# An Overview of the IRC§1031 Tax-Deferred Exchange

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# IRC §1031 Tax-deferred Exchanges in Today's Market

## TABLE OF CONTENTS


**THE ROLE OF THE QUALIFIED INTERMEDIARY** **3**

**LIKE-KIND PROPERTY — A WORLD OF REAL POSSIBILITIES** **4**

**FOUR WAYS TO EXCHANGE** **5**
- The Delayed Exchange 5
- The Reverse Exchange 6
- The Simultaneous Exchange 7
- The Improvement Exchange 7

**SAMPLE IDENTIFICATION NOTICE** **10**

**DON'T SELL YOUR INVESTMENT PROPERTY UNTIL YOU DO THE MATH** **12**
- The Capital Gains Calculator 12
- 100% Deferral 13

**DETERMINING THE PROPER VESTING** **14**

**THE PURCHASE AND SALE CONTRACTS** **15**
- Sample Exchange Contract Addendum – Seller 16
- Sample Exchange Contract Addendum – Buyer 17

**ANSWERS TO COMMON QUESTIONS** **18**

**GLOSSARY OF TERMS** **23**

**IRC § 1031** **25**

# THE ROLE OF THE QUALIFIED INTERMEDIARY

Your first and last concern in the exchange transaction should be security and integrity. *Are your funds secure* and *will your transaction be processed accurately* are the two most important questions you will pose to the Qualified Intermediary ("QI") handling your exchange transaction. Unfortunately, there is no federal regulation of the QI industry. And, because it is fairly easy to become a QI — it is imperative that you place your exchange funds with a QI that can protect your assets. On behalf of your clients you must ask the following three questions: First, will the QI provide a written guaranty of the exchange proceeds? Second, is the QI adequately insured? Finally, what is the financial strength of the QI and its affiliated companies?

THE QUALIFIED INTERMEDIARY:

- ❑ Consults with your tax advisor to assure your transaction is properly structured to qualify for tax-deferred status;
- ❑ Prepares the documents necessary to facilitate the transaction, including: the exchange agreement, the assignment, the exchange contract addendum and the exchange account closing summary;
- ❑ Executes closing documents and where necessary, reviews and executes financing documents;
- ❑ Acts as the principal, by way of an assignment, in the purchase and sale transactions;
- ❑ Holds the exchange proceeds so that the taxpayer does not have actual or constructive receipt of the funds; and
- ❑ Coordinates with the real estate agent, tax advisor and/or attorney, escrow/closing officer and lender to ensure the smooth and accurate processing of your exchange transaction.

*Always consult with your tax advisors. They are essential to a successful tax-deferred exchange. Your tax professional will establish values, allocate sales and purchase price, and recommend the appropriate structure of your transaction.*

# LIKE-KIND — A WORLD OF REAL POSSIBILITIES

IRC §1031 provides that neither gain nor loss is recognized if property held for investment or productive use in trade or business is exchanged for property held for investment or productive use in a trade or business. The fundamental advantages of a tax-deferred exchange may be utilized to diversify, consolidate or leverage your investment portfolio. With respect to real property, the broad definition of like-kind provides investors with numerous options to accomplish their investment goals.

***Properties that qualify for IRC §1031 Treatment***

IRC §1031 provides that to qualify for tax-deferred treatment, the relinquished property must be exchanged for replacement property that is like-kind. Like-kind means similar in nature and character notwithstanding differences in grade or quality. Real property is like kind to other real property whether improved or unimproved and whether used for different purposes. As such, raw land held for investment may be exchanged for single-family rentals used for a trade or business or any combination of the following:

- Single-Family Rentals
- Farms/Ranches
- Office/Commercial
- Motels/Hotels
- Golf Courses
- Multi-Family Rentals
- Raw Land
- Retail
- Industrial
- Leasehold interest of 30 years or more

# 4 WAYS TO EXCHANGE

**1.** ***The Delayed Exchange:*** The most commonly utilized tax planning strategy available to investors is the delayed exchange. A delayed exchange results when there is a time delay between the sale of the relinquished property and the purchase of the replacement property. Also referred to as a "Starker Exchange" because of the landmark 1979 federal case entitled, Starker v. U.S. 602 F2d 1341 (9th Cir 1979) wherein the court substantiated the validity of the delayed exchange process. Prior to the Starker case, §1031 of the Internal Revenue Code authorized tax-free exchanges of real and personal property. Thereafter, Congress, in the 1984 Tax Reform Act, adopted subsection 1031(a)(3) which created the 45-day identification period and the 180-day exchange period. Finally, on April 25, 1991, the IRS promulgated the final regulations under section 1.1031(a)1, *et seq.,* which provide specific rules for deferred like-kind exchanges. Since that time, the Tax Cuts and Jobs Act established in 2018 has eliminated all references to personal property from IRC section 1031, and only real property is eligible for a 1013 exchange.

The delayed exchange provides investors up to 180-days to purchase replacement property once the relinquished property is sold. Additionally, the use of a QI is required to facilitate a valid delayed exchange. The delayed exchange occurs in three fundamental steps:

STEP ONE: *Sale of the Relinquished Property*: Before closing on the sale of the relinquished property the Exchanger retains a QI such as OREXCO. The QI prepares an exchange agreement, assignment of sale contact and closing instructions to the escrow/closing agent. The QI instructs the escrow/closing agent to direct deed the relinquished property to the buyer and to deliver sale proceeds directly to the QI — thereby preventing the Exchanger from having actual or constructive receipt of the funds. Once the funds are delivered to the QI, access to the funds is restricted for the remainder of the exchange period. In short, IRC §1031 provides strict rules pertaining to the release of funds to the Exchanger even where the Exchanger decides not to proceed with the exchange.

STEP TWO: *Identification of the Replacement Property:* The Exchanger must identify replacement property within 45 calendar days of the close of the relinquished property. The identification is proper only if the replacement property is designated as replacement property in a written document signed by the Exchanger and hand delivered, mailed, telecopied, or otherwise sent to the person obligated to transfer the replacement property to the Exchanger (i.e. the seller of the replacement property) or to any other person involved in the exchange other than the Exchanger or a disqualified person. Three identification rules apply:

**3 PROPERTY RULE:** Three properties no matter what the fair market value; *or*

**200 PERCENT RULE:** Any number of properties as long as the aggregate fair market value does not exceed 200% (2x) of the fair market value of all the relinquished properties; *or*

**95 PERCENT RULE:** Any number of properties without regard to value — provided 95% of the value of the identified properties is acquired.

STEP THREE: *Purchase of Replacement Property:* Within 180 calendar days from the sale of the relinquished property, or the Exchanger's tax filing date (assuming no automatic extension is applied for), whichever is earlier, the Exchanger must acquire like-kind replacement property and the property acquired must be one or all of the previously "identified" replacement properties. The Exchanger again assigns the Purchase and Sale Contract to the QI, who purchases the replacement property with the exchange proceeds and causes the transfer of the replacement property to the Exchanger by way of a direct deed from the seller.

| 0 | 45-days | 180-days |
|---|---|---|
| Close of<br>Relinquished Property | End of Identification<br>Period | Close of<br>Replacement<br>Property |

**2.** ***The Reverse Exchange:*** A reverse exchange results when the replacement property is acquired prior to the sale of the relinquished property. The IRS formally acknowledged reverse exchanges effective September 15, 2000 by issuing Rev. Proc. 2000-37. With the help of the QI, the Exchanger utilizes an Exchange Accommodation Titleholder ("EAT") to purchase either the relinquished property or the replacement property. Many QIs — through various title holding entities — perform this service. As with delayed exchanges the reverse exchange must be completed within 180 days—from the date the EAT acquires title to the property to be parked.

TWO DIFFERENT PARKING METHODS FOR REVERSE EXCHANGES:

1) **Exchange Last,** aka **Park Title to Replacement Property or Hold Replacement**: In this parking arrangement, the EAT acquires title to the replacement property with funds loaned by the Exchanger. The EAT holds the replacement property until the Exchanger finds a buyer for the relinquished property. After a buyer is found, the QI sells the relinquished property to the buyer and uses the exchange proceeds to purchase the replacement property from the EAT. The EAT uses the sales proceeds to repay the loan from the exchanger. Thus the exchange occurs at the end of the transaction.

2) **Exchange First,** aka **Park Title to Relinquished Property or Hold Relinquished**: In this parking arrangement, the QI sells the relinquished property to the EAT. The EAT purchases the relinquished property with funds loaned from the Exchanger. Concurrent therewith, the QI uses the proceeds to purchase the replacement property and causes the seller to convey title directly to the Exchanger. Thus, the exchange occurs at the beginning of the transaction. Thereafter, the EAT continues to hold title to the relinquished property until such time as the

Exchanger finds a buyer. After a buyer is found, the EAT sells the relinquished property to the buyer and uses the proceeds to repay the loan from the Exchanger.

In either scenario, the EAT will enter into a management agreement or master lease with the Exchanger to allow the Exchanger to manage the property for the duration of the parking period. And, in a transaction involving financing, the EAT may become the borrower under a non-recourse note and deed of trust. Upon the expiration of the exchange period or the sale of the relinquished property and transfer of the replacement property to the Exchanger, the Exchanger assumes the loan. The EAT will require hazard and liability insurance during the holding period.

**Timeline**: No later than five business days after the EAT acquires its ownership interest in the parked property, the EAT and the Exchanger must enter into a written agreement. In a replacement hold transaction, the Exchanger has 45 days from the date the replacement property is parked to identify one or more relinquished properties. Written identification of the relinquished properties must be delivered to the QI, or the EAT or to another party to the exchange. The exchange must be completed within 180 days (i.e., relinquished property must be conveyed to the third party buyer and replacement property must be conveyed to the Exchanger).

|____________________|______________________________|

| 0 | 45-days | 180-days |
|---|---|---|
| Close of Parked Property | End of Identification Period | Close of Relinquished Property to Buyer/Transfer of Replacement Property to Exchanger, if necessary |

**3.** ***The Simultaneous Exchange*:** A simultaneous exchange occurs when the relinquished and replacement properties close at the same time. The use of a QI such as OREXCO assures the Exchanger that he does not have constructive receipt of his funds thus ensuring the preservation of safe harbor treatment under the Treasury Regulations.

**4.** ***The Improvement Exchange*:** The Improvement, Construction or Build to Suit Exchange occurs when the Exchanger uses exchange proceeds to improve (i.e. make capital improvements) existing property or to improve or develop new replacement property. The improvement exchange can occur in the context of a delayed or reverse exchange. In the context of the delayed exchange — the Exchanger first sells the relinquished property using a QI. Once the sale of the relinquished property is complete, the Exchanger has 45 days to identify the replacement property and its improvements. Thereafter, the Exchanger enters into a purchase and sale contract for the replacement property and enters into a written Qualified Exchange Accommodation Agreement ("QEAA") with the QI's EAT. The Exchanger then assigns the rights to the purchase and sale agreement to the EAT who uses the exchange proceeds to acquire title to the replacement property and complete the identified improvements. Upon completion of the improvements, or at the end of the $180^{th}$ day, whichever is earlier, the EAT will transfer title to the newly improved replacement property to the Exchanger. If — in addition to the Exchange

Proceeds — construction financing is required to complete the improvements, the EAT will become the borrower under a non-recourse note and deed of trust. When the EAT transfers the property to the Exchanger, the Exchanger is substituted as the borrower and assumes the construction financing.

**Note,** the same time frames apply to the improvement exchange in that the replacement property and its improvements must be identified within 45 calendar days. If the replacement property is to be produced, the identification requirement is satisfied if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practical when the identification is made. It is critical that the Exchanger receive improvements/replacement property that are/is substantially the same as the improvements/replacement property identified. Likewise, the improvements must be completed and title conveyed by the EAT to the Exchanger within the earlier of 180 calendar days from the close of the relinquished property or the tax filing date for the Exchanger — assuming no automatic extension has been applied for.

## o IDENTIFICATION NOTICE

To: Old Republic Exchange Company
500 Ygnacio Valley Road, Ste 170 Ph. 800.738.1031
Walnut Creek, CA 94596 Fax: 510-740-6225

Attn:

Re: Relinquished Property: 123 Main Street, Los Angeles, California
File number: XXX

To whom it may concern:
With reference to the exchange of the above-referenced Relinquished Property, I/We hereby identify the following replacement properties: (Check a. or b. below.)

(Note: For those intending to acquire a percentage (%) interest in real property, the intended percentage must be identified)

**Three Property Rule** (Address, City, State)

1.
2.
3.

or:

**200 Percent Rule** (Address, City, State) Total Fair Market Value________

1.
2.
3.
4.
5.

__ a. I/We intend to acquire ___ of the alternative properties identified above.
Following acquisition by QI of that number of identified properties, QI shall have no further obligations to acquire and transfer any additional replacement properties to Exchanger.

__ b. I/We are uncertain how many of the properties identified above are to be acquired. Exchanger understands that unless he has completed the acquisition of all of the properties listed above, he may not receive exchange proceeds or left-over proceeds until after the expiration of the exchange period.

EXCHANGER (Signature REQUIRED)

Date: ________________________________________

Date: ________________________________________

## ADOPTED TREASURY REGULATIONS
## CONCERNING IDENTIFICATION OF REPLACEMENT PROPERTY

The Exchanger must identify Replacement Property in writing by the 45th day after the closing of their Relinquished Property. Regardless of the number of Relinquished Properties transferred by the Exchanger as part of the same exchange, the maximum number of Replacement Properties that the Exchanger can identify is as follows:

Exchanger must identify Replacement Property under only one of these three rules:

**3 Property Rule**: Three properties without regard to the fair market value of the Replacement Properties. or

**200 Percent Rule**: Any number of properties as long as their combined fair market value as of the end of the Identification Period does not exceed 200 percent of the combined fair market value of all the Relinquished Properties as of the date the Relinquished Properties were transferred by the Exchanger. or

**95 Percent Rule**: Any number of Replacement Properties, of any value, but only if the Exchanger receives before the end of the exchange period identified Replacement Property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified Replacement Properties.

## DESCRIPTION OF REPLACEMENT PROPERTY

[Treas. Reg. § 1.1031(k)-1(c)(3)]

Replacement Property is identified only if it is unambiguously described in the Identification Notice or Agreement of Exchange of Real Property. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g. the Mayfair Apartment Building).

Note 1: If, as of the end of the identification period, the taxpayer has identified more properties as Replacement Properties than permitted by Treas. Reg. § 1.1031(k)-1(c)(4)(i), as described above, the taxpayer is treated as if no Replacement Property had been identified.

Note 2: The identified Replacement Property will be deemed received before the end of the exchange period only if the Replacement Property received is substantially the same property as identified. See Treas. Reg. § 1.1031(k)-1(d)(1)(ii).

## REVENUE RULING 2002-83

BEWARE OF PURCHASING REPLACEMENT PROPERTY FROM A RELATED PARTY

A Revenue Ruling is the IRS's official interpretation of the law to a specific set of facts and is published for the information and guidance of taxpayers and others. Both taxpayers and the IRS are expected to rely on Revenue Rulings as guidance. On December 9th, 2002, the IRS issued Revenue Ruling 2002-83 whereby it concluded that a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to non-recognition treatment under Section 1031(a) of the Internal Revenue Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property. Please consult with your tax advisor if you plan on purchasing replacement property from a related party in connection with your exchange.

# DON'T SELL YOUR INCOME OR INVESTMENT PROPERTY….. UNTIL YOU DO THE MATH!

Your goal is to preserve and enhance your investment portfolio. An exchange is a powerful tool to help achieve that goal. Taxes are paid on capital gain, not equity or profit. It is possible to sell property without realizing much profit and still owe substantial capital gains tax. Capital gain is simply the difference between the sales price and the adjusted basis (i.e. what you paid for the property, plus amounts spent on capital improvements, less depreciation taken) less any closing costs associated with the sale.

To calculate your estimated capital gain — first subtract the adjusted basis from the sales price; then subtract the costs of your transaction, commission, fees, transfer tax, etc.; finally, multiply the capital gain by your combined tax rates (Federal and State) to determine your estimated capital gain tax.

**1. Calculate Net Adjusted Basis:**

| | | **Example** |
|---|---|---|
| Original Purchase Price | ______________ | $400,000 |
| Plus Capital Improvements | ______________ | $25,000 |
| Minus Depreciation Taken | (______________) | ($175,000) |
| Equals Adjusted Basis | ______________ | $250,000 |

**2. Calculate Capital Gain:**

| | | |
|---|---|---|
| Current Sales Price | ______________ | $600,000 |
| Minus Closing Costs | (______________) | ($30,000) |
| Minus Adjusted Basis | (______________) | ($250,000) |
| Equals Capital Gain | ______________ | $320,000 |

**3. Calculate Capital Gain Tax:**

| | | |
|---|---|---|
| Gain Attributable to Depreciation<br>($175,000 x 25% = depreciation) | ______________ | $43,750 |
| Plus Federal Capital Gain Tax<br>(320,000-175,000=145,000 x 20%) | ______________ | $29,000 |
| Plus State Tax Capital Gain Tax<br>(e.g. CA approx. 10% x $320,000 (cap. Gain) – n/a in NV) | ______________ | $32,000 |
| Plus 3.8% Surtax[1]<br>(3.8% x $320,000) | ______________ | $12,160 |
| = Combined Tax Due | ______________ | |

$116,910

The formula set forth above is provided to help you determine your **approximate** gain and the sums that you may wish to defer through your exchange transaction. Consult with your tax advisor to determine the correct values and whether an exchange is appropriate for your circumstances.

[1]If your modified adjusted gross income (MAGI) is equal to or less than the threshold amounts specified in IRC 1411, you will not be subject to the 3.8% tax. If your MAGI is above the specified threshold amounts, you will pay 3.8% tax on either your investment income or the excess of your MAGI over the specified threshold – whichever amount is less.

| Filing status | Threshold amount |
|---|---|
| Married filing jointly | $250,000 |
| Married filing separately | $125,000 |
| All other individual taxpayers | $200,000 |
| Trusts and Estates | $12,150 (for 2014) |

***100% Deferral*** — to fully defer state and federal capital gain taxes, an Exchanger must reinvest all exchange proceeds *and* acquire property with equal or greater debt. The following worksheet is a useful tool for determining the amount of cash and debt that should go into the replacement property.

| RELINQUISHED PROPERTY | REPLACEMENT PROPERTY |
|---|---|
| Sale Price: ___________________________ | Approx. Purchase Price: ________________ |
| Minus Existing Loans: _________________ | Minus New Loans: _____________________ |
| Minus Closing Costs: __________________ | |
| **Equals Approx. Net Proceeds: __________** | **Equals Approx. Down:________________** |

**Net Proceeds $\leq$ Down Payment**

Your minimum down payment for the replacement property should be equal-to or greater-than the net proceeds from the sale of your relinquished property. Likewise, you should reinvest all your debt with either new debt or additional cash into the transaction. Otherwise, you may have boot in the form of cash or debt relief.

# DETERMINING THE PROPER VESTING

**Determining Proper Vesting: "Same Vesting Rule"**

The taxpayer who disposes of the relinquished property must be the same taxpayer who acquires title to the replacement property. Problems arise when title to the relinquished property is held differently than title to the replacement property. For example, husband and wife dispose of property and acquire new property to which only husband is on title. Or, partnership ABC disposes of property and partner A individually acquires replacement property with title in A's individual name. Or, ABC Irrevocable Trust disposes of property and A acquires title to the replacement property individually.

**The following scenarios are disallowed:**

- Husband relinquishes and husband and wife acquire property of equal value.
- ABC Corporation relinquishes and XYZ Corporation acquires.
- ABC Partnership relinquishes and partners acquire as individuals.
- ABC Partnership relinquishes and XYZ Partnership acquires.
- Multi-member LLC relinquishes and members acquire as individuals.
- ABC Multi-member LLC relinquishes and XYZ multi-member LLC acquires.

***Exceptions to the "same vesting" rule***: It is possible to have different entities disposing of the relinquished property and acquiring the replacement property if – in fact – the entities are "disregarded entities" wherein the actual taxpayer is the owner or member of the entity and that member/owner taxpayer is the same for both the relinquished property entity and the replacement property entity. A disregarded entity is a certain type of business entity or trust, which is disregarded for federal income tax purposes. In other words, the owner or member of the entity is treated as the taxpayer for federal income tax purposes. For example, revocable living trusts which are used to avoid probate are disregarded entities as are Illinois Land Trusts, single member limited liability companies and Delaware Statutory Trusts.

**Examples of scenarios which are allowed using different entities:**

- Individual relinquishes and an LLC which individual is the sole member or completes the acquisition.
- Husband and wife as trustees of a revocable living trust, which is a true pass-through trust, relinquish, and husband and wife acquire as individuals.
- Single Member LLC relinquishes and sole member acquires as an individual.
- Individual relinquishes and estate acquires due to the death of the exchanger.

# THE PURCHASE AND SALE CONTRACTS

**When exchanging, insert the following language into your purchase and sale contract or call your QI for a personalized exchange contract addendum.**

***PURCHASE AGREEMENT FOR THE SALE OF RELINQUISHED PROPERTY***

Buyer acknowledges that it is the intention of the Seller to effect an IRC §1031 tax-deferred exchange, which will neither delay the closing nor cause additional expense or liability to the Buyer. Buyer further acknowledges that Seller's rights and obligations under this agreement may be assigned to [Old Republic Exchange Company ("OREXCO")], a Qualified Intermediary, to facilitate the exchange. Buyer agrees to cooperate with the Seller and [OREXCO] in a manner necessary to enable Seller to complete the exchange.

***PURCHASE AGREEMENT FOR THE PURCHASE OF REPLACEMENT PROPERTY***

Seller acknowledges that it is the intention of the Buyer to complete an IRC §1031 tax-deferred exchange, which will neither delay the closing nor cause additional expense to Seller. Seller further acknowledges that the Buyer's rights under this agreement may be assigned to [Old Republic Exchange Company ("OREXCO")], a Qualified Intermediary, for the purpose of completing the exchange. Seller agrees to cooperate with the Buyer and [OREXCO] in a manner necessary to enable the Buyer to complete the exchange.

## SAMPLE EXCHANGE CONTRACT ADDENDUM
(Exchanger as Seller)

The following terms and conditions are hereby incorporated in and made a part of that certain agreement dated ________________________________________________________
for the sale of the property commonly known as _________________________
executed by ______________________________________________________(Seller)
and______________________________________________________________(Buyer)

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

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

Buyer acknowledges that it is the intention of the Seller to effect an IRC § 1031 tax-deferred exchange, which will neither delay the closing or cause additional expense to the Buyer. Buyer further acknowledges that seller's rights and obligations under this agreement may be assigned to Old Republic Exchange Company ("OREXCO"), a Qualified Intermediary, to facilitate the exchange. Buyer agrees to cooperate with the Seller and ORECXO in a manner necessary to enable Seller to complete the exchange.

Date__________________ Signature________________________________

Date__________________ Signature________________________________

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

## SAMPLE EXCHANGE CONTRACT ADDENDUM
(Exchanger as Buyer)

The following terms and conditions are hereby incorporated in and made a part of that certain agreement dated ____________________________________________________
for the purchase of property commonly known as _______________________
executed by __________________________________________________(Seller)
and________________________________________________________(Buyer)

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

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

Seller acknowledges that it is the intention of the Buyer to complete an IRC § 1031 tax-deferred exchange, which will neither delay the closing or cause additional expense to Seller. Seller further acknowledges that the Buyer's rights under this agreement may be assigned to Old Republic Exchange Facilitator Company ("OREXCO"), a Qualified Intermediary, for the purpose of completing the exchange. Seller agrees to cooperate with the Buyer and OREXCO in a manner necessary to enable the Buyer to complete the exchange.

Date_________________ Signature_____________________________

Date_________________ Signature_____________________________

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

## ANSWERS TO COMMON QUESTIONS

**What does the term 1031 refer to?**
1031 is the number assigned to the Internal Revenue Code Section that provides for the tax-deferred exchange of real property.

**What does the term Starker refer to?**
It refers to the landmark 1979 federal case entitled, *Starker v. U.S.* 602 F2d 1341 ($9^{th}$ Cir 1979) wherein the court substantiated the validity of the delayed exchange process. Prior to the *Starker* case, the courts had never sanctioned an exchange whereby the relinquished property was sold and — at a later date — the replacement property was purchased.

**What are "Safe Harbors"?**
This term refers to the rules established by the 1994 Treasury Regulations for tax-deferred exchanges which provide that — if followed — the IRS will allow the exchange to qualify.

**What is a Qualified Intermediary?** An individual or business entity that provides the following functions/services in a 1031 exchange: (1) acquires the relinquished property from the exchanger and causes it to be transferred to the buyer; (2) holds the exchange proceeds to avoid exchangers' actual or constructive receipt of funds; and (3) acquires the replacement property and causes it to be transferred to the exchanger.

**Why is the tax-deferred exchange a popular financial planning tool?**
Simply stated, if done correctly, investors defer tax due in connection with the sale of real property, enabling them to access their equity to consolidate, diversify, leverage or relocate their investments.

**Why use a Qualified Intermediary?**
Use of a qualified intermediary is sanctioned as a safe harbor by the IRS.

**What is like-kind?**
Real property of the same nature or quality is like-kind. Generally, real property is like-kind to all other real property, except foreign real property, as long as it is held for investment or the productive use in a trade or business.

**How do I properly identify my replacement property?**
Property is properly identified only if you unambiguously described it in a written document that is signed by you and hand-delivered, mailed, telecopied, or otherwise sent to the person obligated to transfer the replacement property to the Exchanger (i.e. the QI or the seller of the replacement property) or to any other person "involved in the exchange" other than you or a person disqualified under Treas. Reg. §1.1031(k)-1(k). Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g. the Garden View Apartment Building, Fair City, CA). If at the end of the identification period — 45 days — the Exchanger has identified more properties than

permitted by IRC §1031 (k)-1(b)(1) that Exchanger is treated as if no replacement property has been identified and the exchange will be disallowed.

**What are the 45 and 180-day deadlines?**

Beginning with the close of the Relinquished Property, you have 45 days thereafter to identify the properties you intend to purchase and 180 days (or the due date for your tax return — whichever is earlier) to complete the acquisition of those properties. Note that the 45 day identification period and the 180 day exchange period are calendar days. If the $45^{th}$ day or $180^{th}$ day falls on a weekend or holiday, the deadlines still apply. There are no extensions for Saturdays, Sundays, or legal holidays.

**Is there any way to get an extension on the 45-day or 180-day deadlines?**

No extensions are allowed on the 45 day deadline. Your identification must be sent, signed, in writing, on or before midnight of the 45th day. With respect to the exchange period, it ends on the earlier of the 180th day or the due date (including extensions) of your income tax return for the taxable year in which the transfer of the relinquished property occurs. Thus, if the exchange period is cut short by the earlier occurrence of your tax filing date, you may file for an extension in order to get the full 180 day exchange period.

**What is Boot?**

Broadly defined, boot is anything given or received by the taxpayer that is not like kind or does not qualify under section 1031. Boot may be in the form of cash or a promissory note – i.e. ***cash boot*** or it may be in the form of debt – i.e. ***mortgage boot***. Any boot received by the taxpayer in connection with the disposition of the relinquished property that is not offset by boot given on the acquisition of the replacement property is gain that must be recognized – i.e. taxed.

Alternatively, if the taxpayer receives boot but does not offset that boot with boot given on the replacement property, there will be a taxable consequence to the extent of the boot received and not offset. Thus, it is important to understand the boot netting rules.

**Boot netting rules**:

1. Cash paid on the acquisition of the Replacement Property offsets cash received on the disposition of Relinquished Property;
2. Cash paid on the acquisition of Replacement Property offsets debt relief on the disposition of Relinquished Property;
3. Debt acquired/assumed on the Replacement Property offsets debt relief on the disposition of Relinquished Property.

***Caveat***: Debt assumed on the acquisition of Replacement Property will NOT offset cash received on the disposition of Relinquished Property.

**If I own a property with another investor, can I exchange my equity if he doesn't want to?**

Yes. You should clearly allocate each investor's interest in the property before you sell. The investor who wishes to exchange may do so, and the other investor may receive cash (taxable). It is however, very important that the investors be clear on their intentions before entering into an exchange agreement with a Qualified Intermediary.

**What is a partial tax exchange?**
If the equity in your investment property is $150,000 and you wanted to use only $100,000 to purchase your replacement property and take $50,000 out to buy a new car, you would have a partially tax-deferred exchange. The $50,000 cash you took to purchase the car is considered taxable cash boot.

**May I take out my basis and reinvest only the gain?**
No. Both basis and gain must be reinvested to defer taxes. The IRS does not allow you to allocate a portion of the money as basis and a portion as gain. Any money received by you will be considered boot and taxed at a capital gain rate.

**What is the exchange value of the property?**
Simply stated, the exchange value is the sales price less the closing costs. You are responsible for reinvesting both the cash and the loan amount when you purchase the replacement property. (See section on Boot.)

**How is a seller carry-back note handled in an exchange?** To use the note in an exchange, the note and deed of trust must be drawn in the QI's name. During the exchange period, the note must be converted to cash, which cash is then added to the exchange proceeds to be applied to the purchase of the replacement property in one of the following three ways:

(1) Sell the note to a third party for cash that is then added to the exchange proceeds.
(2) Obtain the agreement of the replacement property seller to accept the note as part of the purchase price to be paid for the replacement property; or
(3) Accept only a short-term note (i.e. due in less than 6 months) that will be paid in full prior to acquisition of the replacement property.

**I own a piece of property that has my primary residence as well as a rental unit. Would it still qualify for an exchange?**
Yes, so long as you remain consistent with your past tax returns. Consult with your tax advisor to determine the percentage value of the property you have attributed to investment. You may exchange that portion of the value. See, Rev. Proc. 2004-14 for guidance.

**Can I defer capital gains tax when I sell my primary residence?** No. You can, however, exclude up to $250,000 of gain from taxation (or $500,000 if married) under IRC § 121.

Caveat: If you originally acquired this property as investment property you must have owed the property for a total of 5 years and you must have resided in the property for at least 2 of the last 5 years in order to take advantage of the $250,000/$500,000 exclusion.

And, the normal $250,000/$500,000 amount will be reduced based upon the prorated amount of time the property was used for investment purposes.

**What if I sell an investment property that I previously acquired as a principal residence—can I exclude gain under the §121 primary residence exclusion and defer investment gain under §1031?** Yes, Rev. Proc. 2005-14 established the following rules for applying both sections:

§121 applied before §1031
Gain from depreciation may not be excluded under §121, but can be deferred under §1031
Boot will be taxed, but only to the extent it exceeds the §121

**Can I exchange with a related party?** You can exchange with a related party subject to certain restrictions. ***If you buy your replacement property from a related party, or swap with a related party,*** the related party must also do an exchange and both of you must hold your replacement property for two years. ***If you sell to a related party,*** the related party must hold the property for two years and you must hold your replacement property for two years.

***Caveat:*** If a related party transaction or series of transactions was designed to avoid the application of the related party rules, the exchange will be disallowed.

Related parties include brothers and sisters (whole or half blood), spouses, children, parents and any other ancestors, any lineal descendants, and corporations or other business entities in which you own more than 50% either directly—or indirectly through your family members. Related parties also include certain fiduciary relationships described in IRC §1031.

**How long must I hold a property for investment before I can move into it for my own residence?**
The IRS has never established any rule for a required holding period for investment property to qualify under section 1031. If you are considering converting investment property to a principal residence, we strongly recommend that you consult with your tax advisor.

**What does the term "disqualified party" refer to?**
The Treasury Regulations provide that certain persons/entities are disqualified from acting as a Qualified Intermediary. Disqualified persons include anyone who can be considered your agent, anyone who is a related person as defined in the Code, or anyone who is related, as defined by the Code, to your agent. Your agents include anyone who has acted as your employee, attorney, accountant, investment banker, real estate agent or broker within the previous two years.

**Do I have access to my money during the exchange?**
No. The Treasury Regulations governing exchanges prohibits you from having actual or constructive receipt of the exchange funds during the exchange period. Only if you fail to identify replacement property in writing within the 45 day identification period, you may have your funds on the 46th day following your disposition. Otherwise, you must wait until you complete your exchange or until the expiration of the 180 day exchange period before you receive exchange funds. See Reg. 1.1031(k)-1(g)(6), commonly referred to as the "g6" restrictions or limitations.

**What are Exchange Expenses?**
Exchange expenses are certain costs incurred in connection with selling property that reduce the amount the taxpayer is required to reinvest because paying for these costs reduces the taxpayer's gain. The use of proceeds to pay some closing costs, however, may result in boot. Revenue Ruling 72-456 provides that brokerage commissions reduce the taxpayer's gain and increase the basis of the replacement property. Private Letter Ruling 8328011, implies that other transactional expenses should be disregarded (i.e. reduce gain) if paid from the proceeds in connection with the exchange. These allowable expenses are referred to as "exchange expenses" on IRS Tax Form 8824, but are not specifically listed anywhere. Most tax practitioners consider the following exchange expenses to be allowable for purposes of reducing realized gain and recognized gain: real estate commissions, exchange fees, legal fees, title and escrow fees and transfer taxes.

## Can I exchange my vacation home?
Yes, under certain circumstances, a vacation home may qualify for tax deferral. Rev. Proc. 2008-16, issued on February 15, 2008, specifies safe harbors for these types of exchanges. For relinquished properties, the property must be have been owned by the taxpayer for the 24 months preceding the exchange ("qualifying period") and in each 12 month period of the qualifying period, the property is rented at FMV for 14 days or more **and** personal use is limited to 14 days or less ***or*** no more than 10 percent of the number of rental days. For replacement properties, the taxpayer must own the property for 24 months immediately after the exchange ("qualifying period") and in each 12 month period of the qualifying period, the taxpayer rents the property for 14 days or more **and** limits personal use to 14 days or less ***or*** no more than 10 percent of the number of rental days. *Note definition of personal use in Rev. Proc. 2008-16.*

## GLOSSARY OF TERMS

**ACCOMMODATOR or QUALIFIED INTERMEDIARY or FACILITATOR** — A person or other entity who assists the exchanger to effect a tax-deferred exchange by holding the exchange proceeds and acting as the principal in the sale of the relinquished property and purchase of the replacement property. The facilitator/intermediary/accommodator cannot be the taxpayer, a related party or an agent of the taxpayer.

**ADJUSTED BASIS** — Simply stated, the adjusted basis is equal to the purchase price, plus capital improvements, less depreciation. Transactions involving exchanges, gifts, probates and trust distributions may impact the property's adjusted basis. The Exchanger's tax and legal advisor is the proper party to determine adjusted basis.

**BASIS** —In general, basis is the cost of the property. The starting point for determining gain or loss in any transaction

**BOOT** — Boot is any type of property received in an exchange that is not like-kind, such as cash, mortgage notes, or stock. The Exchanger pays taxes on the boot to the extent of recognized capital gain. In an exchange, any funds not used to purchase the replacement property will taxable boot.

**CAPITAL GAIN** — Generally speaking, this is the difference between the sales price of the relinquished property — less selling expenses — and the adjusted basis of the property.

**CONSTRUCTIVE RECEIPT** — If the Exchanger has control over the exchange proceeds or property during the exchange period, he may be deemed in constructive receipt. If the Exchanger actually or constructively receives the exchange proceeds or property, the exchange will not qualify under IRC §1031.

**DEFERRAL** — The capital gains tax is not paid until such time (i.e. it is "deferred") as the Exchanger sells the replacement property without engaging in another tax-deferred exchange.

**DIRECT DEEDING** — Direct deeding occurs when title to the relinquished property is conveyed direct from the Exchanger to the buyer without an intervening deed to the QI and when title to the replacement property is conveyed direct from the seller to the exchanger without an intervening deed to the QI..

**EXCHANGE ACCOMMODATION TITLEHOLDER ("EAT")** — The entity that holds title to either the relinquished property or the replacement property in connection with a reverse exchange. In most cases, the EAT is affiliated with the Qualified Intermediary handling the reverse exchange.

**EXCHANGE PERIOD** — The time allowed for the Exchanger to acquire the Replacement Property in a delayed exchange, or the time allowed to dispose of the relinquished property, in a

reverse exchange. In a delayed exchange, the exchange period starts on the day the relinquished property is transferred and ends on the *earlier* of the 180th day thereafter or the due date of the Exchanger's tax return, unless the exchanger applies for an extension to file their tax return. In a reverse exchange, the exchange period commences on the day the EAT acquires title to the property and ends 180 days thereafter.

**IDENTIFICATION PERIOD —** Within 45 days after the close of the relinquished property, the replacement property must be identified in accordance with one of the three identification rules. In a reverse exchange, the relinquished property must be identified within 45 days from the acquisition of the replacement property.

**LIKE-KIND PROPERTY —** Refers to the nature or quality of the property the Exchanger gives up or receives in the exchange, such as real property for real property. Real property does not have to be similar in use such as raw land for raw land. Raw land may be exchanged for any other real property that will be used in a trade or business or held for investment. Real property located in the United States and real property located outside of the United States is not like-kind.

**QUALIFIED EXCHANGE ACCOMMODATION AGREEMENT ("QEAA")** — A written agreement whereby the EAT agrees to purchase and hold title to the replacement property or relinquished property until the Exchanger is able to sell the relinquished property.

**REALIZED GAIN —** Gain that is not yet taxed. In a successful exchange the gain is realized but not recognized—i.e. not taxed.

**RECOGNIZED GAIN —** Gain that is subject to tax.

**RELATED PARTY** — IRC §267(b) and 707(b)(1) defines related party as any person or entity bearing a relationship to the Exchanger such as: members of a family — brothers, sisters, spouse, ancestors and lineal descendants; a grantor or fiduciary of any trust; two corporations which are members of the same controlled group or individuals; corporations and partnerships with more than a 50% direct or indirect ownership of the stock, capital or profits in these entities.

**RELINQUISHED PROPERTY (Property Sold) —** The property disposed of by the Exchanger. This portion of the exchange is sometimes referred to as Phase One.

**REPLACEMENT PROPERTY (Property Purchased) —** The property acquired by the Exchanger. This portion of the exchange transaction is sometimes referred to as Phase Two.

**TRANSFER TAX—** A tax assessed by a city, county or state on the transfer of property

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