

> In the Know...

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EXCHANGE TERMINOLOGY- page 1

Many areas of real estate law have language which is generally understood within its own field. IRC 1031 is no different, having many terms which are relative to these transactions alone. The following words are commonly referred by Exchange Practitioners and have the meanings as set forth:

1031 Exchange - The 1031 permits taxpayers to reinvest the proceeds from the sale of property held for investment or business purposes into another investment or business property and defer the capital gains they would otherwise pay. The 1031 code is for use in both real property assets and personal property assets. Previously referred to as "Starker Exchanges".

Accommodator/Qualified Intermediary/Facilitator - The third party, Leverage Exchange Group, LLC, "Safe-Harbor" that helps to facilitate the exchange. This is the party that is required by the IRC 1031 regulations to hold the proceeds from the sale property until the location and closing of the Replacement Property.

Boot - There are many forms of Boot in an exchange. If the taxpayer receives any cash from the closing of the Relinquished Property this is considered "Cash Boot" received by the taxpayer and is taxed at a Capital Gain Rate. If the taxpayer acquires Replacement Property which is of higher value than the Relinquished Property and obtains a loan for the difference this can be called "Mortgage Boot" given by the taxpayer. Cash Boot received from the taxpayer is never offset by Mortgage Boot given by the taxpayer. If the taxpayer does not replace the loan value from the Relinquished Property into the Replacement Property with either another loan of equal or greater value or cash, aside from the exchange funds, then the taxpayer is considered to have received "Mortgage Boot" and will be taxed at a Capital Gain Rate.

Depreciation Recapture - On the sale of Investment Property the IRS requires the taxpayer "recapture" the depreciation which was taken on the sale property. Depreciation is taken against income producing investment property to offset the income received on the property which is taxable each year. At the sale, the IRS recaptures the depreciation at a rate of 25%.

Disregarded Entity - Land Trusts and Limited Liability Companies (LLC) are considered disregarded entities in the eyes of the IRS as long as the taxpayer is the sole beneficiary or member (respectively).

Relinquished Property - The Relinquished Property is the property being sold as part of the exchange. Sometimes the Relinquished Property will also be referred to as the Down-Leg in an exchange. It is the Old Property, the property being sold in the transaction.

Replacement Property - The Replacement Property is the property being purchased as part of the exchange. Sometimes the Replacement Property will also be referred to as the Up-Leg in an exchange. It is the New Property, the property being acquired in the transaction.



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EXCHANGE TERMINOLOGY- page 2

Starker Exchange - Named after Starker a taxpayer who won in U.S. Court of Appeals his case against the IRS. The IRS had asserted that the transaction he completed with the Crown Zellerbach Company was not qualified to receive tax-deferred status under IRC §1031 code, they lost the case. Prior to issuance of the 1991 regulations the transactions were called Starker Exchanges.

Simultaneous Exchange - Any exchange of property which occurs within 45 days from the closing of the Relinquished Property. In a Simultaneous Exchange you do not have to separately identify the replacement property by a written identification document, it is deemed identified by virtue of purchase.

Delayed Exchange - An exchange in which the Replacement Property is acquired after the 45 days but within 180 days. The Replacement Property must be properly identified within the first 45 days from the closing of the Relinquished Property.

Reverse Delayed Exchange - An exchange in which the Replacement Property is acquired prior to the sale of the Relinquished Property. Reverse Exchanges were formally acknowledged by the IRS on September 15, 2000 under Revenue Procedure 2000-37. The employment and use of an Exchange Accommodation Title ("EAT") holding entity is generally used to accomplish this type of exchange.

Related Party - In an exchange IRC §267(b) and 707(b)(1) defines related party as any person or entity bearing a relationship to the Exchanger such as: members of a family – brothers, sisters, spouse, ancestors and lineal descendants; a grantor or fiduciary of any trust; two corporations which are members of the same controlled group or individuals; corporations and partnership with more than a 50% direct or indirect ownership of the stock, capital or profits in these entities.



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EXCHANGE RULES: KNOW THE RULES – OBTAIN THE DEFERMENT

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Identification Periods - The Replacement Property must be identified within 45 days from the closing of the sale of the first Relinquished Property (the "Identification Period"). This 45 day rule is very strict and is not extended if the 45th day should happen to fall on a Saturday, Sunday or legal holiday or for any other reason. You have until midnight of the 45th day to make your identification.

Exchange Period - The Replacement Property must be received by the taxpayer within the exchange period which ends within the earlier of 180 days from the date on which the taxpayer transfers the first relinquished property, or the due date for the taxpayer's federal income tax return for the taxable year in which the transfer of the Relinquished Property occurs. The taxpayer may obtain extensions of the tax-filing deadline up to, but not exceeding, the full 180 days.

Manner of Identification - Replacement Property must be identified in a written document (the "identification") signed by the taxpayer and hand-delivered, mailed, telecopied, or otherwise sent and received before the end of the identification period. Written identification should be made to the person obligated to transfer the Replacement Property to the taxpayer, or any other person involved in the exchange other than the taxpayer or a disqualified person (e.g. Your Qualified Intermediary – Leverage Exchange Group, LLC).

Real Property - In the case of real property, the identification must include the legal description, a street address, or a distinguishable name. In addition, when the identified Replacement Property consists of property to be improved, the taxpayer needs to adequately describe the land and provide as much detail regarding the construction of improvements as is practical at the time the identification is to be made.

Multiple Properties - When identifying replacement property, you may select one of the following rules:

3 Property Rule - The taxpayer may identify as potential Replacement Property any three properties, without regard to their fair market value.

200% Rule - The taxpayer may identify as potential Replacement Property any number of properties, as long as the aggregate fair market value of the properties does not exceed 200% of the aggregate fair market value of all the Relinquished Properties as of the initial transfer date.

95% Exception - If the taxpayer has identified more properties than are permitted by both the rules above, the taxpayer must receive property the fair market value of which is at least 95% of the aggregate fair market value of all properties identified.



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ACCEPTABLE EXPENSES

- Commissions and/or Finder's Fee(s)
- Exchange Fee(s) – Q/Intermediary
- Escrow Fee(s)
- Attorney/Legal Fee(s)
- Premiums for Owners Title Insurance
- Recording Fees(s)
- Transfer Taxes
- Inspection and Testing Fees

NON-ACCEPTABLE EXPENSES

- Loan Fee(s) and/or related Loan Charges (i.e. Loan Points, Application Fee, Mortgage Insurance Premiums and Lender's assumption Fee)
- Security Deposits/Rent Pro-rations
- Prepayment penalties/mortgage interest
- Property Taxes
- Premiums for Property Insurance
- Utilities Charges
- Premiums for Lender's Title Insurance
- Association Fees

*The information contained herein is presented for informational purposes only.
For complete information on acceptable deductions, please consult your tax advisor and/or attorney.*



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REMEMBER THE “g6” I.R.C. RULES

Below for, your reference, are the rules by which your exchange agreement is governed. Please familiarize yourself with these rules. Leverage Exchange Group, LLC must adhere strictly to these rules. The paragraph below is taken, in part, directly from the Exchange Agreement you entered into and are noted as Paragraph 10 of the agreement:

RESTRICTIONS ON ACCESS TO EXCHANGE PROCEEDS. The Parties agree, pursuant to Treas. Reg. 1.1031(k)-1(g)(6), that Exchanger shall have no right to obtain any portion of the Exchange Proceeds or the benefits, or receipt, pledge, borrow, or otherwise obtain the benefits of the Exchange Proceeds thereof at any time prior to the first to occur of the following: (i) the end of the Identification Period - if no identification of Replacement Property(ies) have been made; (ii) after Exchanger has received title to all identified Replacement Property to which the Exchanger is entitled under this Agreement – and only after the Identification Period has expired; (iii) if Exchanger has identified Replacement Property in accordance with the exchange agreement hereof and there has occurred after the end of the Identification Period a material and substantial contingency that (1) relates to the deferred exchange, (2) is provided for in writing and delivered to Intermediary prior to expiration of the Identification Period, and (3) is beyond the control of Exchanger or any disqualified person, as the term is defined in Treasury Regulation § 1.1031(k)(2), (k)(3) or (k)(4), other than the person obligated to transfer the Replacement Property to Exchanger, (iv) the end of the Exchange Period – 181st day.



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AMERICAN JOBS CREATION ACT OF 2004

Five-Year Hold Required to Exclude Gain Under IRC 121

On October 22, 2004, President Bush signed into law corporate and foreign tax legislation (H.R. 4520) that included a provision affecting IRC § 1031. H.R. 4520 includes the following provision to amend 121(d):

(10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE. —If a taxpayer acquired property in an exchange to which section 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property.

Now, an exchanging taxpayer who acquires a rental house as a replacement property that is later converted into their primary residence is not allowed to exclude gain under the principal residence exclusion rules of IRC §121 unless the sale occurs at least five years from the date of its acquisition. As a result of this additional requirement in IRC § 121, anyone exchanging into a rental which they subsequently convert to personal use will have to wait at least five years from acquisition before they can sell it as their residence and exclude any gain under IRC~12 1(a).

The change to the home seller rules of IRC §121 became effective for principal residence sales occurring on or after October 22,2004. Any taxpayer who previously acquired their current residence through a tax deferred exchange within the past three years will now have to wait at least another two years before selling their home and excluding gain. This assumes they meet the two out of five-year occupancy test.

Example: A taxpayer sold her rental house A on May 1,2002, and completed her delayed exchange on September 15,2002, by acquiring rental house B as replacement property. Taxpayer moved into B on October 1, 2004, intending to occupy it as her principal residence. Under the new law, in addition to meeting the 2-year occupancy requirements, taxpayer will need to wait until September16,2007, before selling B in order to exclude gain under IRC 121.



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EXCHANGER FINANCING IN RELINQUISHED PROPERTY - page 1

Important - if the exchanger agreed to provide financing for the buyer of the Relinquished property, important decisions must be made prior to closing!

Exchanger options to be considered prior to closing:

If the Seller plans to complete a §1031 Tax Deferred Exchange and intends to offer financing to the Buyer of the relinquished property, the Seller is combining an exchange with an installment sale (§453). Both have very different tax ramifications and the Seller should consult his tax advisor before the sale closes. The following information is provided as a general guideline for the Exchanger and Tax Advisor to take into consideration.

The terms of a normal exchange agreement call for the Qualified Intermediary to step into the Seller's (Exchanger's) position prior to closing. If the Purchase Contract calls for seller financing, the Qualified Intermediary should then become the beneficiary of that financing. However, if the Exchanger wants to have the proceeds taxed when the principal is paid, then the Exchanger must instruct the settlement agent and the Qualified Intermediary that only the portion of the sales price that is not financed will apply to the exchange. The Qualified Intermediary will then prepare the exchange documents accordingly and the financing documents will name the Exchanger as beneficiary at closing (s/p i.e. \$100,000 sale, \$20,000 financed, Q.I. assigned into 80% of sale).

If the Exchanger intends to defer the gain on the entire sale, including the financing, the Qualified Intermediary **MUST** be named as the Beneficiary in the financing documents **PRIOR** to closing and the Exchanger then has the following options to consider:

Assignment to Seller of Replacement Property:

If the Seller of the Replacement Property agrees to accept financing secured by the Exchanger's Relinquished Property as part of the purchase price, Qualified Intermediary will assign the financing documents to the Seller and deliver them to the Replacement Property settlement agent for recordation at closing. In this event, the financed portion of the sale proceeds is deferred and the Seller of the Replacement Property will receive all payments and principal on the amount financed.

Sold to Third Party:

If, prior to the acquisition of the Replacement Property, the Exchanger can arrange to have the financing documents purchased from the Qualified Intermediary the gain is deferred. (The buyer and the purchase price are determined by the Exchanger.) Funds are deposited into the exchange and the documents are assigned to the buyer. The funds are combined with the Exchanger's other proceeds and used to acquire Replacement Property.



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EXCHANGER FINANCING IN RELINQUISHED PROPERTY - page 2

Important - if the exchanger agreed to provide financing for the buyer of the Relinquished property, important decisions must be made prior to closing!

Paid in full prior to acquisition of Replacement Property:

If the financing is paid off within 180 days of the Exchanger's sale, prior to closing on the Replacement Property, funds can be deposited with the Qualified Intermediary and used to acquire the new property.

Sold to Exchanger:

If the Exchanger has another source of funds and wants to buy the financing documents from the Qualified Intermediary, the Exchanger may, prior to closing the Replacement Property. The Qualified Intermediary then assigns the financing documents to the Exchanger and uses the funds to acquire the Replacement Property. When the financing is paid to the Exchanger, it is a reimbursement of other funds advanced, not proceeds of sale.

IF NONE OF THE ABOVE OPTIONS ARE DONE PRIOR TO THE COMPLETION OF THE EXCHANGE, THE QUALIFIED INTERMEDIARY ASSIGNS THE FINANCING DOCUMENTS TO THE EXCHANGER AND THAT PORTION OF THE SALE REVERTS BACK TO INSTALLMENT SALE STATUS.

