

Compilation of  
Short Articles On

Section 1031  
Tax-Deferred Like-Kind  
Exchange Topics

Legal Disclaimer

1031 Exchange transactions structured pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Department of the Treasury Regulations are complicated transactional structures that involve significant legal, tax and financial issues. You should always consult with competent legal, tax and financial advisors prior to entering into and completing a 1031 Exchange transaction. This article is intended as a brief overview of the subject and is NOT intended to serve as specific legal, tax or financial advice.

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## Exeter National Office Locations

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# Introduction to 1031 Exchanges<sup>©</sup>

## An In-depth Overview

Written by:

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## Introduction to 1031 Exchanges An In-depth Overview

By

William L. Exeter

*President and Chief Executive Officer*

*Exeter 1031 Exchange Services, LLC*

### **Introduction**

What is a tax-deferred like-kind exchange you ask?

Well, the subject won't get your adrenaline pumping unless you are facing a large income tax liability from the sale of investment property. You may not realize that a tax-deferred like-kind exchange can be used to provide powerful tax-deferral benefits on the sale of investment property in order to build your net worth.

If you are like many investors who avoid selling investment property simply because they don't want to pay income taxes, you may now be on the road to increasing your net rental income (cash flow) and your net worth by trading up into larger investment properties while deferring your capital gain and depreciation recapture taxes.

Although the information provided in this article should never replace obtaining competent advice from your legal, tax and financial advisors, it will help you understand the basics of a tax-deferred like-kind exchange.

### **Advantages of a Tax-Deferred Like-Kind Exchange**

A tax-deferred like-kind exchange allows you to sell investment property (relinquished property) and purchase more profitable and/or productive investment property (like-kind replacement property) while deferring Federal, and in most cases state, capital gain and depreciation recapture income tax liabilities.

This transaction is usually referred to as a 1031 Exchange but is also known as a delayed exchange, deferred exchange, starker exchange, and like-kind exchange. Technically speaking, it is a tax-deferred, like-kind exchange pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Department of the Treasury Regulations. I will refer to it as a 1031 Exchange going forward.

### **Full or Partial Tax Deferral**

You must meet certain requirements in order to defer 100% of your Federal, and in most cases state, capital gain and depreciation recapture taxes on the sale of your investment property. Generally, for full tax deferral, you must (1) acquire like-kind replacement



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property that is equal to or greater in value than the relinquished property sold (based on net sales price, not your net equity); (2) must reinvest all of the net proceeds or cash (net equity) generated from the sale of the relinquished property; and, (3) must replace the amount of old debt that was paid off on the disposition of the relinquished property with new debt of an equal amount on the like-kind replacement property.

You can always infuse more cash into your 1031 Exchange transaction but you cannot pull any cash out of the 1031 Exchange without recognizing depreciation recapture and/or capital gain taxes. For example, if you acquired property with a \$60,000 cash down payment and you are now selling the property and are completing a 1031 Exchange transaction, even the \$60,000 initial cash investment must be reinvested in like-kind replacement property in order to defer 100% of your capital gain and depreciation recapture taxes.

The only way you can safely pull any cash out of your property without incurring a depreciation recapture and/or capital gain income tax liability is to refinance the property well before your 1031 Exchange transaction starts or after you have completed your 1031 Exchange by acquiring all of your like-kind replacement properties.

You can also purposely use the 1031 Exchange to defer only a portion of your depreciation recapture and/or capital gain income tax liability. This strategy is generally used when you have other income tax losses than can be used to offset some of your depreciation recapture and/or capital gain taxes.

Trading down in value and/or pulling cash out of your 1031 Exchange will result in the partial recognition of your depreciation recapture and/or capital gain taxes. The amount that is not exchanged for qualified like-kind replacement property is called cash boot or mortgage boot and will generate depreciation recapture and/or capital gain taxes.

It is extremely important that you consult with an experience Qualified Intermediary (also referred to in the real estate industry as a Accommodator) and competent legal, tax and financial advisors for guidance in structuring your 1031 Exchange transactions. There may be other income tax issues not related to the 1031 Exchange that could affect your decision to structure your transaction as a 1031 Exchange.

## **1031 Exchange Structures**

The most common 1031 Exchange structure is a forward, or delayed, 1031 Exchange where you sell your qualified relinquished property first and then acquire your like-kind replacement property either on the same day or at a later date. Closing both transactions on the same day is referred to as a simultaneous or concurrent 1031 Exchange. Closing your sale transaction first and then closing your purchase transaction later is referred to as a delayed 1031 Exchange.

The opposite 1031 Exchange structure is referred to as a Reverse 1031 Exchange where you acquire your like-kind replacement property first and then subsequently

sell your relinquished property at a later date. Reverse 1031 Exchange transactions are much more complex and expensive compared to forward 1031 Exchanges.

This article is intended primarily to provide concise and brief introductory information on forward 1031 Exchanges. For more complete information on reverse 1031 Exchanges, please refer to our article titled “Introduction to Reverse 1031 Exchanges and Revenue Procedure 2000-37” that can be found on the Exeter 1031 Exchange Services, LLC’s website under the Exeter 1031 Exchange Resource Library at [www.exeter1031.com](http://www.exeter1031.com).

Although not discussed further in this article, you should also know that both forward and reverse 1031 Exchanges can typically be structured in conjunction with an improvement (build-to-suit or construction) component where the like-kind replacement property is improved, built, constructed or retrofitted as part of the 1031 Exchange transaction.

### **The 1031 Exchange Qualified Intermediary (Accommodator or Facilitator)**

The 1031 Exchange Qualified Intermediary often referred to in the real estate industry as the 1031 Exchange Accommodator or 1031 Exchange Facilitator (Qualified Intermediary), is the central party in a 1031 Exchange transaction.

The Qualified Intermediary is always selected by you. The Qualified Intermediary is responsible for drafting the 1031 Exchange agreements and related exchange documentation in order to properly structure the 1031 Exchange transaction to be in compliance with Section 1031 of the Internal Revenue Code, Section 1.1031 of the Department of the Treasury Regulations and the various and numerous rulings, procedures, notices and cases.

The Qualified Intermediary must be assigned into the Purchase and Sale Agreement and any related transactional documentation (such as Escrow Instructions) prior to the closing for the sale of each relinquished property and the purchase of each like-kind replacement property. Failure to have your Qualified Intermediary assigned into any of your relinquished or replacement property transactions prior to the closing will result in a failed 1031 Exchange and recognition of your depreciation recapture and/or capital gain income tax liabilities.

Your Qualified Intermediary will also hold and safeguard your 1031 Exchange funds during your 1031 Exchange transaction.

Because of your Qualified Intermediary’s critical role and responsibilities throughout your 1031 Exchange transaction, you should carefully review the tips outlined later in this article to assist you with the careful selection of your Qualified Intermediary.

## **Basic Rules and Requirements**

### **Qualified Use Property**

Your relinquished property must have been held by you for rental, investment or use in your business. And, you must have the INTENT to HOLD your acquired like-kind replacement properties for rental, investment or use in your business.

Property not held for rental, investment or use in your business will not be considered to be qualified use property and will generally not qualify for 1031 Exchange treatment.

For example, property acquired by you with the INTENT to fix-up and then sell (“flipping”) will actually be classified as property HELD for SALE rather than held for rental, investment or use in your business, and will therefore generally not qualify for 1031 Exchange treatment.

Apartments acquired for the sole purpose of converting into condominiums and then being sold is actually real property held for sale and not held for rental, investment or use in your business, and will generally not qualify for 1031 Exchange treatment either.

For more complete information on 1031 Exchange relinquished and replacement property holding requirements, please refer to our article titled “Holding Guidelines for 1031 Exchange Properties” that can be found in the Exeter 1031 Exchange Resource Library on our website at [www.exeter1031.com](http://www.exeter1031.com).

### **Like-Kind Property**

Your relinquished and replacement properties must be like-kind to each other in order to qualify for 1031 Exchange treatment. In regards to real estate, ANY type of real property is like-kind to ANY other type of real property, so long as the qualified use test referenced above has been met.

There is a lot of incorrect information in circulation today stating that if you sell an apartment building you must acquire an apartment building, for example. This is absolutely not true. You can sell vacant land and acquire commercial or industrial property. You could sell multi-family property and purchase an office building, or you could sell a retail center and acquire vacant land.

The following list details property that will generally qualify as like-kind property to each other so that you can exchange between each of the types of property:

- Single family
- Multi-family
- Commercial office
- Retail
- Industrial
- Vacant land



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- Oil & gas interest
- Mineral Interests
- Tenant-In-Common Property Interests (TIC Investments)

The following list details property that will generally not qualify as like-kind property and therefore not qualify for 1031 Exchange treatment:

- Primary residence
- Second home
- Vacation home (see below)
- Property held for sale
- Cash, Stocks and Bonds
- Mutual funds
- Real Estate Investment Trusts (REITs) (except for upREIT transactions)
- Partnership Interests
- LLC Interests
- Shares in Corporation

## **Vacation Properties and Second Homes**

You can 1031 Exchange your vacation property or second home provided you follow the safe harbor guidelines outlined in Revenue Procedure 2008-16. The subject property must be held as investment property for at least 24 months, must be rented for at least 14 days each year within those 24 months, and cannot be used personally for more than 14 days or 10% of the number of days that you rented the property.

## **1031 Exchange of Personal Property**

In addition to real property, personal property can qualify for 1031 Exchange treatment if it meets the qualified use test and like-kind property tests. You must exchange personal property for like-kind personal property. You cannot exchange personal property for real property. Since the definition of “like-kind” is much more restrictive for personal property than for real property, a Qualified Intermediary should be consulted immediately if personal property may be involved with your 1031 Exchange transaction.

## **Taxpaying Entity (Investor)**

The like-kind replacement properties acquired as part of the 1031 Exchange must be acquired by the same taxpaying entity that sold the relinquished properties. There are certain exceptions to this rule not discussed in this article such as single member limited liability companies and fully revocable grantor trusts.

Therefore you should consult with an experienced institutional Qualified Intermediary such as Exeter 1031 Exchange Services, LLC for further information prior to proceeding with your 1031 Exchange transaction.

### **Multiple Properties and Fractional Interests**

You can sell multiple properties and/or acquire multiple properties. For example, you could sell a single family house held as rental property and acquire two condominiums also held for investment, or vice versa.

Your relinquished and/or replacement properties can also involve a fractional, also referred to as partial or co-ownership, interests in the property. In other words, you do not have to acquire and/or own 100% of the property as long as you own an interest in the property.

### **Exchange Requirement**

You must ensure the transaction is structured as a 1031 Exchange and *not* a sale and subsequent purchase. Also, both the relinquished and replacement property transactions must be part of an integrated plan or transaction. An experienced institutional Qualified Intermediary such as Exeter 1031 Exchange Services, LLC can assist you with this process.

### **Identification Requirements**

The like-kind replacement property identification process is where you identify your potential like-kind replacement properties that you are considering for acquisition. This is only an identification requirement and the properties do not need to be under contract in order to be identified. The potential like-kind replacement properties must be identified by the property address, assessor's parcel number and/or legal description to the Qualified Intermediary.

To qualify for a 1031 Exchange, this step requires that you comply with only one (not all) of the following three (3) identification rules. (Refer to Time Deadlines referenced below for information on the deadlines regarding identification of potential like-kind replacement properties).

#### 1) The Three (3) Property Rule:

The three (3) property identification rule allows you to identify up to, but not more than, three (3) potential like-kind replacement properties. In the event you need to identify more than three (3) potential like-kind replacement properties you would ignore the three (3) property rule and look exclusively to the 200% rule, which is described next.

There is no limitation on the market value of the identified like-kind replacement properties under the three (3) property rule. The limitation is only on the total number of like-kind replacement properties you can identify.



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Although you could do so, you are not required to acquire all of the like-kind replacement properties identified. The three (3) property rule provides you the ability to identify more than one like-kind replacement property so you can have back-up like-kind replacement properties identified in case your first choice cannot be acquired for any reason. This is the most common and the easiest of the like-kind replacement property identification rules to work with.

## 2) The 200% of Fair Market Value Rule:

Unlike the three (3) property rule, the 200% rule allows you to identify more than three (3) potential like-kind replacement properties as long as the total fair market value of all the potential like-kind replacement properties identified does not exceed 200% of the net sales price of your relinquished properties.

The limitation is only on the total fair market value of the potential like-kind replacement properties identified. For example, if you sold relinquished property for \$1,000,000 you would be able to identify as many like-kind replacement properties you want provided that the total fair market value of all the identified like-kind replacement properties combined did not exceed \$2,000,000.

## 3) The 95% Exception Rule:

In the event you need to identify numerous like-kind replacement properties that exceed the three (3) property rule and the 200% rule, the identification will still be considered valid for 1031 Exchange treatment if you actually acquire at least 95% of the fair market value of the potential like-kind replacement properties that you identified.

## **Time Restrictions**

1031 Exchanges are subject to very specific time restrictions or deadlines that cannot be extended, waived or altered for any reason.

### 45 Calendar Day Identification Period

In a forward/delayed 1031 Exchange, you have 45 *calendar* days from the close of your relinquished property sale transaction (and the conveyance or transfer of legal title to your relinquished property) to identify potential like-kind replacement properties to be acquired.

The deadline is not extended if the deadline falls on a Saturday, Sunday or legal holiday, so you must ensure that your identification is received by your Qualified Intermediary no later than midnight of the 45<sup>th</sup> calendar day.

You can revoke and change their identification as often as you wish within the 45 *calendar* days by revoking any prior identifications and submitting a new identification

to the Qualified Intermediary. You can not change or alter your identification after the 45 *calendar* day deadline has passed.

### 180 Calendar Day Exchange Period

You must complete your acquisition of one or more of your identified like-kind replacement properties no later than either (1) 180 *calendar* days from the close of your relinquished property sale transaction, OR (2) by the due date, including extensions, of your Federal income tax return for the year in which the relinquished property was sold in order to complete a successful 1031 Exchange.

In other words, if your relinquished property sale transaction closes before October 17<sup>th</sup> of any given tax year, you must close your like-kind replacement property acquisition within the 180 calendar day period.

However, if your relinquished property sale transaction closes after October 17<sup>th</sup>, but on or before December 31<sup>st</sup>, of any given tax year, then your 180 *calendar* day period ends on your deadline, including extensions, to file your Federal income return. You must file for an extension of time to file your Federal income tax return so that you will have the full 180 *calendar* days to complete your 1031 Exchange transaction.

### Actual or Constructive Receipt

You are not allowed to have any actual or constructive receipt of, or control over, your funds during your 1031 Exchange transaction. You will be considered to have actual or constructive receipt of your funds at the time you have actual possession of the funds or you receive any economic benefit from your 1031 Exchange funds.

Actual or constructive receipt of any portion of your 1031 Exchange funds or assets during your 1031 Exchange transaction will result in a disqualified 1031 Exchange and the recognition of your depreciation recapture and/or capital gain income tax liabilities.

In order to avoid this, a Qualified Intermediary *must* be assigned into the purchase and sale agreements (and escrow instructions if applicable) of each of your relinquished properties *and* each of your replacement properties *before* either transaction closes and the properties are transferred to the respective buyers. If either transaction should close before the Qualified Intermediary has been assigned into the transaction, the transaction will fail to qualify as a 1031 Exchange.

### Selecting a SAFE Qualified Intermediary (Accommodator or Facilitator)

Since the Qualified Intermediary will be holding your 1031 Exchange funds during your 1031 Exchange transaction, you should evaluate and select your Qualified Intermediary very carefully.



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There are three (3) primary risks that you should be cognizant of when researching and choosing your Qualified Intermediary. They are (1) lack of experience and expertise resulting in errors in the administration of your 1031 Exchange; and (2) Qualified Intermediary employee error or omission resulting in the disqualification of your 1031 Exchange and recognition of your depreciation recapture and/or capital gain income tax liabilities; and (3) Qualified Intermediary employee theft or embezzlement of funds resulting in the loss of your 1031 Exchange funds.

Professional, experienced institutional Qualified Intermediaries will understand your concerns. They will have analyzed and addressed these concerns and will have already implemented appropriate safeguards to protect your 1031 Exchange funds.

When analyzing 1031 Exchange Qualified Intermediaries, you should ask them the following questions:

- Does the Qualified Intermediary have sufficient experience and expertise to catch errors and/or problems with your 1031 Exchange transaction before the transaction closes?
- Does the Qualified Intermediary maintain sufficient fidelity bond coverage to insure against employee theft or embezzlement of the exchange funds?
- Is the fidelity bond coverage “per occurrence” or merely “in aggregate”?
- Does the Qualified Intermediary maintain sufficient errors and omissions insurance to insure against any error or omission that creates a loss for you?
- Does the fidelity bond and errors and omissions insurance policies cover just the Qualified Intermediary or does it also cover related entity’s operations that might diminish the overall protection to the Investor in the event of multiple losses through the entire entity?
- Does the Qualified Intermediary have significant experience and expertise to ensure your transaction is administered within the prescribed regulations?

You should request copies of the Qualified Intermediary’s insurance binders and as part of your due diligence in order to verify the answers to the above questions.

## **Want to Know More?**

This article is meant to be a brief overview of 1031 Exchanges. You can obtain more detailed, in depth and technical information on the Internet at [www.exeter1031.com](http://www.exeter1031.com) or by contacting the author directly. Investors should always consult with their legal, financial and tax advisors *before* attempting to structure or complete a 1031 Exchange transaction.

# Holding Guidelines for 1031 Exchange Property<sup>©</sup>

Written by:

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# Holding Guidelines for 1031 Exchange Property

By  
William L. Exeter  
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## **Introduction**

While the Department of the Treasury Regulations and numerous rulings make it very clear that you must have the intent to hold your property for rental, investment or use in your trade or business, they fail to define exactly how long you need to hold your relinquished or replacement properties in order to qualify for a 1031 Exchange pursuant to Section 1031 of the Internal Revenue Code or Section 1.1031 of the Treasury Regulations.

## **Holding for Investment**

If your relinquished property was purchased just before your 1031 Exchange transaction, the Internal Revenue Service has routinely taken the position that you actually purchased the property for sale (inventory) rather than holding your property for rental, investment or use in your trade or business. Further, the Internal Revenue Service has also taken the position that if your like-kind replacement property is sold immediately after your 1031 Exchange transaction then it was not held sufficiently long enough by you to qualify for tax-deferred like-kind exchange treatment.

While there is little definitive authority on the holding period or requirements, in one Private Letter Ruling, the Internal Revenue Service stated that a minimum holding period of two (2) years would be sufficient to meet the Qualified Use test, and a number of court decisions have been handed down that have also taken the same position (although they have been somewhat more liberal than the Department of the Treasury and the Internal Revenue Service).

## **Intent to Hold Critical Element**

The amount of time you hold your property is not the only factor the Internal Revenue Service will use to determine whether you had the appropriate intent to qualify for a 1031 Exchange, but it is extremely important.

The easiest way to demonstrate your intent to hold your property for rental, investment or use in your business is to do just that: actually hold the property for rental, investment or use in your trade or business. The longer you hold your property

for investment purposes the stronger your case will be if the Internal Revenue Service questions the sufficiency of your investment intent.

### **Hold for 12 to 24 Months, or More**

Tax advisors frequently recommend that you should hold, treat and report your property as investment property for at least 12 to 24 months, or more, in order to prove that you had the intent to hold your property for investment purposes.

I recommend that you hold, treat and report your property as investment property for at least 12 to 24 months, or more, for three (3) reasons.

1. 12 months is the cut off between ordinary income tax rates and capital gain tax rates and gives a clear indication of what the U.S. Government considers short-term ordinary holding versus long-term investment holding periods.
2. Holding your property for at least 12 to 24 months will mean that your income tax reporting will straddle at least two and most likely three income tax reporting periods with two income tax returns listing rental income, expenses and depreciation, all of which help you to provide a solid argument that you did in fact have the intent to hold the property for rental, investment or use in your trade or business.
3. In addition, the United States Congress at one time (well over a decade ago) considered a minimum holding requirement of 12 months for both relinquished and replacement properties. While the requirement was never enacted by Congress, it does provide a good indication of what sort of holding period Congress would consider sufficient to meet 1031 Exchange requirements.
4. And recent rulings by the IRS have alluded to a 24 month holding period.

If you are considered a “dealer”, you will typically not qualify for tax-deferred exchange treatment because technically your properties are held for sale as “inventory” and thus are not properties held for investment purposes.

In some cases, however, dealers may be able to qualify for 1031 Exchange treatment by segregating assets intended to be held as rental, investment or productive use in a trade or business from those assets being held for sale. In these situations, some legal advisors have advised their clients to form a separate entity, such as a limited liability company, specifically to hold title to the segregated properties in order to potentially qualify for 1031 Exchange treatment in the future. There has not been any guidance in this area, so you should consult with your legal, tax and financial advisors as to the risks involved with this strategy.

If, however, your intention is to buy, fix up and then sell or flip the property or hold for sale, then you clearly do not have the intent to hold your property for investment

purposes. Rather, your intent is to hold the property for sale, and accordingly would not meet the Qualified Use test and will not qualify for 1031 Exchange treatment.

Your holding issue can become more complicated when you hold legal title to your relinquished properties, or you intend to hold legal title to your like-kind replacement properties in a partnership, corporation or multi-member limited liability company.

The partnership, corporation or multi-member limited liability company can certainly sell relinquished property held in the entity's name and then acquire like-kind replacement property to be held in the same entity's name and qualify for 1031 Exchange treatment.

The difficulties arise when the subject investment property is to be sold and some of the underlying shareholders, partners or members of the multi-member entity wish to go separate ways and attempt to exchange their "ownership interests" in that entity as part of a 1031 Exchange. Ownership interests such as partnership interests, shares in a corporation and membership interests in a multiple-member limited liability company are not considered to be interests in real property, but are actually personal property interests, and therefore can not be exchanged for or into real property.

There are solutions for this issue, but you must be proactive in resolving the issue well before you consider selling the property. You should seek professional assistance now in order to have time to prepare for your 1031 Exchange transaction if you hold your investment properties in such a manner.

Only you can determine how aggressive or conservative you want to be in structuring and undertaking a 1031 Exchange. The longer you hold, treat and report a property as investment property prior to your 1031 Exchange, the more conservative the course of action is and the easier it will be to prove that you have satisfied the Qualified Use requirement. Conversely, the shorter the holding period, the more aggressive the transaction is considered and the more difficult it will be to demonstrate that you did in fact intend to hold the property for rental, investment or use in a trade or business.

### About the Author

William L. Exeter is President and Chief Executive Officer of Exeter 1031 Exchange Services, LLC and its affiliate companies. Mr. Exeter has been a senior executive in the 1031 Exchange industry since 1986 and has written and lectured extensively on 1031 Exchange transactions pursuant to Section 1031 of the Internal Revenue Code. He has administered in excess of 75,000 1031 Exchange transactions during his career and is one of a handful of founders of the Federation of Exchange Accommodators.

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# Introduction to Reverse 1031 Exchanges<sup>©</sup> Revenue Procedure 2000-37

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# Introduction to Reverse 1031 Exchanges Revenue Ruling 2000-37

By  
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You can acquire your like-kind replacement property before disposing of your current relinquished property by structuring a Reverse 1031 Exchange transaction pursuant to Revenue Procedure 2000-37. This income tax strategy is especially beneficial markets where there is an imbalance between the supply and demand for investment properties.

You may be concerned about the possibility of not being able to locate, identify and acquire suitable like-kind replacement properties within the required deadlines of a forward (regular) 1031 Exchange transaction. Entering into a forward 1031 Exchange transaction may create undue stress because you must located and identify your like-kind replacement property with in 45 calendar days of closing on your relinquished property.

A [Reverse 1031 Exchange](#) provides you with the flexibility to spend as much time as you need to locate a suitable like-kind replacement property, without the pressure of the forward 1031 Exchange deadlines.

## **Complicated Transactions – Always Review with Legal and Tax Advisors**

1031 Exchange transactions, especially those structured as reverse 1031 Exchanges, are exceptionally complicated income tax strategies.

The sophisticated Investors will always have a good team of experienced professional advisors, including legal, tax, and financial advisors, along with a knowledgeable broker and professional, experienced, institutional Qualified Intermediary, also referred to in the real estate industry as the 1031 Exchange Accommodator or 1031 Exchange Facilitator, with significant technical experience in 1031 Exchange transactions.

You should always seek competent legal, financial and tax counsel before entering into any 1031 Exchange transaction. Exeter Reverse 1031 Exchange Services, LLC is always available to meet and speak with your professional legal, tax and financial advisors in order to assist you in planning your reverse 1031 Exchange.

## **Treasury Department Issues Reverse 1031 Exchange Guidance**

The Department of the Treasury issued Revenue Procedure 2000-37 on September 15, 2000, which included a number of safe-harbor provisions, or guidelines, required to properly structure Reverse 1031 Exchange transactions. This Revenue Procedure has significantly increased the number of Reverse 1031 Exchange transactions being conducted since 2000.

Prior to 2000, Investors completed reverse 1031 Exchanges with little technical and structural guidance from the Department of the Treasury and the Internal Revenue Service. While the technical guidance provided by the Treasury Department has clarified the issues surrounding reverse 1031 Exchanges and provided a much higher comfort level than before, they also leave a lot of unanswered questions and create a more complex and costly 1031 Exchange structure.

## **Parking Property with the Exchange Accommodation Titleholder**

In a reverse 1031 Exchange, an Exchange Accommodation Titleholder, also referred to as an EAT, acquires and holds or “parks” legal title to either your relinquished or replacement properties, and the Qualified Intermediary (Accommodator or Facilitator) administers the 1031 Exchange portion of the transaction.

It is permissible for the Exchange Accommodation Titleholder and the Qualified Intermediary to be one and the same entity, although it is certainly not advisable due to the unnecessary risks to you associated with doing so.

The rolls of the Qualified Intermediary and the Exchange Accommodation Titleholder should be administered by two (2) entirely separate legal entities. This structure protects you against unnecessary exposure to risks. Exeter Reverse 1031 Exchange Services, LLC acts as the Exchange Accommodation Titleholder and Exeter 1031 Exchange Services, LLC serves as the Qualified Intermediary (Accommodator or Facilitator).

## **Exchange Accommodation Titleholder (EAT)**

The Exchange Accommodation Titleholder or EAT must meet all of the following requirements contained in Revenue Procedure 2000-37:

- The EAT must own the Qualified Indicia of Ownership, which is usually the legal title to the property, at all times from the date of acquisition of the property until the property is transferred.
- You can not serve as your own EAT acting on your own behalf, or a disqualified entity such as a related party or related entity.



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- The Exchange Accommodation Titleholder must be subject to Federal, and if applicable, state income taxes. When the EAT is set-up (organized) as and/or if it elects to be treated as a partnership or S corporation, more than 90% of its interests or stock must be owned by partners or shareholders who are subject to federal income tax.

## **Qualified Indicia of Ownership**

Qualified Indicia of Ownership is defined as any of the following:

- Legal title to the property.
- Other indicia of ownership of the property that is treated as beneficial ownership of the property under principles of commercial law for the state in which the property is located (i.e. a contract for deed).
- Interests in an entity that is considered to be a disregarded-entity for Federal income tax purposes, such as a single-member limited liability company; this entity must hold either legal title to the property or other Qualified Indicia of Ownership.

## **Qualified Exchange Accommodation Agreement (QEAA)**

You and the Exchange Accommodation Titleholder (EAT) must execute a formal written Qualified Exchange Accommodation Agreement (QEAA). The QEAA must contain the following terms and conditions as required pursuant to Revenue Procedure 2000-37:

- The Exchange Accommodation Titleholder is holding or parking title to the property for your benefit in order to facilitate a Reverse 1031 Exchange pursuant to Section 1031 of the Internal Revenue Code, Section 1.1031 of the Treasury Regulations and Revenue Procedure 2000-37.
- You and the Exchange Accommodation Titleholder agree to report the acquisition, holding or parking title to, and the ultimate disposition of the property on each of their respective income tax returns as required pursuant to Revenue Procedure 2000-37.
- The Exchange Accommodation Titleholder will be treated as the beneficial owner of the parked property for all federal income tax purposes.

### **Non-Arms Length Contractual Arrangements**

Revenue Procedure 2000-37 allows you and the Exchange Accommodation Titleholder to enter into a number of non-arms length contractual arrangements to complete a Reverse 1031 Exchange transaction. These non-arms length contractual arrangements facilitate the administration of the Reverse 1031 Exchange and eliminate certain risks for you and the Exchange Accommodation Titleholder.

You are responsible for any losses and will receive any profits generated from the property during the time the property is held or parked by the Exchange Accommodation Titleholder.

The property will be leased to you by the Exchange Accommodation Titleholder via a triple-net lease. Once leased to you, you will assume management responsibilities for the property, or you may retain a third-party property management company while the property is parked by the Exchange Accommodation Titleholder.

### **Deadlines for Identifying the Relinquished Property and Transferring the Parked Property**

Deadlines for identifying the relinquished property to be disposed of and transferring or conveying title of the parked property by the Exchange Accommodation Titleholder are the same as those for a forward 1031 Exchange transaction.

You have 45 calendar days after the transfer (conveyance of title) of the parked replacement property to the Exchange Accommodation Titleholder to formally identify the property you intend to relinquish or dispose of as part of your Reverse 1031 Exchange transaction. In most cases you will already know which property you will be selling, so you just have to make sure that you formally identify the property as your relinquished property.

Identification is not necessary when the relinquished property is parked by the Exchange Accommodation Titleholder because the 1031 Exchange has already been completed at the beginning of the transaction. This will be explained in more detail shortly.

In either case, the relinquished property must be sold and transferred (conveyed) to the buyer within 180 calendar days after the parked property was transferred (conveyed) to the Exchange Accommodation Titleholder.

You cannot extend these 1031 Exchange deadlines under any circumstances.

### **Reverse 1031 Exchange Structures**

You must decide whether to park title to the replacement property or relinquished property with your Exchange Accommodation Titleholder. This decision will vary from

transaction to transaction, and not all Qualified Intermediaries will administer both Reverse 1031 Exchange structures. It will typically depend on whether your lender will allow your Exchange Accommodation Titleholder to acquire and park title to the replacement property when your lender is also using the same replacement property as collateral for your financing.

There are other factors that may play a role in determining which property will be parked by the Exchange Accommodation Titleholder as well, including:

- Operational Considerations. Does parking title to either property create any problems with the ongoing operation of the property? Will a change in legal ownership affect any vendor or tenant relationships? Are you in the middle of any permitting or licensing activities that could be disrupted?
- Risk Management Considerations. Are there any specific risks to the Exchange Accommodation Titleholder that may prohibit the EAT from accepting and parking title? Have there been any hazardous or toxic substances used or stored on the property? Do the ongoing operations of the property put the EAT at risk?
- Insurance Coverage Considerations. When property is parked with the Exchange Accommodation Titleholder it is usually held by the EAT in a single-member limited liability company and this may pose problems when attempting to obtain insurance coverage for the EAT during the Reverse 1031 Exchange transaction, especially if there will be construction during the course of completing the transaction.
- Financing Considerations. Properties transferred or conveyed to the Exchange Accommodation Titleholder that have existing financing may risk triggering due on sale clauses with the current lender.
- Liquidity Concerns. In order to defer 100% of the applicable depreciation recapture and capital gain income tax liabilities, you must meet three requirements when structuring 1031 Exchanges: (1) exchange or trade equal or up in value; and (2) reinvest 100% of your equity (net cash proceeds from sale of relinquished property); and (3) replace any debt with new debt on the replacement property. Your equity is trapped in your relinquished property until it has been sold, which may create liquidity or financing challenges for you when structuring a Reverse 1031 Exchange transaction.

Structuring the Reverse 1031 Exchange with your Exchange Accommodation Titleholder acquiring and parking title to your replacement property is generally the most beneficial Reverse 1031 Exchange structure for you. It provides you with much more flexibility.

However, given the considerations outlined above, there are often situations when acquiring and parking title to the replacement property in the name of the Exchange Accommodation Titleholder is not a practical structure. In these cases, title to the relinquished property must therefore be transferred (conveyed) to and parked with the Exchange Accommodation Titleholder.

These two Reverse 1031 Exchange structures are frequently referred to as the Exchange Last Structure (parking title to the replacement property) and the Exchange First Structure (parking title to the relinquished property).

The best way to analyze and understand a Reverse 1031 Exchange transaction is to view it as two separate transactional components – each separate from the other and yet both contractually integrated to form the Reverse 1031 Exchange transaction.

### **Parking Property and a Simultaneous 1031 Exchange**

Contrary to popular opinion Revenue Procedure 2000-37 is not a Reverse 1031 Exchange Revenue Procedure. It really provides safe-harbor guidelines for structuring Reverse 1031 Exchange transactions by utilizing a “parking” structure or strategy. It is commonly called a Reverse 1031 Exchange because it allows you to acquire your like-kind replacement property first and then dispose of your relinquished property at a later date.

The term Reverse 1031 Exchange is therefore really a misnomer because it actually consists of: (1) a parking transaction where either the like-kind replacement property or the relinquished property is acquired and held or parked by the Exchange Accommodation Titleholder; and (2) a simultaneous 1031 Exchange (not a true reverse 1031 Exchange) occurs either at the beginning (Exchange First Structure) or at the end (Exchange Last Structure) of the Reverse 1031 Exchange transaction.

### **Exchange Last Parking Structure – Parking Title to the Replacement Property**

The preferred Reverse 1031 Exchange strategy is the Exchange Last Structure where the Exchange Accommodation Titleholder acquires and parks title to your like-kind replacement property.

This structure provides you with much more flexibility in planning the acquisition and financing of your like-kind replacement property because the actual 1031 Exchange has not yet occurred, so we do not care at this point if you have exchanged or traded equal or up in value, have reinvested your equity (cash) or have replaced any necessary debt on your like-kind replacement property because the only thing that has been completed so far is the acquisition and parking of the like-kind replacement property by the Exchange Accommodation Titleholder.



These 1031 Exchange requirements are easily addressed at the back end of the transaction when the simultaneous 1031 Exchange occurs.

### **Acquiring and “Parking” the Like-Kind Replacement Property**

You will enter into a legal agreement called the Qualified Exchange Accommodation Agreement (“QEAA”) with an Exchange Accommodation Titleholder (“EAT”). Exeter Reverse 1031 Exchange Services, LLC serves in the capacity of the Exchange Accommodation Titleholder.

The Exchange Accommodation Titleholder establishes a new separate single-member limited liability company (“LLC”) or other type of single-member special purpose entity (“SPE”) for each and every Reverse 1031 Exchange transaction for the sole purpose of holding or “parking” title to your like-kind replacement property.

It is important that your Exchange Accommodation Titleholder is involved in the transaction before it closes. If the transaction closes with out the Exchange Accommodation Titleholder it is too late to structure a Reverse 1031 Exchange transaction.

Once you have signed the Qualified Exchange Accommodation Agreement you will assign the Purchase and Sale Agreement and any related escrow instructions or other transactional documents (if any) for the like-kind replacement property to the Special Purpose Entity set-up by the Exchange Accommodation Titleholder in preparation for closing the transaction.

You will either loan and/or arrange for third-party financing for the acquisition of the like-kind replacement property to the Special Purpose Entity set-up by the Exchange Accommodation Titleholder. At the close of the like-kind replacement property transaction, the Exchange Accommodation Titleholder will receive and “park” title to the like-kind replacement property.

### **Interim Activity While Property is Parked with EAT**

The “parked” like-kind replacement property is typically leased by the Exchange Accommodation Titleholder to you using a triple net lease while the replacement property is held or “parked” by the EAT.

The ability to triple net lease the “parked” like-kind replacement property to you while held by the Exchange Accommodation Titleholder gives you the ability to operate the property, including the ability to lease the property, collect the rents and income, and pay the expenses. You are not permitted to depreciate the property while it is “parked” by the Exchange Accommodation Titleholder since you do not technically own it yet (remember that you still own and are depreciating the relinquished property).

Any lease payments made by you to the EAT are offset by any debt payments owed and made by the EAT to the lender or financing company. The lease payments may cover any debt service owed on outside financing. This structure is designed to be tax neutral for the Exchange Accommodation Titleholder so that any and all taxable elements will be borne by you.

You must identify your relinquished properties within 45 calendar days after the close of the replacement property acquisition and legal title to the like-kind replacement property has been transferred or “parked” with the Exchange Accommodation Titleholder.

You will then assign the Purchase and Sale Agreement and any related escrow instructions or other transactional documents (if any) for the disposition of the relinquished property to Exeter 1031 Exchange Services, LLC, as your Qualified Intermediary. The exchange funds at the close of the relinquished property transaction will be sent to the Qualified Intermediary.

### **Acquisition of the Replacement Property from the EAT**

The Qualified Intermediary will use these 1031 Exchange funds to acquire the “parked” like-kind replacement property from the Exchange Accommodation Titleholder. The Qualified Intermediary will acquire the “parked” like-kind replacement property by executing a Purchase and Sale Agreement. You will receive either legal title to the “parked” like-kind replacement property or an assignment of 100% of the membership interest or ownership interest in the Special Purpose Entity that holds legal title to the “parked” replacement property from the Exchange Accommodation Titleholder by completing a simultaneous exchange.

The Exchange Accommodation Titleholder uses the net proceeds received from the sale of the relinquished property to pay down the funds advanced by you and/or the loan from your third-party lender.

You should obtain your lender’s approval prior to entering into an “Exchange Last” Reverse 1031 Exchange transaction if you need to secure institutional financing because many lenders will not lend under such a structure. The SPE/LLC will be the borrower on the loan since the SPE/LLC holds legal title to the property. The Exchange Accommodation Titleholder will typically sign the loan documents and deed of trust or mortgage on a non-recourse basis and you would guarantee the loan documents on a recourse basis.

Make sure that your lender understands that you are contemplating a Reverse 1031 Exchange transaction and not a regular forward 1031 Exchange. Lenders say yes all too often only to say no just a few days before the closing when they find out that the Exchange Accommodation Titleholder will be holding title to the like-kind replacement property. I recommend that a conference call be scheduled between you, your lender

and your Exchange Accommodation Titleholder as early as possible to discuss the specific issues with a reverse 1031 Exchange.

### **Reverse Improvement 1031 Exchange**

The “Exchange Last” structure can be utilized in a reverse improvement 1031 Exchange structure as well (sometimes referred to as build-to-suit or construction 1031 Exchange). In this type of 1031 Exchange, you can build a new structure, improve an existing structure or retrofit the property before selling your relinquished property.

### **When to Use the Exchange Last Parking Structure**

You would typically select the “Exchange Last” structure for a Reverse 1031 Exchange transaction when you are purchasing the like-kind replacement property for all cash or the seller is providing short-term seller financing (seller-carry back financing).

The following table will help you walk through the steps of an “Exchange Last” structure.

### **Exchange Last Parking Structure – Parking Title to the Replacement Property**

You enter into a Qualified Exchange Accommodation Agreement (“QEAA”) with the Exchange Accommodation Titleholder (“EAT”).

Exchange Accommodation Titleholder forms single member limited liability company (LLC) or other special purpose entity to acquire title to property.

You assign your rights under Purchase Contract for like-kind replacement property to Exchange Accommodation Titleholder and provide written notification to all parties involved in the transaction.

You advance funds and/or obtain third-party financing for the limited liability company (LLC) to acquire the like-kind replacement property. The loan will be non-recourse to the LLC and its single member but can be guaranteed by you.

Exchange Accommodation Titleholder acquires title to like-kind replacement property directly from seller and gives you and/or third party lender a note(s) that is secured by a deed of trust or mortgage on the replacement property.

Under the QEAA, you lease the like-kind replacement property from Exchange Accommodation Titleholder under a triple-net lease. Your monthly rent (if any) may cover any debt service owed on outside financing.



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Investor identifies relinquished property within 45 *calendar* days after the closing and parking of the like-kind replacement property.

You execute Sales Contract with buyer to sell relinquished property.

You execute Tax-Deferred Exchange Agreement with Qualified Intermediary

You assign your rights under the Sales Contract to Qualified Intermediary and gives written notice to buyer.

Relinquished property closes with you direct deeding relinquished property to purchaser and closer disbursing all exchange proceeds from relinquished property to Qualified Intermediary.

You and Exchange Accommodation Titleholder execute Purchase and Sales Contract for like-kind replacement property.

You assign rights under Purchase and Sales Contract for like-kind replacement property to Exeter 1031 Exchange Services, LLC as your Qualified Intermediary.

At closing, Qualified Intermediary pays you off and/or your lender in satisfaction of note(s) given by Exchange Accommodation Titleholder to you and/or your lender. Closing must be simultaneous with the relinquished property closing.

Qualified Intermediary instructs Exchange Accommodation Titleholder to either transfer title to like-kind replacement property directly to you or to transfer 100% of the membership interest in Exchange Accommodation Titleholder to you, completing a simultaneous exchange.

Exchange Accommodation Titleholder will usually not hold title of the like-kind replacement property for more than 180 *calendar* days.

## **Issues with Exchange Last Parking Structure**

**Cash Boot Potential:** If the amount of the down payment advanced by you to the Exchange Accommodator Titleholder (initial equity) used to acquire the like-kind replacement property is less than the equity generated from the sale of the relinquished property you may have created cash boot and will recognize depreciation recapture and/or capital gain income tax liabilities to the extent of the cash boot. (*Note:* To qualify for 100% tax-deferral in a 1031 Exchange, the equity in the like-kind

replacement property must be equal to or greater than the equity in the relinquished property.)

The Exchange Last parking structure is the only one of the two that would allow the Exchange Accommodation Titleholder to contribute additional cash if the equity from the relinquished property is more than the down payment on the like-kind replacement property to avoid an income tax liability.

**Financing:** If seller carry back financing is not available, then you must pay cash for the like-kind replacement property or arrange institutional or other third-party financing. Obtaining third-party financing, especially institutional financing, is often difficult because of the parking structure.

If third-party financing is available, the Exchange Accommodation Titleholder will only execute a non-recourse loan and deed of trust or mortgage that will typically be guaranteed by you. When you take title to the like-kind replacement property, you must assume any outstanding loan balances on a subject to basis.

### **Exchange First Parking Structure – Parking Title to Relinquished Property**

In an Exchange First parking structure the relinquished property is acquired, held or parked by the Exchange Accommodation Titleholder instead of the like-kind replacement property.

A simultaneous or concurrent 1031 Exchange transaction is completed by selling (transferring or conveying) the relinquished property to the Exchange Accommodation Titleholder and simultaneously acquiring and closing on the like-kind replacement property. You would acquire and take title to the like-kind replacement property.

The relinquished property may not be transferred to a disqualified entity such as a related party of the Investor or to someone acting as your agent. When you find a buyer for the parked relinquished property, the Exchange Accommodation Titleholder will deed title of the relinquished property directly to the buyer at the close of the transaction and will forward any net sales proceeds to you in repayment of the funds advanced to complete the reverse 1031 Exchange.

In the “Exchange First” parking structure, you will assign a Purchase and Sale Agreement for the relinquished property to the Qualified Intermediary. You will enter into a Qualified Exchange Accommodation Agreement (“QEAA”) with the Exchange Accommodation Titleholder. The Exchange Accommodation Titleholder sets up a single-member limited liability company (LLC) or other special purpose entity to acquire, hold or park title to the relinquished property.

You will sell the relinquished property to the Exchange Accommodation Titleholder in order to complete a simultaneous 1031 Exchange transaction. You and/or your lender will loan funds to the Exchange Accommodation Titleholder, and the Exchange



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Accommodation Titleholder will execute a non-recourse note and deed of trust or mortgage in favor of you or your lender.

The Exchange Accommodation Titleholder uses this financing to acquire, hold or park title to the relinquished property from the Qualified Intermediary. The Qualified Intermediary uses these advanced funds received from the Exchange Accommodation Titleholder to purchase the like-kind replacement property on your behalf. The like-kind replacement property is conveyed directly to you simultaneously with the conveyance of the relinquished property to the Exchange Accommodation Titleholder and the simultaneous 1031 Exchange is completed.

Once a buyer for the relinquished property is found, the proceeds from the sale of the relinquished property are used to satisfy any financing obtained to complete this reverse 1031 Exchange.

## **When to Use Exchange First Parking**

An “Exchange First” parking structure may be a more viable option than an “Exchange Last” when you need to obtain conventional institutional financing on the like-kind replacement property.

Lenders may have difficulty lending on property that is held by a third-party such as an Exchange Accommodation Titleholder on your behalf.

## **Exchange First Parking Structure – Parking Title to the Relinquished Property**

You select the relinquished property to be sold from your portfolio.

You execute a Qualified Exchange Accommodation Agreement (QEAA) with Exchange Accommodation Titleholder.

Exchange Accommodation Titleholder forms an limited liability company (LLC) or other special purpose entity to park title to relinquished property.

You and your Exchange Accommodation Titleholder will execute a Purchase and Sale Agreement for the sale of the relinquished property to the Exchange Accommodation Titleholder.

You will advance funds to or arranges for third-party financing for the Exchange Accommodation Titleholder to “purchase” your relinquished property.

You will execute a Tax Deferred Like-Kind Exchange Agreement with Exeter 1031 Exchange Services, LLC as your Qualified Intermediary.

You will assign the Purchase and Sale Agreement for your relinquished property to



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Qualified Intermediary and notify purchaser (Exchange Accommodation Titleholder).

Exchange Accommodation Titleholder disburses funds advanced or loaned to it directly to the Qualified Intermediary; and the Qualified Intermediary will instruct you to convey relinquished property to Exchange Accommodation Titleholder.

You will enter into a Purchase and Sale Agreement for your like-kind replacement property.

You will assign the Purchase and Sale Agreement for like-kind replacement property to Qualified Intermediary and the Seller of the like-kind replacement property.

Qualified Intermediary disburses loan funds provided by Exchange Accommodation Titleholder to seller of the like-kind replacement property and directs seller to deed the like-kind replacement property directly to you. Exchange is now completed.

Exchange Accommodation Titleholder leases the relinquished property back to you under a triple-net lease.

You will enter into Purchase and Sales Agreement with buyer for your relinquished property that is now being held by the Exchange Accommodation Titleholder.

You will assign the Purchase and Sales Agreement to Exchange Accommodation Titleholder and notifies buyer of the assignment.

Exchange Accommodation Titleholder closes on relinquished property sale and uses sales proceeds from relinquished property to payoff any funds advanced by you or payoff and/or other lender.

Exchange Accommodation Titleholder cannot hold the relinquished property for more than 180 *calendar* days.

## Issues with “Exchange First” Parking Structures

**Cash Boot Potential:** If the equity in the relinquished property is greater than the cash invested in the like-kind replacement property, then you may incur depreciation recapture and capital gain income tax liabilities. Since you have already purchased your like-kind replacement property and completed a simultaneous 1031 Exchange up front, you will not have the opportunity to balance out your 1031 Exchange transaction by adding additional cash at the back end of your transaction you’re your relinquished property ultimately sells. For this reason, having the Exchange Accommodation Titleholder hold the like-kind replacement property under an Exchange Last Parking Structure is usually the preferred method as opposed to the Exchange First Parking Structure.



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**Relinquished Property Loan:** By transferring the relinquished property to the Exchange Accommodation Titleholder, you will run the risk of triggering the due-on-sale clause in your relinquished property financing. This is one of the reasons that many Exchange Accommodation Titleholders will not acquire, hold and park title to your relinquished properties.

## **Pre-Exchange Due Diligence**

Before setting up a reverse 1031 Exchange, the Exchange Accommodation Titleholder will require you to provide the following documents and information:

- 1) Financial statements and/or Federal income tax returns for the last two or three income tax years;
- 2) Grant deed for the relinquished properties showing legal title as currently held by you;
- 3) Binder providing proof of property, casualty and liability insurance coverage and naming the limited liability company (LLC) as the named insured and the Exchange Accommodation Titleholder (EAT) and the Investor as additional named insureds;
- 4) Phase I Environmental Assessment report issued within the last 6 months. The report must indicate that the real property is free of contamination and be certified to the Exchange Accommodation Titleholder. This is typically required on all types of properties, although certain Exchange Accommodation Titleholders may waive this requirement for certain types of property zoned residential; and
- 5) Title insurance binder naming the Exchange Accommodation Titleholder as the named insured (real property). You should inquire as to how the title insurance policy will be assigned to the Investor upon completion of the Reverse 1031 Exchange transaction.

## **Issues with Reverse 1031 Exchanges**

The costs surrounding reverse 1031 Exchanges are considerably more than those for a forward 1031 Exchange transaction. Fees for Reverse 1031 Exchange transactions are higher than fees for forward, delayed 1031 Exchange transactions primarily due to the significantly increased risk that is assumed by the Exchange Accommodation Titleholder (EAT) when acquiring, holding and “parking” legal title to your relinquished or replacement properties.

You will also incur additional title insurance, environmental, loan, legal, property, casualty and liability insurance, and escrow/closing costs depending on the structure of the reverse 1031 Exchange.



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There is also the potential for double taxation of state, county or local taxing authorities such as transfer taxes, property taxes due to incorrect or premature reassessment when either the relinquished or the replacement property is conveyed to the Exchange Accommodation Titleholder and then transferred to the buyer (“Exchange First”) or to the Investor (“Exchange Last”).

However, in a recent Private Letter Ruling (PLR 200148042), the Internal Revenue Service approved an express declaration of agency for all purposes except federal income tax purposes that could be included in the Qualified Exchange Accommodation Agreement with out jeopardizing the reverse 1031 Exchange.

Conveying title to property from an agent to a principal is not a taxable event in most taxing jurisdictions. While the Private Letter Ruling only pertains to the ruling obtained by the specific taxpayer in this case, this nonetheless provides some insight into the Internal Revenue Service’s views on the matter.

**Depreciation:** You can not depreciate the like-kind replacement property acquired, held and parked by the Exchange Accommodation Titleholder until you have acquired title to the like-kind replacement property or have transferred the relinquished property to the Exchange Accommodation Titleholder. The Exchange Accommodation Titleholder does not depreciate the property acquired, held and parked. The property is held on its books as inventory held for ultimate disposition.

## **Alternative Strategies**

After reviewing the costs involved in a reverse 1031 Exchange, Investors may want to consider approaching the seller of the like-kind replacement property and agree to find a way to delay the closing of the like-kind replacement property until they can find a buyer for their relinquished property and can then restructure the transaction in to a forward 1031 Exchange transaction.

You may want to consider securing your like-kind replacement property by including contingency language in the purchase and sale agreement, conditional or non-refundable earnest money or an option or lease/option agreement.

As always, you should seek the advice of legal, tax and financial counsel prior to entering into any 1031 Exchange structure.

# Choosing a SAFE Qualified Intermediary<sup>©</sup>

Written by:

**William L. Exeter**  
*President and Chief Executive Officer*  
*Exeter 1031 Exchange Services, LLC*  
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## LEGAL DISCLAIMER

1031 Exchange transactions pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Department of the Treasury Regulations are complicated transactional structures that involve significant legal, tax and financial issues. Investors should always consult with competent legal, tax and financial advisors prior to entering into and completing a 1031 Exchange transaction. This article is intended as a brief overview of the subject and is NOT intended to serve as specific legal, tax or financial advice.

## Choosing a SAFE Qualified Intermediary<sup>©</sup>

Written By:

**William L. Exeter**

*President and Chief Executive Officer  
Exeter 1031 Exchange Services, LLC*

The Qualified Intermediary (often referred to in the real estate industry as an Exchange Accommodator or Exchange Facilitator) is a crucial part of any successful 1031 Exchange transaction pursuant to Section 1031 of the Internal Revenue Code.

You should therefore exercise significant care when choosing your own Qualified Intermediary because of the critical role it will play in administering your 1031 Exchange transaction.

The purpose of this article is to assist you, as a potential Exchangor, in developing an understanding of the risks involved in selecting a Qualified Intermediary and the questions to ask prospective Qualified Intermediaries as part of your due diligence. The due diligence process should not be taken lightly.

### **Role of the Qualified Intermediary**

The Qualified Intermediary is authorized under Section 1.1031 of the Department of the Treasury Regulations<sup>1</sup> and is essentially responsible for: (1) preparing the 1031 Exchange agreements and related transactional documents in order to properly structure the 1031 Exchange transaction; and (2) receiving, holding and safeguarding your 1031 Exchange funds throughout the transaction; and (3) advising or consulting with you regarding the implementation of your 1031 Exchange transaction to ensure compliance with applicable Internal Revenue Codes, Department of the Treasury Regulations and related Revenue Rulings and Procedures.

### **Qualified Intermediaries Are Not Licensed or Regulated**

It is important to note that Qualified Intermediaries are generally not licensed, regulated, audited or otherwise monitored in most states by any governmental regulatory agency, and Qualified Intermediaries are generally not required to be bonded, insured or maintain any other form of minimum equity capitalization in most states. Anyone can start a Qualified Intermediary and begin administering 1031 Exchange transactions.

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<sup>1</sup> Section 1.1031(b)-1(g)(4) of the Department of the Treasury Regulations.

It is therefore extremely important for you to know how to properly evaluate and choose a safe Qualified Intermediary for their 1031 Exchange transaction.

A careful and thorough due diligence process should be performed by you before making your final selection. Choosing the wrong Qualified Intermediary to administer a 1031 Exchange could be a very expensive mistake due to the Qualified Intermediary's critical fiduciary duties and responsibilities.

### **Due Diligence Process for Evaluating Qualified Intermediaries**

There is very little written or published guidance or reference material available on safe and successful administrative practices for 1031 Exchanges and/or protecting and safeguarding Investors' 1031 Exchange funds.

You may focus all too often on issues such as exchange fees, interest rates paid, turn around times, branch office locations, and the like, when interviewing potential Qualified Intermediaries. While many of these issues are important considerations and should not be ignored or overlooked, there are other more crucial criteria that Investors must question and evaluate first.

### **Identifying and Evaluating Critical Risks**

The critical risk criteria that must be reviewed and evaluated prior to making the final decision on which Qualified Intermediary to retain includes, but is not limited to, the following areas:

- (1) Technical capability of the Qualified Intermediary
- (2) Administrative errors, omissions or mistakes in a tax-deferred exchange
- (3) Theft, embezzlement or misappropriation of exchange funds

An experienced, professional, institutional Qualified Intermediary like Exeter 1031 Exchange Services, LLC will understand these concerns and will be happy to discuss these crucial issues with you.

Well managed institutional Qualified Intermediaries will have already evaluated the applicable risks, addressed the critical issues and implemented appropriate safeguards to protect Investors' 1031 Exchange funds and to ensure the successful completion of the 1031 Exchange transaction.

The following comments will provide specific and acceptable industry guidelines and standards that will be helpful in evaluating Qualified Intermediaries and in determining if acceptable and adequate controls and safeguards are being practiced.

You should never take short-cuts when evaluating and selecting a Qualified Intermediary for your 1031 Exchange transaction; to do so could have disastrous consequences.

### **1031 Exchange Technical Ability – Knowledge, Expertise, and Experience**

The most important issue to evaluate is the technical ability and capacity of the Qualified Intermediary's 1031 Exchange specialists because of the highly technical nature of 1031 Exchanges. The slightest mistake could result in a disallowed 1031 Exchange and the recognition of significant capital gain and depreciation recapture income taxes.

You should ensure that the employees of the Qualified Intermediary have sufficient technical depth, knowledge, experience and expertise to assist with structuring the 1031 Exchange, reviewing transactional documents for potential problems and preparing your 1031 Exchange agreements.

An experienced Qualified Intermediary can easily identify potential problems with a 1031 Exchange and recommend solutions to correct the issue before it is too late. Unfortunately, most technical errors in the administration of a 1031 Exchange can not be corrected after the transaction has closed, so it is vital that problems are identified and resolved before the transaction closes.

You should interview prospective 1031 Exchange advisors. Do not be shy or timid; ask lots of questions and compare the answers and technical depth of experience in order to separate the 1031 Exchange specialists from the average paper pusher. This is a crucial step in selecting the right Qualified Intermediary to administer the 1031 Exchange transaction.

### **Safety of 1031 Exchange Funds**

Another important element that is arguably just as critical as the Qualified Intermediary's technical ability is the safety of your 1031 Exchange funds while being held and safeguarded by the Qualified Intermediary.

Qualified Intermediaries hold significant amounts of 1031 Exchange funds on behalf of many, many clients with no regulatory oversight, no insurance, and no bonding requirements. Qualified Intermediaries have tremendous fiduciary responsibilities to hold and safeguard your 1031 Exchange funds, and yet have no governmental regulatory oversight or minimum financial requirements what-so-ever.

Most clients never ask how their 1031 Exchange funds will be protected or if they are insured. Do not be penny wise and pound foolish. Investigate the methods and structures used to protect your 1031 Exchange investment proceeds. Asking the right questions will make all the difference in the world.

You must ensure the Qualified Intermediary you select to administer your 1031 Exchange takes its fiduciary duties and responsibilities very seriously by obtaining and maintaining the necessary and appropriate levels of bonding and insurance

coverage as well as equity capitalization to cover potential losses sustained by you due to administrative mistakes, errors or omissions by the Qualified Intermediary.

### **Errors and Omissions in the Administration of a Tax-Deferred Exchange**

Although sophisticated internal controls, safeguards, processes and excellent recruiting and training procedures by the Qualified Intermediary can minimize the risk of loss, exchange officers and administrators are still only human and will occasionally make mistakes in the administration of client's 1031 Exchange transactions (errors and/or omissions).

The 1031 Exchange is a highly technical process and mistakes will occasionally occur that could result in a disallowed 1031 Exchange transaction and the subsequent recognition of your depreciation recapture and capital gain income tax liabilities.

To protect against this risk, you should always ensure that the Qualified Intermediary has purchased and maintains sufficient amounts in Errors and Omissions (E&O) insurance coverage to insure against the risk of loss resulting from human error.

Errors and Omissions insurance is perhaps the most important insurance coverage for a Qualified Intermediary to maintain – even more important than Fidelity Bond coverage – because human error is more likely to occur than theft or embezzlement of funds. Most institutional Qualified Intermediaries have Errors and Omissions insurance coverage limits between \$2 million to \$5 million.

Exeter 1031 Exchange Services, LLC maintains \$3 million in Errors and Omissions insurance coverage for the protection of its 1031 Exchange clients.

Errors & Omissions (E&O) insurance coverage for Qualified Intermediaries is extremely difficult to qualify for and obtain – especially in the 1031 Exchange industry. The insurance coverage is also extremely expensive to maintain. Many Qualified Intermediaries do not maintain Errors and Omissions insurance coverage for these reasons.

This should be a major concern for you for the simple reason that human error is a much more likely occurrence than theft or embezzlement of funds, and is more difficult to protect against with internal controls and processes. Errors and Omissions insurance is the coverage you are more likely to need.

While conducting your due diligence, you should make sure that the Qualified Intermediary does in fact maintain sufficient Errors and Omissions Insurance coverage.

To ascertain whether the Qualified Intermediary does maintain sufficient Errors and Omissions insurance coverage, you should request a copy of the insurance binder in order to verify the insurance underwriter, the policy limit, and policy term/expiration date. Ask for the insurance agent's contact information and verify that the Errors and

Omissions insurance coverage does in fact exist and is still in full force and effect and that the information contained on the insurance binder is accurate and complete.

**Theft, Embezzlement or Misappropriation of 1031 Exchange Funds**

Qualified Intermediaries administer thousands of 1031 Exchange transactions and receive, hold and safeguard millions of dollars in 1031 Exchange funds each and every year, so it is critical that appropriate safeguards are put into practice and adequate levels of insurance and bonding are maintained in order to protect your 1031 Exchange funds.

Institutional Qualified Intermediaries like Exeter 1031 Exchange Services, LLC have designed and implemented sophisticated internal controls, independent audit programs and checks and balances to prevent theft or embezzlement of Investor 1031 Exchange funds, including extensive pre-employment background checks.

However, despite these extensive controls, institutional Qualified Intermediaries know that it is not only prudent but critical to maintain sufficient Fidelity bond coverage to insure against potential and unanticipated theft, embezzlement or misappropriation of your 1031 Exchange funds by an employee of the firm. Fidelity bond coverage insures the Qualified Intermediary against this risk of loss.

You should always inquire about the Fidelity bond insurance coverage maintained by the Qualified Intermediary to ensure that the insurance coverage does in fact exist and that it is still in full force and effect (has not been cancelled or expired) and that the insurance coverage or policy limit is sufficient for the size and scope of the 1031 Exchange operation. Most institutional Qualified Intermediaries maintain Fidelity bond insurance coverage limits between \$20 million to \$30 million.

Exeter 1031 Exchange Services, LLC maintains \$30 million in “per occurrence” Fidelity Bond insurance coverage for the protection of its 1031 Exchange clients.

To ascertain whether the Qualified Intermediary does maintain sufficient Fidelity Bond insurance coverage, you should request a copy of the insurance binder to verify the insurance underwriter, the policy limit, and policy term/expiration date. Ask for the insurance agent’s contact information and verify that the Fidelity bond insurance information contained on the insurance binder is accurate and complete.

Ask whether the Fidelity bond is “per occurrence” or merely “in aggregate”. The term “in aggregate” means the policy limit is the total or maximum coverage available to Investors for the 12 month policy period regardless of the number of thefts during the year, and may not be sufficient coverage if the Qualified Intermediary experiences significant losses during the 12 month policy period. The term “per occurrence” means the policy limit applies to each individual theft or loss and provides better protection for you. The difference in the actual amount of coverage provided between “per occurrence” and “in aggregate” can be staggering.



Incidents of theft are quite rare among institutional Qualified Intermediaries. Human error is a more realistic risk to you 1031 Exchange transaction. However, it is important to ensure that the Qualified Intermediary has taken steps to protect the you from each of these risks.

Exeter 1031 Exchange Services, LLC would be happy to discuss these specific issues with you and answer any questions that you might have.



## Biographies of Speakers and Authors

### National Corporate Headquarters Office

William L. Exeter  
President and Chief Executive Officer

Suzanne M. Davis  
Assistant Vice President and Operations Department Manager

Maureen H. Brown  
Assistant Vice President and Exchange Department Manager

### Northern California Branch Office

Jason S. Buckingham, Esq.  
Assistant Vice President and General Counsel

### Central California Branch Office

Steven W. Monk  
Vice President and Regional Manager

### Los Angeles/Orange County, California Branch Office

Barbara Joyce  
Senior 1031 Exchange Consultant

Rosa Esqueda  
Senior 1031 Exchange Consultant

### Hawaii Affiliate Office

Mellanse Lofton  
Branch Manager

### Chicago, Illinois Affiliate Office

Roberto M. Romero-Perez, Esq.  
Senior 1031 Exchange Consultant

Frances Buerman  
Senior 1031 Exchange Consultant



## William L. Exeter

President and Chief Executive Officer  
Exeter 1031 Exchange Services, LLC

William L. Exeter is President and Chief Executive Officer of Exeter 1031 Exchange Services, LLC and its affiliate companies and is located in the company's national corporate headquarters in San Diego, California.

Mr. Exeter has been in the financial services industry since 1980 and entered the 1031 Exchange services industry in 1986. He has written and lectured extensively on 1031 Exchange transactions pursuant to Section 1031 of the Internal Revenue Code and on Tenant-In-Common (TIC) Properties as like-kind replacement property solutions pursuant to IRS Revenue Procedure 2002-22.

In addition, Mr. Exeter is the owner and host of The Exeter Group Real Estate Talk Radio Show™, is a frequent guest expert on "The Financial Advisors — Money Talk Radio Show" on San Diego News Radio AM 600 KOGO and on the "Inside Business Radio Show" on AM 1000 KCEO San Diego.

Mr. Exeter also serves as an industry consultant through Exeter Consulting Group, LLC and as an expert witness on 1031 Exchange related litigation.

Immediately prior to founding The Exeter Group of Companies he served as President and Chief Executive Officer of TransUnion Exchange Corporation (formerly Diversified Exchange Corporation) in San Diego, California for four years and prior to that as Executive Vice President and Chief Operating Officer of The Chicago Trust Company of California and its 1031 Exchange subsidiary for 13 years.

In addition, he served as a senior executive with two 1031 Exchange companies in the 1980s during the tax-deferred like-kind exchange industry's infancy, and is one of the founding members of the Federation of Exchange Accommodators. He has administered in excess of 60,000 tax-deferred like-kind exchange transactions during his career.

Mr. Exeter's professional experience includes 1031 Exchange, title insurance and escrow services, trust and retirement account administration, trust operations, investment management services, commercial banking, and insurance administration.

Mr. Exeter is involved with numerous professional organizations including the Tenant-In-Common Industry Association (TICA), COREnet Global, AIR Commercial Real Estate, ICSC, the San Diego Chapters of CCIM and CREW, NAIOP, SIOR, California Escrow Association, San Diego County Escrow Association, NorCal Escrow Association, and is one of a handful of founding members of the Federation of Exchange Accommodators.

Mr. Exeter graduated from California State University, Los Angeles with a Bachelors of Science degree in Accounting, and from the Canon Financial Institute, attaining the Certified Securities Operations Professional (CSOP) designation. He is currently working toward his Certified Commercial Investment Member (CCIM) designation.



## Suzanne M. Davis

Vice President and  
National 1031 Exchange Operations Manager  
Exeter 1031 Exchange Services, LLC

Suzanne M. Davis is Vice President and National Operations Manager for Exeter 1031 Exchange Services, LLC and its affiliate companies, and is located in the national corporate headquarters office in San Diego, California.

Ms. Davis has day-to-day management responsibility for financial services, cash management, financial and regulatory reporting and trust and corporate accounting operations for our national 1031 Exchange operations.

Immediately prior to joining Exeter 1031 Exchange Services, LLC, Ms. Davis served for four years as Assistant Vice President and National 1031 Exchange Operations Manager for Diversified Exchange Corporation, and previously served seven years as Trust Officer and Manager of the Retirement and Custodial Services Group of The Chicago Trust Company of California (formerly Security Trust Company). She has also accumulated extensive experience while working in numerous management positions with Bank of America for over 18 years.

Ms. Davis has been involved in the community as a member and participant of several career-related Associations such as the San Diego County Escrow Association (SDCEA), California Escrow Association (CEA), NorCal Escrow Association, San Diego County Association of Realtors (SDAR), San Diego chapter of CCIM and CREW, and AIR Commercial Real Estate Association.

She has also volunteered for Sunshine's Walk for Kids, the kick-off to the Children's News day benefiting The Children's Hospital and Health Center and at the Senior Community Centers of San Diego.



## Maureen H. Brown

Vice President and  
National Exchange Administration Manager  
Exeter 1031 Exchange Services, LLC

Maureen H. Brown is Vice President and National Exchange Administration Manager for Exeter 1031 Exchange Services, LLC and its affiliate companies, and is located in the national corporate headquarters office in San Diego, California.

Maureen joined Exeter 1031 Exchange Services, LLC in February 2006.

Ms. Brown previously held the position of Assistant Vice President and National Exchange Manager of Diversified Exchange Corporation.

She is responsible for the over all management and administration of day-to-day 1031 Exchange client account administration, including forward, reverse and build-to-suit 1031 Exchange strategies. She is also responsible for system design and development for the 1031 Exchange operations.

Prior to joining Diversified Exchange Corporation, she served for eleven years with Chicago Title Company in title and escrow operations for residential, commercial and builder services business segments, as well as systems development and training.

Maureen is involved with numerous professional organizations including the California Escrow Association (CEA), San Diego County Escrow Association (SDCEA), Nor-Cal Escrow Association, AIR Commercial Real Estate Association (AIR), and the Federation of Exchange Accommodators (FEA).



## Jason S. Buckingham

Counsel

Exeter 1031 Exchange Services, LLC

Jason Buckingham is Counsel (outside) for Exeter 1031 Exchange Services, LLC and its affiliate companies and is located in the company's Northern California Branch Office located in San Francisco, California, and is a California licensed attorney and commercial real estate broker.

Mr. Buckingham has worked in some aspect of real estate transactions since 1993, with the past several years focused on commercial real estate transactions. Jason has worked with some of the largest real estate developers, owners, and lenders in the country.

Jason has experience in 1031 Exchanges, property analysis, due diligence, title and escrow, acquisitions, entity formation, financing, leasing, and ongoing corporate management issues.

Mr. Buckingham is a frequent speaker for business owners, investors and professionals on issues related to commercial real estate, including 1031 Exchanges, risk management, commercial leasing, and tenant in common investments. Jason is also the Real Estate Legal Issues forum moderator for the Exeter Discussion Board.

Mr. Buckingham graduated from John F. Kennedy University School of Law, Cum Laude, December 2004, and was admitted to practice law in the State of California in May 2005. Mr. Buckingham is a member of the California State Bar, American Bar Association, and Contra Costa County Bar Association.



## Steven M. Monk

Vice President and Regional Manager  
Exeter 1031 Exchange Services, LLC

Steven W. Monk is Vice President and Regional Manager for Exeter 1031 Exchange Services, LLC and its affiliate companies, and is located in the national Central California Branch Office in Fresno, California.

Prior to joining Exeter 1031 Exchange Services, LLC, Steve was with Diversified Exchange Corporation for four years as Vice President and Regional Manager with responsibility for the Central California markets.

He has day-to-day management responsibility for business development, educational program delivery, and client relationship management for our Fresno and Sacramento Branch Offices, including the Central Valley, San Joaquin Valley and Northern California Markets.

He has been in the commercial real estate industry since 1985. Immediately prior to joining Diversified Exchange Corporation, Mr. Monk was Senior Information Director for the commercial real estate brokerage firm Pearson Commercial/Grubb & Ellis Commercial Real Estate Services. His extensive commercial real estate background includes CB Richard Ellis, Inc., Grubb & Ellis Commercial Real Estate Services and Coldwell Banker Commercial Real Estate Service spanning the last 22 years.

Mr. Monk is also a guest author with and member of the Urban Land Institute and is a member of numerous professional organizations including the International Council of Shopping Centers (ICSC), Society of Industrial and Office Properties (SIOR), National Association of Industrial and Office Properties (NAIOP), California Escrow Association (CEA), Central Valley Escrow Association (CVEA), Northern California Escrow Conference (Nor-Cal), Northern California Chapter of CCIM, AIR Commercial Real Estate Association (AIR), and the Federation of Exchange Accommodators (FEA).

Steve and his family are active in numerous community and charitable organizations, including California State University, Fresno Alumni Association, Delta Sigma Pi Alumni Association and National Downs Syndrome Society. He is currently a member of the Fresno Area Downs Syndrome Society and is a member of the board of directors and fundraising chairman for the Fresno Challenger Sports League.

Mr. Monk also holds a California Department of Real Estate salesperson license issued in August of 1997.



## Mellanese S. Lofton

Hawaii Branch Manager  
Exeter 1031 Exchange Services, LLC

Mellanese S. Lofton is a Branch Manager with Exeter 1031 Exchange Services, LLC and its affiliate companies and is located in the company's Kona Hawaii Branch Office. She is also a California licensed attorney.

Ms. Lofton has day-to-day management responsibility for business development, educational program delivery, and client relationship management for our Hawaiian Islands 1031 Exchange operations.

She has over 30 years of experience in the practice of law, including real estate, and has held the position of Vice-President and General Counsel with a major corporation. She is also continuing her private practice in California. In her private practice, she emphasizes estate planning and probate matters.

After moving to the Big Island of Hawaii four years ago, Ms. Lofton became part of the Big Island Hawaiian community giving seminars to local groups and associations on various legal issues, including 1031 Exchanges. She is the co-author of "The Medi-Cal Advantage: How to Save the Family Home from the Cost of Nursing Home Care" and the author of a soon to be published book "Your Move: How to Play the Corporate Game and Win".

She is a member of the North Hawaii Rotary Club, the Kona Board of Realtors, and served as North Hawaii Rotary Club Foundation Chair for two years. She has two children, both of whom are lawyers. Her hobbies are tennis and photography.