1031 EXCHANGE SPECIALISTS, INC.

"QUALIFIED INTERMEDIARY" I.R.C. 1031

The Exchange Process

History of Exchanges

The non-recognition of gain or loss on the exchange of property was first introduced in 1921, some three years after the imposition of income taxes, on the basis of continuity of investment or liquidity, and administrative convenience. The early exchanges were direct simultaneous exchanges between two and three property owners.

In 1979, the famous "Starker" case became the legal basis for the non-simultaneous exchange.

In 1984, Congress established time limits for a non-simultaneous exchange, requiring the Exchangor to identify replacement properties within 45 days and settlement on the replacement property(s) within 180 days following the date the first property relinquished. The ineligibility of exchanging partnership interests was also introduced in the 1984 amendments.

In 1989, new rules for exchanges between "related persons" were added.

In 1991, the IRS issued regulations addressing the role of the Qualified Intermediary, safe harbor rules, assignments of contracts, security of exchange funds, identification requirements, treatment of interest and "disqualified" parties.

The Process is Simple!

1. Enter into a Contract of Sale with a Buyer
2. Execute an Exchange Agreement and other exchange documents with us, as Qualified Intermediary
3. Schedule settlement of your relinquish property and provide us with the Settlement Agent's contact information
4. Relinquish the benefits and burdens of ownership to the Buyer
5. Identify your replacement property(s) to us by the 45th day
6. Enter into a Contract of Sale with the Seller
7. Where applicable, apply for mortgage monies, complete inspections, etc.
8. Assign your replacement property contract rights to us, as Qualified Intermediary
9. Schedule settlement of the replacement property and provide us with the Settlement Agent's contact information
10. Assume the benefits and burdens of ownership from the Seller by the 180th day, or tax return due date, whichever comes first.

The Exchange Documents

A. **Exchange Agreement**, is a written contract between our Company and you. It is the basis by which we act as your Qualified Intermediary for the sale of the above property, as well as the acquisition of your replacement property(s).

B. **Assignments of Relinquished and Replacement Property Contract**, documents your assignment of contract rights, title and interest in and to the above property to us as Qualified Intermediary.

C. **Addendum to Agreement of Sale**, adds 1031 language to the contract between you and your purchaser.

D. **Notice of Assignment of Exchange Property Purchase and Sale Agreement,** formally notifies buyer of relinquished property and seller of replacement property that you have assigned to us as Qualified Intermediary all rights, but not obligations, under the Agreement of sale, and we, as Qualified Intermediary, have accepted the assignment.

E. **Direction Letter,** instructs a seller of replacement property to execute a deed whereby conveying legal title directly from Seller to you, as Exchangor.

F. **The W-9 Form**, serves as verification of your tax identification number for bank and I.R.S. usage.

G. **I.R.C. 1031 Advisory**, addresses areas of importance when completing a 1031 exchange.

The Identification Rules

There are three (3) methods used to designate replacement properties. You should choose the one method that is most applicable to your situation. **The property address and legal description are required for each of the following categories.**

1. The Three Property Rule - You may designate any three properties without restriction as to value or any requirement to acquire more than one of those designated. You may exchange for one, two, or all three. (Most commonly used.)

2. The 200% Rule - You may designate any number of replacement properties as long as their aggregate fair market value does not exceed twice that of the relinquished property. You may acquire any number of these designated properties through this exchange. **Your identification must also include the fair market value of each property.**

3. The 95% Rule - Where the number of properties exceeds 3 and the aggregate fair market value exceeds 200% of the relinquish property value, you may designate any number of properties of any value as long as you acquire 95% of all properties designated as part of this exchange.

You may identify any type of investment or business property - single family rental, duplex, apartment building, hotel, office building, warehouse, commercial building, vacant land, etc.

You may identify property in any state of the United States. Your identification must be specific as to what you intend to purchase. For example, if you intend to purchase only a percentage interest in a piece of property, you must identify it as "__% interest or $__________ interest in replacement property." There are restrictions on acquiring property from related persons. If you plan to do so, please call us.

This identification must be signed, dated and RECEIVED in our office by midnight on the 45th day. According to the 1031 regulations, there can be NO changes to your identification after the 45th day. Property substitutions may only occur within the 45 day identification period. All substitutions must also be in writing, signed, dated, received in our office by midnight on the 45th day and include a notice of withdrawal of any previously identified properties.

Please note, the replacement property must be taken in the same name(s) as the relinquished property previously sold. Closing on all of the replacement properties must be completed by the 180th day after closing on the relinquished property, or by the filing deadline of your federal income tax return for the year in which the exchange began, whichever comes first. (You may find it necessary to have your tax advisor extend your tax return filing date to accommodate the closing of your replacement property)

Items You Need to Know

As Exchangor, it is very important for you to review the following with your tax attorney and/or accountant:

- Applicability and tax consequences of an I.R.C. 1031 tax deferred exchange for your specific situation.
- Recognition or non-recognition of I.R.C. 1031 tax deferred exchanges in your state.
- Deductibility and non-deductibility of expenses incidental to the acquisition and disposition of property and their related mortgages.
- Restrictions of selling to or purchasing from a related person.
- Tax reporting requirements of an I.R.C. 1031 tax deferred exchange.
- Ramifications of canceling an I.R.C. 1031 tax deferred exchange prior to completion. *Note: If cancelled, exchange escrow funds and their respective interest income cannot be released until the 45-day identification period has lapsed.*
- Requirements and restrictions of identifying replacement property under the 45-day rule.
- Requirements for personal property incidental to the exchange. (e.g. furniture and furnishings)
- Tax implications of purchasing a replacement property for a lesser value than the property relinquished
- Tax implications of increasing/decreasing mortgages in an I.R.C. 1031 tax deferred exchange.
- Tax ramifications of exchange funds held by any one other than a Qualified Intermediary.
- Taxability of relinquished property funds returned to you during the exchange or upon completion.
- Requirements for consistency in title on all documents for relinquished and replacement properties.
- Reporting interest income earned on exchange escrow funds in the proper tax year.

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Frequently Asked Questions (FAQs)

1. What is a 1031 exchange?

The numbers "1031" refer to a section of the Internal Revenue Code entitled: "Exchange of property held for productive use or investment". Section 1031 provides that gain or loss is not recognize when property held for productive use in a trade or business, or for investment, is exchanged for like-kind property to be held for productive use in a trade or business, or for investment. Section 1031 exchanges are often referred to as "Like-Kind" exchanges, "Tax-Deferred" exchanges, "Starker" exchanges, "Tax-Free" exchanges and "Swaps". Although not referenced as "Section 1031" when first enacted in 1921, the rationale used as justification for not recognizing gain or loss on the exchange of property was similar to the "economic stimulus packages" of today, whereby, continuity of investment and administrative convenience will, in the long run, result in economic growth.

2. Why would someone choose to do a 1031 exchange versus just paying taxes?

No one enjoys paying taxes! Putting emotions aside, there are several practical financial reasons for choosing to complete a 1031 exchange, such as; (1) consolidation or diversification of investments; (2) greater appreciation and leverage opportunities; (3) increased cash flow; (4) relocation of investments; and (5) exchanging low basis property for high basis property. A taxpayer should consider the money they are not paying in taxes as an interest free loan from the government to help them build wealth.

3. What taxes are imposed on a person when they sell an investment property?

A taxpayer who chooses not to complete a Section 1031 exchange may be subject to numerous federal, state and local taxes. If the property being sold is held less than one year, the gain on the sale of the property is taxed federally at ordinary income tax rates, and although constantly changing, may potentially fall in the high thirty percentile. If the property is held more than one year, the gain on the sale of the property is taxed at the federal capital gains rate, currently at fifteen percent but is subject to change at the end of 2010. If the property being sold was a depreciable property, the portion of the gain resulting from the depreciation deduction is federally taxed at a twenty-five percent rate or at ordinary income tax rates, depending on the asset. In many instances, the sale of a property may affect the calculation of Alternate Minimum Taxes (AMT) for a taxpayer. These "tax preference" items are generally taxed by the federal government at a rate of twenty-six to twenty-eight percent. Let's also not forget our State and local governments, who, for the most part, do not have fixed capital gains rates and impose taxes at their respective ordinary income tax rates.

4. How do the individual states tax 1031 exchanges?

All states, for the most part, follow the federal 1031 law and also allow the deferment of state taxes. For example, Pennsylvania, recognizes 1031 exchanges for C-Corporations, but not for individuals, partnerships, trusts, etc. Several states, including Oregon for example, have a "clawback" provision requiring the payment of Oregon tax on the sale of a replacement property, even if the replacement property is located in another state. Some "clawback" states require an Annual Report be filed until such time as the replacement property is sold. Other states, New Jersey, for example, impose a non-resident withholding tax on the sale of property within the state by individuals domiciled outside the state. However, exemptions to the withholding tax are granted in New Jersey to persons completing a 1031 exchange and to property owned by corporations, partnerships and LLC's. Some non-resident withholding states require several weeks time before sale to grant the withholding exemption. An experienced Qualified Intermediary will be able to advise you of the individual state tax requirements.

5. Are 1031 exchanges just for real estate?

Section 1031 of the Internal Revenue Code applies to real property, personal property, certain intangibles and other non-depreciable personal property. Often state law will determine the classification of real property. For example, a co-operative (stock ownership) apartment in New Jersey is considered real property under state law and is therefore "like-kind" to a fee simple interest in real estate within or outside of New Jersey. Other examples of "like-kind" real estate may include 30 year leases, cell towers, conservation easements, oil, gas and mineral interests, timber, water rights, improvements to be constructed, options, and more. Personal property exchanges, such as a car for a car, are more restrictive in that a car cannot be exchanged for a truck, and a specific class of liquor license cannot be exchanged for another class of liquor license. The IRS has issued "like-class" provisions for personal property but only as a safe-harbor. An exchange may still be "like-kind" and meet the requirements of a Section 1031 exchange, even if not "like-class".

6. What is the role of the Qualified Intermediary in a 1031 exchange?

The role of the Qualified Intermediary, as provided in the Regulations, cannot be that of a disqualified person or an agent of the taxpayer for purposes of a tax-deferred exchange. A disqualified person or agent is one who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker in the two years prior to the exchange, related parties and other beneficial interests. In order to meet the requirements of the Regulation and have a successful exchange, the Qualified Intermediary must (1) enter into an Exchange Agreement with the taxpayer whereby the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property are expressly limited; (2) be assigned the sales and purchase agreements for the relinquished property and replacement property, with written notification of the assignment to all parties to those agreements; and (3) hold the net sale proceeds in its account or with a qualified escrow or trust.

7. Do you need a Qualified Intermediary in each state that you sell or purchase property?

The Qualified Intermediary you choose will remain in the transaction from the sale of your relinquished property(s) to the acquisition of your replacement property(s), or the termination of the exchange, whichever comes first, regardless of which state either transaction occurs. Some states, however, in response to Qualified Intermediary bankruptcies and defalcations, have enacted laws governing exchange facilitators. These laws may include, but are not limited to, registration, insurance, notification and other restrictions imposed on the Qualified Intermediary for transactions where the relinquished property is located within the state or the Qualified Intermediary is considered "doing business" within the state.

8. How is the taxpayer's money protected while held by the Qualified Intermediary?

As mentioned previously, the Qualified Intermediary industry is unregulated with the exception of a few states. The number of defalcations and bankruptcies has been few. However, despite the size of the Qualified Intermediary or its parent company, or the presence of a Fidelity Bond, Errors and Omission, or Directors and Officer's insurance policies, or the availability of audited financial statements, defalcations and bankruptcies still occurred, resulting in the loss of the client's equity. There are safeguards a taxpayer should consider when selecting a Qualified Intermediary. These safeguards include: (1) depositing the taxpayer's funds in FDIC insured accounts; (2) depositing taxpayer funds in accounts that are principal preserved and liquid; (3) depositing taxpayer funds in segregated accounts under the client's name and federal identification number; (3) requiring dual signatures within the Qualified Intermediary company and, where practical, the signature of the taxpayer for any withdrawals; (4) ensure the proper wording is contained in the Exchange Agreement to protect the taxpayer's funds from a Qualified Intermediary bankruptcy; (5) the use of a Qualified Escrow and Trust Agreement; (6) the use of a Security or Guarantee Arrangement; and/or (7) deposit taxpayer funds in a financial institution selected by the taxpayer. The most important safeguard for a taxpayer is to rely on the referrals of their accountants, attorneys, Realtors and former clients of the Qualified Intermediary.

9. What are the time restrictions of a 1031 exchange?

Various time restrictions are included throughout the 1031 Regulations and Revenue Procedures. The most critical of these time restrictions are the 45 Day Identification period and the 180 Day exchange period, which apply to forward, reverse and build-to-suit exchanges. These time restrictions may be impacted by something as significant as federally declared natural disasters, or as insignificant as the filing deadline of the taxpayer's income tax return. Secondarily, time restrictions relating to holding periods of two years and 24 months, respectively, are required when exchanging with a related party or suggested when qualifying a property. Additional time restrictions relating to minimum rental periods and maximum personal use periods are also provided in the safe harbors of a 1031 exchange. A competent Qualified Intermediary will guide you through these timeframes.

10. What are some of the complex areas of 1031 exchanges…e.g. Partnerships, dealers, seller financing, vacation homes, related parties, partial exchanges?

Although the vast majority of 1031 exchange transactions are straight-forward, one-for-one exchanges, with little or no complications, a competent experienced Qualified Intermediary can also guide the taxpayer, their accountant, attorney and Realtor through the very complex transactions, as listed above. A Qualified Intermediary's familiarity with the Regulations, Revenue Procedures and Private Letter Rulings will prove beneficial to the taxpayer when deciding whether the 1031 exchange is a viable tax saving and wealth building tool for their transaction. Please contact us to discuss your specific circumstances and goals.

11. Can a person buy a property before they sell their property in a 1031 exchange…(reverse exchange)?

In 2000, the Internal Revenue Service issued a Revenue Procedure providing a safe harbor permitting an Exchange Accommodation Titleholder ("EAT") to acquire, with all of the benefits and burdens of ownership, the relinquished property or the replacement property in an exchange and hold it for up to 180 days while the taxpayer attempts to sell the relinquished property and/or improve the replacement property. Please see our web page entitled "Reverse Exchanges" at http://www.1031ESI.com for additional details about reverse and build-to-suit exchanges.

12. A 1031 exchange is a deferral of taxes. Are there strategies for eventually eliminating the taxes that were deferred?

A taxpayer has several options available to avoid or eliminate being taxed on the sale of their investment property. The first option is to continue taking advantage of Section 1031 of the tax code, without limitation, when an investment property is sold. This strategy affords the taxpayer use of additional equity, which otherwise would have been paid in taxes, to leverage into higher priced property and build wealth. The taxpayer is also utilizing the unpaid tax dollars interest free from the government. The second option is to convert a 1031 replacement property into a primary home and take advantage of the primary home exclusion. This strategy has been tightened over the last several years as time restrictions, depreciation recapture and allocations of the gain to "qualified" and "unqualified" usage have been imposed. Lastly, if the taxpayer holds the 1031 replacement property until death, the taxpayer's heirs receive the property at a "stepped-up" basis or fair market value on the date of death, whereby, the gain becomes part of the taxpayer's estate, potentially exempt from taxation, and not passed along to the heirs.

13. Can a 1031 exchange and a primary home exclusion be combined to maximize tax savings?

A taxpayer has several options available to maximize tax savings when combining a 1031 exchange and a primary home exclusion. The first option is when a taxpayer has two separate structures used concurrently, such as a Duplex, whereby, part of the property is used for business or investment and the other part is the taxpayer's primary residence. Since the usage of the property is clearly defined and distinguishable between personal and business use, the taxpayer can apply the primary home exclusion to the portion lived in and complete a 1031 exchange on the business portion. The second option is available for a single structure used concurrently, such as, a Boarding house. Since the usage is not clearly definable, the taxpayer would first apply the primary home exclusion to the entire gain and complete a 1031 exchange for the balance of the gain. The third option is available when a single structure is used consecutively, such as, when a principal residence is converted to a business or investment property. The tax application is similar to the Boarding house example above, however, time restrictions are imposed on the taxpayer. Please see our web page entitled "Mixed Use Property" at http://www.1031ESI.com for further information.

14. Are there any disadvantages of a 1031 exchange?

The disadvantages of completing a 1031 exchange are insignificant in comparison to the tax savings and wealth building opportunities afforded those who have taken advantage of this great tax tool. Among the disadvantages of a 1031 exchange are (1) a reduced basis in the replacement property resulting in a lower depreciation expense deduction; (2) an increase in transactional costs; (3) limitation on the use of equity, however, a taxpayer may refinance the replacement property after acquisition to avail themselves use of the property's equity; and (4) unknown future tax rates in the event the taxpayer decides to sell the property without the benefit of a 1031 exchange or any other tax saving strategies as discussed above.

15. What changes have occurred in the last 2 years that impact 1031 exchanges and the primary home exclusion?

Changes to the tax regulations, the issuance of Revenue Procedures and positions taken by the Internal Revenue Service on Private Letter Rulings affecting 1031 exchanges and the primary home exclusion can be found on our web page entitled "1031 Update" at http://www.1031ESI.com. Please refer to this page for the most recent changes.