

How To Do a Like-Kind Exchange

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THE PREFERRED QUALIFIED INTERMEDIARY

Realty Exchange Corporation

Since 1990 our only business is to serve as a Qualified Intermediary for 1031 exchanges. Realty Exchange Corporation's only business is to serve as a qualified intermediary for tax-deferred exchanges throughout the United States. Realty Exchange Corporation realized the need for a dedicated organization to provide informative, experienced, and responsive qualified intermediary services to investors, real estate professionals, and advisors. Our services include all forms of exchanges: Simple Forward, Reverse, Improvement, Build to Suit, and Personal Property exchanges.

Tested Exchange Agreement. Our exchange agreement has been through the IRS private letter ruling process. We know our exchange agreement has all the necessary components to survive IRS scrutiny because we have been tested.

AlwaysSafe™ Security and safety of exchange funds is our first priority. Therefore we implemented the AlwaysSafe™ escrow security system. The AlwaysSafe™ system specifically defines how we handle exchange funds. Realty Exchange Corporation was an early proponent of separate bank accounts for each client.

Bonded and Insured. Realty Exchange Corporation carries a full fidelity bond and complete coverage by errors and omissions insurance.

CES® and FEA. The Certified Exchange Specialist® designation has been earned by all officers of Realty Exchange Corporation. This prestigious designation is specific to the 1031 exchange industry. The CES® designation is recognition that the bearer has met the difficult requirements of experience and comprehensive testing of exchange law and procedures, and abides by a comprehensive Code of Ethics.

Realty Exchange Corporation has been a long time member of the Federation of Exchange Accommodators. The FEA is the recognized trade organization for 1031 exchanges, providing constant industry updates, continuing education, a Code of Ethics, and standards.

Family Owned and Operated. Ed Horan established Realty Exchange Corporation in 1990. We continue to be owned and operated by family members. Our firm is one of the oldest family-owned qualified intermediaries in the country.

HISTORY OF TAX-DEFERRED EXCHANGES

Dating back to 1921, tax-free exchanges were direct, simultaneous exchanges between two or three property owners. In 1979, it was ruled in the famous "Starker" case that there could be a delay between settlements. This became the legal basis for the "delayed" or "deferred" exchange.

In 1984, Congress established time limits for a delayed exchange that required the exchangor to identify potential replacement property within 45 days and then settle on the replacement property within 180 days of settlement of the first property relinquished or the tax return due date, whichever is earlier.

The IRS published specific and clear guidance for the "safe harbor" conduct of like-kind exchanges in 1991. This regulation covers the role and qualifications of the qualified intermediary, safe harbor rules, assignment of contracts, control of escrow funds, identification requirements, and earning of interest. This regulation greatly simplifies tax-deferred exchanges and has revolutionized the exchange process.

In September 2000, the IRS published "IRS Revenue Procedure 2000-37" to provide guidance on how to conduct a reverse exchange.

WHAT IS A TAX-DEFERRED EXCHANGE OF LIKE-KIND PROPERTY?

A tax-deferred exchange is a process that allows a taxpayer to exchange an investment, rental or business property and defer the payment of the capital gains tax. Normally, there is a delay between settlements of the property being relinquished and the replacement property.

REQUIREMENTS AND RESTRICTIONS

Criteria for a Tax-Deferred Exchange of Like-Kind Property

The following criteria must be met for the real estate to be like-kind:

1. The property currently owned must have been **held** by the exchangor for investment, business and/or production of income (*NOTE: It is NOT important how the buyer plans to use the property*);
2. The exchangor must **hold** the new property for investment, business and/or production of income (*NOTE: It is NOT important how the seller is using the property*);
3. The replacement property must be identified in 45 days;
4. The replacement property must be settled in 180 days (or the tax due date, including extension, if earlier); and
5. All properties must be in the United States.

IMPORTANT!!

Reinvestment Requirements

For an exchange to be **totally tax-free**, four reinvestment requirements must be met:

1. The acquisition cost of the replacement property(ies) must be equal to or greater than the adjusted sales price (contract price less selling cost) of the relinquished property.
2. The cash equity (equity less selling costs) from the relinquished property and held in a qualified escrow account must be reinvested in the replacement property(ies). The cash from the escrow account may be applied toward the acquisition cost and/or down payment. Cash boot results if all the cash is not reinvested.
3. The replacement property(ies) must have debt equal to or greater than the debt paid-off or assumed at settlement of the relinquished property(ies). Otherwise, mortgage boot will result. New cash can be added to the down payment to offset any mortgage boot; however, new debt cannot offset any cash boot.
4. The exchangor should not receive any non-like-kind property. *The value of the any non-like-kind property received by the exchangor, including the value of any exchangor-held notes, is considered boot.*

Special Exchange Requirements and Restrictions

IMPORTANT!!

PROPERTIES THAT DO NOT QUALIFY: Properties that should not be exchanged under IRC Section 1031 rules are principal residences, personal use second homes, and dealer properties.

Related Parties: All the property transferred in a related-party exchange must be retained for two years. Direct exchanges and exchanges of the relinquished property may be made with a related party, but the purchase of the replacement property from a related party should be avoided. For additional information, see “Related Party Exchanges” at www.1031.us/Docs/Topics/RelatedParty.pdf.

Partial Interest: A partial or whole interest in a qualified property may be exchanged for a partial or whole interest in a replacement property. As an example, your 50% interest in a property may be exchanged for new property.

Installment Sale: An exchange can be a combination of a tax-deferred exchange and an installment sale. The value of the note will eventually be taxable income while the balance of the capital gain is deferred. To avoid taxable income, Realty Exchange Corporation, as the qualified intermediary may hold the note. For additional information, see “Installment Sale & Treatment of a Note from Buyer” at www.1031.us/Docs/Topics/InstallmentSale.pdf.

Mixed-Use Property: A property used for both personal and business or investment purposes may be exchanged. The gain and proceeds are divided at settlement with the proceeds from the business or investment portion coming directly to the qualified intermediary. When a mixed-use property is purchased as a replacement property, the value must be allocated between the personal use and business or investment portions.

Reverse Exchange: In 2000 the IRS published “safe harbor” procedures for a third-party *exchange accommodation titleholder* (EAT) to take title to the relinquished or eventual replacement property under a separate agreement. The EAT may hold the relinquished or replacement property for up to 180 days. This procedure permits an exchangor to get control of a replacement property even though their relinquished property has not sold. A separate *qualified exchange accommodation arrangement* (QEAA) is required to complete the normal exchange portion of the reverse exchange. Revenue Procedure 2004-51 modified the original “safe harbor” procedure to restrict the transfer to the EAT, as the eventual replacement property, of any property owned by the exchangor within the last 180 days. For additional information, see “Reverse Exchanges” at www.1031.us/Docs/Topics/ReverseExchanges.pdf.

IMPORTANT!!

Vacation Rental Property: A property in a vacation area that has not been used the greater of 14 days or 10% of the days actually rented (maintenance days do not count) qualifies as a business, rental or investment property and may be exchanged. (See IRS Publication 527 and “1031 Classification of Second Homes” at www.1031.us/Docs/Articles/ClassificationofSecondHomes.pdf.)

Visit www.1031.us for more information on these special topics, or call 800-795-0769 for a copy.

STEPS IN THE EXCHANGE PROCESS

STEP 1 Analysis of Tax Impact: A taxpayer should first determine what capital gains tax will have to be paid if an exchange is not completed. An interactive worksheet is available at www.1031.us (select Capital Gains Calculator) to determine the federal tax impact if a property is sold and not exchanged and to determine the reinvestment requirements for a tax-free exchange.

STEP 2 Real Estate Sales Contract: A copy of the sales contract for the property being sold and the name and phone number of settlement agent/attorney must be provided to Realty Exchange Corporation, as the qualified intermediary, in order to start the required exchange documentation.

STEP 3 Exchange Documentation: Realty Exchange Corporation prepares the required exchange and escrow account agreement and the assignment of contract documents and

sends them to the exchangor for signature. Realty Exchange Corporation provides the required notification of assignment to all parties of the contract, and provides specific instructions to the settlement agent/attorney. The exchange documentation **must be in place** prior to the transfer of the relinquished property.

STEP 4 Escrow Funds: The settlement agent transfers the escrow funds directly to the qualified escrow account. The exchange and escrow account agreement limits the exchangor's rights "to receive, pledge, borrow or otherwise obtain benefits from the cash or cash equivalent held in the escrow account." Realty Exchange Corporation, as the qualified intermediary, establishes and controls the escrow account.

STEP 5 Identification of Potential Replacement Properties: The identification of potential replacement properties must be done in writing, be signed by the exchangor, and be sent to Realty Exchange Corporation, as the qualified intermediary, within 45 days after settlement of the relinquished property. Each property is identified by street address and/or legal description.

There are different identification methods available, but the one most often used is to identify a maximum of three properties of any value. An alternate method used when going from a high value property to many lower value properties is the "200% Rule." This rule permits the identification of any number of properties up to 200% of the value of the relinquished property.

Also, if the replacement property is transferred to the exchangor prior to the end of the 45-day identification period, then no separate identification action is required.

Identification may be revoked and new identification made anytime during the 45-day identification period. Again, it must be in writing, signed by the exchangor, and delivered to the qualified intermediary.

WARNING: After 45 days, only those properties that have been identified may be purchased as replacement properties and be part of the exchange. No new properties may be identified after the 45-day identification period.

A replacement property "to be built" may also be identified. Such identification requires the legal description and *the best description available* of what is to be built.

STEP 6 Replacement Property Contract: A copy of the sales contract on the replacement property being purchased must be provided to Realty Exchange Corporation, along with the name and phone number of the settlement agent/attorney.

STEP 7 Replacement Property Documents: After receipt of the replacement property contract, Realty Exchange Corporation will prepare both the assignment and the notification of assignment and send instructions to the settlement agent/attorney. The assignment **must be signed** by the exchangor and returned to Realty Exchange Corporation before exchange escrow funds may be disbursed.

STEP 8 Transfer of Replacement Property: The replacement property being acquired must be received by the end of the 180-day exchange period. The exchange period starts on the day the first relinquished property is transferred and ends at midnight on the earlier of the 180th day or the due date (including on-time extensions) for the exchangor's tax return.

STEP 9 Reporting the Exchange: The exchangor completes the IRS Form 8824, "Like-Kind Exchanges," for the tax year in which the relinquished property was transferred. The form shows taxable income, realized gain, amount deferred, and the new basis for the replacement property. Following completion of the exchange, Realty Exchange Corporation provides a copy of the current Form 8824 and an instruction booklet on how to report the exchange.

THE QUALIFIED INTERMEDIARY

The Role of the Qualified Intermediary

The IRS has established the mandatory use of a qualified intermediary for a “safe harbor” exchange and has prescribed specific rules for the tax-deferred exchange and transfer of ownership. Thus, after the property has been listed and the exchanger and listing agent have placed an exchange addendum on the accepted contract, the qualified intermediary provides the documentation required for the deferred exchange. This includes preparing the required exchange and escrow agreement, providing the required assignment of contacts, receiving the required 45-day identification notice, notifying all parties to the contracts of the assignments, giving instructions to settlement agents at relinquished and replacement settlements, and maintaining control of the client’s funds in the qualified escrow account.

Disqualified Parties

To reduce conflicts of interest, the regulations restrict disqualified parties from serving as the qualified intermediary, controlling the escrow account, and receiving the identification notice. A disqualified party is one who has served as the exchanger’s agent in the past two years (i.e., a family member or any other party who has a business relationship with the exchanger or his/her agent, or any business entity in which the exchanger or agent have over a 10% interest). Agents are listed in the regulation as the exchanger’s employee, attorney, accountant, investment broker, or real estate agent/broker.

Fees

There is no standard fee charged by qualified intermediaries. The exchanger should determine if they are being charged a flat fee, a percentage fee, or an hourly rate, and if there is a separate escrow account fee. The exchanger should also ask if interest is paid on the funds in escrow. Realty Exchange Corporation charges a flat fee paid at settlement of the relinquished property. At the completion of the exchange, interest is paid to the exchanger on the funds held.

This publication is designed to provide accurate information on tax-deferred exchanges. The publisher is not engaged in rendering legal or accounting services. If legal or tax advice is required, the services of a competent professional should be sought.



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