1031 Exchange of SWFL LLC
8144 New Jersey Blvd.
Fort Myers, FL 33912

Qualified Intermediaries for "Sec. 1031" Tax Free Exchanges

INFORMATION BOOKLET
FOR
REAL ESTATE EXCHANGES

"1031 Deferred Exchanges Made Easy"

Phone number: (239) 634-2685 – Fax number: (239) 267-5663

A Tax Haven For Preserving Real Estate Wealth

The §1031 tax deferred treatment of capital gains is one of the best real estate investor vehicles for preserving and building real estate wealth: This provision of the Internal Revenue Code allows property owners to exchange their property for other like-kind property without recognition of capital gains. It makes possible to transfer the financial gain that is realized from the sale of a property into another property without federal capital gains tax at the time of the sale.

The Deferred Exchange is Different From a Swap

Exchanging properties is not new. The "your property" for "my property" type of direct exchange (i.e., a swap) has been in practice for a long time - it's called a two-party exchange. The difficulty is rarely will you find two owners who each want the other's property. Normally, the other owner wants to sell. This presents a problem if you want to dispose of property to finance the acquisition of new property and avoid taxable gains that would substantially reduce your equity.

The three-way or multi-party exchange was a tax-inspired technique designed to solve the dilemma of a two-way swap. However, these exchanges were fraught with danger. When one or more of the parties would not cooperate with the exchange, or one of the legs failed, the exchange failed. Multi-party exchanges, at best, were difficult and risky. And trying to sell your old property before closing on the purchase of the new property almost impossible. This presents a problem if you desire to dispose of property to finance the acquisition of new property but want to avoid selling your property in a taxable event. A sale would produce taxable gains and could substantially reduce your after-tax proceeds. If you could exchange your property tax-free for the desired property, you could benefit from the fair market value of your property undiluted by income taxes on the sale. In other words, you can use your entire equity before taxes to purchase the Replacement Property.

To solve the dilemma, on April 25, 1991, IRS issued the long-promised deferred exchange regulation-Reg 1.1031(k)-1. It permits you to "sell" your Relinquished Property now and use the proceeds to buy the Replacement Property later. As long as it's done following the rules and using the services of a Qualified Intermediary, you get tax deferred §1031 treatment.

New Tax Terms: A deferred exchange is an exchange in which you transfer qualified property called the "Relinquished Property" and subsequently receive qualified property as consideration. The property received is called "Replacement Property".

The Deferred Exchange Regulation is a taxpayer's dream come true. It works without the buyer of your Relinquished Property or the seller of the Replacement Property getting involved in your exchange. The Reg's secret weapon was the creation of a legal entity called the Qualified Intermediary or QI. This new entity is permitted to serve as your agent and perform the exchange for you without getting you involved in a taxable sale of your old property. By using a Qualified Intermediary to handle your exchange transaction, you can now turn the sale of your property, and subsequent purchase of another "like-kind" property, into a §1031 exchange.

This regulation explaining how to put together the §1031 deferred real estate exchange is a powerful tool and strategy for selling appreciated business, farms, land, and investment real estate without recognition of gain for income tax purposes. It spells everything out-step by step. Just follow the rules and you can sell your appreciated property, use the cash proceeds to buy your Replacement Property and qualify for the full benefits of non-recognition of gain under §1031. The regulation has the weight of law and all parties must follow it-even the IRS.

One of the outstanding features of the deferred exchange regulation is it establishes and defines the Qualified Intermediary (QI) as your vehicle to qualify for the safe harbor procedures you must follow to get non-recognition of gain treatment on your deferred exchange.

Capital Gain vs. Equity

Do not confuse capital gain with equity. There is no comparison between the two.

Equity is the amount of money you have in your pocket after you have sold the property and paid off all related liabilities and mortgages. As an example lets say you bought a property $30,000 ten years ago, it's free-and-clear and has basis of $20,000.

If you sold that property today for $115,000, and paid out $15,000 in closing costs and commissions, you have equity of $100,000. That's the amount of cash you would get out of the closing. However your capital gain on this property would be the difference between your basis of $20,000 and your adjusted sales price of $100,000, or $80,000.

Result: If you sell instead of doing a §1031 Exchange, you would be obligated to pay a capital gains tax on the entire $80,000.

Example with Mortgage: If you had mortgage of $90,000 on this property, you will need to repay this loan at the time of closing. This results in net cash to you at the closing of only $10,000 ($100,000 less the loan payoff of $90,000). But your capital gain tax would still be $16,000.

It is in this area you must be extremely careful not to trap yourself with a regular sale. You are almost bound to exchange in a case like this unless you have the additional funds to pay the taxes. In larger transactions with larger dollars and leveraging, the situation only gets worse.

Exchange Requirements for Non Recognition of Gain

There are three conditions that must be met to accomplish non-recognition of gain under §1031:

1. The properties exchanged must qualify, and be of "like-kind".

2. There must be an actual exchange, not a transfer of property for money only.

3. The time requirements must be strictly followed.

Qualified Properties

To meet the requirements of §1031, both Relinquished Property and Replacement Property must qualify. In other words, both the property you are selling and the property you are buying must be qualified property of like-kind. If not, your exchange will fail and be classified as a sale. This is so important it needs repeating:

To qualify as a like-kind exchange, the property must be both (1) qualifying property and (2) like-kind property.

For income tax purposes, real estate is divided into four classifications. Classification is made as of the date the transaction is made. The classifications are:

Held for business use (§1231)

Land held for investment (§1221)

Held for personal use

Held primarily for sale (dealer property)

The first two classifications-held for business and held for investment-qualify for §1031 treatment. The second two-held for personal use and dealer property-do not.

Some properties have more than one classification at the time of sale. For example, a farmer sells his farm including his personal residence. The sale or exchange is allocated between the real estate held for personal use (the personal residence) and the real estate held for use in a trade or business (the farm). Another example is the sale or exchange of a duplex where the seller lived in one unit and rented out the other unit. The sale would be allocated.

Under §1031, both business and investment property qualify. And it does not require only business property for business property or investment property for investment property. You can mix the classifications. For example, you can exchange an apartment house (business property) for two unimproved lots (investment property) or a commercial warehouse (business property) for a 60-acre tract of raw land. All could qualify.

Many real estate investors and professionals have difficulty distinguishing between business real estate and investment real estate. For years we have been buying and selling all kinds of property as a good "investments". But remember, we are dealing with taxation here-not financial investments. To help you understand these two classifications, here, in a nutshell, is the difference.

Real Estate Used in A Business

This property is known as §1231 real estate. There are two types of real estate used in a trade or business:

Owner occupied and the property is used in the owner's trade or business. Examples are a factory you own to produce your products and a warehouse used to store inventory.

Rental income property. The act of renting the property qualifies it as property used in a trade or business. Examples are a factory property you own and rent to a third-party and an apartment house you rent to tenants who live there as their residence.

Net gains from the sale or exchange of §1231 property are taxed as long-term capital gains. However, if the holding period is short, the gain may be recognized as ordinary income. Net losses are deductible as ordinary losses.

Real estate used in a trade or business qualifies for §1031 treatment when exchanged for other business or investment real estate.

Real Estate Held for Investment

Real estate used in a trade or business is not held for investment. Real estate held for personal use is not held for investment.

Investment real estate is a capital asset (IRC §1221). It is property held primarily for appreciation of value due to location, passage of time and other factors outside the activities of the owner. It is treated as a portfolio investment asset. An example of investment real estate is raw land held for appreciation. Even if purchased with the idea you might someday develop the property, if you don't develop it (for any reason), the property will not lose its classification as investment property. Real estate used in a trade or business is not held for investment. Real estate held for personal use is not held for investment.

If sold at a gain, the gain is a capital gain. If sold at a loss, the loss is a capital loss subject to the capital loss limitation rules.

Real estate held for investment qualifies for §1031 treatment when exchanged for other investment real estate or for real estate used in a trade or business.

Like-Kind Property

Like-kind is a federal tax term relating to the nature or character of the real estate in the hands of the owner rather than to its grade or quality. The fact that the real estate is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

Qualified real estate located in the 50 United States is of like-kind when exchanged for other qualified real estate located in the 50 United States and the U.S. Virgin Islands. The definition of "50 United States" means exactly that. Any foreign real estate included in the exchange will be treated as boot paid or received.

Excluded Assets

Section 1031 specifically excludes these assets from nontaxable treatment: Property held primarily for sale (inventory), stocks, bonds, notes, choses in action (accounts receivable), certificates of trust or beneficial interest and securities or evidences of indebtedness

Caution: It doesn't matter if any of the excluded property items are related to real estate; they are always excluded from §1031 treatment. For example, a note secured by real property can never qualify.

Partnership Interests

Your interest in a partnership does not qualify under §1031 if traded for an interest in another partnership. However, a partnership as an entity can exchange real estate it owns for other like-kind real estate.

Transfer Between Spouses

There are no income tax consequences in entering into financial transactions between spouses. In addition, most transfers incident to a divorce are tax free. However, transactions with a former spouse are normally subject to tax unless they qualify for non-recognition under the provisions of §1031.

Sale/Lease Back As An Exchange

A lessee's interest in a lease for real property with a term of 30 years or longer is considered property of like-kind for purposes of §1031 and therefore may qualify for §1031 treatment. The receipt of prepaid lease payments, whether for a 30-year lease or not, are taxed as ordinary income and will not qualify for tax-free exchange treatment.

Personal Property Business Assets

The personal property assets used in a trade or business may be exchanged for like-kind assets of another business and qualify under §1031. Like-kind requirements and classifications for personal property are much more stringent than for real property.

Vacation Homes

A vacation home or second home not held as a rental is classified as real estate held for personal use and does not qualify for §1031 treatment. However, under the rules of §280, a dwelling unit held for both personal use and rental purposes must take a use test each tax year to determine its tax classification for that tax year:

The property is treated as real estate held primarily for personal use and treated as an asset not held for profit if the owner's personal use is more than 14 days or 10% of the total rental days, and the unit is rented for one day or more during the tax year. Does not qualify for §1031 treatment. The property is treated as rental property if the owner's personal use is no more than 14 days or

10% of the rental days during the tax year and the property is rented more than 14 days during the tax year. May qualify for §1031 treatment.

Time Restrictions

Under the Regulations, two time limitation periods have been imposed on deferred real estate exchanges. One limitation requires Replacement Property to be identified within a certain time. The other requires Replacement Property to be received by the exchanger within a certain time period. To successfully qualify for §1031 treatment, your exchange must satisfy both tests.

In a deferred exchange, any Replacement Property you receive will be treated as property which is not like-kind to the Relinquished Property if:

the Replacement Property is not "identified" before end of the "identification period", or

the identified Replacement Property is not received before end of the "exchange period".

The identification period begins on the date you transfer the Relinquished Property and ends 45 days after.

The exchange period begins on the date you transfer the Relinquished Property and ends on the earlier of 180 days after or the due date (including extensions) for your tax return for the taxable year in which the transfer of the Relinquished Property occurs.

Caution: Sometimes in a deferred exchange, you transfer more than one Relinquished Property and they are transferred on different dates. If this happens, the identification period and the exchange period are measured from the earliest date on which any of the properties are transferred.

Replacement Property

Replacement Property must meet exacting identification and receipt requirements. (Replacement Property is the property or properties intended to be purchased with the funds that are received from the sale of the Relinquished Property). There are limitations on how many replacement properties you may identify in the **same** deferred exchange, no matter how many relinquished properties you transfer.

The penalty for violating the permitted maximum is severe. You are treated as not having identified any property within the identification period and the entire exchange will fail.

You may identify more than one property as Replacement Property subject to three rules: the 3-property rule, the 200% rule, and the 95 percent rule. **You only have to satisfy one of these rules-not all of them.**

The 3-Property Rule

The maximum number of replacement properties you may identify is three properties without regard to fair market values of the properties.

The 200 Percent Rule

You may identify any number of properties as long as their total fair market value does not exceed 200 percent of the total fair market value of all Relinquished Properties.

You figure fair market value of Replacement Property as of the end of the identification period. You figure fair market value of Relinquished Properties as of the date you transfer them.

If, as of the end of the identification period, you have identified more properties as replacement properties than permitted, you are treated as if no Replacement Property has been identified.

The 95 Percent Rule

You may identify any number of Replacement Properties if during the Exchange Period you actually received identified Replacement Properties having a fair market value equal to or more than 95 percent of the total fair market value of all identified Replacement Properties.

Special Exception

Any Replacement Property received by you before the end of the identification period is treated as being properly identified under the Identification Rules.

Trade Even or Up in Value

The Replacement Property you wish to acquire needs to have a value equal to, or greater than, the adjusted sales price of the Relinquished Property. ***All proceeds from the Relinquished Property sale need to be invested in the Replacement Property.***

You must also take the subject of mortgage debt relief into account since the IRS treats net mortgage relief the same as cash boot received. Simple arithmetic dictates that in order to trade-up from the sale of mortgaged Relinquished Property, you must pay in an additional amount in the form of cash or new mortgage debt to meet the purchase price of the Replacement Property.

It is not necessary for the amount of the new mortgage debt (if any) in the purchase of the Replacement Property be the same as the amount of your mortgage debt relief.

Gain will be taxable only to the extent that these goals are partially achieved. If all the goals are accomplished, the entire gain will be deferred.

Incidental Property

For purposes of completing a proper identification within the 45-day identification period, it should be noted that property which is incidental to Real Estate property, such as furniture,

laundry machines, appliances, pumps, etc. is not treated as separate property from the real estate property if:

1. In standard commercial transactions the property is typically transferred together with the real estate property, and;

2. The aggregate market value of the incidental property does not exceed 15% of the market value of the real estate property.

Identification

The Replacement Property is considered identified before the end of the identification period only if the following requirements are satisfied. However, any Replacement Property you receive before the end of the identification period will in all events be treated as identified before the end of the identification period.

Replacement Property is identified only if it is designated as Replacement Property in a written document signed by you. This document must be hand delivered, mailed, faxed or otherwise sent before the end of the identification period to a person (other than yourself or a related party) involved in the exchange.

Replacement Property is identified only if it is unambiguously described in the written document or agreement. Real estate is unambiguously described if it is described by its legal description or street address.
Property incidental to a larger item of property is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if in standard commercial transactions, the property is typically transferred together with the larger item of property, and
the aggregate fair market value of all "incidental" property is not more than 15% of the aggregate fair market value of the larger item of property.

Here is an example: The Replacement Property is an apartment house complex worth one million dollars. The furniture, laundry machines, and other items that go with the apartment complex should not then exceed $150,000 in value, which is 15% of one million dollars. For purposes of identification the entire apartment complex, including furniture, laundry machines, etc., will be treated as one property.

Revocation of Replacement Properties

The Identification of replacement properties can be revoked as long as it is done within the 45-day identification period. This revocation must be done in writing and should include a rescission of a purchase and sale agreement, if one was written.

Receipt of Replacement Property

Replacement property is treated as received before the end of the exchange period if:

1. You actually acquired the Replacement Property-close the transaction prior to the end of the exchange period (180 days, or the due date of the taxpayers tax return, whichever is earlier), and

2. The Replacement Property acquired is substantially the same as identified during the 45-day identification period.

New Construction Replacement Property

One of the more interesting stipulations is the regulation that permits you to exchange for real property that has not yet been built. A transfer will still qualify for §1031 treatment if the new construction is identified within the 45-day period, and received within the 180-day exchange period. This property must be carefully identified. This identification should include the legal description of the underlying ground and as much other description as possible for the property to be constructed. Also, the new construction must be completed and received in substantially the same form as described in the identification documents.

You cannot exchange for services. Partially completed real property can be received in a like kind exchange if properly identified.

Exchange or Sale?

The intent of the deferred property exchange is that you have an actual continuation of your old property investment into your new replacement property. To qualify, you must follow the rules and requirements of Section 1031 of the Internal Revenue Code. Intent does not count. What you actually do is what determines if you qualify.

Exchange Requirements

Section 1031 requires an actual exchange of properties. If you simply sell your property and reinvest the money in another property, you will not qualify for exchange treatment, even though it is a simultaneous close.

The secret of a successful deferred exchange is avoiding receipt of money or other property during the transaction. If you receive the cash proceeds from the exchange of your property, you will not qualify for §1031 treatment. While this may sound easy to avoid, it's not. You must overcome the doctrine of "constructive" receipt. The general rules concerning actual and constructive receipt apply to determine if you are in actual or constructive receipt of money or other property before you actually receive like-kind Replacement Property.

You are in actual receipt of money or property at the time you actually receive the money or property. You are also treated as being in receipt if you receive the economic benefit of the money or property. You are in constructive receipt of money or property at the time the money or property is credited to your account, set apart for you, or otherwise made available to you so you may draw upon it at any time or if you can draw upon it if notice of intention to withdraw is given.

In addition, actual or constructive receipt of money or property by your agent is actual or constructive receipt by you.

The deferred exchange Regulation provides a "safe harbor" that permits you to sell your Relinquished Property and acquire Replacement Property and avoid constructive receipt. This safe harbor is your written contractual agreement with a Qualified Intermediary.

Qualified Intermediary

A Qualified Intermediary is a person (or company) who, for a fee, acts to facilitate the deferred exchange by entering into an agreement with you for the exchange of properties. It's OK for your transferee to be your agent, but only if the transferee is a Qualified Intermediary.

To clarify what an intermediary must do to acquire property, the regulations describe limited circumstances under which an intermediary is treated as acquiring and transferring property regardless of whether, under general tax principles, the intermediary actually acquires and transfers the property.

The exchanger or a disqualified person cannot qualify as qualified intermediaries for their own exchange. A person is a disqualified person if the person is an agent of the exchanger at the time of the transaction.

These people are treated as agents of the exchanger: A person who has acted as the exchanger's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties. However, the regulation disregards certain services for purposes of determining if an agency relationship exists. Performance of services with respect to exchanges of real estate intended to qualify under §1031 is not taken into account.

Furthermore, performance of routine financial, title insurance, escrow, trust services by a financial institution, title insurance company, or escrow company is not taken into account.

The Qualified Intermediary does not provide legal or specific tax advice to the exchanger, but will usually perform the following services:

1. Coordinate with the exchangers and their advisors, to structure a successful exchange.

2. Prepare the documentation for the Relinquished Property and the Replacement Property.

3. Furnish escrow with instructions to effect the exchange.

4. Secure the funds in an insured bank account until the exchange is completed.

5. Provide documents to transfer Replacement Property to the exchanger, and disburse exchange proceeds to escrow.

Substituted Basis

Before you enter into any exchange of your real estate, you must figure the basis of the Replacement Property you are acquiring and see how it fits in with your financial and tax plans.

Much depends on this basis. For example, if the Replacement Property is an apartment complex (§1231 property), an allocation must be made of your 'new' basis to figure the amount qualifying for depreciation. You need this to figure the amount of your depreciation deduction. If your unrecognized gain on the Relinquished Property is large, the basis of your Replacement Property will be very low compared to market values. This can have unexpected results if not anticipated.

Your operations statement for the apartment complex will reflect rental income based on today's market values. But your depreciation deduction will be based on "yesterday's cost". You need to recognize this difference and accept it as part of your planning before going ahead with the exchange.

Basis is used as the base point for the calculation of capital gain on a transaction. Capital gain is described as the difference between the basis and the adjusted sales price of a property.

Boot and Taxable Gain

Receiving cash or other boot in a real estate exchange does not defeat the nontaxable provisions of §1031 for the like-kind property involved. If, in addition to the Replacement Property, you receive money or some other kind of boot, you may have taxable gain. But the good news is you are only taxed on gain that comes from the money and other boot received.

Money and unlike property in an exchange is called boot. To figure your taxable gain, determine the fair market value of the boot you receive. Then figure how much your gain would have been if you had sold the property as a regular taxable sale instead. Your taxable gain is the smaller of these two amounts.

Figuring boot in exchange transactions become more complicated when one or both of the properties are mortgaged. If the other party assumes any of your mortgage liabilities as part of the exchange, you are treated as if you received boot in the amount of the mortgage. If you assume or acquire mortgage liabilities as part of the exchange, you are treated as if you paid boot in the amount of the mortgage liabilities.

If each of you assumes the liabilities of the other, the liabilities of one are offset against the liabilities of the other. Only the excess is treated as net boot paid or net boot received. In other words the mortgages are netted. You deduct the mortgage you assume from the mortgage on the Relinquished Property.

Here's an example: You exchange Relinquished Property with an outstanding mortgage of $134,000. The other party assumes this mortgage. The $134,000 is treated as boot received by you. However, you assume a mortgage on your Replacement Property in the amount of $140,000. Since netting cannot be less than zero, your net boot received is zero and you are treated as paying boot in the amount of $6,000 - ($140,000 minus $134,000).

If the amount of the mortgage you assumed were only $110,000, your net boot received from netting the mortgages would be $30,000 - ($140,000 minus $110,000).

QI Duties and Services - Special Issues

Start Up Discussion

One of the most important decisions you will make regarding your exchange is the choice of whom you will use as your Qualified Intermediary. In addition to knowing and understanding the safe harbors prescribed by the regulations, your QI must be experienced in procedures and treatment of different real estate situations and requirements that pop up in many exchange transactions. Mistreatment of these situations can be fatal to the exchange and result in a loss of §1031 tax-deferred treatment.

Reverse Exchanges

A reverse exchange is a transaction in which the Replacement Property is acquired before the Relinquished Property is sold. This powerful tax planning procedure permits you to acquire the Replacement Property currently under favorable circumstances before you are able to sell the Relinquished Property.

If the Relinquished Property is sold before the Replacement Property is acquired, you follow the safe harbor rules of Reg 1.1031(k)-1 and transact a normal or forward exchange. However, if you are unable to dispose of your Relinquished Property first, it is still possible to qualify for the desired tax treatment of §1031 by following the safe harbor rules of Rev. Proc. 2000-37. There are many situations where the reverse exchange can solve exchange dilemmas. However, the safe harbor rules of Rev. Proc. 2000-37 require many complicated legal steps including the creation of an Exchange Accommodation Titleholder entity and other agreements. Since these required procedures can result in substantial legal and other additional fees, we recommend you consider using the reverse exchange safe harbor procedure only if the size of your transaction and resulting savings in capital gains tax justifies the additional fees and expense.

Exchanges Involving Installment Sale Notes

There is an ingenious tax strategy that permits you to take back boot in a §1031 exchange without paying tax on it now. Gain from the boot can be deferred into future tax years. It's done by taking back a purchase money installment note from the "buyer" of the Relinquished Property to balance all or part of the equities. When structured correctly, the taxable gain in the note may be reported using the installment method of tax accounting.

One of the most frequently asked questions here at 1031 Exchange of SWFL LLC is "Can I take a note on the sale of my Relinquished Property and still qualify for a deferred exchange?

In a word, yes. 1031 Exchange of SWFL LLC handles many of these transactions and knows the correct procedure that must be followed to assure §1031 treatment. The installment note and related documents are made out in the name of the QI. You have four choices on how to use it to buy replacement property:

1. You can use it to acquire Replacement Property by trading it to the "Seller" for part of the consideration for purchase of new property. This does not trigger the unrecognized gain in the installment note.
2. You can instruct the QI to sell the note on the open market (you can negotiate this sale or have the QI do it as your agent) and add the amount realized to the exchange proceeds. This will give you all cash to negotiate your replacement purchase. It's less desirable because of the discount you might have to give on the sale of the note. This does not trigger the unrecognized gain in the installment note.
3. A party related to you, the exchanger, such as a closely held corporation or relative can either purchase the installment note from your QI or provide financing so that your QI receives all cash at closing. You should consult with your tax advisor regarding structuring this type of transaction. This does not trigger the unrecognized gain in the installment note.
4. You can wait until the end of the exchange and receive the installment note back from QI. This will result in the note becoming "boot" and it will be taxable. However, at this point the installment sale rules under §453 kick in and you are permitted by election to use the installment method of tax accounting and only recognize capital gain as you collect principal payments each year. Interest on the installment note is always taxable at ordinary income rates. Your installment sale percentage for figuring gain will be 100%.

Construction of Replacement Property

One of the greatest stipulations in the final deferred exchange regulation permits you to exchange for real estate that has not been built yet. A transfer of Relinquished Property in a deferred exchange will not fail to qualify for non-recognition of gain or loss under §1031 merely because the Replacement Property is not in existence or is being produced at the time the property is identified as Replacement Property.

Replacement Property to be produced must be identified. For example, your identified Replacement Property consists of improved real property where the improvements are to be constructed. The description of the Replacement Property will satisfy the requirements if a legal description is provided for the underlying land and as much detail as is practicable at the time the identification is made is provided for construction of the improvements. Two examples of identification of the property to be produced are blueprints and the contract with the builder.

For the 200-percent and incidental property rules, the fair market value of the Replacement Property to be produced is its estimated fair market value as of the date it is expected to be received by you.

For property to be produced, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the Replacement Property received will not be considered to be substantially the same property as identified.

If identified Replacement Property is real property to be constructed and the construction is not completed on or before the date you receive the property, the property received will be considered to be substantially the same property as identified only if it is real property, and it would have

been considered to be substantially the same property as identified had construction been completed on or before the date you received it.

The value of the Replacement Property must be figured on the day of transfer. Construction work completed after the day of transfer will not be treated as part of the exchange.

There are two ways that new construction is handled in an exchange:

You can contract with a builder to purchase a property, which will be completed, and ready to close prior to the end of the 180-day exchange period. You can purchase the land prior to construction as one of your replacement properties, or you can purchase the land and building from the builder at the time of closing. This is the least expensive and easiest method for the exchanger.

You can contract to do what is known as a "Build-out Exchange". Following this procedure, you as the exchanger finance all or part of the construction. Through a special agreement with your QI, the builder draws on the exchange proceeds as certain steps of the construction are completed. This arrangement is more complicated and risky for both you and the QI and will usually increase the cost of the exchange by $2,500 or more.

In either case the purchase and sale agreement should have language in it that requires the builder to bear responsibility for the exchanger's taxes if the exchange fails due to the completion of the construction later than the required 180 day exchange closing period. Any additional production or construction occurring with respect to the Replacement Property after you receive the property will not be treated as the receipt of like-kind property.

Caution: Be very careful not to get caught in an exchange for services trap. The transfer of Relinquished Property won't qualify for §1031 treatment if it's transferred in exchange for services. This includes production services.

Treatment of Earnest Money and Sales Proceeds

1. What should I do with the Earnest Money deposit on the sale of my Relinquished Property?

   · When selling relinquished property in a 1031 exchange, you must avoid actual or constructive receipt of the earnest money deposit. The earnest money should never be deposited in your own account. It should be deposited in an escrow account, or real estate brokers trust account, or with your QI. The earnest money receipt should state that the funds are to be assigned to the QI, and that you have no control or right to direct how these funds are to be used.

2. How do I handle the earnest money deposit for the purchase of my Replacement Property?

   · The best and safest way is to make the deposit from your personal funds. Any unused funds brought into the replacement property transaction, other than the exchange proceeds being held

by your QI can be reimbursed at the time of closing. Exchange proceeds can only be used for earnest money if the purchase and sale agreement has been assigned in writing to your QI and even then they are not true earnest money as the funds can only be released to the seller at the time of closing. If the transaction fails to close the funds will be returned to your QI.

3. Do I have to spend all of the proceeds from my relinquished property on replacement property?
   . No you don't. However, any amount you don't spend will be treated as boot received and taken into account when figuring your net boot received.

4. If I don't spend all of my proceeds when can I receive the unused amount?
   · You can receive unused proceeds anytime after you have acquired all of the properties identified in your 45-day identification time period. If you do not acquire all of the properties identified in the 45-day identification, then the unused proceeds cannot be released until the earlier of the due date of your tax return including extensions, or 180 days after the closing of the sale of the Relinquished Property.

5. If I decide not to go through with my exchange when can I get my money back?

   · We can return your proceeds at any time you decide to abandon your exchange, or in the event you are unable to find Replacement Property to identify by the end of the 45-day period. There is no charge for the return of proceeds.

Replacement Property Issues

You can combine multiple relinquished properties into one or more replacement properties. If the relinquished properties are transferred on different dates, the identification period and the exchange period for the entire exchange are measured from the earliest date on which any of the properties are transferred.

If the replacement property is a rental how long does it have to remain a rental before it can be converted into my primary residence without losing my §1031 exchange benefits?

There are no hard rules here. What the IRS requires is that you show intent to use the replacement property as a rental. Most of tax attorneys we talk to feel that if the property shows up as a rental on two or more consecutive tax returns you will have shown intent.

Exchange Terms & Fee Schedule

FEES:

Real Estate Exchange Transaction including One Replacement Property = $500.00

Each Additional Replacement Property Per Closing = $150.00

Earnest Money Deposit = $250.00

Receipt, Transfer, and Reassignment of Notes = $175.00

Qualified Escrow Account = $150.00

Double Deed (Swap) Type Exchanges - Per Escrow = $495.00 to $795.00

Personal Property Exchanges including One Replacement Property = $895.00

(Airplanes, Commercial Vessels, Computer Equipment, Etc.)

Reverse Starker Exchange = $2000.00 plus monthly processing fee of $150.00

“Buildout” Exchange = $2000.00

Special Document & Rush Fee = $200.00

SECURITY:

The security of your funds is of the utmost importance to us, and because of this we have been highly selective in our choice of banks. We use Bank of America. We are Licensed and Insured. All of our funds are in accounts which keep them constantly secure. When additional security is desired we can set-up an IRS approved Qualified Escrow account with our bank. This account ensures absolute security of your funds. The cost for this service is $75.00. We must make these arrangements prior to the closing of the relinquished property.

SUGGESTED EARNEST MONEY CLAUSE

We suggest that you insert language similar to the following clause into your Purchase & Sale agreement so that all parties are aware that the transaction will be a delayed exchange, and there will be no lack of disclosure which may obstruct the transaction. (This is merely a suggestion, and is not required by the "1031" regulations)

"A material part of this transaction is the successful completion of an I.R.S. Code Section 1031 deferred exchange.”Buyer/Seller" agrees to cooperate with the "Exchanger" (note: insert the full name of the party doing the exchange in place of the word "Exchanger") in signing those documents necessary to complete the exchange, provided that "Buyer/Seller" shall incur no additional costs or liabilities in excess of those which would have occurred had this been an outright "purchase/sale," and not an exchange."