



Tax Deferred Exchanges IRC 1031

The nation's oldest and largest exchange accommodator

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PACIFIC FINANCIAL EXCHANGE CORPORATION

A California Corporation with business directions limited to the exchange of Real Estate under the laws of the Internal Revenue Service Code, Section 1031 and State of California Code, Section 24941.

Earl M. Salter, EA, Real Estate Tax Specialist, developed Pacific Financial Exchange Corporation solely for the application of Tax Deferred Exchanges under Section 1031.

The methods used to determine applicability of tax-deferrals differ from one exchange to another. Therefore, agreements between Pacific Financial Exchange Corporation and "Exchangers" are constantly being up-dated and tailored to meet the ever-changing procedures and requirements of the Internal Revenue Service. These changes are made under the direction of Mr. Salter, EA, IRS Enrolled Agent, licensed to practice before the IRS. Mr. Salter has over 30 years of experience dealing with the IRS concerning various tax problems for taxpayers. He has successfully defended several taxpayers at the audit and appeals level to determine the validity of the exchange agreements and procedures used in exchanges.

With Mr. Salter's experience, Pacific Financial Exchange Corporation has been able to compile one of the most comprehensive tax-deferral Real Estate Exchange programs available.

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TAX DEFERRED EXCHANGES

Due to the inflationary spiral, along with the deduction of depreciation upon the value of real estate, many investors are faced with enormous capital gains upon the sale of their investment property. Whereupon, the question arises as to the method one can utilize the disposition of investment property without realizing capital gains.

Section 1031 of the Internal Revenue Service is the answer. Section 1031 provides that "no gain or loss shall be recognized if property held for productive use in trade or business, or for investment, is exchanged solely for property of a like-kind to be held either for productive use in trade, business, or for investment."

The wording of Section 1031 tells us that "like-kind" means of a similar nature as long as both the property given up and the property received are used in the Sellers trade or business. It is immaterial what the buyer does with your property he or she acquires.

The biggest problem confronting the taxpayer desiring to exchange property was that the potential buyer of the taxpayer's property owns no property that the taxpayer wishes to receive in exchange.

Therefore, a transaction so-called "three-corner" exchange evolved. The Tax Court has agreed that this is an exchange within the meaning of Section 1031. e.g., *Alderson vs. Commissioner*, 317 F. 2d 790 (9th Cir 1963) *State of California rev.* 38 T.C. 215 (1962).

The courts have also agreed, that "It is immaterial that the exchange was motivated by a wish to reduce taxes". *Mercantile Trust Company of Baltimore et al. Trustees vs. Commissioner*, *Supra* at 87.

One of the most publicized court cases to support Section 1031 was the "Starker" Case, U.S. T.C. No. 77-2826. This paramount decision allows a contractual purchase of property for a future exchange. In other words, there does not have to be a simultaneous closing of escrow as long as the proceeds do not come under the control of the seller.

To prevent such control by the seller, Pacific Financial Exchange Corporation, A California Corporation, will act as a "substituted seller" so that the IRS cannot argue that the seller had actual control.

Therefore, Pacific Financial Exchange Corporation will hold the proceeds of the sale until a suitable property of "like-kind" can be found.

The legal basis for this transaction can be found in; *F.B. Biggs vs. Commissioner* 69 T.C. No. 78 (1978), *T. J. Starker vs. Commissioner* 77-2 U.S. T.C. No. 9512, *Leslie Q. Coupe* 52 T.C. No. 394 (1960).

These are only a few cases involving application of I.R.C. 1031. We advise you to discuss these and other cases with your Tax Advisor and or your Attorney prior to entering into this or other similar transactions.

Section 1031 (a) (3) (B) OF INTERNAL REVENUE CODE

Seller, "Exchanger", must locate suitable like-kind property within 45 days of the close of transfer of exchange property in order to comply with the like kind exchange rules under 1031 (a) (3) (B). Also, Seller, "Exchanger", must be aware that no more than 180 days from the date of the transfer of the property relinquished in the exchange, will be allowed for acquisition, or after the due date (including extensions) of the transferor's tax return for the year in which the transfer occurred, whichever deadline occurs first. However, no more than 180 days will be allowed for the Seller, "Exchanger", to acquire his or her acquisition property.

If the property you acquire within the 180 day period is not one of the properties that you identified within the first 45 days, your exchange will be in jeopardy of complete disallowance.

Identification for tax purposes must be made in writing which must be submitted to the Accommodator by mail or fax machine, on or before the 45th day.

In order to have a complete tax-deferred exchange, you must comply with the following:

- 1) Sale price of the acquisition or acquisitions of property or properties must be equal or more of the sale price of the sale property.
- 2) Mortgage or mortgages on acquisition or acquisitions of property or properties must be equal or more of the mortgage on the property given up.
- 3) No Notes or Trust Deeds should be carried back. (If a note is carried back, it must go into the name of the Accommodator until the transaction has been completed and then transferred back to taxpayer).
- 4) No cash should be taken out of the exchange funds.

If any one or all of the four above are not complied with, the *difference* is taxable.

Reverse 1031-Exchanges Rev Proc 2000-37, 2000-40

For transactions after September 14, 2000 new safe harbor rules were created for "Reverse" Like-Kind Exchanges.

IRS will not challenge the qualification of property as either replacement or relinquished property, or the treatment of the Exchange Accommodation Title holder as the beneficial owner of either type of property, if the property is held in a "Qualified Exchange Accommodation Arrangement" (QEAA).

The agreements used to facilitate a "Reverse" Exchange are considerably different and more complex than those used for the standard "Delayed Exchange". The method is described as follows:

PFE II, will establish a Limited Liability Company in the State the property is located in ("Exchange Accommodation Titleholder" or "E.A.T"). The taxpayer/exchanger ("Exchanger") and the E.A.T. will enter into a Real Estate acquisition a "Qualified Exchange Accommodation Agreement" ("QEAA"), the E.A.T will agree on certain terms, to acquire the property, which the Exchanger wishes to use as it's "Replacement Property" in the tax deferred 1031 exchange and to transfer the replacement property to Exchanger at such time as Exchanger has sold the "Relinquished Property" to a third party buyer.

The Exchanger will assign to the E.A.T all of its contractual rights to purchase the replacement property, and the E.A.T will close escrow and acquire the replacement property. The title to the replacement property will be vested in the E.A.T. The Exchanger's relinquished property will be sold pursuant to the first phase of a "Delayed Exchange" using a qualified intermediary ("QI"). This property must be identified within 45 days of the E.A.T agreement and closed within 180 days. The "QI" proceeds from the sale of the relinquished property will be used to purchase the replacement property from the E.A.T. The E.A.T. will deed the replacement property directly to the exchanger, which will complete the exchange.

FIVE MISCONCEPTIONS OF 1031 EXCHANGES

- 1. In order to complete a 1031 Tax-deferred Exchange, a taxpayer has to find someone to “swap” a property with.** Originally, prior to 1970, taxpayers would exchange property as “you give me your property, I will give you my property”. After 1970 with the “Starker” Exchange and with the use of a third party called an “Accommodator”, properties are exchanged for other property. Most Exchanges are structured like a sale with the use of an Accommodator allowing for a subsequent purchase.
- 2. A taxpayer seeking to exchange property has to buy the exact same type of property he is selling in order for it to be considered a “like-kind” exchange.** As long as both the property to be sold and the property to be purchased are held for productive use in a trade or business, or for investment purposes, taxpayers are free to purchase whatever type of property they want. For example, a taxpayer can sell an apartment building and exchange it for an industrial warehouse. Income producing property such as rental income can be exchanged for non-income producing property. Zoning is not an issue. California conforms to most IRS rules on Exchanging.
- 3. Taxpayers must complete the 1031 exchange in one completely simultaneous transaction.** Simultaneous or concurrent closings are no longer recommended. Klein vs Comm. 66-TCM, 1115 1993 has allowed IRS to disallow concurrent closings. By virtue of a favorable ruling to the taxpayer in the now famous case of Starker v. United States in 1979, taxpayers have the ability to complete an exchange on a delayed basis so long as they purchase replacement property within 180 days of selling their first relinquished property. Other structures, including reverse exchanges and improvement exchanges, afford taxpayers other types of flexibility during the exchange time frame.

- 4. Taxpayers must use all the proceeds from the sale of their relinquished property to purchase replacement property.** In order to have a completely tax-deferred exchange a taxpayer must follow three essential steps: (1) buy replacement property where the value is equal to or greater than the value of the original relinquished property; (2) use all of the original equity realized from the sale to purchase a replacement property; and (3) obtain equal or greater financing on the replacement property as was paid off on the relinquished property at the time of its sale.

However, while those are the rules for a complete deferral, a taxpayer may violate any one of them and complete a partial deferred exchange. For example, a taxpayer who seeks to buy a replacement property of a lesser value, or with less financing, will recognize a capital gains tax on that amount not reinvested in the new property. Simply put, taxpayers can buy replacement properties for a lesser amount and put cash in their pocket, so long as they don't mind paying some taxes.

- 5. I don't need a qualified intermediary. I can simply have my attorney or accountant hold the sale proceeds until the replacement property is purchased.** A qualified intermediary is essential to completing a valid delayed exchange. Basically, the IRS disqualifies any person or entity from acting as an intermediary, if that individual has had an existing business relationship with the taxpayer within the past two years.

Although that statement is somewhat broad, some parties who may be considered disqualified parties are the taxpayer's relatives, attorney, accountant and real estate broker. The IRS provides that neither the taxpayer, nor any disqualified person, or entity, can come into receipt of the exchange funds nor during the exchange, or the exchange will be void. Using a well-established qualified intermediary enables a taxpayer to avoid situations that might void an otherwise valid exchange. It is also a good practice to research the expertise and security of the qualified intermediary.

FREQUENTLY ASKED QUESTIONS REGARDING 1031 TAX DEFERRED EXCHANGES

Q 1. Can I exchange my investment property and defer taxes by investing the money into other Property I already own?

A 1. No.

Q 2. Can I exchange my investment rental property for non-income producing property?

A 2. Yes.

Q 3. Can I exchange my residential rental for Commercial Property?

A 3. Yes.

Q 4. After I complete my exchange, how long must I hold the new property before selling?

A 4. No Holding period. However, be aware of Dealer property status.

Q 5. How long must I wait to make my exchange property my personal residence?

A 5. If your intentions at the time of the exchange were to occupy this property as personal residence, IRS will disallow the exchange. Intent is the key.

Q 6. Is there an extension of time on the 45 day identification period or the 180 day time frame?

A 6. No.

Q 7. Can I receive the interest on funds held by the Accommodator, without jeopardizing my exchange?

A 7. Yes. Taxation Budget #95 May 15, 1990.

Q 8. Can I defer taxes by using the proceeds from my exchange, to build or develop other property?

A 8. Yes, however, there are special circumstances. 1031(k)-1(e)(1)

Q 9. Can I defer taxes if I acquire my new property before I sell my old property?

A 9. Yes, this is a Reverse Exchange. Ask about fees and special considerations.
Rev. Proc 2000-37

Q 10. Can I take cash from my exchange?

A 10. Yes, but it must come out of the sale escrow transaction. All remaining funds must be held by the Accommodator. The amount must be stated in our agreement signed in Escrow 1031(k-1)(g)4(vii).

Q 11. Can I exchange a property in California for a property in another state?

A 11. Yes. You can exchange anywhere in the United States, and Pacific Financial Exchange Corp. can accommodate your exchange in any state.

Q 12. Can I use my net proceeds to pay non-recurring closing costs on the purchase of my property?

A 12. Yes.

Q 13. Can I exchange my investment property for a Partnership interest in property?

A 13. No. Section 1031 (a)-1 July 18, 1984.

Q 14. Can I carry-back a Note on my sale property?

A 14. Yes. However, the Note will be taxable.

Q 15. Can I exchange my investment property for a Business?

A 15. No.

Q 16. Can I exchange my business for another business?

A 16. Yes, but certain intangible items are not exchangeable.

Q 17. How long must I wait to refinance property acquired through an exchange?

A 17. No waiting period.

Q 18. Can I exchange one property for two or more properties?

A 18. Yes.

Q 19. Can I pull out my original cash investment from the exchange property and avoid paying taxes on this cash?

A 19. No - The monies have been co-mingled.

Q 20. Can I exchange a partnership interest for a Tenant-in-Common interest and thereby avoid capital gains?

A 20. No - Rev Proc. 2002-22
Entity transfer not considered "Like-Kind".

Q 21. Is it possible to exchange my property for property owned by a relative?

A 21. Related party transactions are being scrutinized by IRS under SEC. 1031 (P), TM 9748006 - 08/25/97 IRS is concerned with abuse of basis. Until we receive further information on related party transfers we are advising against them. IRS appears to be determined to audit all exchanges between related parties.

Q 22. Can I exchange my property for a "Tenant-in-Common" ownership in a "REIT"?

A 22. No - IRS will consider a "REIT" as a publicly traded partnership. Rev. Rul. 2002-22, June 19, 2002. However, you can exchange into a Tenant-in-Common ownership with an undivided interest.

Q 23. If I use my own funds as deposit into the purchase Escrow, can I then have escrow reimburse me?

A 23. No. Your reimbursement must come back to you from the Accommodator and only after you have received clear title to the purchase property. REG 1031 (K)-1(g)(3)(v)

Q 24. Can I refinance my property to be exchanged, prior to close of escrow tax free?

A 24. No. If you refinance after your property has been listed for sale, cash out will be considered to be Boot. Taxable as ordinary income. Long Vs. Comm. 80TC, 491.

Q 25. Can I subdivide my acreage and do an exchange for other property?

A 25. No. Subdividing property will re-classify the land as "Dealer Property" which is not like-kind. Margolis Vs. Comm. 337F2d 1001.

Q 26. Can I exchange my second residence for another piece of Investment Property?

A 26. There are significant problems with this type of transaction, as of January 1, 2005

Q 27. Can I exchange my personal residence for investment property?

A 27. No. Section 121, Personal Residential Code Section is a mandatory Section in that if you have lived in the property for at least 2 out of the last 5 years, then the subject property is personal residence and can not be exchanged under Section 1031.

Q 28. Who must the up-leg property be identified to?

A 28. The Accommodator or Intermediary.

Q. 29. Can I use Section 1031 to Exchange my Personal Residence that I lived in less than 24 months?

A. 29. No. Personal Residence is covered by IRS Section 121, and cannot Exchanged for any other property.