

**The *Why & When*
The *How To*
The *Benefits***

**Trade Secrets of
Exchanging**

**Practical Application
of
IRC §1031**

This brochure is intended to provide a summary of the concepts and practice of tax deferred real estate exchanges (“Exchange”). It is not meant as a substitute for your personal CPA, professional tax advisor or attorney. It is recommended that you consult with your advisors before applying any of the concepts or practices contained herein to your particular real estate situation.

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Sellers Take Notice!

There is no reason to pay any of your hard-earned profit to Uncle Sam in the form of tax on CAPITAL GAINS as long as you intend to invest all of your current equity in other qualifying property.

Read on to find out:

- which properties qualify for non-recognition treatment,
- how an Exchange transaction actually works,
- how easy it is to postpone the payment of taxes and
- what you need to do to comply with the tax code and the regulations.

This brochure outlines a procedure for postponing the recognition of taxes on capital gain income upon disposition of real estate or personal property held for business or for investment.

It explains:

- how to eliminate unnecessary taxes,
- how to retain all of your profit and equity and
- how to get, in effect, an interest-free loan from the federal government.

DO NOT convey your property or accept a proceeds check before you read this brochure. You **MAY NOT** convert a sale into a qualifying Exchange after the fact. You, your attorney or other advisor **MUST NOT** accept a proceeds check if you desire to qualify for tax treatment pursuant to Internal Revenue Code Section 1031 (“IRC §1031”).

Yes! We can amend your executed purchase and sale agreement to qualify the transaction for an Exchange and establish your intent. We need forty-eight (48) hours notice before the scheduled closing.

What Is a Tax-Deferred Exchange?

A tax-deferred exchange (Exchange) is simply a method by which a property owner may trade one property for another without having to pay federal income taxes on the transaction.

In an ordinary sale transaction, the property owner is taxed on any gain realized by the sale of the property. But in an Exchange, some or all of the tax on the transaction is deferred until some time in the future, usually until the newly acquired property is sold.

These Exchanges are sometimes called "tax-free Exchanges," because the Exchange transaction itself is only partially taxed or not taxed at all.

What Is a Tax-Deferred Exchange?

Authority IRC §1031

Method to Defer Tax on Profit (Gain)

Tax-Free Exchange

Interest-Free Government Loan

Exchanges are granted authority under Section 1031 of the Internal Revenue Code (IRC §1031) and the related regulations. When an Exchange is conducted in accordance with IRC §1031 and the regulations, the tax on the gain which is realized by virtue of the sale of the old property will be deferred, (not recognized) until such time as the property acquired in the Exchange is sold or otherwise disposed of in a taxable transaction.

In an Exchange, a property owner simply transfers the old property and receives the new property. However, the Exchange must be structured in such a way that it is, in fact, an Exchange of one property for another, rather than the sale of one property and the purchase of another. A taxpayer is deemed to have sold property in a taxable transaction if the rights and interests in the property are conveyed and the taxpayer is in actual or constructive receipt of the proceeds. Consequently, a taxpayer who transfers title to property to the buyer and walks the proceeds across the street to purchase the new property has sold property in a taxable transaction and will not be afforded the benefits of an Exchange.

The taxpayer may avoid the taxable sale and purchase and qualify for Exchange treatment if, prior to the sale of the old property, the taxpayer enters into an Exchange agreement with a "Qualified Intermediary," a fourth-party principal who helps to ensure that the

Exchange is structured properly and meets all of the requirements of IRC §1031 and the regulations, and, pursuant to the Exchange agreement, assigns all of his/her rights in and to the sale agreement to the Intermediary.

Advantages & Disadvantages of Exchanging

The primary advantage of an Exchange is that the taxpayer may dispose of property without incurring any immediate tax liability. This allows the taxpayer to keep the earning power of the deferred tax dollars working for him/her in another investment. In effect, this money can be considered an interest-free loan from the IRS. There is no interest paid or accrued on the outstanding loan balance and there is no specific call date or due date.

Moreover, the loan is forgiven upon the death of the taxpayer, which means that the taxpayer's estate never has to repay the loan. The taxpayer's heirs get a stepped-up basis on inherited property; that is, their basis is the fair market value of the inherited property at the time of the taxpayer's death. A subsequent sale by the heirs will be taxable only to the extent of the difference between the stepped up-basis and the net sale price.

The taxpayer should also consider the disadvantages of an Exchange. These include the following:

- The taxpayer's basis in the new property (substitute basis), will be the basis of the old property, plus the increase in value between the new property and the old property, plus the amount of gain which may be recognized in the Exchange. The substitute basis will always be less than the contract price of the new property. In fact, the difference between the contract price and the substitute basis will equal the amount of gain that was not recognized by virtue of the Exchange. Consequently, the depreciation deduction will be less than the depreciation which would have been available had the taxpayer sold the old property and purchased the new property.
- There will be increased transactional costs for entering into and completing an Exchange. Typical costs include possible additional escrow fees, attorney's fees, accounting fees, and the Qualified Intermediary's fees.
- The taxpayer may not, without tax consequences, use any of the net proceeds from the sale of the relinquished property for anything except reinvestment in other qualifying property. All proceeds from the sale must be used to acquire replacement property. At the termination of the Exchange, any remaining proceeds not used in this manner may be taxable. To be 100% tax deferred, the taxpayer must acquire new property equal or greater in value to the net sale price of the old property and the taxpayer must spend all of the net proceeds of sale or more on the acquisition.

Before deciding whether or not to engage in an Exchange, the taxpayer should carefully analyze all of his or her options as well as the economic impact of the Exchange. A decision should not be based solely on the tax consequences of the transaction. Rather, business considerations should play the dominant role in the decision. Business considerations include, but are not limited to, the need or desire to:

- consolidate or diversify investments
- obtain greater appreciation on the new property
- increase cash flow
- relocate a business investment
- transfer into or out of a high basis or low basis property
- eliminate management problems
- upgrade the functionality of the property
- exchange out of obsolete property

Misconceptions About Exchanges

People often fail to consider Exchanges as an investment strategy because they are misinformed about the requirements of Exchanging. However, once their misconceptions have been cleared up, property owners usually find that IRC §1031 is worth considering.

Exchange Myths

The 2-Party Swap

**Like-Kind Limitations
Apartments for Apartments
Land for Land**

Simultaneous Transfer

Equal Value Properties

One common source of confusion was that people would often mistake Exchanging for a rollover of a principal residence under IRC §1034. Prior to the repeal of IRC §1034, taxpayers could defer the tax on the sale of their principal residence by replacing the residence with a new principal residence within 24 months of selling the old one. No Exchange was required. However, in May of 1997, IRC §1034 was repealed in its entirety and replaced with the following general provisions under IRC §121. Gain from the sale of a principal residence is excluded from taxable income to

the extent of \$500,000 for a married couple filing a joint return and \$250,000 for a single taxpayer. Under the new provisions, there is no requirement for a rollover into a new

principal residence. These changes will eventually eliminate some of the confusion between the repealed principal residence rollover provisions and an Exchange.

Here are a few other common misconceptions about Exchanges:

Myth: Exchanges require two parties who want each other's properties.

Fact: Two-Party Exchanges are possible, but in reality, such two-party swaps rarely occur. Today, an Exchange is accomplished with the help of a Qualified Intermediary and usually involves four principal parties: the exchangor (taxpayer), a buyer for the relinquished property, a seller of the replacement property, and the Qualified Intermediary. The parties often do not know each other, and their properties may even be located in different states.

Myth: The like-kind requirement limits a taxpayer's options.

Fact: Property must be exchanged for "like-kind" property. But like kind simply means that real property must be Exchanged for real property. All real property is like kind, so a fee simple interest may be Exchanged for a tenancy in common interest; one property may be Exchanged for more than one property; a duplex may be Exchanged for a four-plex; a single family may be Exchanged for a motel; vacant land may be Exchanged for an office building, etc. However, real property may not be Exchanged for personal property, and both the real property given up and the real property received must also satisfy the Purpose Requirement, which will be discussed later.

Personal property may be exchanged for other personal property. However, in an exchange of personal property the definition of like-kind is not as liberal as for exchanges of real property.

Myth: In an Exchange, title to the Exchanged properties must pass simultaneously.

Fact: The properties do not have to close at the same time. However, the replacement property must be received by the taxpayer within 180 days after closing on the relinquished property. When the two transactions do not close at the same time, the Exchange is called a deferred Exchange.

Impact of Tax Changes in 1986, 1991 & 1997

The Tax Reform Act of 1986 (the Act) greatly increased the use of Exchanges by doing several things. First, it eliminated the capital gains rate, so all income was taxed at the same rate, regardless of whether it was capital gain, earned income, or unearned income. By eliminating the more favorable capital gains rate, the Act caused taxpayers to search

for alternatives to simply selling their investment property and paying tax on the gain at their applicable tax rate.

Second, the Act eliminated both short-term depreciation schedules and the use of accelerated depreciation. The new cost-recovery periods of 27.5 years for residential rental property and 31.5 years (now 39.5 years) for non-residential property reduced the significance of depreciation in evaluating real property investments. The availability of depreciation deductions to shelter other income has been severely restricted.

In 1991, the Service issued definitive regulations governing the application and procedural requirements of IRC §1031. Additionally they clarified many of the open issues and brought order and consistency to the Exchange transaction, which further enhanced its use.

In 1997, the Republican Congress successfully passed tax provisions to reduce the capital gain rate from 28% to 20%, bringing some needed relief to investors in real estate and other markets. However, the negotiations failed in some respects when Congress also defined income which qualified as capital gain income. Pursuant to the final tax bill, as approved by Congress and signed by the President, income generated from the sale of a depreciable asset will be taxed at two rates. The difference between the net sale price and the original cost of the asset was taxed at 20%, while the difference between the original basis and the depreciated basis (an amount equal to the accumulated depreciation) will be taxed at the rate of 25%.

Preliminary 1997 proposals, which are not contained in the final tax bill, included Presidential recommendations to change parts of the Exchange provisions, particularly as they relate to the definition of like kind. As proposed, like kind would be changed from its current broad definition to “similar or related in service or use.” Adoption of this provision would have changed the entire practice of Exchanges and limited taxpayers to exchanges of land for land, apartments for apartments, and industrial property for industrial property.

In recent years, the tax rate on appreciated gain has been reduced further to its current rate of 15%.

The Justification for Tax Deferral

Allowing a taxpayer to defer the tax in an Exchange transaction encourages prudent investments. In an ordinary sale transaction, a person sells property for cash. He/she can use a portion of the cash acquired in the transaction to pay tax on the gain. The net proceeds then can be invested in another investment.

But when someone Exchanges one property for another property, he/she may not receive cash from the transaction. Therefore, the taxpayer may have no cash available with which to pay taxes. If taxes were assessed on an Exchange, the taxpayer might have to liquidate other investments to get the cash needed to pay the tax or Exchange into a less valuable property and accept cash for the difference and then use the cash to pay the tax. If the tax on a like-kind Exchange were not deferred, Exchanging one property for another might result in unwise investment practices. By deferring the tax due on an Exchange, Congress has given taxpayers the ability to move from one investment directly into another without having to liquidate other investments or to settle for less valuable property.

Parties & Properties in an Exchange



There are four parties involved in a typical Exchange: the **Taxpayer**, the **Seller**, the **Buyer**, and the **Qualified Intermediary**.

The **Taxpayer** has property and would like to Exchange it for new property.

The **Seller** owns the property that the Taxpayer wants to acquire in the Exchange.

The **Buyer** has the necessary money and wants to acquire the Taxpayer's property.

The **Qualified Intermediary** plays a role in almost all Exchanges today. He/she neither begins nor ends the transaction with any property. He/she buys and then resells the properties at an agreed-upon price in return for a fee. Notice that the party who will end up with the taxpayer's property is NOT the same party who owned the property that the taxpayer will end up with. The typical Exchange is NOT a swap whereby two individuals swap properties with one another. Notice also that there is only one taxpayer. While there will be tax consequences for everyone involved in the Exchange, our concern is with the taxpayer who will receive the benefits of IRC §1031.

The properties involved in an Exchange have special names, too:

- **Relinquished Property:** the property originally owned by the taxpayer and which the taxpayer would like to dispose of in the Exchange.
- **Replacement Property:** the new property that the taxpayer would like to acquire in the Exchange.

In order for an Exchange to be 100% tax deferred, the replacement property must have a fair market value of equal to or greater than the relinquished property and all of the taxpayer's equity or more must be used in acquiring replacement property. This is known as trading up or equal in value and up or equal in equity, and it is essential if the taxpayer desires to defer the tax on all of the gain.

Here is an example of the parties and properties involved in a typical Exchange:

Tom owns an apartment complex in Tacoma worth \$500,000. He believes the Tacoma Apartments are no longer appreciating in value and wants to dispose of them. However, he doesn't want to pay tax on the disposition of the Tacoma Apartments. While he wants to dispose of the Tacoma Apartments, he wants to acquire a larger property, the Boston Apartments, in an Exchange.

Sally owns the Boston Apartments, worth \$750,000. She feels that the Boston Apartments are no longer a good investment for her. She doesn't want any other real estate, instead, she wants to sell the Boston Apartments for cash.

Bart has money. He would like to buy the Tacoma Apartments for cash. Through the assistance of Irving, the Qualified Intermediary, each of the parties will end up with what he or she wants.

When the Exchange is complete, Tom will own the Boston Apartments, Bart will own the Tacoma Apartments, and Sally will have cash.

Deferred Exchange with Qualified Intermediary

Most Exchanges that occur today are delayed or deferred Exchanges. A delayed Exchange is required if at the time when the relinquished property is sold to the buyer by the Qualified Intermediary, the taxpayer does not know what property he or she wants to acquire or the taxpayer is not prepared to receive title to the new property in a concurrent or simultaneous transaction. Therefore, in the typical delayed Exchange, the sale of the old property by the Qualified Intermediary and the transfer of the new property to the taxpayer take place at different times.

The amount of time that is allowed to lapse between the sale by the Qualified Intermediary and the subsequent transfer of the new property to the taxpayer is limited by specific provisions of IRC §1031 and the regulations. The taxpayer has 45 days from the date of sale of the old property by the Qualified Intermediary to identify the property he or she wants as the replacement property in the Exchange. In addition, the transfer of the replacement property to the taxpayer must occur on or before the expiration of 180 days from the date of sale of the old property or before the time for filing the tax return for the tax year of the sale date, whichever occurs first. If the filing date of the taxpayer's return occurs before the receipt of all replacement property, then the taxpayer must file a request for automatic extension so that the tax filing for the Exchange occurs on the return for the year of the sale date.

Example: Tom knows he wants to dispose of the Tacoma Apartments and Bart knows he wants to buy the Tacoma Apartments for cash. For tax reasons, Tom does not want to sell the Tacoma Apartments directly to Bart and then buy another property at a later time; he wants to do an Exchange, but at this time he doesn't know what property he wants in Exchange for the Tacoma Apartments.

The first part of the delayed Exchange takes place when Tom transfers title to the Tacoma Apartments to Irving and Irving sells the Tacoma Apartments to Bart. Bart pays cash to Irving. Sometime later, but within 45 days, Tom identifies the Boston Apartments as the property he wants to receive in the Exchange. Irving uses the funds from the first part of the Exchange to pay cash to Sally, who then sells the Boston Apartments to Irving. Before the expiration of 180 days or before the time Tom is required to file his tax return for the tax year of the original sale date, whichever occurs sooner, Irving transfers title to the Boston Apartments to Tom and concludes the Exchange.

Specific Requirements

Purpose Requirement

Like Kind Requirement

Holding Period

Exchange Requirement

Time Limits

Identification Rules

Constructive Receipt

Specific Requirements for an Exchange

For a transaction to qualify for tax deferred treatment under IRC §1031, certain requirements must be met. We have already touched on some of the requirements briefly. We will examine each of them in more depth now.

Qualified Property

In general, all property, both real and personal, can qualify for tax-deferred treatment so long as the properties meet the like kind and purpose requirements. However, some types of property are specifically *excluded*, namely: stock in trade or other property held primarily for sale; stocks, bonds, or notes; other securities or evidences of indebtedness; interests in a partnership; certificates of trust or beneficial interest; and chooses in action (i.e. interests in law suits). For example, property that is held by the taxpayer as inventory in his trade or business, such as the items on the taxpayer's hardware store shelves or the development lots owned by the taxpayer and held primarily for sale to individuals, are deemed to be "dealer property," property held primarily for sale, and do not qualify for an Exchange. Partners or beneficiaries of a trust may not exchange their partnership interest (limited or general) or beneficial interest and shareholders of corporate shares of stock may not exchange their stock holdings. These exclusions, however, do not prevent a corporation, partnership or trust from exchanging assets held by the corporation, partnership or trust for other assets of like kind which meet the purpose requirement in the hands of the taxpayer.

The Purpose Requirement

Although every type of real property located within the 50 United States and the U.S. Virgin Islands is like kind to all other real property similarly located and is therefore eligible for tax-deferred treatment, there is an additional provision relating to the property which must also be met, called the purpose requirement.

IRC §1031 says that "No gain or loss shall be recognized on the Exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."

That means that to qualify for tax-deferred treatment, the relinquished property must be held by the taxpayer for productive use in a trade or business or for investment, and, in the Exchange, the taxpayer must acquire property which he or she intends to hold for productive use in a trade or business or for investment.

All real property that is rented to others at fair market rent and all property held by the taxpayer for use in a trade or business is property held for the productive use in a trade or business. The store where the taxpayer conducts his hardware business, the multi-unit apartment building, the rented single-family home or residential condominium, the shopping mall are all examples of qualifying property held by the taxpayer for the productive use in a trade or business. However, if the taxpayer moves into the single-family home, or rents it for below market rates, then the property is considered property held for personal use and no longer qualifies for Exchange purposes.

Property held for investment by the taxpayer is property held primarily for the incremental increase in value due to factors beyond the control of the taxpayer. The best example of real property held for investment is raw undeveloped land which the taxpayer acquired for long-term hold and appreciation.

Thus any real property, other than the taxpayer's personal use property (property held as the taxpayer's personal residence or second home) or dealer property (property acquired for resale), qualifies and meets the Purpose Requirement for an Exchange.

The Like-Kind Requirement

Replacement property acquired in an Exchange must be like kind to the property being relinquished. Like kind means "similar in nature or character, notwithstanding differences in grade or quality." All real property is like kind, regardless of whether it is improved or unimproved and regardless of the type of improvement or interest. Therefore, raw land is like kind to a duplex. A tenancy in common interest is like kind to a fee simple interest. One property is like kind to more than one property. A shopping center is like kind to a single family house. A residential apartment building is like kind to a storage facility.

Real property, however, is not like kind to personal property. Therefore, an Exchange of a building lot for a car does not qualify under IRC §1031.

A recently proposed amendment to IRC §1031 would have required that replacement property be similar or related in service or use to the property being relinquished in an Exchange. This requirement would have meant that an office building could only be Exchanged for another office building, an apartment building for another apartment building, raw land for raw land, and so forth. Inasmuch as this proposed amendment did not pass, the definition of like kind continues to be what it has been since 1921, all real property is like kind. Remember, though, that while real property can be Exchanged for real property, the purpose requirement discussed above still applies; that is, the properties, no matter what kind or interest, must be held for productive use in a trade or business or for investment.

However, for Exchanges of tangible personal property, the definition of Like Kind is much more restrictive. Pursuant to IRC §1031 and the regulations, Like Kind personal property is defined as property which is of a like class;

- within the same General Asset Class of Revenue Procedure 87-56 or,
- within the same Product Class from the 4-digit product class within Division D of the standard Industrial Classification Manual, ("SIC Manual").

For Example

- A computer and computer printer are like class because they are in the same General Asset Class, (00.12).
- A road grader may be exchanged for a road scraper without recognition of gain since both are in the same Product Class (SIC Code 3553). Neither property is within the same General Asset Class.
- A United Airlines 747-SP is like class to TWA L-1011 because both airplanes are listed in the SIC Manual in Product Class 3721. The fact that the airplanes are not listed in the same General Asset Class of Revenue Procedure 87-56 does not negate the characterization of the airplanes as like class.
- A diesel locomotive and an electric locomotive are both listed in the SIC Manual under Product Class 3743 and therefore deemed to be like class for purposes of IRC §1031.
- An exchange of the United Airlines 747-SP for a diesel locomotive will not qualify for non-recognition treatment under IRC §1031 because they are not in the same General Asset Class or the same Product Class.
- An automobile dealer who leases passenger vehicles to the general public may want to consider Exchanging the used vehicles at the termination of the lease. All general purpose passenger vehicles are in the same General Asset Class, 00.22. The General Asset Class of heavy general purpose trucks is 00.242. The dealer could Exchange the used vehicles for new vehicles acquired from the manufacturer. Truck and heavy equipment dealers use the Exchange process frequently to supply the needs of their customers. Since these fully depreciated vehicles will retain substantial value at the termination of the lease the Exchange becomes a valuable tool.

The General Asset Classes are:

- 00.11. Office furniture, fixtures and equipment.
- 00.12. Information systems, computers and peripheral equipment.
- 00.13. Data handling equipment. Except computers.
- 00.21. Airplanes except those used for commercial contract carrying of passengers.
- 00.22. Automobiles.
- 00.23. Buses.
- 00.241. Light general purpose trucks.
- 00.242. Heavy general purpose trucks.
- 00.25. Railroad cars & locomotives except ones owned by transportation companies.

- 00.26 Over the road tractor units.
- 00.27 Trailers & trailer mounted containers.
- 00.28 Vessels, barges, tugs and other water transportation equipment.
- 00.4 Industrial steam & electric generation/distribution systems.

Exchanges of intangible personal property and non-depreciable personal property qualify for non-recognition treatment under IRC §1031 only if the property given and the property received are like kind under a strict definition of like kind which requires that;

- the nature and character of the rights and interest which are transferred are like kind and
- the nature and character of the underlying property to which the intangible personal property relates is also like kind.

For example, a copyright of a novel is like kind to a copyright of another novel but is not like kind to a copyright of a song. In both cases, the intangible personal property in the form of the copyright is like kind to the other copyright, however, the underlying properties to which the copyrights relate, the novel and the song, are not like kind and therefore the Exchange of the copyright of the novel for the copyright of the song will not prevail under IRC §1031.

Goodwill or going concern of a business is not like kind to the goodwill or going concern of another business and may not be exchanged under IRC §1031. Examples of goodwill and going concern are the company's name and mailing list.

The Holding Period.

How long must a taxpayer hold property in order for it to qualify for tax deferred treatment? The question applies both to the relinquished property and to the replacement property. A proposed amendment to IRC §1031 would have required that both the relinquished property and the replacement property be held for at least one year in order to qualify for tax deferred treatment. Although that proposal failed, the one-year period has become a rough rule of thumb used by those dealing with Exchanges.

Conservative taxpayers may want to consider the minimum holding period to be longer, possibly one and a half years or two years, especially in light of the changes in the definition of long-term capital gain enacted in the 1997 tax act. Whichever period is elected, taxpayers will be at some risk unless a specific holding period is established by law or regulation.

The holding period is a fact or circumstance to be considered in determining whether the purpose requirement has been met. For example, if a replacement property is acquired and then immediately sold, that might indicate that the property was in fact acquired for

resale and is therefore dealer property and consequently will not qualify for tax deferred treatment. Also, the conversion of use of the relinquished property from personal use to use in a trade or business (rental property) must be documented sufficiently in advance of the Exchange to qualify the property under the purpose requirement.

The Exchange Requirement

IRC §1031 specifically requires that an Exchange take place. That means that one property must be exchanged for another property, rather than sold for cash. The Exchange is what distinguishes an IRC §1031 tax-deferred transaction from a sale and purchase. Congress has had ample opportunity to eliminate the Exchange requirement from IRC §1031. If they intended for a mere roll over to qualify under IRC §1031, they most likely would have amended the law at some time by authorizing treatment as provided in the repealed provisions under IRC §1034 for the replacement of a principal residence.

Likewise, Congress could have eliminated the Exchange requirement when it adopted the Tax Reform Act of 1986, or again in 1989 when IRC §1031 was amended to eliminate Exchanges into or out of foreign properties, and to restrict Exchanges between related parties. But Congress did not do so.

Time Limits

The Tax Reform Act of 1984 imposed time restrictions for Exchanges. For delayed Exchanges in which the taxpayer will acquire the replacement property after transfer of the relinquished property, two time limits are established; The taxpayer is required to identify the replacement property within 45 days after transfer of the relinquished property, AND the taxpayer must receive title to the replacement property before the earlier of (a) 180 days after the transfer of the relinquished property, or (b) the due date of the taxpayer's federal income tax return, including extensions, for the year in which the relinquished property is transferred. The reason for these time limits is simply one of administrative convenience.

Alternative & Multiple Properties

Whether one property or more than one property is transferred by the taxpayer as part of one Exchange, the number of replacement properties that may be identified is:

- Up to three properties, without regard to their fair market value, (the “3 property rule”), or
- More than three properties, if the total fair market value of all these properties at the end of the 45-day identification period does not exceed 200 % of the total fair market value of all property relinquished, (the “200% rule”).

- If the taxpayer fails to meet either the three property rule or the 200% rule, then the taxpayer must acquire 95% of all property identified at the termination of the 45-day identification period (the 95% rule). If the taxpayer fails to meet the requirements of one of the rules, the 3 property rule or the 200% rule or the 95% rule, then all property acquired in the Exchange will be deemed **not** to be like kind. The Exchange shall fail by virtue of the fact that the taxpayer received only non-like kind property and gain will be recognized to the full extent of the realized gain.

Constructive Receipt

If the taxpayer actually receives the proceeds from the disposition of the relinquished property, the transaction will be treated as a sale and not as an Exchange. Even if the taxpayer does not actually receive the proceeds from the disposition of the property, the Exchange will be disallowed if the taxpayer is considered to have "constructively" received the proceeds.

IRC §1031 and the regulation provide that income, even though it is not actually reduced to a taxpayer's possession, is constructively received by the taxpayer if it is credited to his or her account, set apart for him or her, or otherwise made available so that he or she may draw upon it at any time.

However, income is NOT constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Therefore, a crucial question in every Exchange is whether the taxpayer's control over the proceeds from the disposition of the relinquished property is substantially limited or restricted.

There are a number of complicated rules to help a taxpayer and his or her advisors structure an Exchange so that the taxpayer will not be in constructive receipt of the funds. The principal means following the adoption of the final regulations is the use of a Qualified Intermediary.

Why Exchanges Fail

The primary reason why deferred Exchanges fail is due to the taxpayer's inability to properly identify replacement properties before the expiration of the 45-day identification period. This is a practical reason having nothing to do with the structure or integrity of the Exchange and needs to be addressed by the taxpayer before the sale of the relinquished property. It is recommended that the taxpayer have a good understanding of the type and location of replacement properties before entering into the Exchange.

Other reasons Exchanges fail can be avoided by the taxpayer's use of a Qualified Intermediary who has knowledge and experience in orchestrating an Exchange and who

can demonstrate ability to perform the duties of the Qualified Intermediary in a timely and complete fashion. The taxpayer's use of any other intermediary may cause the Exchange to fail for any of the following reasons;

- An agency relationship is established between the taxpayer and the intermediary.
- The intermediary is a disqualified person.
- The taxpayer is in actual or constructive receipt of some or all of the proceeds held by the Qualified Intermediary prior to the receipt of replacement property.
- Lack of established intent to Exchange.
- Non-like kind or non-qualifying properties Exchanged.
- The transaction includes several associated transactions which would otherwise have been taxable.
- The Exchange was between related parties and one party subsequently sold the property received in the Exchange.

Reverse Exchanges

On October 2, 2000, the Internal Revenue Service, (“IRS”) issued Revenue Procedure 2000-37 providing a “safe harbor” for so-called Reverse Exchanges under IRC §1031.

In a typical Exchange, a taxpayer sells a property (Relinquished Property) pursuant to an Exchange agreement with a Qualified Intermediary (QI) and subsequently acquires other property (Replacement Property). In such an Exchange, no gain or loss shall be recognized, except to the extent of the fair market value of any non-like kind property received in the Exchange (Boot) if all of the requirements of IRC §1031(a)(3) are satisfied. However, as a practical matter, not all Exchange transactions can be accomplished in this manner and in many cases the Replacement Property must be acquired from its seller prior to the sale of the Relinquished Property. Such Exchanges are called “Reverse Exchanges.” Typical examples of Reverse Exchanges include:

- Replacement Property which must be constructed may have to be acquired prior to the sale of the Relinquished Property so that the taxpayer has sufficient time to complete the construction project prior to the expiration of the 180 day limitation for Delayed Exchanges.

- In a strong seller's market a taxpayer may need to close on the Replacement Property prior to the sale of the Relinquished Property in order to guarantee that the Replacement Property is available as Replacement Property for the Exchange.

History of Reverse Exchanges

In 1991, when the IRS issued definitive regulations defining the safe harbor procedures for deferred Exchanges under IRC §1031, they specifically stated that the regulations were not applicable to Exchanges where the taxpayer acquired title to the Replacement Property prior to the sale of the Relinquished Property. The IRS has not changed its position on this matter with the issuance of Revenue Procedure 2000-37. The fact remains, if a taxpayer takes title to the Replacement Property prior to the sale of the Relinquished Property, the acquisition and subsequent sale will not qualify for non-recognition treatment under IRC §1031.

Since 1991, however, taxpayers have circumvented the restrictions under IRC §1031 by employing so-called "Parking Arrangements" in which an Exchange Accommodation Title Holder ("EAT") is contracted to hold the Replacement Property or the Relinquished Property until such time as the Exchange can be conducted as a typical delayed Exchange. The Parking Arrangements took on one of two forms.

- **Exchange Last** The taxpayer funds the EAT to acquire the Replacement Property and hold title to the Replacement Property until the sale of the Relinquished Property. Following the sale of the Relinquished Property the EAT transfers the Replacement Property to the QI who transfers the property to the taxpayer in termination of the Exchange.
- **Exchange First** The QI conveys the Relinquished Property to the EAT and causes the Replacement Property to be transferred to the taxpayer in termination of the Exchange. The EAT subsequently sells the Relinquished Property to the buyer.

The most common form of the reverse Exchange is the Exchange Last transaction. In a typical Exchange Last transaction, the taxpayer funds the EAT's acquisition of the Replacement Property either directly or by guaranteeing loans made to the EAT by third party lenders. The EAT holds legal title to the Replacement Property. Upon the sale of the Relinquished Property, the EAT transfers the replacement property to the taxpayer pursuant to the taxpayer's agreement with the QI. The conveyance of the Replacement Property to the taxpayer is usually made subject to the existing loans or in consideration of the forgiveness of the taxpayer's loan to the EAT.

The Exchange Last transaction has been the subject of several tax cases. In J.H. Baird Publishing Company v. Commissioner and in Coastal Terminals Inc. v. U.S. the courts upheld Exchange treatment in two Exchange Last transactions. Notwithstanding these

cases, the courts have not specifically addressed certain issues to determine whether property held pursuant to a parking arrangement qualifies as Replacement Property or Relinquished Property in an Exchange or if the QI is or is not the agent of the taxpayer.

Revenue Procedure 2000-37

Revenue Procedure 2000-37 provides a taxpayer answers to these questions and an element of tax certainty. Specifically, the “safe harbor” provisions of Revenue Procedure 2000-37 provide that the Internal Revenue Service will not challenge the qualifications of property as either Replacement Property or Relinquished Property or the treatment of the title holder as the beneficial owner of such property for federal income tax purposes, if the property is held in accordance with the following provisions under Revenue Procedure 2000-37.

- The title holder of the parked property is not a disqualified person within the meaning of Regulation Section 1.1031(k)(1)(k). The title holder may not be the taxpayer, the taxpayer’s attorney, accountant, broker or a related party pursuant to the provisions of IRC §1031(f).
- The title holder of the parked property must be subject to federal income tax or if a pass through entity at least 90% of the ownership interest must be held by persons subject to federal income tax. The title holder must report its taxable interest in the parked property during the entire term of the parking arrangement and at acquisition and disposition on its federal tax return.
- The title holder of the parked property must acquire legal title to the Replacement Property or be treated as the beneficial owner under applicable principles of commercial law.
- The taxpayer must have a bona fide intent to use the parked property as either Replacement Property or Relinquished Property in an IRC §1031 Exchange.
- The taxpayer and the title holder of the parked property must enter into an agreement which specifies 1) that the title holder is holding the parked property to facilitate an Exchange for the benefit of the taxpayer and, 2) that the title holder will be treated as the beneficial owner of the parked property for federal income tax purposes.
- If the taxpayer is treating the parked property as Replacement Property in an Exchange, the taxpayer must identify the Relinquished Property to be Exchanged prior to the expiration of 45 days following the acquisition of the Replacement Property by the title holder. The identification must be made in a manner consistent with the provisions of Regulation Section 1.1031(k)-1(c). Accordingly, the three property rule, the 200% rule and the 95% rule all apply.

- If the taxpayer is treating the parked property as Replacement Property in an Exchange, the title holder must transfer the parked property to the taxpayer before the expiration of 180 days following the acquisition of the Replacement Property by the title holder.
- If the taxpayer is treating the parked property as Relinquished Property in an Exchange, the title holder must sell the Relinquished Property to a third party buyer, not the taxpayer or a disqualified person, prior to the expiration of 180 days following the transfer of the Relinquished Property to the title holder.

Revenue Procedure 2000-37 also provides guidance in an effort to coordinate the needs of the title holder and the benefits and burdens requirement of being the taxable entity during the term of the parking arrangement. It also provides certain protections in financing arrangements and exit provisions. These procedures permit the taxpayer and the title holder to enter into a variety of arrangements, which may or may not be at arm's length, to protect the title holder's risk and shift benefits to the taxpayer without violating the "safe harbor."

- The taxpayer or a related party may advance funds to the title holder for the acquisition of the Replacement Property or guarantee third party loans made by lenders to the title holder.
- The title holder may lease the parked property to the taxpayer or hire the taxpayer as manager of the property. The lease and management agreements may provide that the taxpayer will be responsible for all costs and expenses related to the ownership of the property.
- The taxpayer and the title holder may enter into fixed price agreements for the transfer of the parked property.

Tenant in Common Interests **Fractional Ownership**

In 2002 the Internal Revenue Service issued Revenue Procedure 2002-22 which contains guidelines relative to the acquisition of Tenant in Common Interests as qualifying replacement property in an Exchange. Specifically, the guidelines established certain requirements that needed to be met so that the acquisition of a Tenant in Common Interest would be treated as an interest in real estate and not a security.

The result of the Revenue Procedure has been to spawn a new exchange related industry to provide an inventory of qualifying property interests for tax deferred exchanges under IRC §1031. Typically, a Tenant in Common sponsor, will locate and contract to acquire

an institutional grade property which is divided into fractional interests and subsequently marketed to multiple investors. The types of properties and their locations are various. Typically the property will consist of class “A” apartment complexes, shopping malls, or office buildings and be leased to quality tenants. The fractional interests usually contain debt and equity components in the property in proportion to the percentage ownership to be acquired. The exchangor will acquire the Tenant in Common Interest using the proceeds from the sale of the exchangor’s relinquished property and by assuming a proportional amount of the debt. The properties are typically managed by professional management companies so that the exchangor does not have to be involved in the day-to-day operation of the property.

Sales of Tenant in Common Interests are handled through licensed broker dealers under the oversight of the Securities and Exchange Commission. Often, a broker dealer will represent several Tenant in Common sponsors each of which may have one or more available property offering. Typically, the broker dealer will have completed its own analysis and due diligence of the property offering and the sponsor and provide their findings to prospective exchangors.

The benefits of acquiring an ownership interest in a Tenant in Common offering are as follows:

- The exchangor desires to reduce management responsibility and hands-on involvement with the property and tenants.
- The exchangor desires to acquire an interest in a multi million dollar class “A” property which (s)he could not otherwise acquire.
- The exchangor desires to diversify his/her holding by acquiring several Tenant in Common Interests offered by different sponsors in different locations.
- The exchangor is unable to identify other suitable replacement property within the 45 day identification period.

Some of the potential pitfalls of acquiring a Tenant in Common Interest are:

- An investment in a Tenant in Common interest, is an investment in the sponsor. How long has the sponsor been in business? Does the sponsor have experience and a track record in structuring Tenant in Common deals? Has the sponsor successfully completed other Tenant in Common transactions?
- Does the proposed transaction meet the guidelines established by Revenue Procedure 2002-22? Does the Tenant in Common interest qualify as replacement property in an IRC §1031 Exchange?

- Do the Tenant in Common owners have the ability to hire and fire management? Does the management company have a successful track record?
- A tenant can make or break any real estate deal. How strong are the tenants? How strong are the leases?
- Every investment must end some day. Does the sponsor have an exit strategy?. Has the sponsor been successful in selling out similar investments at a profit. Does the exchanger have the right to sell individually? What if you need to get out prematurely? Is there a secondary market for your Tenant in Common Interest?

The specific requirements for a qualifying Tenant in Common Interest are as follows:

- Each co-owner must own a fee interest in the property as a Tenant in Common under local law. The property as a whole can not be owned by an entity. The number of co-owners can not exceed 35.
- The co-owners may not file a partnership or corporate return, conduct business under a common name, form a partnership or other business entity, or hold themselves out to be partners, shareholders, or members of a business entity.
- The co-owners must have the right to approve the management company, the sale of the property, any leases, and any debt. All such decisions must be made by the unanimous approval of the co-owners.
- Each co-owner must have the right to transfer, encumber and partition the co-owner's Tenant in Common interest in the property without the agreement or approval of any other person.
- Each co-owner must share in the revenues and costs associated with the property in proportion to the co-owner's percentage Tenant in Common interest.
- Each co-owner must share in any loan secured by the property in proportion to the co-owner's percentage tenant in common interest.

Tenant in Common or fractional ownership is rapidly becoming a recognized tool in the exchange industry and the concept and practice of acquiring Tenant in Common interests as qualifying replacement property is growing at a remarkable pace in order to meet investor demand. More and more sponsors and broker dealers are appearing in the marketplace with numerous property offerings. While Tenant in Common ownership may not be ideal for all investors, many investors are sure to find the opportunities offered by

the Tenant in Common industry both competitive with conventional real estate investments and rewarding.

Other Applications of IRC §1031

- Replacement Property to be Built
- Exchanges & Installment Sales
- Exchanges in Anticipation of Foreclosure
- Related Party Exchanges

Duties of a Qualified Intermediary

The duties, responsibilities and challenges involved with operating a Qualified Intermediary business are in general a thorough familiarity and knowledge of the regulations, ability to provide documentation in compliance with the regulations, an understanding of all of the elements of the Exchange and the knowledge and ability to perform in compliance with the Exchange agreement and the regulations. In addition, the Qualified Intermediary must;

- Preserve the integrity of the Exchange through preparation of proper documentation and complete the Exchange in compliance with the regulations.
- Make sure the "Safe Harbors," if used, are not violated and therefore cease to apply.
- Interpret and apply the regulations to complex transactional issues.
- Provide proper and accurate accounting to the taxpayer.
- Respond to short time constraints which are prevalent in Exchanges.
- Manage the Exchange funds in a prudent and safe manner which incorporates sound business practices.

Qualifications of a Qualified Intermediary

The Qualified Intermediary is in the business of facilitating deferred Exchanges by intermediating between the principals. The Qualified Intermediary must protect the integrity of the form of the Exchange agreement between the Qualified Intermediary and the taxpayer and protect the taxpayer from actual or constructive receipt of money or other property prior to the transfer of replacement property.

The Qualified Intermediary must have a complete understanding of the current regulations, must have the ability to perform and must have a working knowledge of all of the ancillary problems and pitfalls of the Exchange transaction.

Disqualified Persons

The regulations specifically state that a "disqualified person," one, who may not act as a Qualified Intermediary, is any person who acts as the taxpayer's agent, employee, attorney or broker and any brother, sister, spouse, ancestor or lineal descendants. A disqualified person is also any corporation where 10% of the outstanding stock is owned by or for the taxpayer either directly or indirectly or any beneficiary of a trust where the taxpayer is the grantor.

The Exchange Authority, LLC

The Exchange Authority, LLC is a wholly owned subsidiary of Fidelity Bank whose parent company is Fidelity Mutual Holding Company. The Exchange Authority specializes in the practice of acting as Qualified Intermediaries for the Exchange of real and personal properties under IRC §1031. The Exchange Authority, LLC is a member of the Federation of Exchange Accommodators.

The Exchange Authority, LLC was formed in 1999 as a continuation and expansion of the Qualified Intermediary business established in 1983 by John Kimball under the firm name of Kimball & Kimball Associates.

John Kimball, Founder and Consultant, is an active real estate investor with over 20 years experience in the exchange field. He is the past president of the New England Chapter of the National Council of Exchangers, was named the national exchanger of the year in 1989, and a national speaker and educator on the benefits and pitfalls of exchanges and related issues. Since starting the Qualified Intermediary business in 1983, he has been involved in Exchange transactions valued over \$300 million.

Timothy G. Halligan, President a former resident of upstate New York, moved to Massachusetts in 1999 to join the Exchange Authority as a principal and partner. Tim brings to the Exchange Authority over 30 years of real estate and exchange related experience. He is a past officer and director for several national exchange organizations and a certified instructor for Exchange courses offered by the New York State Division of Continuing Education. He earned the CES® Certified Exchange Specialist designation from FEA in 2003.

Robert Pingeton, Senior Vice-President has provided accredited continuing educational §1031 Exchange Seminars for hundreds of CPA firms, law firms, real estate agencies, investment groups and lenders through the Northeast and has helped to educate these professionals regarding §1031 exchanges through his work with the MA, RI, CT CPA Societies, as well as colleges, universities and real estate schools. Mr. Pingeton is a certified exchange specialist (CES®) and a member of the FEA. He has a B.S. in Business Administration and an M.B.A. from Assumption College.

Services Provided by the Exchange Authority, LLC

The Exchange Authority, LLC provides the following services for Exchange clients:

- Exchange documents for review and consideration by the taxpayer and the taxpayer's attorney.
- Exchange transaction accounting and analysis including the Exchange recapitulation, analysis of net non-like kind property received recognized gain and Exchange basis for review and consideration by the taxpayer and the taxpayer's accountant.
- Orchestration and coordination of the Exchange including interfacing with all principals, their agents and attorneys.

How Safe Is Your Money?

IRC §1031 of the Internal Revenue Code requires that a taxpayer is not in actual or constructive receipt of money or other non-like-kind property until after receipt of like-kind property. The regulations issued relative to delayed Exchanges further stipulate that the money and other non-like-kind property must be held by a party who is not a disqualified person or held in a qualified trust.

Therefore, any taxpayer desiring preferential treatment pursuant to the IRC §1031 must allow that the proceeds from the sale of the relinquished property be held by a party who is often unknown by the taxpayer. This fact is a concern to most taxpayers, and rightfully so.

In order to eliminate this concern, the Exchange Authority, LLC has established the following procedure for holding the taxpayers money.

- Proceeds from the sale of the relinquished property will be made payable at the time of settlement directly to Fidelity Bank and not to the Exchange Authority, LLC.
- Funds held by Fidelity Bank, members of the Share Insurance Fund, are insured in full without limit or exception.

- The funds will be held by the bank as Escrow Agent for the Exchange subject to specific written and signed escrow instructions which limit account access and activity to the account as follows:
- Funds may be withdrawn from the account ONLY upon receipt by the bank of written instructions signed by a managing partner of the Exchange Authority, LLC and affirmed in writing by the taxpayer.
- Written instructions to the bank must contain the exact amount of funds to be withdrawn, the name of the payee and appropriate forwarding instructions.
- Exchange Authority, LLC is bonded through Continental Casualty Company, a member of the CAN Insurance Companies.

Conclusion

Exchanges require advance tax planning and attention to structure formalities. The purpose of this booklet is to bring attention to opportunities available in using an Exchange as an investment strategy. The application of IRC §1031 to a particular transaction or property can be determined only after careful study of the taxpayer's particular facts and circumstances and analysis by his tax advisor, attorney, real estate agent and Qualified Intermediary.

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