THE EXETER

# EXCHANGE

The Newsletter for Customers of Exeter 1031 Exchange Services, LLC    Volume I Issue I

## Choosing the Right Qualified Intermediary

The 1031 exchange Qualified Intermediary (often referred to in the real estate industry as an Accommodator or Facilitator) plays a critical role in a successful 1031 exchange transaction. You should, therefore, choose your Qualified Intermediary, or QI, with care.

The QI is authorized under Section 1.1031 of the Department of Treasury Regulations and is responsible for: (1) preparing the 1031 exchange legal agreements and related transactional documents in order to properly structure the 1031 exchange transaction; (2) receiving, holding and safeguarding your 1031 exchange funds throughout the transaction; and (3) advising 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 Regulated**

QIs are not licensed, regulated, audited or otherwise monitored by any regulatory body. In addition, they are not required to be bonded or insured, nor are they required

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# Look Before YOU LEAP

Because tax-deferral and tax-exclusion strategies are plentiful, it's important for you to consider all available options before proceeding with a specific tax planning strategy. Here's an overview of what's available:

**Section 1031 — Exchange of Property Held for Investment**

Section 1031 of the Internal Revenue Code provides that property held as rental or investment property or property used in your business ("relinquished property") can be exchanged for like-kind property also held as rental or investment property or property used in your business ("replacement property") allowing you to defer your Federal, and in most cases, state capital gain and depreciation recapture income tax liabilities. This applies to real and personal property.

Note that 1031 exchange transactions are tax-deferred exchanges — not tax-free exchanges — as many speakers, authors and advisors frequently refer to them. Capital gain and depreciation recapture income tax liabilities are merely deferred — and can be continually and indefinitely deferred — into like-kind replacement properties acquired as part of a series of 1031 exchange transactions.

A 1031 exchange allows you to sell, dispose or convert real property without reducing your cash position by paying capital gain or depreciation recapture taxes. This provides the liquidity necessary to increase your real estate portfolio by trading up in value and ultimately increasing your net worth by improving cash flow and capital appreciation from the portfolio.

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# Choosing an Accommodator

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to maintain any other form of minimum equity capitalization.

Anyone can become a Qualified Intermediary and begin administering tax-deferred exchange transactions. You should always perform a thorough due diligence review of a QI's qualifications before making a final decision. Never pick your QI based solely on their 1031 exchange fees and charges. Choosing the wrong QI to administer a 1031 exchange can be costly due to critical fiduciary responsibilities and obligations throughout your 1031 exchange transaction.

**Due Diligence Process**

There is very little written or published guidance or reference material available regarding safe business practices for 1031 exchanges and safeguarding your 1031 exchange assets.

Often, investors focus on issues such as exchange fees, interest rates paid, turn-around times and branch office locations when interviewing potential Qualified Intermediaries. While many of these are important considerations and should not be ignored or overlooked, there are other more important criteria when evaluating a QI.

**1031 Exchange Technical Capability — Knowledge, Expertise, and Experience**

The most frequent problem encountered in the 1031 exchange industry is that many Qualified Intermediaries do not have the technical depth, experience and expertise necessary to review the transactional documents and catch problems before the transaction closes. Many QIs know how to process 1031 exchange transactions but often do not know what to look for when reviewing your transactional documents, or will not review them out of concern for their own liability.

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

agreements. When interviewing prospective 1031 exchange advisors, ask lots of questions and compare their answers and technical depth of experience in order to separate the true 1031 exchange experts from the rest.

**Internal Audit Controls**

Sophisticated internal processes and internal audit controls will minimize the risk of loss to your 1031 exchange assets while being held, managed and safeguarded by your Qualified Intermediary. Internal controls monitor and safeguard 1031 exchange funds during the administration of your 1031 exchange transaction.

Sound internal processes and controls begin with employee recruiting. Hiring should always include a complete background check of Federal, state, county and city records for criminal convictions, civil liens or judgments, credit or collection problems, and more. Prospective employees should also be screened for illegal substance abuse issues.

In addition, members of the Federation of Exchange Accommodators (FEA) also require employees that control, manage or otherwise handle or have access to clients' assets to be fingerprinted. The FEA also performs another criminal background check when the fingerprint cards are submitted for processing.

Institutional QIs will have sophisticated internal audit controls to ensure the safety of 1031 exchange funds. They include checks and balances, including a requirement that multiple parties initiate any disbursement of funds, processing of checks, wire transfers, daily balancing and reconciliation of all fiduciary bank accounts.
In addition, 1031 exchange administration processes should be segregated from operational functions such as cash management and balancing.

**Safety of 1031 Exchange Funds**

Qualified Intermediaries hold significant 1031 exchange funds on behalf of multiple clients with no regulatory oversight or requirements for insurance, or bonding. Most investors never ask how their 1031 exchange funds will be protected or if they are insured. We recommend you investigate the methods and structures used to protect your 1031 exchange funds. Ensure that the QI maintains appropriate levels of bonding and insurance coverage and is adequately capitalized to cover any losses due to administrative mistakes, errors or omissions.

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# Considering the Options

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**Section 1032 — Exchange of Corporation Stock for Property**

Section 1032 of the Internal Revenue Code provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

**Section 1033 — Involuntary Conversion (Eminent Domain or Natural Disaster)**

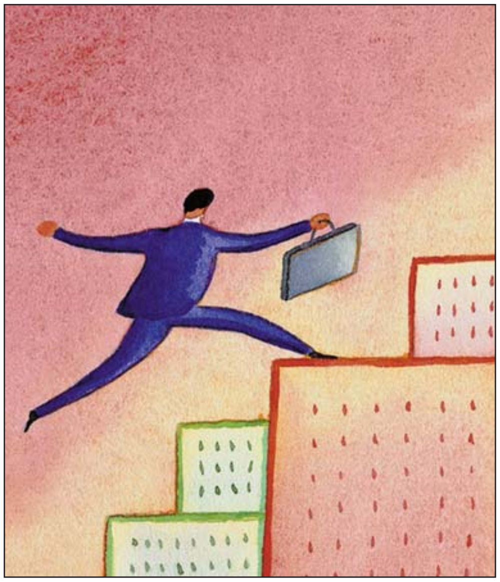
If your property is the subject of a compulsory or involuntary conversion from condemnation via an eminent domain proceeding by local, state or Federal government, you may qualify for Section 1033 of the Internal Revenue Code. This section provides that real property can be exchanged by you on a tax-deferred basis for "like-kind" real property that is similar or related in service or use to the property that was involuntarily converted.

You have up to two years to replace property destroyed by a natural disaster, sometimes referred to as an Act of God, and up to three years to replace property converted because of a condemnation via eminent domain proceeding.

**Section 1034 — Rollover of Gain from Sale of a Primary Residence**

Section 1034 of the Internal Revenue Code was repealed and replaced by Section 121 of the Internal Revenue Code. Still, it is important to understand the origin of Section 1034, what changed with its repeal and the differences between the old and new laws.

Section 1034 allowed an owner of real property used as a primary residence to sell or otherwise dispose of the primary residence, deferring 100% of the capital gain tax liability by acquiring another primary residence of equal or greater value.



**Section 1035 — Exchange of Life Insurance, Endowment or Annuity Contracts**

Section 1035 of the Internal Revenue Code allows you as owner of a life insurance policy, endowment, or annuity contracts or policies to exchange or swap these contracts for other life insurance, endowment, or annuity contracts or policies and defer the income tax consequences.

**Section 721 — Exchange of Property into A Real Estate Investment Trust (REIT)**

Section 721 of the Internal Revenue Code allows you to exchange your rental or investment real estate for shares in a Real Estate Investment Trust (REIT). This is called a 721 exchange — also known as an up-REIT or 1031/721 exchange.

You would typically utilize the up-REIT when you sell relinquished property and acquire like-kind replacement property pursuant to Section 1031 of the Internal Revenue Code. Once held as rental or investment property for 12 to 18 months or more to demonstrate your intent to hold the property and qualify for 1031 exchange treatment, the replacement property is contributed into a REIT in exchange for shares of stock in the REIT under Section 721.

The 721 exchange does not have to be processed in conjunction with a 1031 exchange. You can simply contribute rental or investment property you already own directly into the REIT as part of a 721 exchange.

Section 721 can provide you an excellent exit strategy by enabling you to exchange out of your investment real estate portfolio and into shares of a REIT. The REIT should provide more liquidity once it becomes publicly traded and listed on a securities exchange. In addition, you gain complete control and flexibility over the recognition of the capital gain tax by determining the timing and the quantity of shares sold in the REIT.

The 721 exchange eliminates your ability to exchange back into real estate and defer your capital gain taxes by using a 1031 exchange because you own securities instead of a real estate interest.

**Section 453 — Capital Gain Deferred with an Installment Sale Carry Back Note**

Section 453 allows you to defer your capital gain income tax liabilities when you carry back a promissory note on the disposition, or sale of your property. This is often referred to as seller carry-back financing or installment sale treatment.

When you sell your property and carry back a promissory note to help the buyer finance the acquisition of your property, you can defer the recognition of your capital gain income tax liabilities until you receive principal payments over the term of the promissory note.

Depreciation recapture cannot be deferred with an installment sale and should be recognized in the year in which the disposition (sale) occurs.

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# Choosing

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**Bonding and Insurance**

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.

Inquire about the Fidelity bond insurance coverage maintained by the Qualified Intermediary to ensure that the insurance coverage is in force and effect, and that coverage 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. 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, complete and up-to-date.

**Invest the Time Up Front**

Qualified Intermediaries are more than administrators. They advise on exchange structures and guidelines for compliance while controlling proceeds from the sale and purchase of property. Be sure you choose your QI with care because of the important role they play.

# Exchange Options

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**Section 121 — Exclusion of Capital Gain on the Sale of Primary Residence**

The Taxpayer Relief Act of 1997 repealed and replaced the tax deferral "rollover" provisions contained in Section 1034 with a tax-free capital gain exclusion provision pursuant to Section 121 of the Internal Revenue Code ("121 Exclusion").

You can sell real property held (owned) and used (lived in) as your primary residence and exclude from your gross income up to $250,000 in capital gains if you are single, and up to $500,000 in capital gain taxes if you are married and filing a joint return.

You are required to have owned and lived in the property as your primary residence for at least 24 out of the last 60 months. The 24 months need not be consecutive and there are certain exceptions to the 24 month requirement when a change of employment, health or other unforeseen circumstances has occurred.

Section 121 is effective for dispositions (sales) of real property held as a primary residence after May 7, 1997. You can complete a 121 exclusion once every two years.

As a taxpayer, you should carefully monitor the amount of "built-up" capital gain in your primary residence. You may want to seriously consider selling your primary residence before the capital gain tax liability exceeds the $250,000 or $500,000 limitation.

Capital gain tax liability in excess of these exclusion limitations will be taxable. A sale of your primary residence will preserve the tax-free exclusion of the capital gain and will allow you to acquire another primary residence and start all over again.

Special legal, tax and financial planning is needed in circumstances where you already have a significant capital gain tax liability in excess of the $250,000 or $500,000 exclusion limitation.

For example, your primary residence could be converted to rental or investment property and then sold as part of a 1031 exchange after it has been rented for a sufficient amount of time in order to demonstrate your intent to hold the property as rental or investment property. This would allow you to dispose of your primary residence, defer all of the capital gain tax liability, and diversify and allocate the capital gain tax liability pro rata over a number of rental properties, clearing the way for further financial, tax and estate planning opportunities.

There are special rules applicable to real property initially acquired as replacement property through a 1031 exchange transaction and then subsequently converted to your primary residence and sold pursuant to Section 121 of the Internal Revenue Code.

**Other Tax-Deferral and Tax Exclusion Strategies**

Charitable Remainder Trusts (CRTs) permit you to transfer your highly appreciated property or asset into a trust for the benefit of charities you designate.

The CRT provides you an immediate income tax deduction for the donation of a property or asset into the CRT and allows you to immediately dispose of the property or asset without incurring any depreciation recapture or capital gain income tax liabilities.

You can then reinvest the net sales proceeds into investments providing better cash flow. There are different types of CRTs, so you should discuss your options with your legal, tax and financial advisors.

In the past there was significant discussion regarding Private Annuity Trusts (PATs); however, the IRS effectively eliminated PATs as a tax-deferral option in late 2006.