§ 1031 Like-Kind Exchanges

A Refresher Course

Carol Hayden, Presenter

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Investors Title Exchange Corp. - 1031 Exchange Checklist for Attorneys

Issues to Discuss with Client:

____ **Are the properties eligible?** (Both relinquished and replacement properties must be *held* for *investment* or *business* use. How long has property or will property be held? Does the use of the property qualify?)

____ **Like-Kind Requirements** (Is any personal property included with the real estate?)

____ **Constructive Receipt Issues** – By or before closing the first closing, the client must enter into an exchange agreement with the Qualified Intermediary that restricts his access to the exchange funds. Otherwise, he will be in constructive receipt of the funds and his exchange will fail. The Q.I. may only use the exchange funds for the purchase of identified replacement properties. Make sure the client understands that he may not pledge, borrow or receive the funds being held by the Q.I. until:

a) after the 45-day identification period, if he does not identify replacement property; or
b) after his receipt of all the property he identified in the exchange; or
c) at the end of the 180-day exchange period.

____ **Deadlines:**

a) 45-day identification period
b) 180-day acquisition period or the due date for filing the tax return for the year the Relinquished Property sold, whichever is earlier.

____ **Identification Rules:**

a) 3-property rule (May identify up to three properties without considering fair market values);
b) 200% rule (If more than 3 replacement properties are identified, their combined fair market value cannot exceed 200% of the relinquished property value);
c) I.D. must be signed by the taxpayer and sent to Qualified Intermediary within the 45-day deadline;
d) Special identification rules for property to be produced;

____ **Considerations for full tax deferral:**

a) Trade up or equal in Fair Market Value;
b) Trade up or equal in equity;
c) No cash boot or other property to taxpayer at either closing;
d) Some closing expenses may be taxable if paid out of exchange proceeds (Prepaid rents, security deposits, property taxes, loan acquisition costs, etc.)

____ **Problem Spotting – check for the following potential problems:**

a) If the property is owned by more than one owner, are the owners deemed a partnership?
b) If the property is owned by a partnership, do only some of the partners want to exchange?
c) Is the client planning to exchange with a related party?
d) Does the taxpayer intend to provide seller financing on the relinquished property?
e) Does the taxpayer intend to hold title the same way on all properties?
f) Does the taxpayer intend to build replacement property?
g) Does the taxpayer intend to acquire replacement property before conveying relinquished property?

Logistics/Paper Trail:

____ **Purchase & Sales Contracts –** should include exchange language.

____ **Relinquished Property Closing:** Qualified Intermediary must be employed and exchange documents must be executed by or before the first closing:

a) Fax a copy of the contract(s) for the relinquished property to ITEC at (800) 653-9811;
b) ITEC will produce exchange documents and return them to you to be signed at or before closing;
c) Return signed exchange documents, a copy of the settlement statement & exchange funds to ITEC.

____ **Settlement Statements:** should show "Investors Title Exchange Corporation, Qualified Intermediary for *John Doe*" as Seller (Relinquished Property) or Buyer (Replacement Property); or use ITEC's Addendum to the Closing Statement (Relinquished Property) or Footnote (Replacement Property) and show the funds sent to ITEC or received from ITEC as line-items. The attorney should review all settlement statements for non-exchange expenses that may be taxable if paid from exchange funds.

____ **Replacement Property Closing:** Order funds and documents from Qualified Intermediary:

a) Fax a copy of the replacement property contract to ITEC at (800) 653-9811;
b) ITEC will prepare a replacement property assignment and return it to be signed at the closing;
c) Fax a written request for the exchange funds, wiring instructions (if applicable) and a copy of the settlement statement to ITEC at (800) 653-9811;
d) ITEC will wire the exchange funds or overnight a cashier's check for closing.

____ **Tax Filing:** The client's tax return for the year the first relinquished property sold should include:

a) IRS Form 4797, "Sales of Business Property" (for depreciable property) or IRS Schedule D "Capital Gains and Losses" (for non-depreciable property); <u>and</u>
b) IRS Form 8824, "Like-Kind Exchanges".
c) The attorney will file the usual Form 1099-S, reporting the sale price as "gross proceeds", but indicating on the form that the taxpayer may receive like-kind property as part of the consideration for the transaction.

I. Eligible Property

A. I.R.C. § 1031

§ 1031(a) Non-recognition of Gain or Loss From Exchanges Solely in Kind.

(1) In general. – 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.

(2) Exception. – This subsection shall not apply to any exchange of –

(A) stock in trade or other property held primarily for sale,
(B) stocks, bonds, or notes
(C) other securities or evidences of indebtedness or interest,
(D) interests in a partnership,
(E) certificates of trust or beneficial interests, or
(F) choses in action

B. Vacation homes, second residences, or rental houses – a safe harbor was created in Revenue Procedure 2008-16, which allows treatment of these properties as investment properties, if:

For Relinquished Property:

- The taxpayer owned the relinquished property for at least 24 months immediately before the exchange;
- In each of the 12-month periods prior to the exchange, the taxpayer rents the relinquished property at fair rental value for 14 days or more;
- In each of the 12-month periods prior to the exchange, the taxpayer's person use is limited to no greater than 14 days or 10% of the rental period;

For Replacement Property:

- The taxpayer continues to own the replacement property for at least 24 months immediately before the exchange;
- In each of the 12-month periods after the exchange, the taxpayer rents the relinquished property at fair rental value for 14 days or more;
- In each of the 12-month periods after the exchange, the taxpayer's person use is limited to no greater than 14 days or 10% of the rental period;

Caveats: The taxpayer is deemed to have used the dwelling for personal use if:

- It is used by a co-owner, unless the co-tenant has entered into a "shared equity financing agreement." (I.R.C. §280A(d)(3)) ;
- It is used by a family member or a co-owner's family member (related parties as defined in §267(c)(4), subject to exception in §280A(d)(3), if related party pays fair market rent as their principal residence);
- It is used by anyone in exchange for the use by the owner of some other dwelling;
- It is used by anyone for less than fair market rent.

C. Exclusion for stock in trade or other property held primarily for sale

This includes inventory or "dealer" property. There is no bright line defining whether property is held for investment or for sale, but case law has been determined by weighing certain factors such as:

- The purpose for which the property was acquired
- The use of the property while it was held
- The length of time it was held
- The extent of improvements made to the property
- The ordinary business of the taxpayer
- The extent of advertising for the sale of the property, including listings
- The way the property was listed on taxpayer's books

Examples of ineligible property

- Property acquired by a developer, who subdivides it into lots, grades the lots, puts in roads, and begins selling lots
- A lot acquired by a builder, who improves the property, and sells it to a purchaser
- An "investor" who acquires a "fixer-upper", with the intent to sell it after repairs or remodeling. (But, perhaps, the Revenue Procedure 2008-16 safe-harbor might apply.)

D. Holding Periods?

Other than the Rev. Proc. 2008-16 safe harbor, and the related party rules, no specific holding period applies. Questions to ponder:

- Does the qualified use of a decedent transfer to their heirs?
- What if the taxpayer acquires replacement property with the intent to immediately exchange it for other property? (Rev. Ruling 77-297)
- What if the taxpayer wants to change a tenant in common interest into a partnership or LLC interest?

II. Like-kind Requirement

A. Real Property – broad like-kind requirement

As long as each property is considered eligible real property, held either for investment or for productive use in a business or trade, any property is like-kind to other property, if both properties are defined as real property under State law. Thus one "kind" of real property can be exchanged for another "kind" of real property. Eligible properties can be mixed and matched, such as:

- Office building
- Vacant land
- Farm land
- Apartment building
- Rental dwelling
- Easement
- Conservation Easement
- Tenancy in Common interest
- Fee Interest
- Leasehold Interest with 30 years or more to run (Reg. §1.1031(a)-1(c). See recent case VIP's Industries Inc. et cl. V. Commissioner; T.C. Memo. 2013-157; No. 18584-11.

B. Personal Property – narrower like-kind definition

Depreciable tangible personal property held for productive use in a business or trade or for investment is like-kind to either:

- Like-kind property – vague definition, decided on case by case basis, determined by the difference in "nature and character", but not merely "grade or quality."
  Example: A sedan is like-kind to an SUV, but a sedan is not like-kind to a truck.
- Like-class property – See Reg. §1.1031(a)-2
  - Within the same "General Asset Class", as described in Rev. Proc. 87-56; See also Reg. §1.1031(b)-2; or
  - Within the same "Product Class", described in a six-digit product class of the North American Industry Classification System (NAICS). See Reg. §1.1031(b)-3.

Intangible Personal Property must be like-kind to other intangible personal property. Reg. § 1.1031(c).

Examples:

A copyright for a novel can be exchanged for a copyright on another novel.

C. Mixed-use Properties

Each asset must be individually matched up in exchange for other like-kind property.
Example: The sale of a hotel my include real property and various classes of personal property, such as furniture, kitchen equipment, generators, goodwill, etc.

D. Property Considered Not Like-Kind by Statute or Regulation:

- Real property located outside the U.S. is not like-kind to real property located in the U.S. - I.R.C. §1031(h)(1).
- Personal property used primarily outside the U.S. is not like-kind to personal property used primarily in the U.S. - I.R.C. § 1031(h)(2).
- Caveats – U.S. Virgin Islands, property may qualify if the taxpayer is a citizen or resident of the U.S. and has income derived from V.I. (Ltr. Ruls. 9038030 & 200040017.) U.S. Taxpayer may be able to exchange into property in Guam & Northern Mariana Islands – Reg. §1.935-1(c)(1)(ii)(E).
- Relinquished property is not like-kind to Replacement property that was not identified within 45 days of the transfer of relinquished property – I.R.C. § 1031(a)(3).
- Relinquished Property is not like-kind to Replacement property that was not acquired by the earlier of 180 days after the transfer of the relinquished property or the due date for the tax return (with extensions) for the year the relinquished property sold.– I.R.C. § 1031(a)(3).
- My favorite – male livestock is not like-kind to female livestock! – I.R.C. § 1031(e).
- A copyright on a novel is not like-kind to a copyright on a song. – Reg. § 1.1031(c)(3).
- Goodwill or going concern value of a business is not like-kind to goodwill or going concern value of another business. – Reg. §1.1031(c)(2).

III. Constructive Receipt Issues

A. The Qualified Intermediary Safe Harbor – Reg. §1.1031(k)-1

The QI safe harbor was created by regulation in 1991, to facilitate a sale followed by a purchase as an "exchange", qualifying under Section 1031.

- A QI is not considered the Agent of the taxpayer, as long as they are not a "disqualified person" Reg. § 1.1031(k)-1(k). Disqualified persons include:
  - Related parties
  - Any person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, real estate agent or broker, within the last 2 years.
- The following parties are eligible. Reg. § 1.1031(k)-1(k)(2)
  - Financial institution, Title Insurance Company, Escrow Company
- The taxpayer must transfer the relinquished property to the QI, under an agreement which obligates the QI to transfer the replacement property to the taxpayer. This is accomplished in an exchange agreement.
- The contract for the sale must be assigned to the QI, and notice of the assignment given to the purchaser. Direct deeding is allowed. Therefore, albeit the paper "transfer" of the property from the taxpayer to the QI, the deed may go directly from taxpayer to purchaser.
- The sales proceeds may not go the taxpayer, and must go either to the QI or into a Qualified Escrow or Trust, as defined in the Regs.
- The Exchange Agreement with the Qualified Intermediary must limit the taxpayers legal rights to receive the sales proceeds, under Reg. §1/1031(k)-1(g)(6) ("the (g)(6) limitations"), until the later of:
  - After the 45-day i.d. period has expired, if the taxpayer does not identify any replacement property;
  - After the taxpayer's receipt of all the property identified in the Exchange; or
  - After the end of the 180-day exchange period.

- These (g)(6) limitations are critical. If, during the exchange, the Taxpayer has the right to ask the Qualified Intermediary for the exchange funds, the IRS considers the Taxpayer to be in constructive receipt of the money. Constructive receipt is treated the same as actual receipt, and the exchange will fail. Therefore, it is critical for the Taxpayer to only be entitled to receive funds (i) after the 45 day identification period if no property is identified; (ii) after receipt of all identified property; or (iii) after the 180 day exchange period if property was identified but for some reason cannot be closed.
- The contract to purchase the replacement property must be assigned to the QI, notice of the assignment given to the seller, and the QI uses the exchange proceeds to purchase the replacement property. Again, direct deeding is permissible from the seller to the Taxpayer.

B. Interest Earned on Exchange Funds

- "Growth Factor", as termed in the Regulations, is also subject to the (g)(6) limitations. Reg. § 1.1031(k)-1(g)(5).

C. Actual Receipt of Funds

- If closing occurs, and the property is transferred before the taxpayer has entered into an Exchange Agreement with the QI, and assignment of the contract interest, it is too late to structure an exchange. Even if the funds are still held in the attorney's trust account, the taxpayer is in constructive receipt, because the (g)(6) limitations are not in place, and the taxpayer has the right to request the funds from the attorney.
- Earnest Money on the Relinquished Property sale may be received by the taxpayer or an agent, prior to closing. If the taxpayer keeps the earnest money, it will be considered "boot" in the exchange, but if the earnest money is returned to closing, such that it becomes part of the exchange funds, the taxpayer can avoid treatment of the earnest money as "boot."
- The taxpayer may want to take some cash boot at closing. The (g)(6) limitations only apply to the funds held by the QI. Reg. § 1.1031(k)-1(j)(3), Example 2.

IV. Deadlines

A. Identification Period

Replacement property must be identified within 45-days after the transfer of the Relinquished Property. I.R.C. § 1031(a)(3)(A).

B. Acquisition Period

Replacement property must be acquired by the earlier of:

- 180-days after the sale of the relinquished property; or
- The due-date of the tax return for the year the relinquished property sold, respective of extensions. I.R.C. § 1031(a)(3)(B).

C. Other considerations

- No extensions for holidays or weekends
- Permissible extensions for federally declared disasters, terroristic or military actions, as set forth in I.R.C. § 7508A. Taxpayers are entitled to an extension if the IRS publishes a notice or issues other guidance, which will define the affected taxpayers, and will describe the duration of the extension.

V. Identification Rules

A. Manner of Identifying Replacement Property

- In writing, signed by the taxpayer Reg. §1.1031(k)-1(c)

- Sent, by midnight of the 45th day after transfer of the Relinquished Property to either:
  - The person obligated to transfer the replacement property to the taxpayer (usually the QI); or
  - Any other person involved in the exchange other than the taxpayer or a "disqualified person".
- Within the 45-day period, property identifications can be revoked and new identifications made. But, once the 45-day period has ended, no further changes to the identification can be made.

B. Number of Properties that can be identified – Reg. § 1.1031(k)-1(c)(4)

- Three Property Rule: Up to three properties may be identified, without regard to the fair market value of the properties. The taxpayer may intend to acquire all three, or only one, and has named the additional properties as alternates. If there are multiple relinquished properties in an exchange, the taxpayer cannot use this rule to identify three properties for each relinquished property.
- 200% Rule: If more than 3 properties are identified, the total value of all the identified properties may not exceed 200% of the value of all the relinquished property.
- 95% Rule: If more than 3 properties are identified, and the value of the identified replacement properties exceeds 200% of the value of the replacement property, it is still a valid identification, if the taxpayer actually acquires 95% of the identified properties. Example of when this might be used, sale of a hotel for $1M, and purchase of 20 rental houses, totaling $2.5M, where the taxpayer actually acquires all of the identified replacement property within the 180-day acquisition period, or acquires at least enough of those properties, that total $2.375M.
- If these rules are broken, the replacement property is deemed not identified.
- Questions to ponder – are contiguous parcels considered one property or two properties for these rules?

C. Form of Identification

- Unambiguously identified – Reg. § 1.1031(k)-1(c)(3).
- Legal description
- Street address
- Distinguishable name, such as the name of the shopping center, apartment complex.

D. Special ID rules for property to be produced – Reg. § 1.1031(k)-1(e).

- If improvements will be put on the property between the time it was identified and the time it is to be acquired, those improvements need to be specifically identified.
- Construction materials or services prepaid for do not count, the improvements must be attached at the time of the acquisition, to count as like-kind real property.
- The substantially the same requirement, discussed below, may apply in this context.

E. Substantially the same requirement - Reg. § 1.1031(k)-1(d)(1).

- Substantially the same requirement – The property received must be substantially the same as what was identified. Examples in the regulations of what complies with this requirement, include:
- Taxpayer identified a tract of raw land, before he acquired it, a fence was installed on the property;
- Taxpayer identified two acres, but only acquired a 1.5 acre portion of the identified tract.

F. 15% Diminimus Rule – Reg. 1.1031(k)-1(c)(5)

- For purposes of identification, only, if incidental property is to be transferred with a larger whole, it is deemed identified, if its value is not more than 15% of the whole.

- Example – Taxpayer sells an apartment building, consisting of both real and personal property. The Taxpayer identifies a new apartment building as replacement property. The new apartment building also consists of both real and personal property. The personal property includes lobby furniture, pool furniture, a billiards table, fitness equipment, and washer-dryers in a Laundromat area. As long as the value of the personal property does not exceed 15% of the total value of the Apartment Complex that was identified, the personal property is deemed identified too. However, the taxpayer must still match up like-kind values of real and personal properties, asset classes, etc., in order for the replacement property to qualify.

VI. Considerations for Full Tax Deferral

A. The "Napkin Test"

The regulations are lengthy, regarding how gain is deferred, the effect of an exchange on the basis of the replacement property, treatment of liabilities paid and liabilities assumed, etc. See Regulations §§ 1.1031(b)-1; 1.1031(d)-1; 1.1031(d)-2; 1.1031(j)-1(as to multiple asset classes). The result of these regulations has been summed up in what has been dubbed "the napkin test", in the industry. In order to fully defer gain from the sale of the relinquished property, the taxpayer must:

- Trade up or equal in value. Example: if the relinquished property sold for $1M, he must buy replacement property worth at least $1M, to fully defer gain recognition.
- Trade up or equal in equity. Example: if the relinquished property sold for $1M, but was encumbered by a deed of trust with an outstanding balance of $600k, the taxpayer must buy replacement property worth at least $1M, and use the $400K equity from the relinquished sale (that the QI is holding) as *equity*, in the replacement property, and may borrow the balance. In other words, if the taxpayer does not use all the equity from the relinquished property as equity in the replacement property, he will end up getting money back from the QI, which will be taxed as boot in the transaction. Caveat: If, for example, the loan on the replacement property is too high, such that the taxpayer ends up getting cash back at closing, this will be taxed as "boot". Be careful to comply with the (g)(6) limitations on receipt of the boot, so the entire exchange isn't ruined!
- The taxpayer's basis in the replacement property equals the fair market value of the replacement property, less the amount of the gain deferred by the taxpayer from the exchange.

B. Examples:

- Example 1:

	Relinquished Property	Replacement Property
FMV	$100,000.00	$150,000.00
DEBT	$25,000.00	$75,000.00
EQUITY	$75,000.00	$75,000.00
BASIS	$50,000.00	$_________

TAXABLE GAIN $_______________

- Example 2:

	Relinquished Property	Replacement Property
FMV	$220,000.00	$250,000.00
DEBT	$ 80,000.00	$150,000.00
EQUITY	$140,000.00	$100,000.00
BASIS	$100,000.00	$__________

TAXABLE GAIN $_______________

C. No cash boot or other property received by the taxpayer at either closing.

Unless, as previously discussed, the taxpayer intends to recognize a portion of the gain. Some closing costs may be taxable as gain, if paid out of the exchange proceeds:

- Prepaid rent credit to the buyer, on sale of relinquished property.
- Prepaid security credit to the buyer, on sale of relinquished property.
- Pro-rated property taxes
- Loan acquisition costs
- Payment for non-like-kind property out of exchange proceeds (personal property, etc.)
- State or FRPTA withholding, on sale of relinquished property

VII. PROBLEM SPOTTING

A. Multiple owners of relinquished or replacement property

Ascertain whether or not the multiple owners own in a valid tenants in common arrangement, or if they would be deemed a partnership, by virtue of operating a business together. I.R.C. § 1031(a)(2)(D) prohibits the exchange of a partnership interest.

- A tenant in common can exchange its T.I.C. interest.
  - Example, raw land that was purchased as investment property is owned as T.I.C. by 3 siblings. Can only one sibling structure an exchange? Yes, the one T.I.C. can exchange his or her 1/3 undivided interest for like-kind property.
  - Example, a rental house that was purchased as investment rental property is owned as T.I.C. by 3 siblings. Can only one sibling structure an exchange? Yes. Revenue Ruling 75-374 concludes that the mere co-ownership of rental property does not constitute a deemed partnership. But, beware, if other business services are provided, such as a fitness center, laundromat, etc.
- Tenants in Common can comply with the guidance set forth in Rev. Proc. 2002-22, such that there passive ownership is considered a tenant in common interest, and not deemed a partnership. Requirements include:
  - Each co-owner must hold the property either directly or in their own disregarded entity;
  - Number of co-owners is limited to 35. Husband and wife may be treated as one co-owner;
  - The co-owners may not operate under a common name, or file a partnership return;
  - The co-owners may enter into a tenants-in-common agreement;
  - The co-owners must unanimously agree to certain decisions, such as hiring of a property manager, the sale of all or a portion of the property, leases, blanket mortgages, etc.;
  - No restrictions on alienation against co-owners;
  - Proportionate sharing of profits and losses. (No special allocations, such as you might have in a partnership.);
  - Proportionate sharing of debt;
  - Options for co-owners must be at FMV;
  - No shared business activity – must be passive ownership.

B. Partnership ownership

- A partnership, as an entity, can exchange under Section 1031
- Do only some of the partners want to exchange, and others want to cash out? Some techniques that have been used include:

    - Drop and Swap – Distribute partnership property to partners as tenants in common, which is tax-free under Section 731. Then the tenants in common can do exchanges. Caveat – the tenants in common must establish their own "held for investment or productive use in a business or trade" requirement. Holding period?
    - Swap and Drop – Each partner can designate their own replacement property. The partnership does the exchange, and sometime later, the partnership distributes the separate properties to the separate partners. Caveat – same holding period issues. Does identifying the separate properties establish intent of the partnership to transfer the property to the partners, rather than to hold it for a qualified use?
    - Swap and Functional Division – Similar to above, but with special allocations to each partner, pertinent to the properties they have each identified.
    - Partnership Division – The partnership divides into two separate partnerships – one composed of at least two partners who want to cash out, and the other composed of at least two partners who want to exchange. This can, possibly, occur before, during or after the exchange.

C. Related Party issues

- I.R.C. §1031(f) requires a two year holding period for related parties who exchange property with each other. The stated legislative purpose of this subsection is to prevent abusive basis shifting that results in a cash out of investment with less taxable consequences by structuring an exchange of real estate between related parties.
- Section 1031(f)(4) contains a catch-all provision that denies §1031 nonrecognition "to any exchange which is part of a transaction or series of transactions structured to avoid" the related party rule.
- Revenue Ruling 2002-83 applies the catchall provision by holding that: "… a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under § 1031(a) of the Internal Revenue Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property."
- Private Letter Ruling 200440002 was issued in October, 2004 which held that as long as the related party from whom the taxpayer acquired replacement property was also doing an exchange, and received its own replacement property instead of cash or non-like-kind property, and each held onto the property they acquired in the exchange for 2 years pursuant to §1031(f)(1), they would both be entitled to nonrecognition of gain.
- Private Letter Ruling 200616005 – Taxpayer intends to structure an exchange with a qualified intermediary, in which the relinquished property is sold to an unrelated party. The taxpayer will acquire one replacement property from a related party who is also doing an exchange to acquire its own replacement property. Both related parties intend to retain their respective replacement properties for 2 years after the exchange. Since the taxpayer's relinquished property is more valuable than the related party's property, taxpayer intends to identify additional replacement property from an unrelated party with the remaining funds. Taxpayer asked what the consequences would be if he is unable to acquire the additional replacement property. IRS ruled that the taxpayer would only be subject to recognition of gain as to the taxable boot he received.
- It is not a problem to sell the relinquished property to a related party, and acquire replacement property from an unrelated party. No basis shifting.
- Related parties are defined in § 1031(f)(3).
    - Siblings, parents, grandparents, children, grandchildren, spouses
    - Not cousins, aunts, uncles, in-laws
    - Attribution rules apply, as defined in the code, for entities.

D. Seller Financing of the Relinquished property

An installment sale under I.R.C. § 453 is an alternative to § 1031, for deferring gain recognition over the life of the Note received by the seller. A taxpayer may wish to elect out of installment sale treatment, and do a 1031 exchange, instead. Or, a taxpayer may wish to combine a 1031 exchange and installment sale.

- Regs. § 1.1031((k)-1(j)(2) and § 15a.453-1(b)(3) address a combined exchange and installment sale. However, all basis is first allocated to the like-kind property under these rules, and only remaining gain can be deferred under the Note.
- Receipt of the note, directly, by the taxpayer constitutes receipt of cash boot.
- Most common method of structuring, involves:
    - Note payable from purchaser to QI
    - QI receives the note and interest payments during the exchange
    - The taxpayer may use the note to purchase the replacement property (if a seller is willing to assume the QI's interest in the Note as partial payment for the replacement property, in which case the Note is assigned from the QI to the seller.); or
    - The taxpayer purchases the Note from the QI at the closing of the Replacement property for cash, providing the cash equity, represented by the note, for purchase of the equity portion of the replacement property.

E. The "Same Taxpayer" Requirement

In general, the same taxpayer that owned the relinquished property must acquire the replacement property, as the tax deferral is per taxpayer. Considerations include:

- Husband and wife ownership as TBE is considered TIC ownership for tax purposes. See Technical Advice Memorandum 9429004. If H&W owned relinquished property, H&W should acquire replacement property. If only one spouse owned relinquished property, they would have to replace the value of their property in their own name, not as TBE.
- Disregarded entities. A taxpayer may sell the relinquished property held in his own name, and acquire the replacement property in a disregarded entity, and vice versa. Disregarded entities include:
    - A Single-Member LLC (See the following Ltr. Rulings: 9751012, 9807013, 200732012, 200807005, 20118023, 201216007, among other rulings.)
    - A Husband-Wife LLC, in community property states. (Rev. Proc. 2002-69)
    - Grantor or Revocable Trusts. (Rev. Ruling 2004-86)
- The estate of a taxpayer who dies during the exchange (but not the heirs) can complete the exchange. Ltr. Rul. 9829025
- Successor entities in certain nontaxable mergers may complete the exchange. Ltr. Rul. 975012.

F. Building Replacement Property

Construction services are not like-kind to real property. The taxpayer who relinquishes real property in an exchange must acquire real property for his replacement property. Therefore, a taxpayer who wishes to have the value of improvements qualify as like-kind property cannot acquire the land on which the improvements are to be placed until after the completion of enough improvements so that the land and improvements received equal the value of the property sold. If the taxpayer fulfills the requirements of a 1031 exchange by acquiring land within the exchange period and then constructs improvements on that property, the purchase of the real property will qualify as replacement property, but the value of the improvements will not qualify as like-kind property.

Several alternatives have been used to solve the problem of land ownership during the construction phase of an exchange. The simplest scenario is when the taxpayer enters into a contract with a seller/developer to buy the land and improvements that the developer is currently constructing. The taxpayer will identify the land and improvements, and then buy the completed real property from the seller within 180 days of closing on his relinquished property sale. When the taxpayer, however, desires to purchase land and improvements not part of a developer's inventory, the question of who will take title to the land during the construction becomes an issue. Typically, an Exchange Accommodation Titleholder (EAT) is used, pursuant to the reverse exchange safe harbor rules, set forth in Rev. Proc. 2000-37

- The improvements must be specifically identified, as previously discussed;
- The improved property must be acquired within 180-days of the sale of the relinquished property
- Once the taxpayer takes title to the property, only the improvements that are complete will count towards the like-kind value of the replacement property, as real estate. Beware of the "substantially the same property as identified" requirement.
- If QI funds are to be used as progress payments towards the construction, the contract between the Builder, who typically owns the property, or the EAT and the taxpayer must be assigned to the QI, such that the QI is obligated to use the exchange funds to pay for the improvements, under the purchase contract. This prevents constructive receipt, under the (g)(6) limitations.
- The taxpayer cannot build on land he already owns, because construction services are not like-kind to real property.
- If more than 180-days are required to build sufficient improvements, these transactions are usually structured as reverse construction exchanges.

G. Reverse Exchanges

Reverse exchanges are accomplished with an Exchange Accommodation Titleholder (EAT) parking either the relinquished or replacement property. Revenue Procedure 2000-37, effective September 15, 2000, provides the reverse exchange safe harbor. Important provisions include:

- The Service recognizes that parking transactions have been taking place, with an accommodator parking either the relinquished property or replacement property to facilitate a "reverse" exchange. Prior to this safe harbor, taxpayers attempted to make certain that the accommodator was a true owner of the property for federal income tax purposes, i.e., has economic burdens and benefits of ownership, based on all the facts and circumstances.
- In the interest of public policy, the Service created a safe harbor to facilitate the reverse exchange of property, where the taxpayer has a bona fide intent to treat the parked property as exchange property and can complete the exchange in a short time frame.
- Strong non-inference language - reverse exchange parking transactions may still work outside of the safe harbor. This is done if the parked property needs to be held for more than 180-days.
- Provides a mechanism where the Exchange Accommodation Titleholder (EAT) is treated as the beneficial owner for tax purposes when it "parks" either the relinquished or replacement property in a reverse exchange. The Exchange Accommodation Titleholder (EAT):
  - Must have "qualified indicia of ownership"
  - May not be a "disqualified person"
  - May also serve as qualified intermediary in the exchange
  - Must enter into a written agreement with taxpayer called a Qualified Exchange Accommodation Agreement (QEAA)
  - Must be a party subject to federal income tax
  - Must report its acquisition and disposition of the parked property on its tax return
- The Safe-harbor outlines requirements of a Qualified Exchange Accommodation Arrangement, including a list of permitted agreements and arrangements that will not destroy the reverse exchange.
  - Written agreement between EAT and taxpayer must be in place within 5 days after EAT's acquisition.
  - Must state taxpayer's bone fide intent that the property EAT acquires be either relinquished or replacement property in a like-kind exchange.
  - If EAT parks replacement property, Taxpayer must identify relinquished property within 45-days. Same ID rules apply as in deferred exchanges.
  - EAT may not park property for more than 180 days.
  - EAT may take title in a special purpose entity. (LLC)

    - Taxpayer may loan EAT the funds for its purchase, or guarantee a third-party loan. The loan to EAT may be non-recourse.
    - EAT may ground lease the property to the taxpayer during its ownership, and taxpayer may thus derive income from the property, manage the property, supervise improvements.
    - Puts or calls for conveyance of the property to taxpayer are permissible if they do not exceed 185 days.
- Typical steps in a reverse exchange: Warehousing of the Replacement Property
    - The Taxpayer enters into a written Qualified Exchange Accommodation Agreement in which the Accommodation Titleholder agrees to hold title to the replacement property for the taxpayer until an ultimate purchaser is found for the relinquished property.
    - Within 45-days after the acquisition of the replacement property by the Accommodation Titleholder, the Taxpayer must formally identify the relinquished property.
    - The Taxpayer enters into a Deferred Exchange Agreement with a Qualified Intermediary.
    - The Taxpayer, via the Qualified Intermediary, transfers the relinquished property to a third-party buyer.
    - The Taxpayer, via the Qualified Intermediary, acquires the replacement property from the Accommodation Titleholder within 180 days after it was acquired by the Accommodation Titleholder.

Frequently Asked Questions

1. Once I've decided I want to do an exchange, what do I need to do to get started?

Once a taxpayer has decided he might want to do a 1031 Exchange, he should first contact a real estate or tax attorney for counsel. He should then contact Investors Title Exchange Corporation at (800) 724-8791 to initiate the process. ITEC will coordinate with the taxpayer's counsel the production of exchange documents that must be executed by or before the first closing.

2. Can my attorney serve as qualified intermediary?

The tax code prohibits an attorney, CPA, or other agent of the taxpayer to serve as qualified intermediary if he has represented the taxpayer in any matter during the past two years. ITEC is a professional qualified intermediary service that handles hundreds of exchanges every year and is a member of the national Federation of Exchange Accommodators.

3. How much will it cost to do an exchange?

An exchange is a paper-intensive transaction that requires legal and tax advice beyond the scope of a normal closing; so, there are additional fees beyond normal closing costs. ITEC charges a low, flat rate fee for its services as qualified intermediary. Please call us for our current rates. The taxpayer's attorney also charges for his services in coordinating the exchange and rendering legal advice. However, these expenses are considered exchange expenses and can usually be deducted from the sales proceeds. The additional transaction costs should be measured against the potential tax savings.

4. Will I earn interest on the funds that the intermediary is holding?

Yes. Your exchange agreement will specify your interest rate. The interest you earn becomes a part of the exchange funds and is subject to the same rules regarding constructive receipt as the exchange funds themselves, so it is unavailable to the taxpayer until the end of the exchange. Although most taxpayers use the interest to purchase the new property, it is still taxable as interest income.

5. What about the safety of my funds?

ITEC's accounts are independently audited by a reputable accounting firm. ITEC practices sound accounting principles, and all disbursements from your account must be approved by you or your attorney. ITEC is a wholly-owned subsidiary of Investors Title Company, which was cited by *Forbes* magazine in 1998 and 1999 as one of the 200 Best Small Public Companies in America, and by *Fortune* magazine in 2004 as one of the fastest-growing companies in the U.S.

6. Can I purchase the Replacement Property before I sell the Relinquished Property?

In Sept. 2000, the IRS in Revenue Procedure 2000-37 provided a safe harbor for reverse exchanges. Under the provisions of a qualified exchange accommodation agreement that meets the safe harbor requirements, the taxpayer's replacement property is acquired by an Exchange Accommodation Titleholder (EAT) who holds the property until the taxpayer sells the relinquished property. The relinquished property is then exchanged for the replacement property via a Qualified Intermediary. Reverse exchange rules mirror deferred exchange rules, requiring the taxpayer to identify his relinquished property within 45 days of the EAT's acquisition of the replacement property, and close on the sale of the relinquished property within 180 days. Investors Title Accommodation Corporation (ITAC), in conjunction with ITEC, provides reverse exchange services. To avoid the additional complexity and expense of a reverse exchange, taxpayers should first try to delay the purchase of replacement property until after the relinquished property sells. But where this is impossible, a reverse exchange is a valuable tool. Taxpayers should seek experienced counsel for advice in structuring a reverse exchange.

7. Can I purchase a lot and build on it as my Replacement Property?

Called a "build-to-suit" exchange, this can be even more complex than a reverse exchange. The taxpayer cannot take title to the Replacement Property land until after the construction is complete, and the building must be complete within the 180-day exchange period. Issues such as who will hold title to the land during construction, finance the improvements and manage and supervise the construction must be addressed. This is another example of a complicated exchange requiring experienced counsel and generally costs more to structure. ITEC, working closely with the taxpayer's counsel, can assist with facilitating a build-to-suit exchange. Any improvements to be built as replacement property must be specifically identified within the 45-day ID period.

8. Can I do an exchange with a related party?

The tax code permits exchanges with related parties, but more stringent rules apply. In a direct 2-party exchange with a related party, neither party may sell the property they acquired in the exchange for the following two years. In a deferred exchange using a qualified intermediary, the rules are more complex. The IRS has permitted a taxpayer to sell relinquished property to a related party, through a QI, and acquire replacement property from an unrelated party without triggering the two-year holding period. But, IRS Revenue Ruling 2002-83 prohibits the sale of relinquished property to an unrelated party and acquisition of replacement property from a related party, if, as a part of the transaction, the related party receives cash or non-like-kind property. If you are contemplating an exchange that involves a related party, you should seek counsel to ensure that you are complying with the related party rules.

This guide is not intended as a comprehensive analysis of §1031 Exchange requirements and should not be relied on as a substitute for legal advice from your attorneys. Rather, it is a brief summary of the most basic elements of a 1031 Exchange.

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FEDERATION OF EXCHANGE ACCOMMODATORS

Investors Title Exchange Corporation

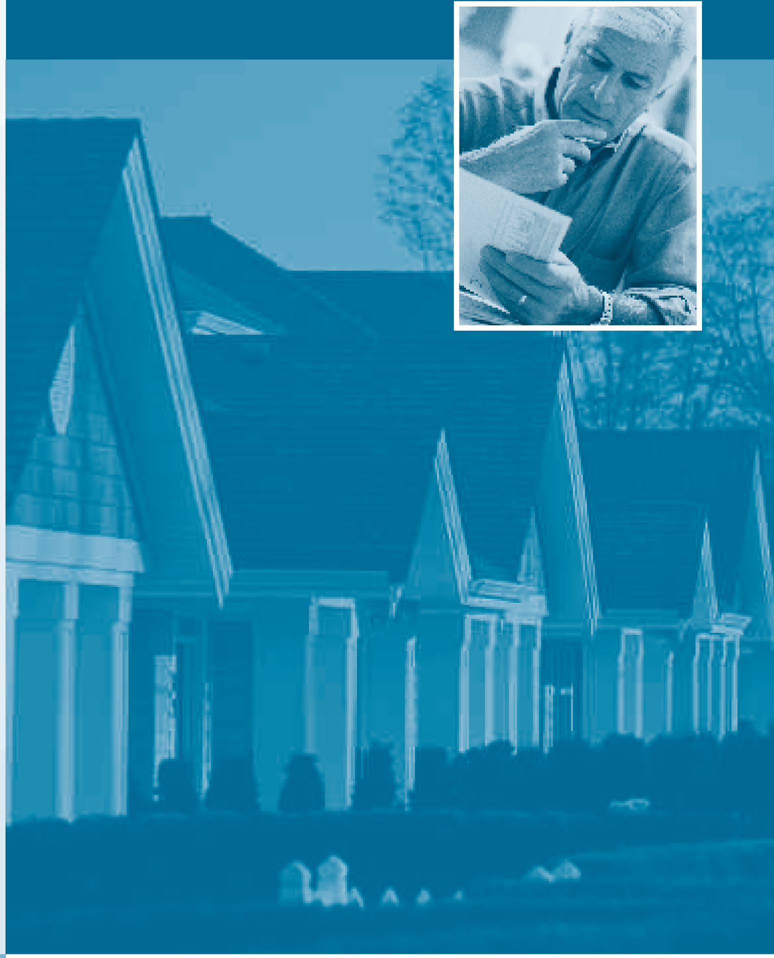
121 North Columbia Street (27514)
P.O. Drawer 2687
Chapel Hill, North Carolina 27515-2687
919/968-2220, 800/724-8791, Fax: 919/968-2225, 800/653-9811
Email: exchanges@invtitle.com
Please visit us at www.1031itec.com

NASDAQ Symbol: ITIC

B-25 (Rev. 5/2011)

Basic Guidelines For A Like-Kind Exchange

Utilizing the Qualified Intermediary Safe Harbor



Investors Title Exchange Corporation

INNOVATIVE BY INSTINCT

Exchange Participants and their Roles

☐ Taxpayer

The taxpayer is the individual or entity who owns investment or business property and who would like to exchange that property for another like-kind investment or business property. By structuring the transaction as a 1031 Exchange rather than a sale of the old property followed by a subsequent purchase of new property, the gain from the sale of the old property (the Relinquished Property) will not be recognized, eliminating the need to pay capital gains taxes on the transaction. Instead, the taxpayer will receive a reduced basis in the property acquired in the exchange (the Replacement Property). If the taxpayer sells the replacement property at some time in the future, the gain will be taxed at that point. (Unless the taxpayer does another exchange!)

☐ Qualified Intermediary (QI)

The most commonly used method of effecting a 1031 Exchange is through the use of the Qualified Intermediary Safe Harbor, as set forth in Section 1031 of the tax code. The qualified intermediary (QI) is the taxpayer's exchange partner, also referred to as facilitator or accommodator. This relationship is governed by an exchange agreement which must be entered into before the closing for the sale of the Relinquished Property. In a deferred exchange, the QI acquires the right to sell the relinquished property, directs that the relinquished property be deeded directly from the taxpayer to the purchaser, holds the proceeds from the sale, receives the taxpayer's identification of replacement property, acquires the right to purchase the replacement property, uses the exchange funds to purchase the replacement property, and directs that the replacement property be deeded directly to the taxpayer. The QI may also be called on to draft standard exchange documents for review by the taxpayer's exchange advisor.

☐ Exchange Advisor

The taxpayer should employ a real estate attorney, a tax attorney, and/or a CPA to advise him as soon as he contemplates doing a 1031 Exchange. The regulations for effecting an exchange are complex and rigid. Failure to seek competent advice in structuring an exchange may result in a failed exchange and immediate recognition of all or part of the taxable gain. The advisor's role may include determining eligibility of properties, analyzing tax benefits, advice on structuring the exchange, reviewing exchange documents, instructing settlement agents, answering legal questions, and coordinating the transaction with the QI regarding the disbursement of funds and the generation and execution of exchange documents.

Definitions, Requirements and Basic Guidelines

☐ Like-Kind Exchange

The exchange of property, as distinguished from a sale and subsequent purchase, allows for a deferral of gain recognition in the transaction. Rather than currently recognizing gain, the purchase basis in the Replacement Property is reduced by the amount of gain deferred, and gain is only recognized upon an ultimate disposition of the property. The rules which govern exchange transactions are found in Section 1031 of the tax code and the corresponding IRS regulations. This transaction is also known as a 1031 Exchange, Tax-deferred Exchange, Tax-free Exchange or Starker Exchange. Although there are several methods of structuring exchanges, the most common method involves the use of a qualified intermediary.

☐ Relinquished Property

The property owned by the taxpayer which will be given up in exchange for new property.

☐ Replacement Property

The property to be received by the taxpayer to replace the Relinquished Property.

☐ Eligible Property

For property to be eligible as either Relinquished Property or Replacement Property in a 1031 Exchange, it must be held by the taxpayer for productive use in a trade or business or for investment purposes. Examples of eligible property include: rental property, raw land held for appreciation, farms, offices, motels/hotels, industrial property, leasehold interests of 30 years or more, etc. Although most exchanges are done with real property, personal property exchanges are also permissible. Common personal property exchanges include airplanes, trucks, and business equipment. Examples of ineligible property include: stock in trade, inventory or other property held primarily for sale; stocks, bonds or notes; an interest in a partnership or a personal residence. Personal use property, such as property previously used (or to be used in the future) as a principal residence or vacation home, may not qualify. See IRS Revenue Procedure 2008-16, which provides a safe harbor for qualifying such property in a 1031 exchange. Please call ITEC at 800-724-8791 to request a copy of this IRS ruling.

☐ Like-Kind Requirement

The Relinquished Property and the Replacement Property must be of a "like-kind." For real property exchanges, the like-kind requirement is quite broad. Any real property is considered like-kind to any other real property. For instance, raw land is like-kind to improved land, a lease of 30 years or more is like-kind to fee simple interest in the property, etc. For personal property exchanges, the like-kind requirement is more narrow. Personal property is like-kind if it falls within the same General Asset Class or the same product Class as defined in the tax code or IRS Treasury Decisions. However, property located outside of the U.S. is not like-kind to property located within the U.S.

☐ Deadlines

The taxpayer has 45 days from the closing of the sale of the Relinquished Property to identify to the qualified intermediary the replacement property he wishes to acquire. The deadline for actually acquiring the replacement property is the earlier of 180 days or the due date for his tax return (including extensions) for the year in which the relinquished property was sold. (For example, if the Relinquished Property is sold on December 30, 2011 and the taxpayer's return for 2011 is due by April 17, 2012, the taxpayer will have until April 17, 2012 to purchase replacement property unless he files for an extension. However, if the same taxpayer sells the relinquished property on January 1, 2012, he will have the full 180 days to acquire Replacement Property.)

☐ Constructive Receipt

The taxpayer may not directly or indirectly receive the proceeds from the sale of the Relinquished Property. "Constructive receipt" of exchange funds occurs when the taxpayer has the unrestricted ability to ask for the funds at any time during the exchange. The most common method used to avoid the constructive receipt of funds in an exchange is the utilization of a qualified intermediary. The taxpayer must enter into a written exchange agreement with the QI before closing on the sale of the Relinquished Property. That agreement, among other provisions, specifies that the proceeds from the sale of the relinquished property will be sent to the QI and are to be used by the QI to acquire the Replacement Property for the taxpayer. The agreement must also limit the taxpayer's right to receive any of the exchange funds until:

a) after the expiration of the 45-day identification period if no Replacement Property has been identified; or

b) after the expiration of the 180-day acquisition period if the taxpayer has identified Replacement Property but has not acquired all of it; or

c) after the taxpayer has acquired all the property which was timely identified.

☐ Identification Rules

In general, the taxpayer may identify up to three Replacement Properties without regard to fair market value of either the Relinquished or Replacement Properties. He may acquire one, two, or all three of those Replacement Properties that were identified in the exchange. If the taxpayer identifies more than three Replacement Properties, the fair market value of all the identified properties cannot exceed 200% of the fair market value of the Relinquished Property. The identification of the Replacement Property must be in writing, signed by the taxpayer, and sent to the QI by midnight of the 45-day deadline.

☐ Calculating Tax Benefits

The rules for determining deferred gain in an exchange are complex, and many factors can affect the amount of gain actually deferred. An attorney or CPA should be consulted to determine the actual tax benefits and how they can be achieved. However, the rules can be briefly summarized by the following principles:

a) The fair market value of the Replacement Property should be equal to or greater than the fair market value of the Relinquished Property.

b) The equity the taxpayer has in the Replacement Property should be equal to or greater than the equity he had in the Relinquished Property.

c) The taxpayer will be taxed on the greater of the trade-down in equity or fair market value.

The taxpayer will also want to ask his advisor about the ramifications of paying certain closing costs, security deposits, or prepaid rents out of the exchange funds. (Examples of closing costs not considered exchange expenses would be payment of loan costs, payment of county real estate taxes or payment of security deposits and prepaid rents.)

☐ Documentation

The exchange should be well-documented from the outset to show the intent of exchanging rather than selling and purchasing. The following language is suggested for inclusion in the contract to sell and purchase the Relinquished and Replacement Properties:

☐ Relinquished Property Contract Language:

The Seller desires to effect a like-kind exchange for the property transferred under this Contract; and the Buyer and Seller agree that, notwithstanding any provision to the contrary, the Seller's rights, title and interests under this Contract may be assigned to Investors Title Exchange Corporation as Qualified Intermediary.

☐ Replacement Property Contract Language:

The Buyer desires to effect a like-kind exchange involving the real property to be transferred to Buyer pursuant to this Contract; and the Buyer and Seller agree that, notwithstanding any provision to the contrary, Buyer's rights, title and interests under this Contract may be assigned to Investors Title Exchange Corporation as Qualified Intermediary.

Your attorney or QI will draft other documents before the sale of the Relinquished Property and before the purchase of the Replacement Property which are also required to effect an exchange.

☐ Tax Filing Requirements

Your attorney or CPA can determine exactly which forms should be filed with the IRS to comply with IRS reporting requirements to benefit from the exchange. These will most likely include Form 8824 and either Form 1040 – Schedule D or Form 4797. You may want to seek assistance from an attorney or CPA in calculating the tax savings to be realized, including the amount of gain deferred and the basis attributable to the Replacement Property.

Like-Kind Exchange Procedures and Information

Investors Title Exchange Corporation ("ITEC") provides Qualified Intermediary services for property owners who wish to effect a §1031 Exchange. ITEC, in its role as qualified intermediary, coordinates the exchange aspects of the transaction with your closing agents. Our duties include drafting standard exchange documents (including an Exchange Agreement, Relinquished Property Assignment and Replacement Property Assignment), holding the funds between the sale of your old property and the purchase of your new property, and accepting the formal identification of your replacement property within the 45-day identification period. In its role as qualified intermediary, ITEC does not provide tax or legal advice or file your tax returns with IRS. All taxpayers must be represented by counsel.

If you have any questions about our service or you would like to initiate an exchange transaction, please call ITEC at (800) 724-8791. We would also be happy to refer you to an attorney or CPA to answer your legal or tax questions.

IRS Circular 230 Disclaimer:
To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including attachments) is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code.

Steps in the exchange process:

1. Fax ITEC a copy of the Exchange Order Form and contract(s) for the sale at least five days before closing.
2. ITEC will produce standard exchange documents and send them to your attorney for review.
3. The exchange documents must be signed at or before closing, and the net sales proceeds will be sent to ITEC. You will earn interest on the exchange funds as specified in the Exchange Agreement.
4. Identify your replacement property to ITEC within 45 days after closing the sale.
5. Contact us at least 5 days before the closing for the replacement property purchase so we can coordinate delivery of exchange documents and funds to the closing agent. The replacement property closing(s) must occur within 180 days of the first relinquished property closing. We will need a written authorization from you or your attorney in order to release funds to the closing agent.

Suggested contract language for §1031 Exchange sale and purchase contracts can be found in the Basic Guidelines brochure or at our Web site, www.1031itec.com. Please contact us for our current fees.

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Investors Title Exchange Corporation

121 North Columbia Street (27514)
P.O. Drawer 2687
Chapel Hill, North Carolina 27515-2687
919/968-2220, 800/724-8791, Fax: 919/968-2225, 800/653-9811
Email: exchanges@invtitle.com
Please visit us at www.1031itec.com

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B-37 (Rev. 3/2006)

Like-Kind Exchange Order Form

Investors Title Exchange Corporation

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Like-Kind Exchange Order Form

To Investors Title Exchange Corporation

Attention Exchange Coordinator
Telephone: 800/724-8791
Fax: 800/653-9811

From ____________________

Telephone ____________________ Fax____________________

Email ____________________

How did you hear about ITEC? Check all that apply.

☐ Publication: ____________________ ☐ Seminar: ____________________

☐ Realtor: ____________________ ☐ CPA: ____________________

☐ Attorney: ____________________ ☐ Closer: ____________________

☐ Other (Internet/Trade Show/etc.): ____________________

Exchange Information

Exchangor:

Name ____________________

Spouse's Name ____________________

Mailing Address ____________________

____

Telephone ____________________ Fax____________________

Email ____________________

Tax I.D. Number(s)____________________

Exchangor's Advisor (The Attorney or CPA advising you):

Name ____________________

Firm ____________________

Mailing Address ____________________

____

Telephone ____________________ Fax____________________

Email ____________________

Relinquished Property

Attach a copy of the contract(s) for the sale of relinquished property.

Brief Description ____________________

(or Address) ____________________

____

Title is currently in the name(s) of: ____________________

Buyer's Name ____________________

Effective date of contract ____________________ Contract Price____________________

Closing Information:

Closer ____________________ Closing date____________________

Mailing Address ____________________

____

Telephone ____________________ Fax____________________

Email ____________________

Will Seller be at closing? ___ Yes ___ No Will Buyer be at closing? ___ Yes ___ No

Replacement Property (if known)

Attach a copy of the contract(s) for the purchase of replacement property.

Brief Description ____________________

(or Address) ____________________

____

Title to be held by ____________________

Seller's Name ____________________

Effective date of contract ____________________ Contract Price____________________

Closing Information:

Closer ____________________ Closing date____________________

Mailing Address ____________________

____

Telephone ____________________ Fax____________________

Email ____________________

Will Seller be at closing? ___ Yes ___ No Will Buyer be at closing? ___ Yes ___ No