

## 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. Copyright by Investors Title Exchange Corporation, 2006.

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# Basic Guidelines For A Like-Kind Exchange

Utilizing the Qualified  
Intermediary Safe Harbor



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# 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:

- after the expiration of the 45-day identification period if no Replacement Property has been identified; or
- after the expiration of the 180-day acquisition period if the taxpayer has identified Replacement Property but has not acquired all of it; or
- 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:

- The fair market value of the Replacement Property should be equal to or greater than the fair market value of the Relinquished Property.
- The equity the taxpayer has in the Replacement Property should be equal to or greater than the equity he had in the Relinquished Property.
- 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.