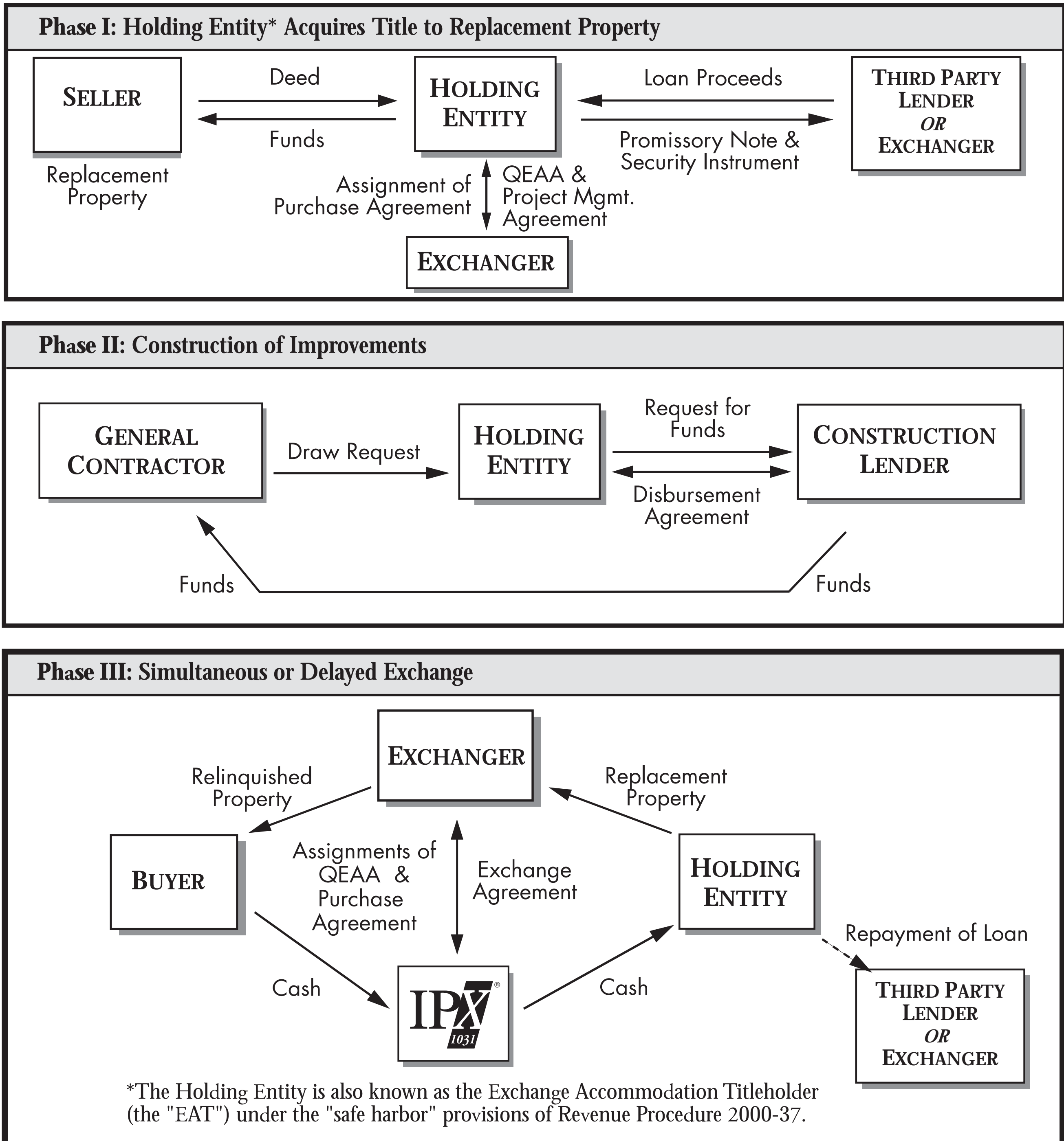
"Relinquished Property Parked" Reverse Exchange



*The Holding Entity is also known as the Exchange Accommodation Titleholder (the "EAT") under the "safe harbor" provisions of Revenue Procedure 2000-37.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

"Reverse Build-To-Suit" Exchange



*The Holding Entity is also known as the Exchange Accommodation Titleholder (the "EAT") under the "safe harbor" provisions of Revenue Procedure 2000-37.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Property Held for Resale Purposes

The intent by the taxpayer to hold property "primarily for sale" will prevent the property from qualifying for IRC §1031 treatment. Over the years the courts have struggled with this exclusion from tax deferred exchange treatment. The courts have attempted to define the term "primarily" to mean "principally" or "of first importance" and to differentiate the holding of the property as a "capital asset" as compared to one that is held as "stock in trade primarily for sale to customers in the ordinary course of the taxpayer's trade or business" as provided in IRC §1221. *George M. Bernard*, 36 T.C.M. (1967) and *Guardian Industries v. Commissioner*, 97 T.C. 308, 317 n.2 (1991), aff'd, 1994 U.S. App. (6th Cir.). In contrast to IRC §1221, IRC §1031 appears to be stricter in its application of the stock in trade exclusion since there is no requirement under IRC §1031 that the taxpayer must have held the property "for sale in the course of the taxpayer's trade or business". While, in general, most properties owned by developers, builders and people who perform rehabilitation work will probably be considered to be held primarily for sale and may not be allowed exchange treatment, the courts look to the intent of the taxpayer in determining whether the property qualifies for exchange treatment. The courts measure the taxpayer's intent at the point of the date of the sale or exchange of the property and not necessarily to the pre-exchange or post-exchange use of the property. In determining the Exchanger's intent at the time of the exchange the courts can look to the Exchanger's prior use of the property. At the time of the disposition of the property the Exchanger must be determined to have intended to hold the property for investment or use in the Exchanger's trade or business. David B. Downing, 58 T.C.M. (1989). The courts, however, have held that the Exchanger can change its intent and still qualify for tax deferred exchange treatment. *Guardian Industries v. Commissioner*, 97 T.C. 308, 317 n.2 (1991), aff'd, 1994 U.S. App. (6th Cir.), Rev. Rul. 57-244, 1957-1 C.B. 247.

Over the years the courts have listed many factors to be considered in determining whether the taxpayer's property is "held for sale" and does not qualify for exchange treatment. All of these factors can usually be categorized into three important factors that when weighed together assist the court in determining whether a property is "held for sale". *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409 (5th Cir.), cert. denied, 429 U.S. 819 (1976) and *Suburban Realty Co. v. United States*, 615 F.2d 171 (5th Cir.), cert. denied, 449 U.S. 920 (1980). These three factors are:

- The frequency, number and extent of the real estate transactions entered into by the taxpayer;
- The development activity of the taxpayer, which includes subdividing, grading and improving the property; and
- The nature and extent of the efforts by the taxpayer to sell the property.

The most important factor used by the courts in determining whether a specific property owned by the Exchanger is held for sale and does not qualify for exchange treatment is the nature, extent and sales history of the Exchanger with respect to other properties owned by the Exchanger. While the courts do not agree as to how many properties an Exchanger must sell over a specified period of time, the courts do seem to agree that the more property sales by the Exchanger, the more likely the court will find that the property is "held for sale" and does not qualify for exchange treatment. For cases approving tax deferred exchange treatment: *See Byram v.United States*, 705 F.2d 1418 (5th Cir. 1983), *Bramblett v. C.I.R.*, 960 F.2d 526 (5th Cir. 1992) and *Loren F. Paullus v. Commissioner*, 1996 T.C.M. (1996). For cases disapproving tax deferred exchange treatment: See *S&H, Inc. v. Commissioner,* 78 T.C. 234 (1982), *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409 (5th Cir.), cert. denied, 429 U.S. 819 (1976) and *William D. Little*, 63 T.C.M. (1993). It is important to note that even if a taxpayer is a dealer/developer with respect to other properties that the taxpayer owns that this does not necessarily mean that the other taxpayer owned properties will not qualify for exchange treatment. *Margolis v. C.I.R.*, 337 F.2d 1001 (9th Cir. 1964). The next factor the courts consider is the extent of the taxpayer's development activities, such as subdividing the property, adding streets, roads, sewers and utility services, obtaining a rezoning of the property and renovating the property. Ultimately, the court is looking at the extent that the gain on the sale of the property was attributable to the taxpayer's own efforts on the property as opposed to a gain due to external factors. The courts have, however, also held that the fact that a taxpayer has subdivided the property does not necessarily prevent the taxpayer from receiving exchange treatment on the disposition of the property. *Buono v. Commissioner*, 74 T.C. 187 (1980) and IRC §1237. Substantial improvements by the taxpayer to a property, however, make it very difficult for the taxpayer to claim that the property was not held "primarily for sale" and, therefore, not qualified for exchange treatment. *Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984). The same is true for taxpayers who purchase property, renovate it and then sell it. Most likely, this transaction will be disallowed for exchange treatment. *Ethel Black*, 35 T.C. 90 (1960). The last main factor that the courts use in determining whether the sale of a taxpayer's property qualifies for exchange treatment is the sales efforts of the taxpayer. This includes the taxpayer's advertising efforts, the use of sales personnel, the use of a business office to handle the sales efforts for the property, the proportion of the Exchanger's income that is derived from the sale of the property and the extent of the taxpayer's involvement, time, effort, supervision and control over the sales activities regarding the property. *Victor Harder*, 59 T.C.M. (1990). Exchangers are always advised to consult with their tax and legal advisors regarding the exchange status of a property before attempting an exchange.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Other Interests in Real Property and Mixed Use Exchanges

In addition to a fee interest in real property, certain other interests in real property may be exchangeable as replacement property. The IRS will look to state law to determine whether the interest in the property is treated as real property or as personal property. *Aquilino v. United States*, 363 U.S. 509 (1960). The following are examples of *other interests* in real property that are considered to be of like kind to a fee interest in real property:

- Mineral rights, water (riparian) rights, scenic easements, agricultural conservation easements, and possibly air rights, development rights and zoning rights (which must be considered real estate under state or local law to be an interest in real property);
- A remainder interest in realty; and
- Cooperative apartments provided they are considered equivalent to real estate under state law, such as in California.

Timber rights: In some states standing timber is considered an interest in real property and can be exchanged for any other interest in real property, such as an apartment complex or a retail mall. *Anderson v. Moothart*, 198 Or. 354, 256 P.2d 257 (1953) and *Cary A. Everett*, T.C.M. 1978-53. If the timber is being sold subject to a cutting contract, however, which requires that the timber be removed from the land within a reasonable time, this may be considered a personal property interest under applicable state law and not be of like kind to real property for purposes of an exchange. A personal property exchange is still possible, but the "like-kind" requirement for personal property exchanges limits the replacement property to cut timber. *Oregon Lumber Company v. Commissioner*, 20 T.C. 192 (1958).

Leasehold interests: A lease with 30 years or more remaining to run, including renewal options, is considered to be of like kind to a fee interest in real estate, whereas a lease with a term of less than 30 years is not of like kind to real estate for exchange purposes. *Century Electric Co. v. C.I.R.*, 192 F.2d 155 (8th Cir. 1951); Treas. Reg. §1.1031(a)-1(c) and Rev. Rul. 78-72, 1978-1 C.B. 258. A "carve out" of a lease interest does not qualify for exchange treatment. Therefore, a fee owner of real property cannot exchange a "carve out" 30-year lease in that property for a fee interest in a replacement real property. Rev. Rul. 66-209, 1966-2 C.B. 299. This is in contrast to an exchange of real property that is "subject to" a long-term lease, which is still treated as real property for purposes of qualifying for an exchange since this is equivalent to the lessor's reversionary interest. Rev. Rul. 76-301, 1976-2 C.B. 241.

Undivided interests: Another issue arises when there is a partition of property between co-owners, or when co-owners of the same property desire to exchange their undivided interest in the whole property for an exclusive fee interest in a portion of the same property. These transactions have been allowed and accorded favorable exchange treatment. Rev. Rul. 79-44, 1979-1 C.B. 265; Rev. Rul. 73-476, 1973-2 C.B. 301. The Internal Revenue Service has issued guidance for reviewing the viability of using an exchange to acquire a tenancy in common (or fractional ownership) interest in a replacement property where there are a large number of co-tenants in a co-tenancy arrangement. Rev. Proc. 2002-22. The main issue for the IRS is that the large number of co-tenants in the replacement property may cause the ownership structure to be recharacterized as a partnership, which would be disallowed as replacement property for exchange purposes because an interest in a partnership is excluded from exchange treatment.

Mixed uses: Exchangers hold properties for various reasons, such as for investment, personal use, primarily for sale, or use in their trade or business. In these situations, tax and legal advice is necessary to allocate sale and purchase prices to the appropriate qualified and non-qualified property portions of the exchange. In *Sayre v. U.S.*, 163 F. Supp. 495, the court ruled that any reasonable allocation would be acceptable. There is no requirement that the property be surveyed or partitioned to achieve this dual tax purpose. An allocation could be determined, for example, by an appraisal based upon the number of units or the relative square footage of the units. It is important to note that the proceeds from the sale of the qualified exchange portion of the relinquished property must be used to purchase qualified replacement property and not be used toward the purchase of that portion of the replacement property that will be used for personal purposes, otherwise it will be considered taxable as boot. For example, an Exchanger relinquishes the family homestead and the surrounding ranch, a mix of personal use and business use. The Exchanger can take advantage of the principal residence capital gains tax exclusion (subject to specific limitations) under IRC §121, while simultaneously pursuing an exchange of the ranch portion of the property under IRC §1031. The Exchanger's replacement property could be a single replacement property consisting of both another personal residence and ranch or two separate replacement properties consisting of a separate home and an apartment complex.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Personal Property Exchanges

Deferring capital gain and other taxes through an IRC §1031 tax deferred exchange is also available for personal property held for investment or for productive use in a trade or business. Despite its name, personal property does not necessarily mean property that is used by an individual in a personal capacity. Rather, personal property refers to all property, both tangible and intangible, that is not considered real property. If the sale of such personal property will result in a gain, the taxpayer may want to consider an exchange.

Generally speaking, both tangible depreciable personal property, such as cars, trucks and planes and intangible personal property, such as franchise rights, copyrights or broadcast spectrums, are acquired for a certain value known as a tax or cost basis. For example, if a truck is purchased for $10,000 cash and $30,000 in a loan, the tax basis for the truck is $40,000. The tax basis can decline over time because of use, wear, or obsolescence. This concept, known as depreciation, can affect the tax basis of property at different rates depending on the type of property and when it was acquired. For example, an automobile is currently considered a five year property under the Modified Accelerated Cost Recovery System (MACRS) of IRC §168, meaning that five years after its acquisition its tax basis will be zero.

Although an asset starts out with a tax basis, it is the amount that is known as the adjusted basis, which will determine the taxable gain, if any, upon the sale of the asset. An asset's adjusted basis is determined by subtracting the amount of depreciation taken, if any, from its tax basis and adding capital improvements made to the asset, if any. For example, an airplane is acquired for $120,000, which is its tax basis. Over a period of time it is depreciated in the amount of $36,000 to account for normal wear and tear, but it has had a capital improvement in the form of an avionics upgrade in the amount of $20,000. Therefore, the tax basis of $120,000, minus the depreciation of $36,000, plus the capital improvement of $20,000 results in an adjusted basis of $104,000.

In order to calculate if there is a capital gain tax liability from the sale of an asset, you must subtract the adjusted basis from the net sale price of the property. If the resulting amount is positive, there is a gain, and in most cases, a determination must be made as to what portion of the gain is due to the depreciation of the asset, and what portion of the gain is due to the appreciation (rise in market value) of the asset, as they may be taxed at different rates. For example an automobile is purchased for use by a business for $38,000, and is sold for $24,000 after three years. Although its cost basis was $38,000, it has been depreciated in the amount of $28,500, leaving an adjusted basis of $9,500. Accordingly, since the automobile is selling for $14,500 more than its adjusted basis, there is a tax liability. Assuming a 35% tax rate for depreciation recapture, the taxpayer in this example would owe approximately $5,075. For leasing companies and companies with large privately held fleets that dispose of and acquire thousands of vehicles per year, the tax liability can be staggering. As a result, companies that utilize tax deferred exchanges as part of their tax planning strategy can benefit from significant tax savings.

Although a tax deferred exchange is created by Federal statute, Exchangers must look to state law to determine if the property to be exchanged is real or personal. The following are examples of types of personal property that can be exchanged:

Broadcast Spectrums	Airplanes	Franchise Licenses	Coin Collections
Trailers and Containers	Trucks	Construction Equipment	Copyrights
Restaurant Equipment	Barges	Artwork	Office Furniture
Fleet of Automobiles	Helicopters	Agricultural Equipment	Buses

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Personal Property Exchanges *(Continued)*

The "like-kind" requirement is more challenging for personal property exchanges than it is for real property exchanges. An asset may be either "like-kind" or "like-class". To be of "like-class," the relinquished and replacement depreciable tangible personal property must be in either the same **General Asset Class** or **Product Class**. For example, the exchange of a hotel may require a separate exchange for each different asset class: delivery trucks, restaurant equipment, furniture, and computer equipment.

The General Asset Classes are as follows:

- Office furniture, fixtures and equipment;
- Data handling equipment, except computers;
- Information systems (computers, etc.);
- Airplanes (except commercial passenger or freight carriers) and all helicopters;
- Automobiles, including taxis;
- Buses;
- Light general purpose trucks;
- Heavy general purpose trucks;
- Railroad cars and locomotives;
- Tractor units;
- Trailers and trailer-mounted containers;
- Vessels, barges, tugs, except those used in marine construction;
- Industrial steam and electric generation and/or distribution systems

The **Product Classes** are from Sectors 31 through 33 of the North American Industry Classification System (NAICS), which was adopted in 2002 but not utilized for tax deferred exchanges until August, 2004 under the new regulations adopted by the IRS. If the depreciable tangible personal property does not fall within either a General Asset Class or a Product Class the exchange can still be completed as long as the relinquished and replacement properties are considered to be of a "like-kind."

An exchange of intangible personal property and non-depreciable personal property qualifies for tax deferral only if the exchanged properties are of a "like-kind" since there are no like classes provided for these types of properties as in depreciable tangible personal property. The test as to whether intangible personal property is of a "like-kind" depends upon the "nature or character of the rights involved" and also on the "nature or character of the underlying property to which the intangible personal property relates". For example, a copyright on a novel can be exchanged for a copyright on another novel but a copyright on a novel cannot be exchanged for a copyright on a song because they are not considered "like-kind" property. The goodwill of one business, however, is not considered "like-kind" with the goodwill of another business and is, therefore, not eligible for exchange treatment. Also, livestock of different sexes is not considered "like-kind" property.

Tax advisors are essential for a successful personal property exchange since, among other necessary elements, they will help the Exchanger determine the respective property values and allocate sales price and purchase price to each element of the transaction.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Multiple Asset Exchanges

Many times Exchangers own property that consists of both real and personal property, such as a hotel or restaurant. An exchange of such a multiple asset property creates issues when trying to allocate the various assets into their proper like-kind categories using a property-by-property comparison. Another issue is the allocation of the deferred gain and basis among the various exchanged assets. However, by utilizing a multiple asset exchange structure Exchangers can realize a greater benefit than if they had structured the transaction as separate exchanges for each various type of asset.

Tax deferred exchanges fall into two distinct types: real property and personal property. Both types of property must be held for productive use in a trade or business, or for investment purposes, and be exchanged for property that is to be held for productive use in a trade or business, or for investment purposes. IRC §1031 (a)(1). However, real property can only be exchanged for other real property and personal property assets can only be exchanged for other personal property assets since real property and personal property are not like kind to each other. And, although tax deferred exchanges are regulated by Federal statute, it is state law that determines if property is real or personal. Treas. Reg. §1.1031(a)-1(b) & (c), *Aquilino v. United States*, 363 US 509 (1960).

Initially, the Internal Revenue Service issued Rev. Rul. 57-365 wherein it stated that an exchange of identical business assets, including real and personal property, of two telephone companies would be considered "property of like kind" within the meaning of IRC § 1031. In 1989, Rev. Rul. 89-121 sought to clarify the "identical business asset" rule set forth in Rev. Rul. 57-365 by stating that the mere fact that multiple assets comprise a business or an integrated economic investment does not mean that they may be treated as the disposition of a single property. The IRS stated that a review of the underlying assets pursuant to Rev. Rul. 55-79 was required to determine whether the property was to be considered of like kind. Accordingly, pure "business swaps" are no longer allowed.

The current system under the Treasury Regulations for tax deferred exchanges, which became effective for all transactions occurring on or after April 11, 1991, requires all exchangers contemplating a multiple asset exchange to group the properties, both real and personal, into like-kind or like-class groups. Treas. Reg. §1.1031(j)-1. The value to structuring an exchange as a multiple property exchange, as opposed to a separate exchange for each unit, is that a multiple property exchange provides an exception to the general rule that requires a property-by-property comparison when computing the gain and basis. Thus, although the assets are segregated into exchange groups consisting of like-kind properties, the aggregate value and liabilities of the units are computed in aggregate with a gain being recognized for the exchange group only to the extent of a difference in these aggregate values. Treas. Reg. §1.1031(j)-1(b). This does not, however, change the computation of the resulting basis, which is determined separately for each exchange group. Treas. Reg. §1.1031(j)-1(c). The end result is an exchange of multiple properties wherein a greater proportion of the gain can be deferred than if the transaction were structured as several separate exchanges.

An important distinction when considering an exchange of a business and all its various assets is the value of the business' goodwill or "going concern" value. Treas. Reg. §1.1031(a)-2(c)(2) provides that "[t]he goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business." The stated reason for this exclusion is that due to the inherent uniqueness of any single business, the good will or going concern value of two businesses could not possibly have the same nature or quality. Thus, an exchange of "Tony's Pizza of NY" for "Joe's Pizza of SF" can only consist of the real property and the equipment. The value of Tony's goodwill, which, excluding the real property, may represent the bulk of the business' value, is excluded from like kind exchange treatment.

A careful review of most commercial real property transactions will often reveal a large amount of depreciated personal property being sold in addition to the real property. By taking the time to review the impact of these additional assets, and contemplating a multiple property exchange, an Exchanger can defer much more of the taxable gain than the Exchanger originally thought possible or feasible. Due to the complexities of multiple asset exchanges, Exchangers are strongly advised to obtain competent tax and legal counsel prior to the exchange.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

COMBINING SELLER FINANCING WITH TAX DEFERRED EXCHANGES

In most cases, it is preferable for the seller (Exchanger) to receive all cash for the sale of the relinquished property. However, many real estate sale transactions require the seller to "carry back" a part of the purchase price as financing to assist the buyer in purchasing the property. In this situation the Exchanger may elect to:

1. Sell instead of exchange. Treat the buyer's promissory note as an installment sale (IRC §453) and pay any capital gain taxes on the principal payments on the note when these payments are received by the Exchanger; or
2. Provide the funds required for the seller-financing from the Exchanger's own funds at the closing of the relinquished property, thereby acting as a "third-party lender" for the buyer; or
3. Combine the seller-financing portion of the sale with a tax-deferred exchange for the balance of the relinquished property (Treas. Reg. §1.1031(k)-1(j)(2)). The capital gain attributable to the portion of the relinquished property that was exchanged will be deferred into the replacement property and the capital gain that is attributable to the installment note will be deferred over the life of the note and recognized upon receipt of the principal. Generally, all of the basis on the sale property will be allocated to the replacement property and the installment note will have no basis; which means, all payments received will be fully taxable; or
4. Include the seller-financing note as part of the exchange by specifying the Qualified Intermediary as the payee of the note and beneficiary of any trust deed or mortgage at the close of the relinquished property. The value of the note must be converted to "down-payment equity" to be used by the Qualified Intermediary for the purchase of the replacement property (Treas. Reg. §1.1031 (j)(2)). The Exchanger can then have the Qualified Intermediary use the note in several ways to defer the taxable gain into the replacement property:
   (A) Assign the note to the seller of the replacement property. The result is a complete tax deferral into the replacement property. However, the seller of the replacement property does not get installment sale treatment on the receipt of the Exchanger's note.
   (B) Sell the note to a third party for cash and then use the cash to purchase the replacement property. The Exchanger must consider whether a discount charged by the buyer of the note, if applicable, exceeds or is offset by the capital gain tax that would have been paid under the normal installment sale rules.
   (C) Sell the note for cash to the Exchanger or to a friendly party and use the cash to purchase the replacement property.

While there is no legal authority as to whether the Exchanger can successfully use this option to defer the note proceeds into the replacement property, the approach is reasonable and if done properly should result in favorable treatment. However, the Exchanger should only use this method upon the advice of their tax or legal counsel. Also, the Exchanger or the friendly party should not purchase the note at a discount.

If the Qualified Intermediary is unable to utilize any of the above options, the note will be reassigned to the Exchanger at the termination of the exchange. The Exchanger will receive the same installment sale treatment under IRC §453 as if the Exchanger had not attempted to defer the note through the exchange. Moreover, the date for commencement for the installment sale treatment is the date the note is reassigned to the Exchanger from the Qualified Intermediary and not the date of sale of the relinquished property.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Refinancing Before and After Exchanges

Refinancing to pull equity out of a property prior to or after completing a tax deferred exchange can result in a taxable transaction under the "step transaction doctrine." The IRS can argue that a "cash-back" refinancing, immediately before or after the exchange is completed, is just one step in the many steps of an exchange transaction and, therefore, the refinance loan proceeds should be taxable as boot in the exchange. This "step transaction" doctrine allows the IRS to recharacterize seemingly separate transactions into one transaction for tax purposes. The result is an unfortunate outcome for the Exchanger if the IRS believes that there was no independent business purpose for the refinance loan. In other words, the threshold question is "was the purpose of the loan nothing more than the Exchanger's desire to take cash out of the equity of either the relinquished or replacement properties without paying the capital gain tax?" Prior to the enactment of the current Treasury Regulations for IRC §1031, the proposed Regulations in 1990 prohibited "refinancing in anticipation of an exchange." The final Regulations in 1991, however, omitted any reference to this refinancing prohibition because the IRS believed that it would create "substantial uncertainty in the tax results of an exchange transaction involving liabilities." *Preamble to TD 8343*, 56 Fed Reg 14851 (April 12, 1991).

Although there is a mixed case law history on refinancing in conjunction with an exchange, current case law favors the position that the Exchanger can obtain cash by increasing debt on the property prior to or after completing an exchange. In *Fred L. Fredericks v. Commissioner*, TC Memo 1994-27, 67 TCM 2005 (1994), the Exchanger refinanced the relinquished property two weeks after executing a contract to sell the property less than a month prior to the resulting exchange. Using the step transaction doctrine, the IRS argued that the refinance proceeds should be considered taxable boot. The Exchanger prevailed by showing that he had attempted to refinance the property over a two-year period. In this instance the Court concluded that the refinance transaction: (a) had an independent business purpose; (b) was not entered into solely for the purpose of tax avoidance; and (c) had its own economic substance which was not interdependent with the sale and exchange of the relinquished property.

In *Phillip Garcia v. Commissioner*, 80 TC 491 (1983), aff'd. 1984-2 CB 1, the seller of a replacement property increased the debt on the property just prior to exchanging with the Exchanger. The increased debt was incurred to equalize the liabilities on the replacement property with the liabilities on the Exchanger's relinquished property. In this case the IRS took the position that the increase in the mortgage by the seller should be deemed as boot to the Exchanger because it artificially reallocated the liabilities for the purpose of avoiding taxes. The Court rejected the IRS's position finding that the increase in the debt had "independent economic substance."

In *Behrens v. Commissioner*, TC Memo 1985-195, 49 TMC 1284 (1984), the Exchanger was held to have received taxable boot when he received cash at the closing of his replacement property because he had increased the amount of the purchase money financing to the seller of the replacement property, thereby reducing the amount of down payment required from the Exchanger. In the Court's dicta the Court opined that this adverse result could have been avoided if the Exchanger had borrowed the cash from a third party lender secured by the property either before or after the exchange occurred. For further discussion on the factors used by Courts in determining whether there was an "independent economic substance' of the refinancing, see Letter Rulings 8248039, 8434015 and 200131014.

Exchangers should carefully consider the following issues to avoid the pitfalls of the "step transaction doctrine":

- The refinance loan should not appear to be solely for the purpose of "pulling out equity," thereby avoiding the capital gain tax that is otherwise attributable to non-exchange transactions.
- As a rule of thumb, the refinance transaction should be separated from the exchange sale or purchase transaction to help separate the exchange from the refinance.
- At a minimum, the Exchanger should attempt to complete the refinancing transaction prior to listing the relinquished property for sale.
- The refinance loan and the sale or purchase in the exchange should be documented as separate transactions to avoid any "interdependence" of the transactions.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

PARTNERSHIP, LLC AND REIT ISSUES

In general, exchanges of partnership **interests** are excluded from non-recognition treatment under IRC §1031(a)(2)(D), as enacted in the Tax Reform Act of 1984. The Code specifically states that Section 1031(a)(1) does not apply to an exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. As a result, a taxpayer cannot exchange an interest in *ABC Partnership* for an interest in *XYZ Partnership* . It is also important to note that a partnership interest is personal property, which is not like-kind to real property owned by a partnership.

A partnership, however, may exchange **real property** with any other entity in a transaction qualifying under IRC §1031, as long as the partnership meets the requirements that apply to all exchange transactions (i.e. both the relinquished and replacement properties will be held for investment or business purposes).

A key issue when addressing exchanges involving partnerships is to first determine the investment objectives of the individual partners in the partnership. When the *entire partnership* wants to structure a tax deferred exchange, it is clear that the transaction can qualify under IRC §1031. Problems arise, however, when one or more of the individual partners have different investment objectives.

The most commonly asked question is **"Can a valid exchange still be structured if one of the partners drops out of the partnership?"** Often one or more of the partners desire to withdraw from the partnership and receive cash or other property in return for their partnership interest.

Although there are many structures, conservative practitioners believe that there is less risk of an exchange being disallowed on audit if the parties desiring to receive cash on the sale of the relinquished property receive a distribution of their partnership interest in the form of an undivided interest in the relinquished property prior to the closing of the sale. Then, as long as there are still at least two remaining partners, this leaves the partnership alive to accomplish the exchange. At the closing, the surviving partnership and each of the former partners convey their respective interests in the relinquished property, with the former partners receiving cash, and the Qualified Intermediary receiving the net proceeds due the partnership to enable the partnership to complete their exchange when they locate replacement property.

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. While there are no recent cases directly on point, it is advisable to transfer ownership to the individual Exchangers as far in advance of the exchange as possible. If a distribution or dissolution occurs shortly prior to the sale, the key issue is whether the relinquished property was "held for productive use in a trade or business or for investment purposes." This "qualified use" requirement must be met for any exchange. The strategy of distributing to the "cash out" partners prior to sale, thus allowing the partnership to accomplish the exchange avoids the qualified use issue altogether.

The Tax Court seems to utilize the *substance-over-form doctrine* in situations like these. In *Bolker v. Commissioner*, 81 TC 782 (1983), aff'd 760 F2d 1039 (CA9 1985), the individual taxpayer entered into an exchange agreement for his 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 is met as long as the taxpayer does not intend to liquidate the relinquished property or use it for personal pursuits.

In *Maloney v. Commissioner,* 93 TC 89 (1989), a corporation exchanged real property and, at the time of the exchange, had the specific intent to liquidate and distribute the replacement property to its shareholders. One month after completing the exchange, the corporation liquidated under the former IRC §333, distributing the replacement property to its shareholders. The Court held that even though there was a change in ownership, the continuity of investment satisfied the qualified use requirement and upheld the validity of the exchange.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Partnership, LLC and REIT Issues *(Continued)*

Although ***Bolker*** and ***Maloney*** both involve corporations, the argument that the taxpayer is merely continuing its investment in another form is equally logical in the partnership context given the aggregate nature of a partnership.

See also *Magneson v. C.I.R.,* 753 F.2d 1490 (9th Cir.1985) where the courts allowed tax deferred exchange treatment based on the holding that 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. Also, see *Chase v. C.I.R.*, 92 T.C.53 (1989), which is instructive on the elements to avoid when attempting to dissolve a Partnership prior to an exchange, such as the Exchanger's failure to negotiate on behalf of themselves as individuals, their failure to pay their respective portion of the broker's fees, and the fact that in apportioning the net sales proceeds, the Exchangers were treated as partners, rather than as direct owners.

As a result, if properly structured, it appears that a valid tax deferred exchange can occur as long as the taxpayer does not "cash-out" their investment. However, a prudent taxpayer must plan carefully. Failing to properly liquidate a partnership interest prior to an exchange can lead to a taxable event. Transactions of this type can be complicated and should be carefully reviewed by qualified tax and legal counsel to determine whether the facts and circumstances are strong enough to support a defensible tax deferred exchange.

LLC Issues

Alternate forms of ownership on the purchase side of a tax deferred exchange that may be required when a lender wishes to shield its security interest in the replacement property in a bankruptcy remote entity, are now generally less problematic than the above Partnership scenario. The most common form of ownership in a new entity is the single member limited liability company ("LLC"). In addition to a single member LLC, there are other so called "pass-through" entities which are disregarded by the IRS as a entity separate from the taxpayer, such as a Delaware business trust, a Massachusetts nominee trust, an Illinois land trust, and grantor trusts. Other examples, such as subsidiaries of corporations, or new corporations formed by mergers or acquisitions of other corporations, can also provide for different parties on each side of an exchange.

In the case of single member limited liability companies, the initial question has always been whether taking title in the name of the new LLC would be characterized as a Partnership or beneficial interest, therefore falling under one of the exclusions enumerated in IRC §1031(a)(2). One exception to the general rule that the same taxpayer entity that sells the relinquished property has to purchase the replacement property is found in Treas. Regs. §301.7701-(3)(b)(1) which allows "single-member LLC's" that acquire property to be ignored for tax purposes and to be treated as the direct owners of the property. Not all states allow single member LLC's so the taxpayer should consult with legal counsel to determine if the taxpayer's state will allow the use of a single member LLC. The use of single member LLC's allow an individual or entity to sell property to start an exchange and complete the exchange by purchasing the replacement property in the name of the LLC.

In general, an entity with only one owner will be classified either as a disregarded entity, or a corporation, whereas an entity with two or more members will be classified as a Partnership or a corporation. Accordingly, an entity with only one member, which does not elect to be treated as a corporation, will be treated as a disregarded entity. This allows a taxpayer to take title in a new entity, fulfilling a lender's requirement, without jeopardizing the viability of the exchange. Treas.Reg. §301.7701-2(c). A classification change can be accomplished by an eligible entity by filing Form 8832 – Entity Classification Election. Treas. Reg. §301.7701-3(c)(1)(i). A classification change can be effective up to 75 days prior to, or 12 months after the date upon which the election is filed. However, the entity may not make any additional classification elections within 60 months after the effective date of the previous classification election. Treas. Reg.§301.7701-3(c)(iv).

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

PARTNERSHIP, LLC AND REIT ISSUES *(Continued)*

Private Letter Rulings are instructive regarding the flexibility afforded by single member LLC's. The IRS has approved of replacement property acquired by a 2 member LLC in which the taxpayer and the taxpayer's wholly-owned corporation were the members of the LLC. At the behest of the lender, the lender's representative sat on the Board of taxpayer's corporation, which was formed, and made a member of the LLC, solely to prevent the taxpayer from placing the LLC into bankruptcy. 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 2 member LLC as an entity separate from the taxpayer similar to the treatment of a single member LLC. LTR 199911033. An Exchanger was permitted to acquire replacement real property by assignment of the sole membership interest in the Seller's single member LLC, rather than by deed. LTR 200118023. A taxpayer, who acquired the replacement property in its own name, was allowed to deed it into a single member LLC in which the taxpayer was the sole member, without violating the "held for" requirement. LTR 200131014

As LLC's become increasingly popular as a means for investors to own real estate the same questions arise for LLC's and their members as with Partnerships. There is little authority regarding LLC's and exchanges, but most tax analysts agree that assuming the LLC is treated as an association, the same principles apply. If the LLC were going to do an exchange, it would be prudent for the same members to sign the Replacement Property Identification Notice as would be necessary to bind the LLC in any other matter. See Example 5 in Treas. Reg. §1.1031(k)-1(j)(3) which shows that liabilities on the Relinquished Property may be netted against liabilities on the Replacement Property. Therefore, it seems likely that the "liability gap" issues under IRC §752 will not cause recognized gain for LLC members, or Partnership partners, because of an exchange. The "at risk" rules of IRC §465 may apply to the LLC's members', or partners', detriment if the Replacement Property is not considered an "aggregation" of the Relinquished Property.

REIT ISSUES

Another type of problem arises when a taxpayer exchanges into or out of an interest in a Real Estate Investment Trust ("REIT"). Generally an interest in a REIT will be considered a security, and thus fall into the exclusions enumerated in IRC §1031(a)(2). However, if structured properly, there are alternatives for taxpayers wishing to do these types of exchanges. An owner of real property can contribute real property to an "UPREIT " or "DOWNREIT" pursuant to IRC §721. However, many times a REIT is not interested in property currently owned by the taxpayer, but wishes the taxpayer to exchange into new property, which the REIT identifies, and then has the taxpayer contribute that new property into the REIT. The issue with this structure is whether that taxpayer will have been deemed to have held the property for business or investment purposes, or held the property only for resale to the REIT. See IRC §1031(a).

As an alternative to contributing newly acquired replacement property to an UPREIT, the taxpayer may be given a right to place the property with the UPREIT after a year or more as a "put", and the UPREIT will have the option, after a year or more to acquire the property, as a "call", in exchange for UPREIT units. Problematic to this structure is whether these options will run afoul of the rules expressed in *Magneson v. C.I.R.*, 753 F.2d 1490 (1985). In *Magneson, a* taxpayer exchanged into replacement real property, and thereafter immediately contributed that property to a Partnership, in exchange for a general Partnership interest. The Court ruled that *Magneson* did not hold the property for business or investment purposes pursuant to IRC §1031(a). In the instant case, the structure of the "put" and "call" give the taxpayer and the UPREIT the right, but not the obligation to complete the placement of the real property into the UPREIT. By structuring the transaction in this way, taxpayers can attempt to avoid the problems of *Magneson* by not contributing the real property immediately post-exchange. The IRS could view these steps as an integrated whole under the so called "step transaction doctrine", in which case the IRS would characterize the transaction complete upon the mutual "put" and "call" agreement, in violation of *Magneson.* However, since neither party is obligated to complete the transaction, it would seem to be difficult for the IRS to characterize the transaction in this way. Although this is a very general overview of structuring an exchange of property into an UPREIT, it would appear that a transaction of this type is a viable alternative to realizing a capital gain tax for investors wishing to "exchange into" a REIT.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

INSTALLMENT LAND SALES CONTRACTS

An installment land sales contract (also known as a contract for deed or a contract of sale) is an agreement between the Seller and the Buyer for the purchase of real property in which the payment of all or a portion of the purchase price is deferred. The purchase price may be paid in installments over the period of the contract, with the balance due at maturity. When the Buyer completes the required payments, the Seller must deliver good legal title by a deed. During the period of the contract in which the Buyer is making the installment payments on the purchase price, the Buyer is entitled to possession of the property and equitable title to the property while the Seller holds legal title and continues to be liable for payment of any underlying mortgage.

The issue is whether either the Seller or Buyer in an installment land sale contract can exchange their interest under IRC §1031 and defer the capital gain taxes. Exchanges of "beneficial interests" are expressly disqualified under IRC §1031. However, no published case has considered whether a party who has an interest under an installment land sale contract constitutes a "beneficial interest." Under the doctrine of equitable conversion, the **Buyer** is treated as the equitable owner of the property. Furthermore, the Buyer is entitled to possession of the property. Therefore, an argument can be made that the Buyer should be considered the "owner" of the property for purposes of IRC §1031 and not merely the holder of an excluded "beneficial interest." If the Buyer adopted this theory of equitable conversion, then the Buyer could exchange his/her interest in the property under IRC §1031 for like-kind replacement property. See *Starker v. United States*, 602 F2d1341 (9th Cir 1979); *Biggs v. C.I.R.*, 632 F2d1171 (5th Cir 1980). For purposes of tax deferred exchanges the issue of determining the rights created in the property, and thereby the character of the property that is owned, turns on when the benefits and burdens of ownership of the property have shifted.

Conversely, under the doctrine of equitable conversion, the **Seller** under an installment land sale contract is viewed as retaining only a limited interest in the property. The Seller in essence owns the purchase price with an equitable lien on the property for the unpaid balance. Although the Seller retains legal title, the Seller is viewed as holding it in trust for the Buyer. The Seller's interest in the property is similar to that of a beneficiary under a promissory note secured by a deed of trust or a mortgage, which is specifically excluded under IRC §1031. Therefore, an argument could be made that the Seller under an installment land sale contract should be excluded from exchanging his or her interest under IRC §1031. Consequently, it is unlikely that the Seller under an installment land sale contract would be able to successfully defend the tax deferred exchange treatment for their transaction if challenged by the IRS.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Disqualified Parties and Your Attorney as Accommodator

Why This Can Jeopardize The Exchange

An IRC §1031 tax deferred exchange can fail if the Exchanger has "actual or constructive receipt" of exchange proceeds or other property. Therefore, it is essential for the Exchanger to retain a Qualified Intermediary to satisfy the necessary "safe harbor" requirements under Treas. Reg. §1.1031(k)-1(g)(4). A "disqualified person" is defined in Treasury Regulation §1.1031(k)-1(k). A disqualified person is someone who is the agent of the Exchanger (taxpayer) at the time of the exchange. If a disqualified person performs the exchange and holds the exchange proceeds the exchange may fail if the IRS determines that as a result of the disqualified party's involvement the Exchanger had "actual or constructive" receipt of the exchange funds. For purposes of this Regulation, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two year period preceding the date of the transfer of the first relinquished property by the Exchanger is treated as an agent of the Exchanger at the time of the exchange and, therefore, a disqualified person. Solely for purposes of this Regulation, there is an exception for the performance by a person of services for the Exchanger with respect to only exchanges of property under IRC §1031 and the performance by a person of routine financial, title insurance, escrow, or trust services for the Exchanger by a financial institution, title insurance company or escrow company. These types of services shall not be taken into account as performances of services by a disqualified person. See Treasury Regulations §1.1031(k)-1(k)(2). Other disqualified persons are any parties that are considered "related parties" to the Exchanger, or parties that are related to the Exchanger in that the Exchanger and the related party have more than a 10% interest in the respective related partnership, corporation or trust. See Treasury Regulations §1.1031(k)-1(k)(3), (k)(4). To insure the safety of the exchange it is important to have a "safe harbor", such as the use of a Qualified Intermediary, against the actual or constructive receipt of the exchange proceeds or property that would otherwise occur by using a disqualified person who will be considered the agent of the Exchanger. If a Qualified Intermediary is retained, the determination as to whether the Exchanger is in actual or constructive receipt of the exchange proceeds or other property is made as if the Qualified Intermediary is not the Exchanger's agent. See Treasury Regulations §1.1031(k)-1(g)(4)(i).

To qualify as a "safe harbor" the Qualified Intermediary must be someone other than the Exchanger (taxpayer) or a "disqualified person." See Treasury Regulations §1.1031(k)-1(g)(4)(iii). **Agents of the Exchanger at the time of the transaction are disqualified persons.** Examples of agents include the Exchanger's attorney if they have acted as the Exchanger's agent within the two-year period ending on the date of the transfer of the Exchanger's first relinquished property. **If an attorney has provided tax or legal services to the Exchanger within the two-year prescribed period, the attorney is a disqualified person.** Attorneys performing services solely in connection with exchanges are excepted from the disqualified person rule. However, this exception is extremely limited and an attorney proceeding under this exception should do so with extreme caution since the Exchanger could suffer severe adverse tax consequences if the attorney is determined to be a disqualified person with respect to the Exchanger's exchange. If an attorney is a disqualified person, the following are also disqualified: the attorney's law firm, a partner in the law firm who owns more than a 10% interest in the firm, any entity in which such partner owns more than a 10% interest and any entity in which the law firm owns more than a 10% interest. This is because the regulations provide that a separate corporation or other entity in which the Exchanger or a disqualified person has a 10% or more interest also constitute a disqualified party. Treasury Regulations §1.1031(k)-1(k)(2)-(k)(4). While the Exchanger's attorney should not act as the Qualified Intermediary, they are invaluable to the Exchanger for tax and legal advice during the exchange.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

HELPING THE CLIENT PLAN FOR THE EXCHANGE

A successful IRC §1031 exchange transaction requires additional preparation, expertise and support. Investment Property Exchange Services, Inc. (IPX1031), as your Qualified Intermediary, will handle the exchange details and documentation, and safeguard the exchange equity. Laying the proper groundwork before you or your clients enter into a tax deferred exchange for an investment property is essential to making the sale/s run smoothly. Although the following will provide some of the fundamental exchange questions to review, a more comprehensive checklist is available on request or through our website.

By gathering the following key information you will avoid unnecessary obstacles once you or your clients have accepted an offer and have started their search for replacement property:

I. Determine the following:

- Confirm that the property being sold (Relinquished Property) was held as a rental or investment property and that you or your clients intend to do the same with the Replacement Property.
- Make sure the title to the Replacement Property will be held in the same manner as title is held on the Relinquished Property.
- Confirm that the lender for the Replacement Property has no specific requirements for holding title that would cause problems with the exchange.
- Will you or your clients need to use sale proceeds to make cosmetic or structural improvements on the Relinquished or Replacement Property.

II. Ask the following questions:

- Will part of the proceeds be used to pay personal debt?
- Will additional parties be added to the title on the Replacement Property?
- Will all members on title to the Relinquished Property be participating in the exchange?
- Are you or your clients selling any of their property to or intending to buy property from a related party?
- Do you or your clients plan to offer seller financing on the sale of the Relinquished Property?
- Are you or your clients aware of the various types of exchanges that may meet their exchange objectives? (e.g. simultaneous, delayed, build-to-suit, and reverse exchanges)

Investment Property Exchange Services, Inc., as your Qualified Intermediary, can be very helpful in the early stages, advising on how the "answers" to these questions will determine the best means of planning the exchange. Our expert staff, including a full-time managing attorney, can explain the various exchange types and assist all parties in selecting the most appropriate structure for the exchange. Of course, exchangers should always seek tax and/or legal advice prior to starting the exchange.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

The Impact of Depreciation Recapture on Exchanges

Depreciation is an integral part of calculating the adjusted basis of property and, thus, is an important component of the non-recognition provisions of IRC §1031. The calculation of gain from the sale or exchange of an asset is based in part on the depreciation calculation associated with that particular asset.

Depreciation in the Internal Revenue Code ("Code") is a means of allowing the taxpayer a reasonable deduction for the exhaustion, wear and tear of business use property (not property held for personal use). When business use property is sold or exchanged the Code requires the depreciation previously taken by the taxpayer to be "recaptured". Upon the disposition of the taxpayer's property depreciation recapture is that portion of the gain subject to taxation to the extent the taxpayer recovers the depreciation deducted in prior tax years. All business use property is subject to depreciation recapture. The recapture provisions, however, are different depending on whether the asset being sold or exchanged is real or personal property.

IRC §1250 property is generally defined as improved commercial real estate and is real property subject to a depreciation deduction on the taxpayer's return. The recapture provisions applicable to §1250 property are fairly complex but essentially make a distinction between property placed in service by the taxpayer before 12/31/86 ("Pre '87 property") and property placed in service after that date ("Post '86 property"). Pre '87 property is §1250 property that generally used an accelerated cost recovery method of depreciation.1 For §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 unrecaptured depreciation under straight-line depreciation ("unrecaptured §1250 gain") is currently taxed at a 25% federal tax rate.

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

Example:

Facts: Taxpayer transfers a Post '86 office building with an adjusted basis of $100,000 for a fair market value of $1,000,000. Over the years the Taxpayer has taken $500,000 in depreciation deductions.

i) In an outright sale the Taxpayer will recognize a total gain of $900,000 ($1,000,000 - $100,000). $500,000 will be unrecaptured §1250 gain taxed at 25%. $400,000 will be considered capital gain taxed at 15%.

ii) Assume the Taxpayer's building was 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 $300,000 of depreciation will be unrecaptured §1250 gain taxed at 25% and the remaining $400,000 of gain will be considered capital gain taxed at 15%.

iii) If, however, the Taxpayer exchanges the building into another commercial real estate asset valued at $1,000,000 in a §1031 exchange transaction he will defer all of the gain arising from the disposition of his office building.

IRC §1245 property is generally depreciable personal property, although the Code does classify certain types of real property placed in service prior to 1987 as §1245 property. Currently, §1245 property is only personal property used in a trade or business. Dispositions of §1245 property that result in a gain are subject to depreciation recapture. Unlike §1250 property, however, recaptured depreciation on §1245 property is not entitled to a preferential lower tax rate. Under §1245 all depreciation that has been taken on the subject property must be recaptured and taxed as ordinary income but only to the extent that gain is recognized on the sale or exchange transaction. In a §1031 exchange transaction any recaptured depreciation will only be taxed to the extent that §1031 requires taxable boot to be recognized. Any gain recognized in excess of the recaptured §1245 depreciation is considered a capital gain and is currently taxed at 15%.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

THE IMPACT OF DEPRECIATION RECAPTURE ON EXCHANGES

(Continued)

Example:

Facts: Taxpayer disposes of a construction crane (§1245 property) with an adjusted basis of $5,000 for a fair market value of $75,000. Since its acquisition the Taxpayer has taken $45,000 in depreciation deductions as allowed under MACRS.

i) In an outright sale the Taxpayer will recognize a total gain of $70,000 ($75,000 - $5,000). Of that gain, $45,000 will be taxed as ordinary income to the taxpayer; the remaining $25,000 will be taxed as a capital gain at 15%.

ii) If the Taxpayer were to dispose of the crane in a §1031 exchange transaction for another crane with a value of at least $75,000 no gain will be recognized.

iii) If, however, the Taxpayer were to dispose of the crane in a §1031 exchange transaction for another crane with a value of only $60,000 then a $15,000 gain will be recognized as taxable boot in this exchange. It will be considered depreciation recapture under §1245 and taxed as ordinary income at the Taxpayer's marginal tax rate.

Another important depreciation concept relates to the correct method of depreciating property acquired in a §1031 exchange. In January 2000 the IRS issued guidance on this topic by requiring the exchanged basis[2] of replacement property to be depreciated over the remaining recovery period by using the same depreciation method and convention as that of the relinquished MACRS property. Any excess basis in the replacement property is to be treated as a new asset and depreciated accordingly. This method – commonly referred to as "step in the shoes" depreciation – remained in effect for four years.

In March 2004 the IRS revised the rules for step in the shoes depreciation to eliminate any tax advantage of acquiring replacement property with a longer recovery period or slower accelerated depreciation method than the relinquished property it replaced. Treas. Reg. §1.168(i)-6T requires exchanged basis to be recovered over the remaining life of the relinquished property using the same method that was used for the relinquished property if the replacement property has the same or shorter recovery period or the same or more accelerated depreciation method. Alternatively, the regulation requires exchanged basis to be recovered over the remaining life of the replacement property utilizing the depreciation method of that replacement property if it has a longer recovery period or a less accelerated depreciation method. In summary the IRS wins both ways. Property acquired in an exchange must now be depreciated using the recovery period and method applicable to either the relinquished or replacement property, whichever is less advantageous to the taxpayer.

Depreciation issues are complex and are an integral part of calculating taxable gain. It is important to understand the different tax consequences of depreciation recapture and capital gain associated with real and personal property. For a more complete understanding of the depreciation issues associated with the sale or exchange of an investment or business use property Exchangers should consult with their legal and tax advisors.

[1] An accelerated cost recovery system ("ACRS") allows a taxpayer to deduct the largest portion of the property's cost in the initial years of its service. This depreciation method was intended to more accurately reflect the actual rate of diminution in value of the asset.

[2] Exchange basis is equal to the adjusted depreciable basis of the relinguished property.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Master Like-Kind Exchange Programs

A traditional like-kind exchange transaction allows an Exchanger to defer the tax on the gain arising from the sale of business use or investment property. Some assets, such as an off-lease automobile, when sold generate relatively low gain and thus are not economically feasible to place in a single exchange transaction. If, however, the Exchanger disposes of many of the same assets on a continual basis, a "master" like-kind exchange ("Master LKE") program can be beneficial. A Master LKE program is designed to extend the benefits of IRC §1031 to the ongoing exchange of a high volume of like-kind personal property assets. Auto, truck, and equipment lessors as well as construction, trucking, and rental companies are typical of the types of companies that can benefit from the implementation of a Master LKE program.

A Master LKE program offers several benefits to companies with regular and repetitive turnover of business assets. A well designed program provides an efficient and affordable way for a company to reap tax benefits with minimal changes to their business processes. The program provides significant tax deferral on aggregate annual gains. Capital available for reinvestment can be maximized since the company's tax liability is paid later rather than sooner. The Master LKE program can also enhance competitiveness by allowing the tax savings benefits to be passed through to the customer thus lowering pricing.

A Master LKE program is subject to and follows the provisions of IRC §1031. The program, however, is customized to integrate into the Exchanger's existing disposition and acquisition process while still meeting the §1031 requirements. The following is a typical exchange process for a Master LKE program[1]:

- Exchanger enters into a Master Exchange Agreement with a Qualified Intermediary (QI) to set up the program and establish the necessary exchange funds, investment, and disbursement accounts.
- Exchanger enters into a contract to sell personal property (e.g. off-lease autos or trucks) to Buyer and assigns its rights (but not its obligations) under the Sales Contract to the QI.
- To complete the sale, QI directs Exchanger to transfer (relinquished) property to Buyer and directs the Buyer to transfer proceeds to the QI's controlled exchange funds account.
- Exchanger enters into an agreement to purchase new (replacement) property from Seller and assigns its rights (but not its obligations) under the Purchase Contract to the QI.
- Exchanger transfers any additional funds necessary to complete the purchase to the QI's controlled disbursement account.
- To complete the acquisition, QI disburses funds to Seller and directs Seller to transfer (replacement) property to Exchanger.

The following chart illustrates the benefits of a Master LKE program for an automobile leasing company that sells 1,000 partially depreciated off-lease vehicles per year. The cars are sold randomly throughout the year for $18,000 each. The sale proceeds, when received, are used to acquire newly leased automobiles:

	Exchange	Sale
Fair Market Value	$18,000,000	$18,000,000
Tax Basis (Assumed 38.4%)	$ 6,912,000	$ 6,912,000
Recognized Gain	-0-	$11,088,000
Annual Tax Liability @35%	-0-	$ 3,880,800
Funds Available for Reinvestment	$18,000,000	$14,119,200

A Master LKE program provides a significant opportunity for companies with a high volume of dispositions and acquisitions to enjoy the benefits of tax deferral on their portfolio of sold assets. By deferring current taxes more cash is available to fund additional purchases. When structured correctly, a Master LKE program will minimally intrude upon the company's operations. Due to its complexity it is important for any Exchanger to consult with competent tax and legal advisors before establishing and engaging in a Master LKE program.

[1] For a detailed listing of the requirements for a qualified Master LKE program see Rev. Proc. 2003-39 (2003-22 IRB 1).

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Tenancy in Common Interests - A Replacement Property Solution for Exchanges

Exchangers engaged in a like-kind exchange of real estate often face difficulty in finding replacement property to complete their exchange. IRC §1031 allows the Exchanger only 45 days to identify replacement property. In addition §1031 requires the replacement property to be located in the United States (assuming the relinquished property is in the U.S); have a value equal to or in excess of the relinquished property for full tax deferral; and, must be acquired within 180 days of the closing of the relinquished property. Although the definition of real estate in §1031 is expansive – all U.S. real estate is like-kind to all other U.S. real estate - many Exchangers have a tough time complying with the time deadlines and other exchange requirements in finding a satisfactory parcel to complete their exchange transaction. Corporate taxpayers are often in a position of not being able to easily find real estate that meets the needs of §1031 as well as their other business considerations, such as location, size, zoning, and cost. Similarly, individual taxpayers must consider geography, management issues, and investment value when choosing a replacement parcel. These considerations, in addition to §1031's strict requirements, are an ever-present factor in real estate like-kind exchanges.

One possible satisfactory solution when an Exchanger cannot find an acceptable parcel for use as replacement property is for the Exchanger to acquire a tenancy in common ownership interest in real property ("TIC property") to satisfy the like-kind requirement of §1031. In today's marketplace, a TIC property is generally commercial real estate whose ownership has been split into fractional shares. Exchangers, who are typically unaffiliated with each other, then own their respective fractional shares, much like stock ownership. Each Exchanger as a tenant in common owns an undivided fee interest in the property equal to his/her proportionate share of the real estate. In addition to his equity interest the Exchanger also acquires a proportionate share of any non-recourse debt secured by the property. As a result, by acquiring an undivided fee interest in real property the Exchanger complies with the like-kind replacement property requirement of §1031.

TIC ownership can be used for any type of real estate but most of these types of properties are shopping centers, strip malls, office buildings, or other types of larger commercial real estate. Acquisition of a TIC property gives the Exchanger considerable flexibility. Along with providing a means for a desperate Exchanger to complete his exchange, the TIC structure affords the Exchanger the opportunity to acquire investment grade property, obtain a consistent monthly cash flow, and participate in any appreciation without the necessity of purchasing the entire parcel. A TIC investment is passive and the property is professionally managed. Financing, negotiating leases, payment of taxes and other responsibilities of ownership are all performed by the property manager. The Exchanger need not even be located in the same geographic region as the TIC property.

TIC ownership is not for the casual investor. As with any real estate transaction it is important to "do your homework". Exchangers interested in acquiring a TIC property should consult their real estate advisor for a listing of TIC providers ("sponsors"). The Exchanger should discuss their specific needs with the sponsor and obtain information about available TIC properties. Before proceeding with the purchase, the Exchanger should feel comfortable with the sponsor's advice and thoroughly review the materials and information on the TIC property provided by the sponsor. Once the Exchanger has decided upon his investment level and selected the appropriate TIC property, the TIC sponsor should then guide him through the transaction, providing all necessary documentation and disclosures.

TIC ownership has been around for many years, but its use as a replacement property solution is relatively recent. Many real estate brokers, syndicators, and investment companies offer some form of the TIC product. In recognition of the increased interest in TIC's, the IRS issued 15 guidelines to assist taxpayers in determining if their TIC ownership will qualify as replacement property in an exchange. Revenue Procedure 2002-22 (2002-14 IRB 733). These guidelines address items such as: the allowable number of co-owners; the right to transfer or encumber the interest; the proportionate sharing of profits, losses, and debt; and, the ability of the co-owners to enter into a management or brokerage agreement for the property.

Most TIC sponsors have attempted to craft their TIC programs to substantially comply with the guidelines set forth in Rev. Proc. 2002-22. An Exchanger considering the acquisition of a TIC interest to complete a tax deferred exchange should research the various TIC sponsors to select a sponsor whose TIC program either complies with these guidelines or, in the alternative, the sponsor for the TIC program can provide the Exchanger with an opinion of competent legal and tax counsel that the structure of the TIC arrangement complies with the requirements of §1031. In addition, the Exchanger should consult with their own competent legal and tax counsel to assure that the acquisition of a particular TIC interest as replacement property satisfies the requirements for their exchange.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Estimating The Capital Gain Tax On The Sale Of Investment Property

An Exchanger/taxpayer should always consult with competent independent legal and/or tax advisors to determine the applicability of any IRC §1031 tax deferred exchange benefits. The gain, not the profit or equity, from the transfer of investment property is subject to the combination of federal and state capital gain taxes and federal taxes on the gain due to the depreciation taken on the property. Remember, it is possible to have little or no equity in the investment property being transferred and still owe taxes!

This formula is a guide to estimate the potential capital gain tax owed on the transfer of property:

1. **First, calculate the Adjusted Basis:**

	Original Purchase Price		$__________
Plus	Non-expensed Improvements	+	$__________
Equals		=	$__________
Minus	Depreciation Taken	–	$__________
Equals	Adjusted Basis	=	$__________

2. **Second, use the Adjusted Basis to determine the Capital Gain Tax:**

	Sales Price		$__________
Minus	Adjusted Basis	–	$__________
Equals		=	$__________
Minus	Transaction Costs	–	$__________
Equals	**Total Gain on Sale**	=	$__________
Times	State Capital Gain Tax Rate	x	$__________
Equals	State Capital Gain Tax	=	$__________(A)
Times	Federal Capital Gain Tax on Gain Due to Appreciation	x	$__________
Equals	Tax on Appreciation	=	$__________(B)
Times	Federal 25% Tax Rate on Gain Due to Depreciation	x	$__________
Equals	Tax on Depreciation Taken	=	$__________(C)
Total of Taxes A + B + C Equals The Capital Gain Tax Exposure		=	$__________(*)

** This is the approximate amount of tax that is deferred by doing an IRC §1031 tax deferred exchange. NOTE: The federal deduction for state taxes is not included in this calculation.*

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.

Exchange Addendum

The following terms and conditions are hereby incorporated in and made a part of the agreement dated____

on property known as____

executed by ______________________________, Buyer ☐ Seller ☐ Other ☐ _________

and ______________________________, Buyer ☐ Seller ☐ Other ☐ _________

By executing this Addendum the parties intend to modify their existing Agreement as below. All other provisions of the existing Agreement shall remain in full force and effect.

1. **INTENT TO EXCHANGE:** IT IS THE INTENT OF ______________________________ ("EXCHANGER") TO UTILIZE THIS TRANSACTION AS PART OF A TAX DEFERRED EXCHANGE AS PROVIDED IN INTERNAL REVENUE CODE SECTION 1031, AS AMENDED AND THE TREASURY REGULATIONS PROMULGATED THEREUNDER.

2. **EXCHANGE COOPERATION CLAUSE:** SELECT THE APPROPRIATE COOPERATION CLAUSE.

   - ❑ **Buyer hereby acknowledges it is the intent of the Seller to effect an IRC Section 1031 tax deferred exchange which will not delay the closing or cause additional expense to the Buyer. The Seller's rights under this Agreement may be assigned to Investment Property Exchange Services, Inc., a Qualified Intermediary, for the purpose of completing such an exchange. Buyer agrees to cooperate with the Seller and Investment Property Exchange Services, Inc. in a manner necessary to complete the exchange.**
   - ❑ **Seller hereby acknowledges it is the intent of the Buyer to effect an IRC Section 1031 tax deferred exchange which will not delay the closing or cause additional expense to the Seller. The Buyer's rights under this Agreement may be assigned to Investment Property Exchange Services, Inc., a Qualified Intermediary, for the purpose of completing such an exchange. Seller agrees to cooperate with the Buyer and Investment Property Exchange Services, Inc. in a manner necessary to complete the exchange.**

3. **ADDITIONAL TERMS:**

   ____

   ____

   ____

4. **TAX AND LEGAL ADVICE:** **The manner in which an exchange is structured will have significant tax and legal consequences. The parties hereto should always consult with their tax and/or legal advisor regarding the structure and specific requirements of an exchange. By signing below the parties hereto acknowledge a copy of this Addendum.**

Signature __________________ **Date** ________ **Signature** __________________ **Date** ________

Signature __________________ **Date** ________ **Signature** __________________ **Date** ________

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2006 Investment Property Exchange Services, Inc.