

Essentials of Exchanges for Investors

This is a summary of the basic knowledge a real estate investor should have about exchanging property. The information provided will help you understand how to do a tax-deferred exchange. It is not a substitute for appropriate provisions of the law and it will not replace professional review and assistance.

What is a 1031 Exchange?

The Internal Revenue Code, Section 1031, is the section that allows for the deferral of gain where a transfer of properties occurs at different times. The properties must be used in a trade or business or as investment properties. In other words, if you sell a piece of property that is not a personal residence, then reinvest the money within the 180-day replacement period in another piece of qualifying property (not your personal residence), then there may be little or no tax due at that time.

These provisions in the law have been around in various forms nearly as long as the income tax itself. They are not tax "loopholes" but rather a method of deferring taxes when a taxpayer does not receive any cash equity or debt relief.

Why is it important for the Investor to know about exchanges?

1. Tax Savings

If your property has increased in value, or if you have depreciated it over a number of years, your tax basis (your "cost basis") probably is much less than the property's fair market value. If you were to sell the property, you would have a taxable gain based on that difference. Federal capital gain rates are now 15 percent. You must factor in your state rate as well as most states also taxes these gains. For depreciable real property there may be a recapture the depreciation you have taken over the years. This is called "Section 1250 recapture" and that rate is 25. The combination of these various rates will tell you about how much tax you will have to pay in a standard property sale.

If you reinvest the sales proceeds into another property, however, the taxes on the gain may be deferred. Taxes will not be payable if an exchange is done properly. This method is completely legal, and in fact, was carved out in its present form by the Internal Revenue Service in 1991. The reason there is no tax due rests on a long-standing principle in tax law which states that taxes are not due where no sale occurs, or where no cash is received.

2. Ease of Use

A tax-deferred exchange will "feel" very much like an ordinary property sale. There will be some additional steps that must be followed, but they will be handled by the Qualified Intermediary. For the most part, it will be as if you sold one property and bought another. If the two transactions are handled correctly, you can defer your taxes otherwise due. Most investors find this a painless process, because the work is handled primarily by professionals - the Intermediary and your tax preparer, CPA or attorney.

When should you ask about an exchange?

Always when you are the Seller of investment real estate. It is a good idea to ask about this even when you only have a listed property that has not evolved to a contract. After a property sale has closed, it is too late to complete a tax-deferred exchange. The earlier you learn about the 1031 Exchange process, the more informed your decisions will be. It will allow you more flexibility and time to prepare to buy a replacement property or properties, and will allow time for you to discuss the matter with your tax preparer or attorney.

Planning an exchange -- What should I look for?

- 1. Preserve your tax savings.**
This is the primary goal for the entire process and the sole reason that you must adhere to proper documentation and procedure throughout the escrow. The other goals are related.
- 2. Be sure your transaction will stand up to the scrutiny of an IRS audit.**
It is not your Realtor's responsibility to know how to test the documentation and ask the appropriate questions to be sure the transaction will stand up to an IRS audit. It is the responsibility of the Investor to be sure that these matters are attended to. A good tax counselor, Qualified Intermediary or an attorney familiar with 1031 Exchanges will be able to help.
- 3. Obtain professional assistance and review.**
Once retained, your attorney, tax counsel or Intermediary will have specific questions about the type of property under contract, as well as questions about related or attached personal property and their values. There are valid reasons not to do an exchange which should be reviewed as well.
- 4. Make the best business decision for your situation.**
A common error is to attempt to force into a property which does not meet your needs. Perhaps reducing other debt, or obtaining a different type of asset will serve you more wisely. Make this good business decision first, then attempt to develop the best tax strategy after words. Don't let tax savings be the primary consideration, but only give it the weight it deserves after you have decided where you should reinvest your proceeds.

Defining some terms with which you will become familiar.

- 1. "Like-Kind" --** Like-Kind Real Property is simply other Real Estate interest which are for investment or use in a trade or business. IRS regulations issued in 1991 greatly simplified what had been a source of uncertainty in the law. There are many facets of "like-kind" property, but for Investors, it is a valid principle that ANY INVESTMENT OR BUSINESS REAL PROPERTY MAY BE EXCHANGED FOR ANY OTHER TYPE OF REAL PROPERTY THAT IS FOR INVESTMENT OR USE IN A TRADE OR BUSINESS.
- 2. "Investment Property" or "Property used in a Trade or Business" --** The properties involved in the 1031 Exchange must be Investment or Property used in a Trade or Business. Generally, if you hold property purely for investment or are renting the property, then it qualifies. These provisions DO NOT apply to your personal residence. Raw land may be traded for an apartment house. A residential rental may be traded for raw land or for a commercial building. Your professional advisors will deal with the question of whether the property is an Investment Property or a Property used in a Trade or Business.
- 3. Accommodator --** an unrelated third party who holds funds and purchases replacement properties on behalf of an Exchangor. Also called a Qualified Intermediary or Facilitator. It is used interchangeably throughout this document.
- 4. Exchangor --** This is you as the Seller, and is often referred to as the Taxpayer.

5. **Relinquished Property** -- This is the property that you are transferring and wish to dispose of.
6. **Replacement Property** -- This is the property that you end up with at the end of the transaction.
7. **Boot** -- In an exchange of real estate, the "boot" is any asset received other than the replacement property. There are different types of "boot." For instance, if you receive the replacement property plus \$100,000 in cash, the cash is the "boot." Mortgage boot is based upon the difference in liability between the two properties involved.

When to use an Accommodator

It is relatively easy to identify property one would like to trade for. It is nearly a miracle to find that the owner of that property is willing to trade for yours. Generally, Sellers sell for cash and do not wish to trade. This all-to-common scenario means that a third party will have to be brought in to handle the needs of all parties. Any time properties do not transfer simultaneously, an Accommodator is necessary. Over 98% of all tax-deferred exchanges are of this non-simultaneous type.

The IRS regulations carved out a Safe Harbor that allows participants to be assured of their tax savings when they properly use a Qualified Intermediary or Accommodator. This has taken much of the uncertainty out of the exchanging process.

Principles which the Investor will need to keep in mind throughout the transaction.

1. **You are essentially assigning your interest in the transaction (not the property itself) directly to the Accommodator for tax purposes.** This is vital to validate the exchange requirement legally.
2. **You, as an Exchangor, will be able to review and approve all documentation.** Accommodators will insist that language be added to all escrow documentation that shows that the Exchangor has reviewed and approved all documents. This is a protection to both you and the Accommodator. In every case, you will remain essentially in command of the transaction, but your rights to receive cash will be restricted

How do you "Identify" a property?

Under the law, you **MUST** formally identify any property or properties which you might choose to be replacement properties. Notification must be made within the Identification Period which is the first 45 days after your first closing. A description of these properties must be: written, as specific as possible and must be signed by the Taxpayer. Any ambiguities may cause the exchange to fail from a tax standpoint. Your Accommodator may provide the format for this notification.

There are IRS regulations about the number and value of replacement properties that are too voluminous to deal with here. The Accommodator will be familiar with these rules and will advise you directly. The easily remembered rule is that you may identify up to three properties, regardless of value.

What is Constructive Receipt?

Constructive Receipt is a tax concept that means that you have control of, have access to, can borrow against or pledge the closing funds. It is important that you never have constructive receipt, or the exchange will fail. Even if a title company issues a check in your name which you do not pick up or negotiate, the IRS has ruled that you may have constructive receipt.

What is direct deeding and why is it important?

Even though a contract has been assigned to the Intermediary, regulations allow that the Exchangor may directly deed the property to the Buyer, as opposed to having a deed go from the Exchangor to the Intermediary, then on to the Buyer. Intermediaries are simply acting on behalf of Exchangors and are facilitating a transaction. It is not their intention to become owners of these properties. Environmental liability also plays into this concern. Exchange Agreements should have a provision dealing with this matter.

Overview

The first and foremost point is to be aware of the significant benefits of exchanging property and to ask questions and explore these possibilities. The second point is to know where to get answers to your questions about this area of the law so you can intelligently plan and control the process. There are significant tax savings to be realized by properly conducting your transaction in a 1031 Exchange.

Above all, do not be intimidated by the process. It is not as complex as it may seem at first. Good professional help will take you through the steps necessary to preserve your tax savings.

Overview of the Exchange Process: A sample of our Executive Summary

This is a short version of what actually happens in the exchange process and may be helpful to you in understanding how an exchange works.

The Exchange Agreement states specifically what each of our responsibilities are, and more important, to establish the correct, specific parameters necessary to support the transaction for tax purposes. That task requires "legalese." To be more communicative, this summary is given to assist you in understanding the full text of the Exchange Agreement and to outline simply the major aspects of your exchange. A signed copy of these should be returned to BP & A Holdings, Inc.

BEFORE YOUR EXCHANGE STARTS

~ If you are not completely sure that there is enough tax deferral to make the fees and all our combined efforts productive, please call so we can simply and quickly analyze this.

~ For planning purposes consider the following rules for when gain is reportable:

- 1) When you end up with any cash in your pocket, or,
- 2) If you get money out of the exchange before you put it in (like released earnest money) or,
- 3) When you buy less than the net sales price of the property(ies) you sold, or,
- 4) When you receive tax deductions, or non-like kind property, or,
- 5) When you violate the rules, including late identification (beyond 45 days) or late purchases (beyond 180 days)

~ If you buy replacement property which is less than the net sales price of your relinquished property, there will be some gain to report.

~ If you finance your replacement property to the extent where you receive any cash, that cash will likely be taxable. Be careful how much you borrow.

~ It is not sufficient to reinvest just your profit or your equity to fully defer taxation.

~ You may request some cash out PRIOR to closing of your relinquished property which will be taxable. After closing, there are only a very few, very narrow circumstances that allow release

other than under these terms. Finding that a replacement property is too expensive or not feasible is not sufficient to allow early release of exchange funds to you.

~ If you carry back a promissory note on the sale of your property, it is important to assess the viability of the exchange as acceptance of these notes could materially affect the exchange benefits.

~ You can cancel and withdraw at any time up to your first close of escrow and only under certain circumstances thereafter.

AFTER YOUR SALE IS CLOSED

~ We must have from you a signed, written identification of potential replacement properties in the file within 45 days of the first closing. We do not have to purchase everything identified, but we can not use any property as a valid replacement unless it was identified in a timely fashion.

~ Locate your replacement properties. Call BP & A when you have any possibilities in mind and before you submit any offers. In this way we can help preserve your confidential tax information and negotiating position and continue to comply with the law.

~ Please inform us whenever you open a new escrow. **Please do not rely strictly on your escrow company or Realtor® to make this connection.** If you call us, we will be responsible to track down the required information.

HANDLING YOUR REPLACEMENT PROPERTY

~ Let us know if you are considering taking title to any replacement in any name other than how the relinquished property was held.

~ You may not purchase an interest in a partnership, corporation or multiple-member LLC as your replacement property.

~ We will NOT release your funds under any circumstances, unless you specifically tell us to do so. Even though an escrow officer may request funds, we understand that there are circumstances where you do not wish transfer. Therefore, you are responsible to authorize all releases of your funds. This may be done by telephone.

~ It is our counsel that you do not initially disclose the presence of your exchange when you are only in the first stages of acquisition of replacement property. It may be fully disclosed at a later date without jeopardizing your negotiating position. Your exchange will not affect the Seller.

~ You may not, in most circumstances, purchase replacement property from a relative. You may generally not construct replacement property on land you already own. Improvements made to the property after you purchase it will not be tax deferred.

~ You may use your exchange proceeds to deposit earnest money on a replacement property, but there are some simple, but important steps we must take to protect your tax deferral. We can not send earnest money unless your escrow officer has responded to us in writing.

WHAT HAPPENS TO THE CASH

~ There are restrictions in place in the law that limits your ability to receive the funds in the exchange trust. These funds may come back to you ONLY:

1. If you do not identify any replacement property by the 45th day after close, or,
2. If you have purchased EACH and EVERY property you identified, or,
3. On day 181 after close, at which time all remaining funds may be returned.

We must respectfully decline any request for return of funds until one of these three events occurs.

FEES

~ Our fees will generally be withheld by the settlement agents and do not need to be paid directly by you. If that is not possible, we will transfer fees from your exchange trust funds and account for them to you.

~ Interest earned by BP & A at whatever the current rates may be, will directly reduce the fees and will be refunded to you dollar for dollar at the conclusion of the transaction. If sufficient interest is earned beyond the fees stated above, then that interest income will accrue directly to you as well.

~ At the date we receive any exchange funds on your behalf, we will invest them as soon as possible in an appropriately conservative money market fund, or at an FDIC-insured institution, at the best return rate BP & A can offer. This rate will fluctuate. These types of investments, as with all similar type products are considered very safe, but are not insured by FDIC as with passbook type accounts.

~ Please call is you are wanting to construct improvements or if you must take title to a replacement property before your property sells.

~ You will not be charged for Fed-Ex fees, postage, long-distance phone calls and the like, regardless of who requested them.

AFTER YOUR EXCHANGE IS COMPLETE

~ We are available to you and your tax advisors for consultation at any time. Our experience and expertise are an important part of the service we provide, but this can not replace the ultimate responsibility for the tax consequences with you and your tax advisors. **We are not acting as your Tax Advisor in any fashion.** As is always the case, if you have any question about any aspect of this exchange transaction, do not hesitate to contact us or your independent counsel.

~ If your Exchange first started after the first of October but before January 1st and is ongoing at April 15 of the following year, it is very important that your tax return be extended. This is very simple, but is vital to protect your tax deferral.

~ We will properly instruct any title or escrow companies, attorneys, or any other individual or entity that you retain to assist with your transactions, but we are not responsible for their failure to comply with those instructions or any other omissions on their part.

OTHER INFORMATION IN GENERAL

Our office will be closed on those days that the banks are closed.

You have a **Service Guarantee** which puts control into your hands. If you find any part of service inadequate, you have the option of a full or partial refund at your discretion.

Clients of **BP & A** are insured under a **Fidelity Bond** underwritten by Continental Casualty Company against losses resulting from dishonest acts, such as embezzlement, conversion, fraud, theft, etc. of the employees, partners and owners of **BP & A**.

You have **unlimited access to our firm's consulting** on your exchange, both before and after completion. This allows you or your tax preparer to **call and spend as much time as necessary** to assure proper reporting and accounting. We are most valuable to you when these inquiries are made.

We will be available to answer your questions and we welcome them. This transaction can be complex, but there is nothing within it that we can not explain simply, without the legal jargon. **Our services will be more valuable to you if you ask questions along the way and you are welcomed to do just that.**

Thank you for your choice of firms. We will show that to be a good business decision.

Respectfully Submitted,

BP & A Holdings, Inc.