The Guide to

Successful §1031 Exchanges

Compliments of

Haven Exchange

Your Expert Source for 1031 Solutions™

Serving you Nationwide

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Revised: June, 2012

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Table of Contents

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Introduction

We at Haven Exchange are proud to bring you *The Guide to Successful §1031 Exchanges*. In addition to making every effort to fill *The Guide* with the most current and correct information available, we have also endeavored to present it in a way that is accessible and easily understood. Often cited as “The most powerful wealth building tool still available to U.S. taxpayers”, 1031 Exchange has long been a major part of the success strategy of countless financial wizards and real estate gurus. More importantly, the 1031 Exchange is Anyone involved with advising or counseling real estate investors should know about 1031 Exchanges, including Realtors, lawyers, accountants, lenders, tax advisors, financial planners and escrow and closing agents. There is no compelling reason for taxpayers to pay capital gains taxes on their sale of investment property when they intend to reinvest their position into more investment property. Utilizing the power of 1031 Exchange to build and preserve wealth and assets, generate cash-flow from investment property, diversify, restructure and/or consolidate real estate holdings, etc., is the express right of every owner of investment property in the U.S. It is with you in mind that we wrote this guide.

In reading through the tax code and its guidelines for 1031 Exchange, one immediately notices that the language used by the IRS can at times seem cryptic and ambiguous. Also, the complex and cumbersome tax code doesn’t always do a good job of pointing out what is important or why. That is where we come in. Haven Exchange is committed to helping the American taxpayer understand and benefit from the tremendous tax advantages made possible by IRS §1031 Tax-deferred Exchanges. Toward that end, instead of simply paraphrasing the tax code, we will explain the issues, using realistic numbers and sample scenarios to illustrate ideas and effects. More than simply conveying information, we hope to empower you with tools and strategies you can use to guide your 1031 Exchange to its successful completion.

Even though *The Guide to Successful §1031 Exchanges* should answer most of the questions you may have during your exchange, you can always call us for your answers too. Haven Exchange’s experienced support staff is here to make the Exchange process smooth and simple for you. We are always glad to speak with you and help you with your 1031 Exchange.

Be aware that, as is the case with the authoring of any “Guide”, there is always a chance of error. Tax rules, regulations, and laws vary by state and are subject to change. Because of space constraints, state and local tax matters cannot be fully addressed herein. However, be advised that these tax liabilities may be considerable, and could have a dramatic effect on your overall tax planning. Therefore, you will want to bear in mind that the information contained herein is in no way intended to be used as a substitute for accounting, legal, or tax advice. Very often, those who utilize a 1031 Exchange will defer tens or hundreds of thousands, even millions of dollars in would-be taxes. With this in mind, it certainly makes sense to spend some time discussing your prospective 1031 Exchange with your tax advisor before you put any investment property on the market.

President Dorothy Zink and all the staff at Haven Exchange are here to make the 1031 Exchange process smooth & simple for you. Please feel free to call on us any time and we will be glad to help you.

What is a 1031 Exchange?

A Safe Haven for Protecting Real Estate Wealth

Named for Internal Revenue Code §1.1031(k)-1 which defines it, a 1031 Exchange allows taxpayers to keep more of their own money working for their benefit by giving them a way to sell their investment property and replace it with more investment property, without having to pay capital gains taxes on the transaction. In the words of the IRS **"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."** This is the IRS' way of saying that as long as all the proper guidelines are followed, a taxpayer selling investment property can use the money they would otherwise have paid in capital gains taxes to buy more investment property. This can be done within and between all classes of real property anywhere in the U.S. The benefits to the taxpayer are HUGE! The table below gives a very achievable but simplified example of one benefit of using a 1031 Exchange. We compare two identical sales of investment property, side by side. On the left, the sale is conducted normally and the investor will give up a portion of their profit as capital gains taxes. On the right, the sale is structured as a 1031 Exchange and since the investor will, following IRC § 1031 guidelines, use all of the money to buy more suitable investment property there will be no recognized gain and no taxes due. As with any tax strategy, always consult your tax advisor before acting.

Selling Investment Property Without a 1031 Exchange	$$$	Selling Investment Property as a 1031 Exchange	$$$
If your Sale Price is:	$500,000	If your Sale Price is:	$500,000
Less the Mortgage:	$350,000	Less the Mortgage:	$350,000
This Leaves Equity of:	$150,000	This Leaves Equity of:	$150,000
With your Sales Price at:	$500,000	With your Sales Price at:	$500,000
And your original purchase price at:	$300,000	And your original purchase price at:	$300,000
There is a Taxable Gain of:	$200,000	There would be a taxable gain of:	$200,000
At the base Federal Capital Gain Tax rate of: x	15%	However, since a 1031 Exchange is used to reinvest your position into more suitable investment property, your actual taxable gain is:	$0.00
There will be Capital Gains Taxes due:	$30,000	Taxes due:	$0.00
Net cash left for investment: *(State taxes and depreciation recapture are not included in these figures, but would represent significant additional benefit in doing a 1031 Exchange)*	$120,000 (Equity – Tax)	Net cash left for investment:	$150,000
		Tax Savings:	$30,000

By structuring their sale of investment or business property as a 1031 Exchange, taxpayers are able to use the money they would otherwise pay in capital gains taxes to buy more investment or business property.

This can be done within and between all classes of real property anywhere in the U.S.A.

fig.1 Comparison: Paying Capital Gains Taxes vs. Utilizing a 1031 Exchange

Regardless of the type of U.S. real property sold to begin an exchange, the replacement property can be of any type of U.S. real property (Commercial, Residential, Industrial, Vacant Land, Agricultural, etc.) as long as the taxpayer will hold the property for "productive use in a trade or business" or "for investment." For example, an owner of a rental home in California can exchange for a parcel of vacant land in Texas. Later that same taxpayer can exchange the land for a warehouse in Florida. Later the warehouse can be exchanged into an undivided partial interest in an office tower in Chicago. Later the partial ownership of the office tower can be exchanged for total ownership of a local office building, which will be occupied in part by the taxpayer's sole proprietorship, the rest being leased for income. These are just some of the scenarios made possible by the enactment of IRC § 1031.

Additional beneficial uses of 1031 Exchange: (This is just a fraction of the potential.) A taxpayer can exchange property that has reached a plateau in value for a property on the upswing. Unproductive land can be exchanged for income-producing property. Management-intensive properties can be exchanged for something more suited to the needs of the taxpayer. Distant properties can be exchanged for others closer to home. A taxpayer can diversify or consolidate real estate holdings geographically or otherwise. A run-down strip-mall can be exchanged for a newer, trendier shopping center. A taxpayer can exchange a property that has been fully depreciated (i.e. zero basis, see adjusted basis pg. 10) for more expensive property having more room for depreciation. Using a "Build-To-Suit" Exchange, any property can be exchanged for land which will be developed with exchange funds and completed during the exchange. Property investors are using the power of 1031 Exchange to reach a very wide variety of financial objectives.

"There is no compelling reason for taxpayers to pay capital gains taxes on their sale of investment property when they intend to reinvest their position into more investment property."

The benefits of using 1031 Exchange become even more dramatic over time. Below, we continue following the same side by side comparison along its logical progression over time. The parallel property transactions will start exactly where we left them on the previous page. The investor on the left has just paid $30,000 in capital gains taxes and has $120,000 remaining cash available for re-investment. The investor on the right just completed his first 1031 Exchange, deferred $30,000 in capital gains taxes and has $150,000 remaining cash available for investment. Both investors had a mortgage of $350,000 previously and will take an equal mortgage on the next purchase. The investor on the left (Not using 1031s) takes his remaining cash: $120,000 and a new mortgage of $350,000 and purchases the next property for $470,000. The investor on the right (Using 1031s) takes his remaining cash: $150,000 and a new mortgage of $350,000 and purchases the next property for $500,000. (To keep matters as simple as possible at this very early point in the guide we are leaving out any considerations for costs of selling, depreciation, improvement or any adjustment of basis. These matters do warrant consideration and are covered in detail in their time later in this guide.)

For the purpose of this demonstration we will make two assumptions. 1) Both investors will wait a period of time for the value of each property to increase by 50% before selling it. 2) On both sides, a new mortgage equal to that held on the previous property along with all proceeds from the previous sale are used to buy the next investment/business property. As before, the investor on the left will not use 1031 Exchanges. However, the investor on the right will use a 1031 Exchange as a part of each sale and purchase. As stated previously, these early examples are very simplified. There are important rules to be aware of and many factors to understand before beginning your exchange. Always consult your tax advisor when planning a 1031 Exchange.

Without using 1031 Exchanges		***$$$***		**Utilizing the Benefits of 1031 Exchange**		***$$$***	
4th Initial Cost	$470,000	Mortgage	$350,000	4th Initial Cost	$500,000	Mortgage	$350,000
Sell Price	$705,000	Proceeds	$355,000	Sell Price	$750,000	Proceeds	$400,000
Gain	$235,000	<u>Taxes Due</u>	$35,250	Gain	$250,000	<u>Taxes Due</u>	$0.00
Cash available for re-investment			$319,750	Cash available for re-investment			$400,000
5th Initial Cost	$669,750	Mortgage	$350,000	5th Initial Cost	$750,000	Mortgage	$350,000
Sell Price	$1,004,625	Proceeds	$654,625	Sell Price	$1,125,000	Proceeds	$775,000
Gain	$334,875	<u>Taxes Due</u>	$50,231	Gain	$375,000	<u>Taxes Due</u>	$0.00
Cash available for re-investment			$604,394	Cash available for re-investment			$775,000
6th Initial Cost	$954,394	Mortgage	$350,000	6th Initial Cost	$1,125,000	Mortgage	$350,000
Sell Price	$1,431,591	Proceeds	$1,081,591	Sell Price	$1,687,500	Proceeds	$1,337,500
Gain	$477,197	<u>Taxes Due</u>	$71,580	Gain	$562,500	<u>Taxes Due</u>	$0.00
Cash available for re-investment			$1,010,011	Cash available for re-investment			$1,337,500
Total Taxes Paid: $187,061		Property Deficit: $327,489		Total Taxes Deferred: $208,125		Property Advantage: $327,489	

fig.2 Comparison: Long View - Paying Capital Gains Taxes vs. Utilizing 1031 Exchanges

At the conclusion of the comparison we see that after transaction 2 (the first one on this page, top left) the investor on the left sells for $705,000 paying off a mortgage of $350,000 and leaving proceeds of $355,000. Also, creating a capital gain of $235,000 of which he pays 15% in federal capital gains taxes, $35,250. Subtracting that from his proceeds leaves $319,750 cash available for re-investment into the next property. Together with a new mortgage of $350,000 the investor buys the next property for $669,750, and so on. At the end of the experiment the investor on the left has $1,010,011 available to buy more investment property. Not too bad, unless he is compared with the investor who utilized 1031s the whole way through, shown on the right.

In total, between the three transactions above and the one on the previous page, the investor who didn't use 1031s has paid $187,061 more in capital gains taxes than his counterpart using 1031s. Furthermore, because his money wasn't able to be invested in and appreciating with his property, the property he owns is worth $327,489 less than the investor who used 1031s every time. Of course, the investor on the left could have kept pace with the one using 1031s, but would have had to shoulder an additional $327,489 in debt. Given the cost of debt service on a mortgage that size, that wouldn't keep pace with the investor on the right at all. Giving investors the ability to keep more of their money's momentum working, 1031 Exchange is widely regarded as one of the most powerful wealth building strategies still available to U.S. taxpayers. Utilized by individuals, trusts, limited liability companies, corporations, partnerships, etc. 1031 Exchange is quickly becoming standard practice for real estate investors and business owners of every stripe.

"1031 Exchange is similar to taking an interest free loan from the IRS and using the money to buy more investment property."

1031 Basics

1. **Investment Property & Business Property only.** To be considered qualifying property for the purpose of a 1031 Exchange, both the relinquished and replacement property must be U.S. real property (including equipment.), which is held for investment purposes or used in the taxpayer's trade or business. For example, any real estate in the U.S., whether improved or unimproved, that is kept for business, investment or income producing purposes, including the taxpayer's office facilities, shop, etc. (Equipment not to exceed 15% of total value) Property which cannot be part of a 1031 Exchange includes but is not limited to:
~ A taxpayer's personal residence, except perhaps that portion of it which is rented out or is the taxpayer's home office
~ Property purchased or held for resale, including Construction for resale or Fix n' Flips and Inventory Property
~ Land which is under development
~ Stocks, Bonds, or Notes nor "Beneficial interest" in a partnership or trust.

2. **The same taxpayer that sells the "Relinquished Property" must buy the "Replacement Property.** If a husband and wife own property as tenants in common or in joint tenancy, the replacement Property must be deeded to both spouses, but they can share title as either tenants in common or joint tenants. Corporations, partnerships, limited liability companies, and trusts must also be on title to the replacement property the same way they were on the relinquished property, except in the case of *disregarded entities*. This matter is usually very straight forward for any one entity, individual or married couple. However, some transactions may present certain challenges to using identical ownership vesting. (See "Special" Issues pg.11 for a discussion of some of these issues.)

3. **To avoid taxable "Boot" always buy replacement property of equal or greater value, less qualified costs.** The prevailing idea behind 1031 Exchange is that since the taxpayer is merely exchanging one property for another property(ies) of "like-kind" there is nothing received by the taxpayer that can be used to pay taxes with. All the gain is still locked up in real estate and so no gain or loss can be claimed. The taxpayer can choose to buy more than one property to complete their exchange or even sell multiple properties to buy a more expensive one. Qualified costs reduce the amount of replacement property needed. Qualified costs include: Escrow fees, Title fees, Real Estate commissions, exchange fees, attorney fees and some others. For whatever reason, loan fees are not considered qualified costs. So, it is recommended practice to pay loan fees with your own personal funds. To summarize, if for example, a taxpayer is selling property for $500,000, and qualified costs incurred by the taxpayer are in total, between both the relinquished and the replacement properties, $40,000, then that taxpayer would need to acquire at least $460,000 ($500k – $40k = $460k) in replacement property to avoid receiving any "Boot". (More at "Boot" Camp pg. 8)

Any "Boot" received in addition to "Like Kind" replacement property will be taxable (to the extent of gain realized on the exchange). This is not necessarily a bad thing and can be a part of a well planned exchange, depending on the taxpayer's goals. For instance, if the taxpayer wants to get some cash or debt reduction out of the deal and is willing to pay some taxes. Otherwise, boot should be avoided in order for a 1031 Exchange to be completely tax-free.

4. **Time Limits: Identification Period - 45 days & Exchange Period - 180 days.** In a 1031 Delayed Exchange the clock begins ticking when the relinquished property closes. All properties that will be used as replacement property for the exchange must be identified in writing before the end of the identification period. All replacement property purchases must be closed before the end of the exchange period.

5. **There must be a valid exchange.** Simply selling property and subsequently buying replacement property is not enough. Not even if all of the time limit requirements are met. Internal Revenue Code §1031 requires, among other things, that there be a written "Exchange Agreement" between taxpayer and intermediary which serves to protect the taxpayer from ever having "Constructive Receipt" of the exchange funds during the exchange period. Or as the code says it; the agreement must "Expressly limit the taxpayer's rights to receive, borrow, pledge or otherwise receive the benefits of the money or property held by the intermediary during the period of the exchange." So, the funds can be used right away towards completion of the exchange but not for any other purpose, during the exchange period.

Exchange Cooperation Clause: We suggest that you insert language similar to the following clause into your Purchase & Sale Contract making all parties are aware that the transaction will be part of a 1031 exchange. (This is merely a suggestion, as disclosure of the 1031 Exchange is not required to be included in the Purchase & Sale Contract.) When "Seller" is exchanging use the clause below. When the Buyer is exchanging, reverse the placement of "Seller" & "Buyer" in the clause: **"Buyer hereby acknowledges that it is the intent of the Seller to utilize an IRC §1031 tax deferred exchange, which will not delay the closing nor cause additional expense or liability to the Buyer. The Seller's rights and obligations under this agreement may be assigned to Haven Exchange a Qualified Intermediary, for the purpose of completing such an exchange. The Buyer agrees to cooperate with the Seller and Haven Exchange in a manner necessary to complete the exchange."**

There is more than one way to structure a tax-deferred exchange under Section 1031 of the Internal Revenue Code. However, the 1991 Regulations established "safe-harbor" procedures which include the use of a Qualified Intermediary, direct deeding, the use of qualified escrow accounts for temporary holding of "Exchange funds" and other procedures which now have the official blessing of the IRS. Therefore, it is desirable to structure exchanges so that they can be in harmony with the 1991 Regulations. As a result, exchanges commonly employ the use of direct deeding and the services of a Qualified Intermediary. Exchanges can also occur without the services of a Qualified Intermediary when parties to an exchange are willing to exchange deeds or if they are willing to enter into an Exchange Agreement with each other. However, two-party exchanges are relatively uncommon since in the typical § 1031 transaction, the seller of the replacement property is not the buyer of the taxpayer's exchange property.

Follow the guidelines laid out by IRS and you can use the advantages of 1031 Exchange to build and preserve wealth. As a Treasury Regulation, Section 1031 carries the full weight of the law and all parties must follow it, even the IRS.

Types of 1031 Exchanges

A Delayed Exchange, the type of 1031 utilized most often and to which the majority of this guide is devoted, is an exchange where the Replacement Property is closed on at a later date than the closing of the Exchange Property. The exchange does not have to be simultaneous or on the same day. This type of exchange is sometimes referred to as a "Starker Exchange" after the well known Supreme Court case which ruled in the taxpayer's favor for a delayed exchange before the Internal Revenue Code provided for such exchanges. There are strict time frames established by the Code and Regulations for completion of a delayed exchange, namely the 45-Day Clock and the 180-Day Clock.

A Reverse Exchange (Title-Holding Exchange) is an exchange in which the taxpayer desires to acquire replacement property before the relinquished property is sold. The Qualified Intermediary creates a single purpose, single asset LLC (limited liability company), for the purpose of acquiring the replacement property and holding title to it until the taxpayer can find a buyer for his relinquished property and close on the sale under an Exchange Agreement with the Qualified Intermediary. The replacement property will be available for use by the taxpayer during the exchange. Subsequent to the closing of the relinquished property (or simultaneous with this closing), the Qualified Intermediary conveys title to the replacement property to the taxpayer.

An Improvement Exchange (Title-Holding Exchange), also called a **"Build to Suit Exchange"** is an exchange in which a taxpayer desires to acquire a property and arrange for construction of improvements on the property before it is received as replacement property. The improvements are usually a building on an unimproved lot, but also include enhancements made to an already improved property in order to create adequate value to close on the Exchange with no boot occurring. Structured either as a Delayed or Reverse 1031 Exchange, myriad options await the savvy investor.

The Code and Regulations do not permit a taxpayer to construct improvements on a property as part of a 1031 Exchange after the taxpayer has taken title to that property. Therefore, for each "Title holding exchange" it is necessary for the Qualified Intermediary to create a unique single purpose, single asset LLC. The LLC will, on behalf of the taxpayer, purchase, take and hold title to the property until the improvements are constructed and then convey title to the improved property to the taxpayer as replacement property, before the end of the 180 day exchange period. Following the completion of the exchange the LLC will be dissolved and its tax return will be filed by the Qualified Intermediary.

A Simultaneous Exchange is an exchange in which the closing of the relinquished property and the replacement property occur on the same day, usually simultaneously. There is no interval of time between the two closings. This type of exchange is covered by the "Safe Harbor" Regulations and is the only exception to the IRS' requirement that a Qualified Intermediary be used to facilitate each exchange. However the exchange must be truly simultaneous. Even the delay caused by wiring to an escrow company in another county will ruin a simultaneous exchange. There is a risk that a short delay in closing can result in full taxes being due. Since the guidelines for delayed exchange allow for much more time between closings, most investors opt for the security provided by a delayed exchange instead of taking a gamble with a simultaneous exchange and hoping for the best.

What is a Qualified Intermediary?

A Qualified Intermediary, or QI, is formally defined as a person who is not the taxpayer or a disqualified person, who enters into a written agreement (the "Exchange Agreement") with the taxpayer and, as required by the "Exchange Agreement", acquires the relinquished property from the taxpayer and transfers it to the buyer, then acquires the replacement property from the seller and transfers it to the taxpayer. The qualified intermediary does not actually have to receive and transfer title when direct deeding is used.

The "Safe Harbor" Regulations in IRC §1031 also specify *disqualified persons*. Generally a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within a two year period, direct linear relations (i.e. taxpayer's parent, child, sibling, etc.), and certain other parties are not allowed to act as the Qualified Intermediary. Furthermore, none of these persons can own as much as 10% of any Qualified Intermediary used by their clients without also becoming disqualified. For example, if even so much as 10% ownership of a Qualified Intermediary is held by a CPA or Real Estate Agent, then that QI is considered to be a "*Disqualified Person*" for every client who has used that CPA or Real Estate Agent in the last 2 years. Any exchange handled by a QI who is a "disqualified person" to the taxpayer fails to meet "Safe Harbor" requirements and does not qualify for tax deferred treatment under IRC §1031.

The Role of the Qualified Intermediary

Acting as the catalyst which transforms the ordinary purchase and sale of property into an exchange, the Qualified Intermediary is a crucial component of a valid and successful 1031 Exchange. In order for a 1031 Exchange to qualify under the "safe harbor" Regulations, there must be a written agreement between the taxpayer and the intermediary stating the seller's intent to exchange and expressly limiting the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the money or property held by the intermediary. The intermediary can act with respect to the property as the agent of any party to the transaction and further, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to the agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. This provision allows a taxpayer to enter into an agreement for the transfer of the relinquished property (i.e., a contract of sale on the property) and thereafter to assign his rights in that agreement to the intermediary. Providing all parties to the agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as having entered into the agreement and, upon completion of the transfer, as having acquired and transferred the relinquished property. The Qualified Intermediary does not provide legal counsel or offer specific tax advice to the exchanger, but will usually perform the following services:

~ Coordinate with the exchangers and their advisors, to structure a successful exchange.
~ Prepare the documentation for the Relinquished Property and the Replacement Property.
~ Furnish escrow, title agent or closing attorney with instructions and documents to affect the 1031 Exchange.
~ Secure the funds in an insured bank account until the exchange is completed.
~ Provide documents to transfer Replacement Property to the exchanger, and disburse exchange proceeds to the closing.
~ Hold the document of Identification of Replacement Properties sent by the Taxpayer.
~ Submit a full accounting of the Exchange for the taxpayer's records.
~ Submit a 1099 to the taxpayer and the IRS for any growth proceeds/interest earned by exchange funds and paid to the taxpayer.

Though not required by IRS, in the past a reputable Qualified Intermediary would carry Fidelity Bond coverage with a "Per Occurrence" value higher than the sum total of all 1031 Exchange funds it holds. We always did. This was thought to provide clients with 100% protection against theft or dishonesty on the part of the QI. Even though the customers of Haven Exchange lost nothing, the recent economic downturn demonstrated the insufficiency of Fidelity Bonds. Haven Exchange held their exchange funds only as cash in separate money market accounts for each exchange, but many Q.I.s invested funds in government backed instruments, for a higher return. They lost millions in the collapse. Since it was so disclosed in their exchange agreements, the bonding companies would not pay a dime because the loss wasn't due to dishonesty or theft. A very small number of Q.I.s, thinking that recovery was imminent, began using their exchange funds in a "pyramid" fashion. As the recession dragged on and their investment losses went un-recovered, eventually they were caught short. Still, not one dime replaced by the bonding companies. Clearly, the investment policies a QI may have in place regarding Exchange funds are key, because a Fidelity Bond does not protect against losses resulting from foolish or risky investing of Exchange funds by the QI. A "Good Stewardship" policy should be in place to govern where and in what type of vehicle Exchange funds can be invested. Haven Exchange never invests exchange funds, which is why we had no losses. We open a separate, completely segregated account for each exchange. Further, we offer you "veto power" over that account. Your account is locked down to all debits, requiring your authorization with the bank prior to any release of funds. Better than any bond.

Note to exchangers in California: Effective January 1, 2003, AB 2065 changes the tax withholding requirements for sales of real property in California (the California Foreign Investment in Real Property Tax Act, or "Cal-FIRPTA"). As originally drafted, Cal-FIRPTA required buyers to withhold 3 1/3% of the sales price of real property purchased and forward those funds to the California Franchise Tax Board, but only if the funds are to be transferred to an out-of-state seller or to the seller's financial intermediary. AB 2065 expands the withholding requirement to apply to sales by California residents and nonresidents alike. Fortunately, AB 2065 exempts various transactions from the withholding requirement, including sales of principal residences, 1031 exchanges, involuntary conversions, and sales resulting in a loss. In addition, withholding on sales by corporations, LLCs, irrevocable trusts, and certain other sellers, generally remain subject to more traditional withholding requirements that turn on the seller's residency. The difficulty that AB 2065 presents for individual sellers is that they cannot request a reduction in the amount of the withholding that would limit the amount to the approximate tax that will be owed. Instead, the withholding is to be calculated on the whole sales price. Alternately, if there is a partial 1031

Exchange done and the taxpayer still has unused exchange funds at the end of the exchange, then 3 1/3% of the remaining funds will be withheld for the Franchise Tax Board.

Delayed Exchanges - The Exchange Process, Its Requirements & Timelines

In the past all exchanges were simultaneous, with the sale of one property and the purchase of another both closing at the same instant. However, in a Delayed Exchange the taxpayer, through a Qualified Intermediary, will sell the relinquished property first and then, through a Qualified Intermediary, buy the replacement property later, hence the delay. A taxpayer intending to structure a 1031 Exchange lists the property for sale in the normal manner without regard to the contemplated 1031 Exchange. A buyer is found and a

contract to sell the property is executed. Accommodation language is usually placed in the contract securing the cooperation of the buyer to the seller's intended 1031 Exchange however such accommodation language is not required to be included in the contract. When contingencies are satisfied and the contract is scheduled for a closing, the services of a Qualified Intermediary are arranged for and the taxpayer enters into an Exchange Agreement with the QI.

The Exchange Agreement will usually provide for:

~ An assignment of the Exchanger's contract to sell the relinquished property as well as buy the replacement property(ies) to the QI.
~ A closing where the QI receives the proceeds due the seller at closing.
~ Direct deeding out of the relinquished property as well as into the replacement property.
~ Compliance with the requirements of IRC §1031 that the Exchanger will not have constructive receipt of exchange funds during the exchange period or before the Exchange Agreement terminates. q
~ An interval of time within which the Exchanger must locate and identify suitable replacement property and another interval within which the replacement property must be received by the taxpayer. These intervals of time are subject to the 45-Day and 180-Day rules.
~ A closing where the QI uses the exchange funds in its possession to acquire the replacement property(ies) for the Exchanger.

Identification

The 45-Day Rule for Identification: The first timing restriction for a 1031 Delayed Exchange limits the "Identification Period". The taxpayer must identify all potential replacement property(ies) within 45 days from the date of transfer of the relinquished property. The 45-Day Rule is satisfied if replacement property is received before 45 days has expired. Otherwise, the identification must be by written document (the identification notice) signed by the taxpayer and sent to the Qualified Intermediary. The identification notice must contain an unambiguous description of the replacement property. This includes, in the case of real property, the legal description, street address or a distinguishable name. During the Identification Period the taxpayer can change the list of "Identified Properties". However, after midnight on the 45th day no further changes can be made. Restrictions are also imposed on the number of replacement properties which can be identified in an exchange. More than one potential replacement property can be identified as long as you satisfy one of these rules: The Three-Property Rule: Any three properties regardless of their market values.
The 200% Rule: Any number of properties as long as the aggregate fair market value of the replacement properties does not exceed 200% of the aggregate FMV of all of the Relinquished Properties as of the initial transfer date.
The 95% Rule: Any number of replacement properties if the fair market value of the properties actually received by the end of the exchange period is at least 95% of the aggregate FMV of all the potential replacement properties identified.

Although IRC Regulations only require written notification within 45 days, it is wise practice for a solid contract to be in place before the end of the 45-day period. Otherwise, if the deal(s) falls apart for any reason and the 45 days have passed, and if the taxpayer has no other identified property to buy instead, the exchange fails and the gain becomes taxable. After 45 days have expired, it is not possible to close on any other property which was not identified in the "identification notice" letter. Failure to submit the "identification notice" letter before the end of the identification period (45 days after sale closes) causes the Exchange Agreement to terminate.

The 180-Day Rule for Receipt of Replacement Property: The replacement property must be received and Exchange completed no later than the earlier of 180 days after the transfer of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the exchanged property was transferred. The replacement property received must be substantially the same as the property which was identified under the 45-day rule described above. IRS has never given an extension of the 180 or 45 day deadlines to any individual taxpayer for any circumstance or hardship. However, IRS has at times given an extension to those affected by certain particularly severe natural disasters. If the exchanger, the Qualified Intermediary, the identified replacement property, title, escrow, attorney or real estate agent is in an area federally designated as a "Disaster Area" during the exchange, the Identification Period and the Exchange Period may be extended by up to 120 days. This was the case with hurricanes Rita and Katrina, when IRS issued a notice giving extensions to those adversely affected. As noted above, the 180-Day Rule is shortened to the due date of a tax return if the tax return is not put on extension. For instance, if an Exchange commences late in the tax year, the 180 days can be later than the April 15 filing date of the return. If the Exchange is not complete by the time for filing the return, the return must be put on extension. Failure to put the return on extension can cause the Exchange to terminate on the due date of the return. This can be a trap for the unwary if you file your tax return before completing your exchange. Caution: If the exchanger will combine funds from two exchanges to buy any one replacement property, then those two exchanges become linked to one another and share the same life-span. Timing for BOTH exchanges begins when the first relinquished property sale closes. The replacement property must be identified as such for BOTH relinquished properties within 45 days from the first relinquished property closing, whether or not the second relinquished property is even sold by that time.

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"Boot" Camp

Although it is not used in the Internal Revenue Code, the term "Boot" is commonly used in discussing the tax implications of a 1031 Exchange. Boot is an old English term meaning "Something given in addition to". "Boot received" is the money or fair market value of "Other Property" received by the taxpayer in an exchange. Money includes all cash equivalents, debts, liabilities or mortgages of the taxpayer assumed by the other party, or liabilities to which the property exchanged by the taxpayer is subject. "Other Property" is property that is non-like-kind, such as personal property, a promissory note from the buyer, a promise to perform work on the property, a business, etc.

There are many ways for a taxpayer to receive "Boot", even inadvertently. It is important for a taxpayer to understand what can result in boot if taxable income is to be avoided. The most common sources of boot include the following:
~ Cash boot taken from the exchange. This will usually be in the form of "Net cash received", or the difference between cash received from the sale of the relinquished property and cash paid to acquire the replacement property(ies). Net cash received can result when a taxpayer is "Trading down" in the exchange (i.e. the sale price of replacement property(ies) is less than that of the relinquished.)
~ Debt reduction boot occurs when a taxpayer's debt on replacement property is less than the debt which was on the relinquished property. As is the case with cash boot, debt reduction boot can occur when a taxpayer is "Trading down" in the exchange.
~Sale proceeds being used to pay non-qualified expenses. For example, service costs at closing which are not closing expenses. If proceeds from the sale are used to service non-transaction costs at closing, the result is the same as if the taxpayer had received cash from the exchange, and then used the cash to pay these costs. Taxpayers are encouraged to bring cash to the closing of the sale of their property to pay for the following: Non-transaction costs: i.e. Proration of rent, Utility escrow charges, Tenant damage deposits transferred to the buyer, and any other charges unrelated to the closing.
~ Excess borrowing to acquire replacement property. Borrowing more money than is necessary to close on replacement property will not result in the taxpayer receiving tax-free money from the closing. The funds from the loan will be the first to be applied toward the purchase. If the addition of exchange funds creates a surplus at the closing, all unused exchange funds will be returned to the Qualified Intermediary, presumably to be used to acquire more replacement property. Loan acquisition costs (origination fees and other fees related to acquiring the loan) with respect to the replacement property should be brought to the closing from the taxpayer's personal funds. Taxpayers usually take the position that loan acquisition costs are being paid out of the proceeds of the loan. However, the IRS may take the position that these costs are being paid with Exchange Funds. This position is usually the position of the financing institution also. Unfortunately, at the present time there is no guidance from the IRS on this issue which is helpful.
~ Non-like-kind property which is received from the exchange. Some examples of non-like-kind property:

- Seller financing, promissory note.
- Sprinkler equipment acquired with farm land.
- Ditch stock in a mutual irrigation ditch company acquired with farm land (possible issue).
- Big T Water acquired with farm land (possible issue).

Acquisition of ditch stock or Big T water is a possible issue with the IRS. In reporting their exchanges of farm land most taxpayers take the position that water on the farm land is like kind to the land. The IRS has been known to have a different view.

Boot Offset Rules: Only the net boot received by the taxpayer is taxed. In determining the amount of net boot received by the taxpayer, certain boot off-set rules come into play. They are as follows:
~ Cash boot paid (replacement property) always offsets cash boot received (relinquished property).
~ Debt boot paid (replacement property) always offsets debt-reduction boot received (relinquished property).
~ Cash boot paid always offsets debt-reduction boot received. Debt boot paid never offsets cash boot received (net cash boot received is always taxable).
~ Qualified costs paid (between both the relinquished and replacement property closings) always offset net cash boot received
Boot tips:
~ Always trade "Across" or up. Never trade down. Trading down always results in boot received, either as cash, debt reduction or both. The boot received can be off-set by qualified costs paid by the Exchanger.
~ Bring cash to the closing of the replacement property to cover loan fees or other charges which are not qualified costs. (See above)
~ Do not receive property which is not like-kind.
~ Do not over-finance replacement property. Financing should be limited to the amount of money necessary to close on the replacement property in addition to exchange funds which will be brought to the replacement property closing.

Capital Gain vs. Equity

Capital gain must not be confused with equity. There is no comparison between the two. Capital gain is described as the difference between the basis and the adjusted sales price of a property, less costs. Equity is the amount of money you have left over after you have sold the property and paid off all related liabilities and mortgages. As an example lets say you bought a property for $200,000 five years ago, it has a mortgage of $130,000 and has a basis of $166,667. If you sold that property today for $400,000, and paid out $30,000 in closing costs and commissions, you have equity of $240,000 (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: $166,667 and your adjusted sales price of $370,000 (Price: 400k – Costs: 30k = 370k), in this case $203,333. If this sale is not turned into 1031 Exchange, there will be capital gains tax owed on the entire gain. At the base federal rate of 15%, that's $30,499.95 due in federal taxes alone. Be careful here if you have refinanced since your original purchase, it is in this area you want to be very cautious not to trap yourself. In a situation like this you are almost obligated to exchange unless you have the additional funds to pay the taxes. For example, a taxpayer buys property for $400,000 with a mortgage of $320,000. Later its value increases to $650,000 and the taxpayer refinances with a new mortgage of

$585,000. If the taxpayer sells this property for $650,000 and does not use a 1031 Exchange, the equity may be only $65,000 (sale: 650 – mortgage: 585 = equity: 65) but it is the gain of $250,000 upon which federal and state taxes will be due. That's $37,500 in federal taxes alone. (sale: 650k - Basis: 400k = Gain: 250k x Federal Cap Gains tax: 15% = Taxes due 37,500) In this example, after paying just the federal taxes the taxpayer is left with $27,500, less than half of the equity. The larger the transactions and the more money and leveraging involved, the greater the inherent tax burden of cashing out. The advice of your tax advisor is priceless in this instance.

Adjusted Basis

Before you enter into any exchange of real estate, you must first figure the adjusted basis of the replacement property you are acquiring to see how it fits in with your financial and tax plans. For real property assets, basis is the term given to the price that was originally paid for the property, plus any capital improvements, less depreciation. Basis is used as the start 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, less costs. So, if a taxpayer purchased property for $10.00 and sold it for $12.00 and incurred qualified costs of $0.25, the capital gain would be $1.75 (Sale: 12 – Original Price: 10 – Costs: 0.25 = Gain 1.75). When a taxpayer uses a 1031 exchange to defer gain from a sale, the gain is ultimately passed along to the replacement property where it awaits the next sale and the taxpayer's anticipated eventual cashing out. The basis of the replacement property is the price paid for it less the gain previously deferred, less any further depreciation. For example, if a taxpayer bought a property ten years ago for $50,000 and has depreciated that property at $1,666 a year for the last ten years, the taxpayer's basis on that property is now $33,340. If the taxpayer then sold that property for $85,000 and did a 1031 Exchange into a property priced at $100,000, the substituted basis on the new property would be only $48,340. (Sale price: 85,000 – Basis: 33,340 = Gain: 51,660) (Replacement property price: 100,000 – Deferred gain: 51,660 = adjusted basis: 48,340). If the property from the example above was later sold for cash, the amount of capital gain would be determined by subtracting the costs of the sale and the substituted basis from the new sale price. The remainder is the capital gain. If the sale price was $150,000 and qualified costs to the taxpayer were $12,000, the capital gain in this example would be $89,660. (New Sale Price: 150,000 – costs: 12,000 - Adjusted basis: 48,340 = Gain: 89,660)

"Special" Issues

Multiple-Asset Exchanges and Personal Residences: A Multiple-Asset Exchange occurs when a taxpayer is selling/exchanging a property which includes more than one type of asset. A Common example is a farm property including a personal residence, farm land and farm equipment. The Treasury Department has issued Regulations which govern how multiple-asset exchanges are to be reported. The Regulations establish "Exchange Groups" which are separately analyzed for compliance with the like-kind replacement requirements and rules of boot. Farm land must be replaced with qualifying like-kind real property. Farm equipment must be replaced with qualifying like-kind equipment. A personal residence is not 1031 property and is accounted for under the rules applicable to the sale of a personal residence. The Multiple-Asset Regulations are ambiguous concerning how the personal residence portion of a multiple-asset exchange should be accounted for. However, it is common practice for the closing on the Exchange Property to be bifurcated into two separate closings; one for the personal residence and the other for the remainder of the property. The proceeds applicable to the sale of the personal residence are usually disbursed to the taxpayer directly. The balance of the proceeds is disbursed to the Qualified Intermediary for use in acquiring like-kind replacement property under the Exchange Agreement. Another common example of multiple-asset exchanges is a real property sale that includes personal property (i.e. furniture and appliances). Rental properties including this type of personal property are multiple-asset exchanges. Hotel properties are a good example of a multiple-asset exchange including real and personal property. In practice, the value of the personal property that is transferred with a rental property is commonly disregarded for calculation and income tax reporting purposes. However, there is no rule which permits a taxpayer to disregard the value of personal property, even if it is nominal. The Multiple-Asset Regulations are complex and require the services of a tax professional for analysis purposes and income tax reporting. The tax professional is essential and will help in determining values, allocations of sale price and purchase prices to the elements of the transaction. Exchanges that include personal property of significant value should reference the personal property in the exchange agreement and be completed in a manner that complies with all of the exchange rules concerning identification, etc.

Sale/Lease Back as an Exchange: A lessee's interest in a lease with a term of 30 years or longer on real property is considered "like-kind" to other real property. In addition, property which is subject to a lease can, if the lease is for a term of 30 years or longer, be the subject of a tax-deferred exchange. However the receipt of prepaid lease payments in an exchange for a 30-year or longer lease is taxed as ordinary income and will not qualify for tax-deferred treatment.

Partnership and Co-Ownership Issues: Investment real estate is commonly owned by a partnership containing two or more partners, or by co-owners as tenants in common. An exchange of a tenant in common interest in real estate poses no problems and is eligible for 1031 Exchange treatment. Each tenant can exchange separate from the others. A partnership can exchange real estate that it owns but ownership interest in a partnership itself cannot be exchanged under IRC §1031. Real property is real property, but a partnership is only an idea, an agreement, and not real property. If a partnership desires to exchange property that it owns, the partnership will be the entity that is the Exchanger and party to the Exchange Agreement and will take title to the Replacement Property. Frequently, individual partners in a partnership desire to exchange their share of the sale of the partnership's property, replace it with qualifying property in their own names and end their relationship with the partnership. This presents problems that require careful planning by the taxpayer's legal/tax advisor and is not without tax risk. If a two-partner partnership wishes to discontinue the partnership, sell the property and go their separate ways with either the cash or a 1031 Exchange, it is necessary for the individual partners to receive deed to the property from the partnership well in advance of the sale of the property. This is done in the context of a distribution of property from the partnership to its partners. The individual partners are then generally required to hold the property as tenants in common for an unspecified period of time ("a decent interval of time") in order to comply with the requirement for a taxpayer to have "held" the property for business or investment purposes prior to the exchange. If a partnership with multiple partners wishes to exchange property but some of the partners want to "Cash-out" or go separate ways, it is common for the partnership to do a "Split-off." The partnership distributes tenancy in common title to a portion of the partnership property to those individual partners who wish to part ways, and the partnership (and its remaining partners) proceed separately with an exchange in the name of the partnership. The services of a tax professional are essential for tax planning and structuring of successful exchanges of partnership and co-ownership interests in real estate.

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. For description purposes, the legal description or street address of the real estate property can be used to describe the entire property. There is no need to list the particular incidental property attached to it.

Seller Carry-Back Financing: A loan or note issued by the seller/exchanger will often turn out to be "Boot" if it is part of a 1031 Exchange of real estate. The reason is that a promissory note is property received which does not meet the requirement that real estate be exchanged solely for other like-kind property (real estate). If seller financing is necessary due to circumstances, there are alternatives to being taxed on the amount of the note. 1) The taxpayer can buy the note out from the exchange. By bringing personal funds in the amount of the note to the closing, the taxpayer will trade cash for the note, use the cash to purchase replacement property, and hold the note personally apart from the exchange. Instead of being taxed on the face value of the note, the taxpayer is only taxed on the income received from the note. OR 2) The taxpayer can direct the Qualified Intermediary to sell the promissory note to a financial institution or investor and use the cash received in its place as exchange funds to acquire qualifying replacement property. OR 3) The taxpayer can use the promissory note in the exchange as consideration for the acquisition of replacement property. In other words, a taxpayer can take a carry-back note from the buyer of the relinquished property, as a part of that sale and later trade that note to the seller of the replacement property, as a part of that purchase. A problem with this is that in the hands of the seller of the replacement property, that note is a third-party note not eligible for installment sale reporting under IRC 453. It will be called a "third party" note because it is a note between you and the buyer of your relinquished property, now held by the seller of your replacement property, a 3rd party. That person will not be able to do 1031 Exchange with that note and will likely be taxed on its value in the tax year it is received. Accordingly, there is disincentive for the seller to take the note as part of the consideration to be received from the sale of his property. This problem is compounded if the seller is also trying to do a 1031 Exchange of his property. Caution: These dispositions are not covered by the 1991 Regulations and are not protected by the "safe-harbor" provisions. Therefore, if seller carry-back financing is part of the sale of the relinquished property potential tax issues are always possible under an examination by the IRS. Otherwise, the note is "Boot" to the taxpayer unless it is offset by "Boot", paid by the taxpayer, at the Replacement Property closing table. "Cash boot paid" by a taxpayer always offsets "Cash boot received."

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. Either 1) 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. This property does not qualify for 1031 treatment.
Or 2) 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 if the property is rented more than 14 days during the tax year. This property may qualify for 1031 treatment.

New Construction of 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 (i.e. a contractor's obligation to do work or build on the property, etc.) Partially completed real property can be received in a like kind exchange if properly identified.

There are two ways that new construction is handled in a Delayed Exchange: 1) You contract with a builder to purchase a property that will be completed, and closed, prior to the end of the 180-day exchange period. This is the least expensive and easiest method for the exchanger. *Or* 2) You can contract with the Qualified Intermediary to structure what is known as a "Build-to-Suit " Delayed Exchange. This allows the replacement property to be acquired by the QI and developed with exchange funds during the "*Exchange Period*". The help of your CPA will be invaluable here. The relinquished property closes first. The QI forms a single purpose, single asset LLC, for the purpose of acquiring and holding the replacement property while exchange funds are used to fund its development directly. The replacement property acquired can be vacant land or property that is already developed which will be further developed within the exchange period with exchange funds. The Exchanger is free to add his own funds to the transaction if additional monies are needed. After completion, and certainly before the end of the 180 day exchange period, title to the replacement property is conveyed to the Exchanger, completing the exchange. The QI then causes the dissolution of the LLC.

In both cases, the Purchase & Sale Agreement should contain language that requires "The Builder" to bear responsibility for the "The Exchanger's" taxes if the exchange fails due to the "Builder's" failure to complete the construction prior to the 180th day. If "The Builder" refuses to sign such an agreement, then at least you know where you stand. If a taxpayer's exchange is approaching its 180th day and construction will not be complete, to salvage the exchange, the taxpayer can have "The Builder" convey ownership to the taxpayer to that portion of the property that is complete. In such an instance, the value of that portion is added to the total amount of replacement property purchased for the exchange. 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.

Related Parties: In the past, in order to evade proper taxation, etc., people have transacted slanted real estate deals between related parties, that the IRS has issued strict guidelines regarding their involvement in a 1031 Exchange. If not handled properly, selling to or buying from a related party can disqualify your 1031 Exchange. CPAs should be prudent and use caution when a related party is involved in an exchange transaction. Related parties are treated differently and have a unique set of rules. Knowing these rules should eliminate unpleasant surprises. 1) A taxpayer can only sell relinquished property to a related party if the related party will hold that property for at least 2 years after the exchange and neither party is involved in "basis shifting" nor trying to avoid the spirit of the §1031 regulations. Related Parties include the following:
~ Members of a family, including only brothers, sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.)
~ An individual and a corporation when the individual owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation
~ Two corporations that are members of the same controlled group as defined in 1563(a), except that "More than 50%" is substituted for "At least 80%" in that definition
~ A trust fiduciary and a corporation when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation
~ A grantor and fiduciary, and the fiduciary and beneficiary, of any trust
~ Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts
~ A tax-exempt educational or charitable organization and a person who, directly or indirectly, controls such an organization, or a member of that person's family
~ A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership
~ Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation or Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation
~ An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest
~ Two partnerships if the same persons own directly, or indirectly, more than 50% of the capital interests or profits in both partnerships,

or a person and a partnership when the person owns, directly or indirectly, more than 50% of the capital interest or profits interest in the partnership.

Frequently Asked Questions

What should I do with the Earnest Money deposit on the sale of my Relinquished Property? The earnest money should never be deposited in your own account. It should be deposited with the title or escrow company, closing attorney 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 will never have possession or constructive receipt of those funds.

How do I handle the earnest money deposit for the purchase of my Replacement Property? Typically it is handled in one of two ways. 1) If your funds are with the QI, you can direct the QI to send the deposit out of your exchange proceeds or 2) You can give an earnest money deposit from your own personal funds, even before the relinquished property has closed (However, you must not close on the replacement property prior to closing on the relinquished.) If you directly put some of your own personal money into the purchase transaction and if there are unused funds at the closing which are not exchange funds, then you can be reimbursed up to the amount of your “out of pocket” deposit, when that purchase closes. If the transaction fails to close the funds should be returned to your Qualified Intermediary by the closer.

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

If I don't spend all of my proceeds when can I receive the unused amount? The IRC §1031 guidelines specify that you can receive the unused proceeds anytime after you have acquired all of the properties identified by you during the 45-day identification period. If you do not acquire all of the identified properties the unused proceeds cannot be released until the end of the 180 day exchange period or the due date of your tax return, including extensions, whichever is earlier.

If I decide not to go through with my exchange when can I get my money back? If you cancel the exchange before your sale closes, even if Haven has issued your Exchange Agreement, we will waive our fee, as a courtesy. If you cancel the exchange after your sale has closed there are strict IRS guidelines pertaining to release of exchange funds that must be followed. Specifically, if no replacement property is identified by you during the 45 day identification period, the exchange ends and the proceeds can be released any time afterward. However, if you identify replacement property for your exchange that you do not acquire, the funds cannot be released until the end of the 180 day exchange period or the due date of your tax return, including extensions, whichever is earlier. Your funds will continue to earn interest for you throughout.

How long do I have to hold the replacement property before I can sell it or move in and occupy it as my primary home? It must be the taxpayer’s intent at the time of the exchange to hold the replacement property for use in trade or business or for investment. The Treasury Regulations pursuant to IRC § 1031 do not stipulate a specific period of time that replacement property acquired through a 1031 must be held before it can be either sold or occupied as the exchanger’s primary home. Barring instances of hardship, most tax advisors recommend holding at least two full years, but some say only two tax years, which could be as short as 13 months depending on timing. Circumstances vary, so always get the advice of your own tax advisor beforehand. Occupying or selling too soon could cause the IRS to disallow the exchange. If you do eventually occupy a 1031 replacement property as your primary home, you will need to live in the property for three years before you will be able to claim the primary home tax exemption on it, if you were to sell it.

Resources

Internal Revenue Code § 1.1031 and all related Rev. Procs and PLRs.

Federation of Exchange Accommodators Phone: (916) 388-1031

N.A.R. - National Association of Realtors Toll-Free: (800) 874-6500

Howser & Brown A.P.C. Attorneys at Law - N. Brooke Gabrielson, Attorney at Law

4340 Campus Drive, Suite 100, Newport Beach, CA 92660

Phone: (949) 852-8500 - www.HowserBrown.com

SECURITY

Haven Exchange provides its clients with the highest degree of safety and security for their 1031 Exchange Funds. Funds from each 1031 Exchange are placed in separate, fully segregated, completely liquid, FDIC insured bank accounts. Your account is labeled with your name, making clear who the money belongs to, yet not granting you the power to spend it that would disqualify the exchange. Further, we offer you “veto power” over that account. Your account is locked down to all debits, requiring your authorization with the bank prior to any release of funds. Again, without the power to spend the money or otherwise benefit from it, you still retain the power to be sure it isn't used in any way you have not sanctioned. There is no better security than that. The bank contacts you directly to make this agreement, and Haven Exchange has no ability to affect that agreement.

SERVICE

Haven Exchange is here for you 7 days a week, from 7am to 7pm PST so that we can be available when you need answers. Because of the obvious advantage to our clients, we are highly responsive in providing your 1031 Exchange documents, service and funds. This means the documents for your 1031 tax Exchange can be delivered within minutes and that we can fund your closing the same day we receive the necessary signatures, up to 12pm Pacific Standard Time. As an active member of the Federation of Exchange Accommodators, Haven Exchange maintains an awareness of the tax code and any coming changes that may affect our clients. We proactively seek to educate the public and provide them with the most current and useful information available on 1031 Exchanges. Wherever you are located, Haven Exchange is as close as your phone. Whether you are in need of a Qualified Intermediary, have questions about a potential 1031 Exchange, or would simply like to discuss the possibilities, please feel free to call us. We will be glad to hear from you and will help you in any way we can. Toll-Free: (866) 794-1031 – Local: (714) 373-9101

Schedule of Fees for 1031 Exchange of Real Property

Haven Exchange · Your Expert Source for 1031 Solutions™

Delayed Exchange:

~ A complete 1031 Exchange, including one sale and one purchase	$ 750.00
~ If more than one property is purchased, each additional closing add (If applicable)	$ 175.00 (Upon Client’s Request)
~ Receipt, Transfer, and Reassignment of Carry-Back Notes (If applicable)	$ 275.00 (Upon Client’s Request)
~ Wire fee (If applicable)	$ 30.00 (Upon Client’s Request)

“Build to Suit” Exchange:

Pricing determined on a case by case basis, depending on the actual needs of the Exchanger — Call for a quote

Reverse Exchange:

Pricing determined on a case by case basis, depending on the actual needs of the Exchanger — Call for a quote

Seek Haven • Your Expert Source for 1031 Solutions™

2124 Main Street, Suite 165 - Huntington Beach, CA 92648

Toll-Free: (866) 794-1031 - **Local:** (714) 373-9101 - **Fax:** (714) 200-0120

www.HavenExchange.com

Step 1. Retain the services of tax counsel/CPA. Become advised by same.

Step 2. Sell the property, including an "Exchange Cooperation Clause" in the sales agreement. Make sure your escrow officer, title officer or closing attorney is aware that your sale will be part of your 1031 Exchange.

Step 3. Enter into an exchange agreement with Haven Exchange, in which "Haven" is named as principal in the sale of your relinquished property and the subsequent purchase of your replacement property. Along with said agreement, an amendment to the closing/escrow instructions is signed which names Haven Exchange as the substituted seller. The deed is prepared for recording as directly from the taxpayer to the buyer. This is called direct deeding. It is not necessary to have the replacement property identified at this time.

Step 4. The sale of the relinquished property closes and the proceeds from the sale are forwarded to Haven Exchange. Exchange funds are kept in segregated, FDIC insured accounts. The day the relinquished property closes is the day your 1031 Exchange really begins and the Exchange deadlines start approaching. Haven Exchange makes a "1031-Exchange Orientation" call to the client to discuss the exchange and answer questions and also sends a letter to the taxpayer, advising them of the amount of proceeds and the dates of the 45th and 180th days. A *Replacement Property Identification* form and *Earnest Money Deposit Request* form accompany the letter.

Step 5. The taxpayer sends written identification of the replacement property(ies), including address or legal description, to Haven Exchange, on or before Day 45 of the exchange. It must be signed by every signatory on the exchange. It may be faxed, hand delivered, or mailed. We recommend having it sent via certified mail with *Return Receipt* Requested. The taxpayer will then have proof of receipt by the QI, verified by a government agency.

Step 6. Taxpayer enters into an agreement to purchase replacement property, again including the Cooperation Clause. An amendment is signed naming Haven Exchange as substituted buyer, but again the deeding is direct from the seller to the taxpayer.

Step 7. When conditions are satisfied and the purchase is ready to close (and certainly prior to the180th day), Haven Exchange forwards the exchange funds to the closing. A final accounting is sent by Haven Exchange to the taxpayer, showing the funds coming in from one escrow, and going out to the other, all without constructive receipt by the taxpayer.

Step 8. Taxpayer files form 8824 with the IRS when taxes are filed, and whatever similar document your particular state requires.

Exchange Cooperation Clause: We suggest that you insert language similar to the following clause into your Purchase & Sale Contract making all parties are aware that the transaction will be part of a 1031 exchange. (This is merely a suggestion, as disclosure of the 1031 Exchange is not required to be included in the Purchase & Sale Contract.) When "Seller" is exchanging use the clause below. When the Buyer is exchanging, reverse the placement of "Seller" & "Buyer" in the clause: "Buyer hereby acknowledges that it is the intent of the Seller to utilize an IRC §1031 tax deferred exchange, which will not delay the closing nor cause additional expense or liability to the Buyer. The Seller's rights and obligations under this agreement may be assigned to Haven Exchange a Qualified Intermediary, for the purpose of completing such an exchange. The Buyer agrees to cooperate with the Seller and Haven Exchange in a manner necessary to complete the exchange."

Glossary of Terms

Basis: The value of property for purposes of depreciation. For a purchased real property asset the basis is the initial amount paid for the property, plus capital improvements, less depreciation.

Boot: Something given in addition to. Cash or personal property over and above equity. Generally used in exchange transactions to refer to something given, other than the major properties to be exchanged, in order to equalize value.

Boot-Offset: When a taxpayer both pays and receives boot certain boot-offset rules apply.

Capital Cost: Cost of improvements which tend to extend the useful life of the property or add to the facility.

Capital Expenditures: Money spent on improvements such as land, buildings, machinery, and similar major expenditures which are not inventory.

Capital Gains: Gains realized from the sale or exchange of capital assets. Generally, the difference between cost (i.e. basis) and selling price, less certain deductible expenses. Used mainly for income tax purposes.

Capital Loss: Loss suffered through the sale or exchange of a capital asset.

Cash Boot: Cash and non-qualifying property (i.e. not like kind) received in an exchange.

Constructive Receipt: A taxpayer is said to be in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it.

Continuity of investment rationale: One of the rationales believed to be behind the original enactment of IRC §1031 which provides that if the taxpayer's money is still tied up in the same kind of property as that which is was originally invested, he is not allowed to compute and deduct his theoretical loss, nor is he charged with the tax on his theoretical profit.

Dealer: A person who holds property primarily for sale to customers in the ordinary course of his trade or business. The importance of the term is for tax purposes. If IRS determines that a taxpayer is a dealer, the taxpayer will not be allowed the capital gains benefits of an investor, but will be taxed at ordinary rates.

Debt Relief: Another term for mortgage boot received, which means that the taxpayer's liabilities have been assumed or taken subject to, in the exchange.

Depreciation: Decrease in value to real property improvements brought about by age, physical deterioration, functional or economic obsolescence. Also a loss in value as an accounting procedure to use as a deduction for income tax purposes.

Disqualified Person: The IRC "Safe Harbor" regulations restrict the use of related parties as qualified escrow agents, trustees and intermediaries. Generally a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within a two year period, direct linear relations (i.e. taxpayer's parent, child, sibling, etc.), and certain other parties are not allowed to act as the intermediary. Furthermore, none of these persons can own as much as 10% of any Qualified Intermediary used by their clients without also becoming disqualified. For example, if even so much as 10% ownership of a Qualified Intermediary is held by a CPA or Real Estate Agent, then that QI is considered to be a "Disqualified Person" for every client who has used that CPA or Real Estate Agent in the last 2 years. "Safe Harbor" regulations specify that any exchange handled by such a QI would be disallowed upon review by IRS.

Disregarded Entity: An entity that the IRS has determined need not file its own tax return. The two most common and most applicable to 1031s are the "Living Trust" and the "Single Member LLC". Any income or expense from the assets owned by the "Living Trust" must be reported on the tax return of the entity controlling the trust. Likewise with LLCs and the tax return of the LLCs sole member.

Equity: The fair market value (FMV) in excess of mortgages and other liens. Do not confuse equity with gain.

Exchange: The act of giving one thing as equivalent for another. To trade. The process of conveying and acquiring "Like kind" investment properties in a manner to avoid or defer payment of taxes on the capital gain.

Exchange Period: The period of time within which the taxpayer must receive the replacement property. It begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer's tax return for the tax year in which the transfer of the relinquished property occurs.

Holding Period: In an exchange, it begins on the date of acquisition of the original property.

Identification period: The period set by IRC §1031 during which the taxpayer must identify replacement property. The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter.

Incidental Property: Property which will not be treated as property separate from 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 the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property. (Treasury Regulation §1.1031(k)-1(c)(5), i.e. Laundry room facilities in an apartment complex.)

Indicated Gain: The potential gain that would be recognized were the property sold for cash.

Installment Sale: A tax term used to describe a sale which is usually accomplished by use of a land contract. If the seller receives less than 30% of the sale price in the year of the sale (not including interest), then the tax on the gain from the sale may be paid over the installment period, provided that no more than 30% of the sale price is received in any given year.

Like Kind Property: Like kind does not refer to the grade, type or quality of property, but only to the way the taxpayer uses the property. So, all real property in the U.S. is like kind to all other real property in the U.S. so long as each is either held for productive use in trade or business or held for investment by the taxpayer doing the exchange.

Mortgage Boot: Liabilities assumed or taken subject to in an exchange.

Net Loan Relief: Net mortgage boot received after applying boot-offset rules. The amount of the taxpayer's liabilities which have been assumed or taken subject to by another, less the amount of liabilities which the taxpayer has assumed or taken subject to.

New Basis: Basis of the new property in the hands of the new owner after acquisition of the property through purchase or exchange.

Ninety Five Percent Rule: One of the rules for identifying alternative and multiple replacement properties specified by Treasury Regulation §1.1031(k)-1(c)(4)(ii)(B) which provides that the taxpayer may identify any number of replacement properties, no matter their aggregate fair market value, so long as the taxpayer receives no less than 95% of the aggregate fair market value of all identified properties, before the end of the exchange period.

Old Basis: Adjusted cost basis of the property being exchanged.

Ordinary Income: Taxable income other than Capital Gains Income, subject to the full graduated tax rates.

Qualified Intermediary: A Qualified Intermediary, or QI, is an independent party who facilitates tax-deferred exchanges pursuant to Section 1031 of the Internal Revenue Code. The QI cannot be the taxpayer or a disqualified person. Acting under a written agreement with the taxpayer, the QI acquires the relinquished property and transfers it to the buyer. The QI will hold the sales proceeds to prevent the taxpayer from having actual or constructive receipt of the funds. Finally, the QI acquires the replacement property and transfers it to the taxpayer to complete the exchange before the end of the exchange period.

Realized Gain: The excess of the amount realized over the adjusted basis of the property transferred.

Recognized Gain: The net gain ultimately realized from an exchange, which is taxable.

Straight Line Depreciation: A method of replacing the capital investment of income property, but likewise reducing the value of the property by a set amount annually from the income, over the economic life of the property.

Capital Gain Worksheet

This is for informational purposes only and is not a substitute for the advice of your tax counsel. The purpose of this worksheet is to help you estimate your potential tax burden and conversely, the potential benefit of utilizing a §1031 Exchange.)

Calculation of Adjusted Basis

Purchase Price: $________________________________ **(1)**

Deferred Gain from previous 1031 Exchanges: $________________________________ **(2)**

Capital Improvements: $________________________________ **(3)**

Depreciation: $________________________________ **(4)**

Adjusted Basis: **(1 minus 2) + (3 minus 4)** $________________________________ **(5)**

Calculation of Capital Gain

Sale Price: $________________________________ **(6)**

Capital Gain: **(6 minus 5)** $________________________________ **(7)**

Classification of Gain

Depreciation Recapture: **(4 above)** $________________________________ **(8)**

Capital Gain: **(7 minus 8)** $________________________________ **(9)**

Total Realized Gain: **(8 plus 9)** $________________________________ **(10)**

Estimation of Federal Tax Due

Amount from Line 8 x 25%: **=** $________________________________ **(11)**

Amount from Line 9 x 15%: **=** $________________________________ **(12)**

Total Fed Cap-Gain Tax Due: **(11 plus 12)** **= $**________________________________ **(13)**