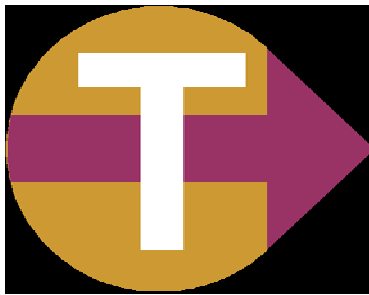


1031 TAX-DEFERRED EXCHANGES

IN TODAY'S MARKET



AIELLO & ASSOCIATES
Real Estate & Financial Services

Disclaimer	1
Reverse Exchanges	2 – 2a
The History of Exchanges	3
Some of the reasons Investors might Exchange, rather than Sell	4
Why Exchange?	5
The Basic criteria for a successful Tax Deferred Exchange	6
Like-kind properties (Under Sec. 1031)	7
Equal or up rule and Boot	8
Most Frequently Asked Questions regarding the 1031 Tax Deferred Exchange	9 – 9a
Seven Steps for a successful 1031 Tax Deferred Exchange	10
Exchange Language for Sale and Purchase Contracts	11
Adopted Treasury Regulations Concerning Identification of Replacement Property	12
Identification Notice	13
Choosing an Intermediary	14
Do not sell your income or investment property... until you do the math!	15
Sample Fee Schedule	16

FLOWCHARTS

Warehousing Exchange with Independent Intermediary – Flowchart	17
Delayed Exchange – Flowchart	18
Reverse Exchange – Flowchart	19
Simultaneous Exchange with an Exchange Facilitator – Flowchart	20
Simultaneous Exchange – Buyer acts as Accommodator – Flowchart	21
Simultaneous Exchange – Seller acts as Accommodator – Flowchart	22
Simultaneous Exchange – No party acts as Accommodator (Incorrect) – Flowchart	23
Simultaneous Exchange – Two-party – Flowchart	24

Notes	25 – 25a
Glossary of terms	26 – 26b

Nothing in this Handbook is to be considered as advice. The accuracy of the enclosed material is deemed reliable, but not guaranteed.

This material is being provided to you free of charge for informational purposes only and to help you locate and secure professional assistance.

The enclosed material was obtained from Old Republic Title Company and is deemed reliable, but not guaranteed.

The (IRS) Internal Revenue Service has just issued Revenue Procedure 2000-37, which sets forth certain rules and procedures relating to the "Reverse Exchange". By way of background, this is actually a Deferred Exchange under Section 1031 of the Internal Revenue Section Code only the steps are taken in somewhat of a reverse order. Under a typical deferred exchange, the taxpayer sells his relinquished property, and later identifies and acquires the replacement property. This is usually done through a qualified intermediary or accommodator. In the reverse exchange, the replacement property is acquired prior to the sale of the relinquished property.

The reverse exchange is normally conducted through what is called a "parking" transaction. An accommodation party will acquire the desired replacement property, and "park" the property until the taxpayer arranges for the transfer of the relinquished property, at which time the "parked" property is then acquired by the taxpayer as the replacement property in the exchange. In other cases, the accommodation party acquires the replacement property, and then exchanges the replacement property for the relinquished property, which is then "parked" with the accommodation party. Thereafter, the accommodation party will dispose of the "parked" relinquished property.

Often these reverse exchanges or "parking" transactions have extended over a period of a year or more. In addition to providing procedures for conducting a reverse exchange, the IRS has established certain time periods within which this type of exchange must be completed.

The IRS has indicated that they will not challenge the qualification of property as either "replacement property" or "relinquished property" where the property is held in a qualified exchange accommodation arrangement (QEAA). Under such an arrangement, a person or entity known as the exchange accommodation titleholder must receive what is called "qualified indicia of ownership" of the property in question. This titleholder must not be the taxpayer or a disqualified person, and must be subject to federal income tax. Generally, the qualified indicia of ownership, means that the titleholder has the benefits and burdens of ownership of the real property.

Some of the important time periods applicable to this reverse exchange are as follows:

- Within five (5) days after transfer of the ownership of the property to the exchange accommodation titleholder, the taxpayer and exchange accommodation titleholder must enter into an appropriate written exchange agreement.
- No later than forty five (45) days after the transfer of the property to the exchange accommodation titleholder, the taxpayer must identify the property to be relinquished. (Alternative and multiple properties may be identified as set forth within the rules.)
- The exchange process must be completed one hundred eighty (180) days after the acquisition of the property by the exchange accommodation titleholder.

The IRS goes on to tell us, that certain contractual arrangements between the parties to the exchange will not cause the exchange to lose its qualification. These arrangements would include the fact that the exchange accommodation titleholder may also act as a qualified intermediary in the exchange. The taxpayer or disqualified person may guarantee obligations or advance funds to the exchange accommodation titleholder in order to provide funding for the exchange accommodation titleholder to acquire the replacement property. The property being held by the exchange accommodation titleholder may be leased to the taxpayer or the taxpayer may otherwise manage the property on behalf of the exchange accommodation titleholder.

As with the rules for the deferred exchange that we have dealt with for several years, these rules and procedures relating to the reverse exchange must be followed in strict fashion. Also, we must always keep in mind that these procedures provide for a deferral of tax, and do not provide for an avoidance of tax.

Simply stated, a Reverse Exchange in an exchange whereby the taxpayer receives the replacement property prior to the date on which the taxpayer transfers the property that is to be relinquished in the exchange.

When possible, it is to the taxpayer's advantage to try to structure the exchange as a delayed exchange, or a simultaneous exchange. Nevertheless, reverse exchanges are becoming an increasingly popular strategy because, for example: they give the taxpayer the ability to acquire the replacement property currently at a favorable price while deferring the transfer of the relinquished property to a time when, hopefully, a better price can be obtained. Such transactions become more frequent in a "Buyer's Market". Another scenario occurs where the owner of the investment property listed for sale finds the ideal replacement property available before finding a buyer for the relinquished property.

In a typical arrangement, the taxpayer enters into a simultaneous exchange with the intermediary, which then holds the relinquished property until a buyer is found. Alternatively, the intermediary may acquire and hold the replacement property until a buyer is found and then enter into a simultaneous exchange with the taxpayer. In both arrangements, title to the replacement property, is acquired by the Accommodator with money borrowed from the Exchange. When the Accommodator completes the sale of the relinquished property as the Principal in the escrow, the Accommodator then pays back the loan it received from the Exchanger using the proceeds derived from the sale of the relinquished property.

TYPE I ARRANGEMENT

- Step 1: Intermediary borrows funds from the Exchanger to acquire the replacement property. Exchanger assigns his/her rights and duties under the purchase contract, to the Intermediary, who then acquires the replacement property as the Principal in the escrow. Simultaneously with the acquisition of the replacement property, the Intermediary deeds the replacement property to the Exchanger, in exchange for the relinquished property.
- Step 2: Intermediary holds and manages the relinquished property until a buyer is found, or until the escrow is ready to close.
- Step 3: The escrow for the relinquished property closes and title is conveyed to the purchaser. Proceeds derived from the sale of the relinquished property are used to pay off the loan advanced by the Exchanger for acquisition of the replacement property.

TYPE II ARRANGEMENT

- Step 1: Intermediary borrows funds from the Exchanger to acquire the replacement property. Exchanger assigns hi/her rights and duties under the purchase contract, to the Intermediary, who then acquires the replacement property as the Principal in the escrow.
- Step 2: Intermediary holds and manages the replacement property while waiting for the relinquished property to sell.
- Step 3: Intermediary exchanges relinquished property for replacement property when relinquished property is ready to close. Exchanger assigns his/her rights and duties under the purchase contract, for the relinquished property, to Intermediary, who completes the sale of the relinquished property as Principal in the escrow.
- Step 4: Using the proceeds derived from the sale of the relinquished property, the Intermediary repays the Exchanger for the loan advanced to purchase the replacement property.

It is important to recognize that although reverse exchanges have become increasingly prevalent during the past several years, there is no statutory authority for them. Due to this and the complexity of these types of exchanges, it is very important to review any proposed reverse exchange with the taxpayer's CPA or tax attorney, to ensure that the exchanger is aware of any potential structuring or tax issues, which may arise.

1918 – First Income Tax Law Imposed

1921 – First Exchange Tax Laws Enacted

1935 – Mercantile Trust Company of Baltimore vs. Commissioner

- 1) First Exchange with an Accommodator
- 2) First test of “cash in lieu” provision

1979 – Starker II. 602 F2d. 1341 (9th Cir. 1979)

- 1) Delayed Exchange upheld
- 2) First use of Exchange credits

1984 – The Deficit Reduction Act

- 1) 45 Day Identification Period
- 2) The sooner of 180 days from transfer of the Relinquished Property, or the due date, including extensions of the Exchanger’s tax return, to complete the Exchange and receive the Replacement Property.

1986 – Tax Reform Act

- 1) Special Treatment for Capital Gains eliminated
- 2) Capital Gains taxed at ordinary income rates

1987 – Nixon vs. Commissioner, 318 T.C.M. (1987)

Delayed Exchange of 300 acres for 109 acres. Taxpayer received check for 300 acres and placed the check in his freezer, and later endorsed the check to the seller of 109 acres. Denied.

Note: Putting the cash on ice will not avoid constructive receipt.

1989 – The Revenue Reconciliation Act

- 1) U.S. Property for Foreign Property
- 2) Two-year holding period for Exchanges between related parties

1990 – Revenue Ruling 90-34

- 1) Direct deeding on the Replacement Property

1991 – Treasury Department Final Rules & Regulations for Delayed Exchanges

- 1) Specific Identification Requirements
- 2) Safe Harbors to avoid Constructive Receipt
- 3) Disqualified Intermediaries (agents & related parties)
- 4) Improvement Exchange Guidelines
- 5) Qualified Intermediary safe harbor extended to Simultaneous Exchanges

1997 – Tax Simplification Act of 1997

- 1) IRC 1034 rollover rules repealed & IRC 121 amended new exclusion amounts and new rules for exclusion of gain on primary residence.
- 2) New holding period requirements and new capital gains rates on the sale of investment real estate.

Some of the Reasons Investors might Exchange, Rather than Sell

- Allows Investors to defer Capital Gains Tax and use the increased equity to purchase a larger property or properties.
- Investors may be spending more time than they like, maintaining properties. They can exchange several properties into one, in order to relieve the burden.
- Investors may want to diversify and exchange a property into another city or state.
- An Investor may want to exchange out of one property that has lots of equity for several smaller properties. If down the road, the Investor wants to sell off some of the smaller properties, the tax burden would be significantly less.
- Take advantage of increased growth and appreciation in a specific area.

The information set forth herein is intended as an overview of IRC 1031 tax-deferred exchanges and should not be construed as legal, financial, or tax advice. Every Investor should consult his or her own counsel regarding the use of a 1031 exchange.

Exchanging real property instead of selling and paying Capital Gains Taxes, makes good financial sense. The examples below illustrate the distinct advantage of Exchanging:

1) Using and Exchange to preserve Equity

Sales Price:	\$250,000
Loan/Debt:	\$50,000
Proceeds:	\$200,000
Basis:	\$50,000
Gain:	\$200,000

Estimated Tax Rate of 25% combined State and Federal Taxes

	SALE	EXCHANGE
Tax Due:	\$200,000	<i>No Tax Due</i>
	X 25%	
	<hr/>	
	\$50,000	

Cash Available For Reinvestment:

\$150,000	\$200,000
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2) Using an Exchange to Maximize Growth and Leverage

Example: Acquiring a property with a 25% down payment

Value:	\$600,000	\$800,000
Loan/Debt:	\$450,000	\$600,000
Equity:	\$150,000	\$200,000

3) Using an Exchange to Maximize Cash-Flow

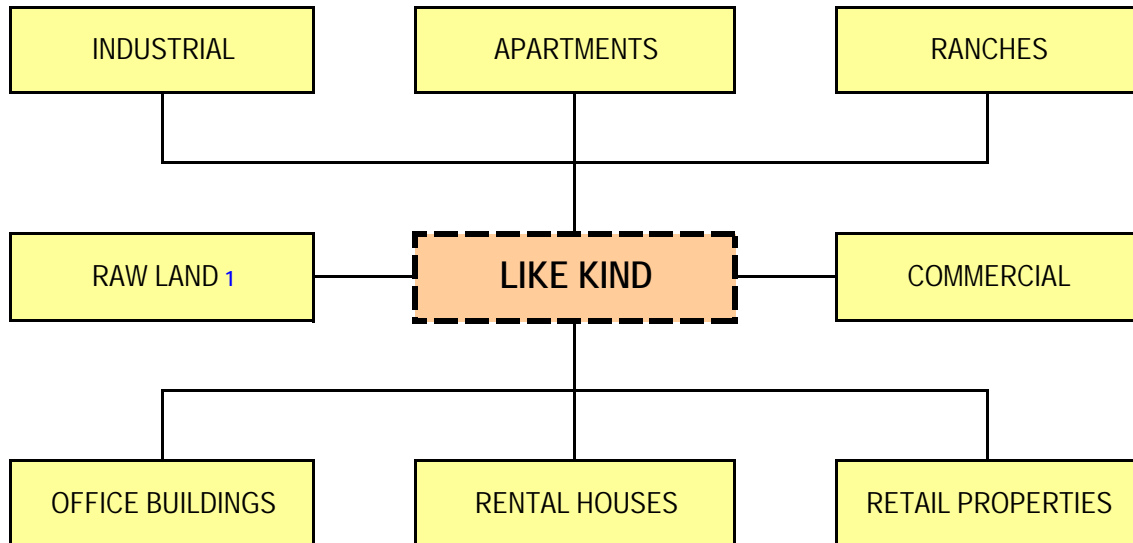
Example: Acquiring a property of equal value

Value:	\$250,000	\$250,000
Loan/Debt:	\$100,000	\$50,000
Equity:	\$150,000	\$200,000

Estimated cash-flow from above example, using a rental income of \$2,000/Month, with a loan at 10%, amortized over 30 years:

Income:	\$2,000	\$2,000
Debt:	- \$878	- \$438
Net:	<hr/>	<hr/>
	\$1,122	\$1,560

- First, an Investor should verify with their accountant, financial advisor, and attorney that an exchange is in their best interest.
- Intent must be to exchange. Exchange language should be added to both, the sale and purchase contracts. (We include the exchange language for you in this information packet).
- Use a “Facilitator” to accommodate the exchange transaction.
- Trade for like kind property.
- Follow the 45/180-day rule. Must identify replacement property within 45 days from the close of escrow of the relinquished property and escrow must close within 180 days of such date, or the tax filing date for the taxable year in which the sale occurred.
- Follow identification requirements:
 - a) 3 Property Rule
 - b) 200 Percent Rule
 - c) 95 Percent Rule
- Trade equal and up in equity and debt.



1) Depreciation must be recaptured

Properties Not Allowed

PERSONAL RESIDENCE

DEALER PROPERTIES

PARTNERSHIP INTERESTS

INVENTORY

To qualify as like kind, any type of real property held for investment or productive use in a trade or business, may be Exchanged for any other type of real property to be held for investment, or held for productive use in a trade or business.

To have a fully Tax Deferred exchange, the taxpayer must acquire the same or more in equity and debt.
Below are some examples:

1) Exchanging for EQUAL VALUE and EQUAL EQUITY = No Boot

	Conveys "Sells"	Acquires "Buys"	Boot?
Exchange Value:	\$100,000	\$100,000	
Debt:	\$50,000	\$50,000	\$0
Equity:	\$50,000	\$50,000	\$0

2) Exchanging UP IN VALUE and EQUAL EQUITY = No Boot

Exchange Value:	\$100,000	\$200,000	
Debt:	\$50,000	\$150,000	\$0
Equity:	\$50,000	\$50,000	\$0

3) Exchanging for EQUAL VALUE but REDUCED EQUITY = Cash Boot

TAXABLE!

Exchange Value:	\$100,000	\$100,000	
Debt:	\$50,000	\$75,000	\$0
Equity:	\$50,000	\$25,000	\$25,000

4) Exchanging for REDUCED VALUE and EQUAL EQUITY = Mortgage Boot

TAXABLE!

Exchange Value:	\$100,000	\$75,000	
Debt:	\$50,000	\$25,000	\$25,000
Equity:	\$50,000	\$50,000	\$0

**Seller Carry-Back Financing may create Boot problems
But, can be used effectively to defer tax in a 1031 Exchange**

Value:	\$100,000	
Loan:	\$50,000	
Equity:	\$25,000	
	\$25,000	[Seller Carry-Back Note]

The Most Frequently Asked Questions Regarding the 1031 Tax Deferred Exchange

1031 Tax-Deferred Exchanges – Page 9

What does “1031” mean?

1031 is the number assigned to the Internal Revenue Code Section that deals with the Tax Deferred Exchange.

Why is it popular?

Investors utilize the 1031 Exchange as a way to defer tax that would otherwise be due on a straight sale. It allows for greater flexibility in their investments, and they can utilize all their equity to purchase another property or properties.

What is a Delayed Exchange?

Also called a Non-simultaneous, deferred or a “Starker Exchange”. A Delayed Exchange is a Tax Deferred Exchange, where the replacement property is received after the transfer of the relinquished property.

What is a Simultaneous Exchange?

Also referred to as a “Concurrent Exchange”. A Simultaneous Exchange is an Exchange transaction whereby the Exchanger transfers out of the Relinquished Property and receives replacement property at the same time.

What are the requirements that a taxpayer must follow in order to complete a Tax Deferred Exchange?

1. First discuss the Exchange with your accountant, financial advisor, and attorney.
2. You must trade for “Like kind” property and the property must be held for investment or productive use in trade or business and not primarily for sale.
3. Trade equal or up in equity and debt.
4. You must follow the 45/180-day rule.
5. Your intent must be to Exchange, and your transaction must be structured as an Exchange.
6. You must avoid “Constructive Receipt” of Exchange proceeds.

Do I have access to my money at all during the Exchange?

During the Exchange transaction, your Exchange proceeds are put into an Exchange Trust Account. This is done so you don't have “Constructive Receipt” of the proceeds. You do have an option, and can earn interest on those funds. If you choose to cancel the Exchange transaction after the sale of your investment property, your funds are returned to you and you will be taxed on the gain from the sale.

If a 1031 Exchange transaction is Tax Deferred, when will I be required to pay the taxes?

When you sell the investment property without exercising the Exchange.

How do I know if I'm better off exchanging a property versus selling?

You will need to consult with your tax advisor, accountant, or legal advisor.

What is a partially taxable Exchange?

If the equity in your investment property is \$150,000 and you wanted to use only \$100,000 to purchase your replacement property, and take the \$50,000 out to purchase a new car, you would have a partially Tax Deferred Exchange. The \$50,000 cash you took out is considered cash “Boot” and you would pay Capital Gains Tax on that amount.

What is a Boot?

Boot is any type of property received or given up in an Exchange that does not meet the like kind property requirement. For example: if the Exchanger receives a car, plane, cash or mortgage relief, he has received Boot, not real property, and will be taxed (see Glossary of Terms for more information on Boot).

What is the primary reason for doing an Exchange?

An Exchange allows you to defer paying the tax due, as a result of a direct sale of real property, and allows you to invest the entire proceeds into another property or properties.

What is “Like Kind”?

Under Section 1031, in an Exchange of real property, in order to qualify as “Like Kind”, the property given up or received must be held for productive use in a trade or business, or held for investment to qualify.

The Most Frequently Asked Questions Regarding the 1031 Tax Deferred Exchange

1031 Tax-Deferred Exchanges – Page 9a

What is “Like Kind”?

Under Section 1031, in an Exchange of real property, in order to qualify as “Like Kind”, the property given up or received must be held for productive use in a trade or business, or held for investment to qualify.

What wouldn't qualify as “Like Kind”?

A personal residence, as well as partnership interests would not qualify as “Like Kind”.

If I own property in California, can I Exchange it for property in another state?

Yes. Some Exchange Facilitator Companies do handle Exchanges in all 50 states.

If I own property with another investor, can I exchange my equity, even if my co-investor doesn't want to?

Yes. You would Exchange your interest into a replacement property, and your co-investor can take his/her cash. He or she however, would be taxed on his or her portion.

Can I take cash out of an Exchange transaction?

Yes. You would pay tax on the amount taken, and use the remainder to acquire your replacement property. (Otherwise known as a Partially Tax Deferred Exchange).

Can I earn interest on exchange proceeds in the trust account?

Yes. The Exchange Facilitator Company will have Fee Schedules from which you can choose to be paid interest on your Trust Account proceeds for a small fee. The interest earned will be until the time you acquire your replacement property.

If I own a piece of property and carry a note for the buyer, is this a taxable event?

Yes. Carrying a Note is considered “Boot” and is taxable. For example: You carried a \$10,000 Note with interest only payments of \$100.00 for 5 years. The \$10,000 is considered “Boot” and you would pay tax on that amount. However, you have an option to elect to pay tax on an installment basis. This means you would pay ordinary tax on the interest income each year, until the Note is due, at which point, you would pay Capital Gains Tax on the \$10,000.

If I own a piece of property that, such as a Duplex, and I occupy one of the units as my principal residence, would the property still qualify for an Exchange?

Yes. The most important thing here is to remain consistent with your past tax returns. Consult your tax advisor to determine what percentage of the value of the property, you have indicated as an investment. You can then exchange that portion of the value.

If I buy a home for my primary residence, live in it for a few years, and later decide to turn it into a rental property, would it still qualify for an Exchange?

We suggest you always consult with your tax or legal advisor in this case, because the IRS has not set timeframe (unless you're exchanging with a family member, in which case you must have owned the property for 2 years prior to the Exchange, and 2 years after the Exchange). As long as it's been rented out long enough to show investment intent, some feel 2 years tax returns showing the unit as an investment property is substantial and shows investment intent.

How do the new tax laws affect my personal residence and the 1031 Exchange?

The new tax laws did not affect the 1031 Exchange because you cannot Exchange a personal residence. There are new holding period requirements, and new rates however for Capital Gains Tax on the sale of investment real estate. The most significant change was that the IRC 1034 rollover rules have been repealed and provide new rules and exclusion amounts for a property owned and used as a primary residence for 2 of the last 5 years. An individual can exclude Capital Gains Tax on \$250,000, or a married couple filing a joint tax return can exclude up to \$500,000. Any access would be taxed at the new Capital Gains Tax rates, and this can be done every two years.

What does an Exchange Facilitator Company do for me?

1. They explain the Exchange process and requirements for a valid Exchange.
2. They prepare the necessary Exchange documents.
3. They assist you, the Escrow Officer, as well as your Broker/Agent and tax or legal advisors throughout the entire Exchange transaction.
4. They hold the Exchange proceeds until you acquire your replacement property and complete the Exchange.

The Most Frequently Asked Questions Regarding the 1031 Tax Deferred Exchange

1031 Tax-Deferred Exchanges – Page 9b

Can I purchase my replacement property before I sell my investment property?

This calls for a more thorough discussion. This would be considered a Reverse Exchange, and in certain circumstances, the Exchange Facilitator Company can accommodate a Reverse Exchange. You will need to contact the Exchange Facilitator Company directly for further information.

Can a relative of mine be my accommodator?

No. An Accommodator must be a non-related party. Also, no Accountants, Lawyers or Realtors can be your Accommodator.

SITUATIONS TO BE AWARE OF:

- Seller carry-back financing
- Exchange between related parties
- Properties held in a family trust
- Construction of replacement property
- Out of State Investors selling California property

Step 1

Consult with your tax and financial advisors

This is to determine if a Tax-deferred Exchange is appropriate for your circumstances and compatible with your investment goals.

Step 2

Listing the Relinquished Property for sale with a Licensed Real Estate Broker

During the first step, the Exchanger will list the Relinquished Property with a Real Estate Broker. The Broker/Agent will disclose the intent to complete an exchange in the Listing Agreement.

Step 3

Offer, Counter Offer and Acceptance

The Exchanger enters into contract with the Buyer for the Sale/Exchange of the Relinquished Property. The Broker/Agent discloses to the Seller, Exchanger's intent to exchange into the Purchase Agreement and Receipt for Deposit.

Step 4

Open escrow for the Relinquished Property and coordinate with the Facilitator

All earnest money deposits should be placed with the Escrow Company. The Facilitator prepares the Exchange Agreement and the necessary amendments and assignments, and coordinates with the Escrow Holder. The close of escrow of the Relinquished Property and the receipt of the net proceeds by the Facilitator completes [Phase-I](#) of a Tax-deferred Exchange.

Important: The Exchange documents must be in place and signed by all parties, prior to the close of escrow.

Step 5

Replacement Property Identification

The Exchanger must identify all Replacement Property within 45 days from the close of escrow of the Relinquished Property. The identification must be in writing, and signed by the Exchanger.

Step 6

Contracting for the Replacement Property

After closing on the Relinquished Property, the Exchanger has 180 days to acquire the Replacement Property. With the assistance of her or her Broker/Agent, the Exchanger enters into contract to purchase the Replacement Property from the Seller. In the contract to purchase, the Broker/Agent discloses the Exchanger's intent to complete the exchange and obtains the Seller's cooperation.

Step 7

Open Escrow for the Replacement Property

The Facilitator prepares the [Phase-II](#) Exchange documents and coordinates with the Replacement Property Escrow Holder. At the instruction of the Facilitator, the Escrow Holder deeds the Replacement Property from the seller directly to the Exchanger. The funds held in trust by the Facilitator, are placed in escrow and the Replacement Property is purchased by the Facilitator from the Seller. The transaction is closed as [Phase-II](#) of a Delayed Exchange.

PURCHASE AGREEMENT FOR THE SALE OF RELINQUISHED PROPERTY

Buyer herein acknowledges that it is the intention of the seller to create an IRS Code Section 1031 Tax Deferred Exchange, and that the seller's rights and obligations under this agreement may be assigned to:

[Exchange Facilitator Company]

to facilitate such exchange. Buyer agrees to cooperate with the seller in a manner necessary to enable seller to qualify for said exchange at no additional cost or liability to the buyer.

PURCHASE AGREEMENT FOR THE ACQUISITION OF REPLACEMENT PROPERTY

Seller hereby acknowledges that it is the intention of the buyer to complete an IRS Code Section 1031 Tax Deferred Exchange, and that the buyer's rights and obligations under this agreement may be assigned to:

[Exchange Facilitator Company]

for the purpose of completing such exchange. Seller agrees to cooperate with the buyer and:

[Exchange Facilitator Company]

in a manner necessary to complete said exchange at no additional cost or liability to the seller.

Regardless of the number of relinquished properties transferred by the Exchanger as part of the same exchange, the maximum number of replacement properties that the Exchanger can identify is as follows:

Three Property Rule

Three properties - Without regard as to the fair market values of the replacement properties.

OR

200 Percent Rule

Any number of properties as long as their aggregate fair market value, as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties, as of the date the relinquished properties were transferred by the Exchanger.

EXCEPTION

95 Percent Rule

Any number of replacement properties identified before the end of the identification period and received before the end of the exchange period, but only if the Exchanger receives before the end of the exchange period, identified replacement property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified replacement properties.

ADDITIONALLY

Re: Description of Replacement Property [IRS Section 1031 (K)(1)(C)(3)]

Replacement property is identified only if it is unambiguously described in the identification notice or exchange agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g. the Mayfair Apartment Building).

Identification Notice

DATE: _____

TO: _____
[Exchange Facilitator Company]

RE: _____
[Relinquished Property]

[File Number]

To Whom It May Concern:

With reference to the exchange of the above referenced Relinquished Property, I/We hereby identify the following replacement properties (please check one or the other):

Three Property Rule

- 1) _____
- 2) _____
- 3) _____

OR

200 Percent Rule

Market Value

- | | |
|----------|----------|
| 1) _____ | \$ _____ |
| 2) _____ | \$ _____ |
| 3) _____ | \$ _____ |
| 4) _____ | \$ _____ |
| 5) _____ | \$ _____ |
| 6) _____ | \$ _____ |

[Exchanger Name – Please Print]

[Exchanger Signature]

The Intermediary acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

One of the safe harbors:

- 1) A qualified Intermediary cannot be the taxpayer or a disqualified person.
- 2) Enters into a written agreement with the taxpayer.

Unregulated Industry

Funds are held in the name of the Intermediary

Protection

- Dual Signature Accounts
- Bonding
- Standby Letter of Credit
- The Financial Strength of the Accommodator

Don't Sell Your Income or Investment Property... Until You Do The Math!

"Analyze the Benefits of an Exchange Before You Sell"

The real power of a Tax-deferred Exchange is not the just tax savings - it's the tremendous increase in purchasing power generated by this tax savings! With the advantages of leverage, every dollar saved in taxes allows a real estate investor to purchase two to three times more real estate.

Many investors are surprised to discover that capital gain taxes are far higher than 20%. State taxes which can be as high as 11% in some states, are added to the Federal capital gain tax owed. In addition, depreciation deducted over the ownership period is taxed at a rate of 25%. The Net result is often a large percentage of your profits going directly to pay taxes.

Your goal is to preserve and enhance your investment portfolio. An exchange is a powerful tool to help achieve that goal. Taxes are paid on Capital Gain, not equity or profit. It is possible to sell property without realizing much profit, and still owe substantial Capital Gains Tax. Capital Gain is simply the difference between the sales price, and the adjusted basis (i.e. what you paid for the property, plus amounts spent on capital improvements, less depreciation taken), less any closing costs associated with the sale.

To calculate your Estimated Capital Gain - First, subtract the adjusted basis from the sales price; then subtract the costs of your transaction; commission, fees, transfer tax, etc.; finally, multiply the Capital Gain by your combined tax rates (Federal and State) to determine your Estimated Capital Gain Tax.

1) Calculate Net Adjusted Basis

Example

Original Purchase Price:	\$ _____	\$400,000
[+] Capital Improvements:	\$ _____	\$25,000
[-] Depreciation Taken:	\$ _____	\$175,000
[=] Adjusted Basis:	\$ _____	\$250,000

2) Calculate Capital Gain

Current Sales Price:	\$ _____	\$600,000
[-] Exchange Expenses:	\$ _____	\$30,000
[-] Adjusted Basis:	\$ _____	\$250,000
[=] Capital Gain:	\$ _____	\$320,000

3) Calculate Capital Gain Tax

Recapture Depreciation: <u>25%</u> (25% x \$175,000 for depreciation = Depreciation Recapture)	\$ _____	\$43,750
[+] Federal Capital Gain: <u>15%</u> (\$320,000 - \$175,000 = \$145,000 x 15%)	\$ _____	\$21,750
[+] State Capital Gain Tax: <u>10%</u> (e.g. for California: Approx. 10% x \$320,000 Capital Gain)	\$ _____	\$32,000
[=] Total Tax Due:	\$ _____	\$97,500

The formula set forth above is provided to assist you in determining your approximate gain and the sums that you may wish to defer through your Exchange transaction. Consult with your tax advisor to determine the correct values and whether an Exchange is appropriate for your circumstances.

Below is a Sample Fee Schedule of what Exchange Facilitator Companies may typically charge to assist you with the Tax-deferred Exchange: Costs and fees may vary between companies.

Schedule A:

- Setup Fee (non-refundable): \$650.00 per relinquished property
- First three replacement (acquisition) properties are **free** - \$250.00 for each additional replacement property thereafter.
- The Exchange Facilitator Company retains all the interest earned on the Exchange Proceeds

OR

Schedule B:

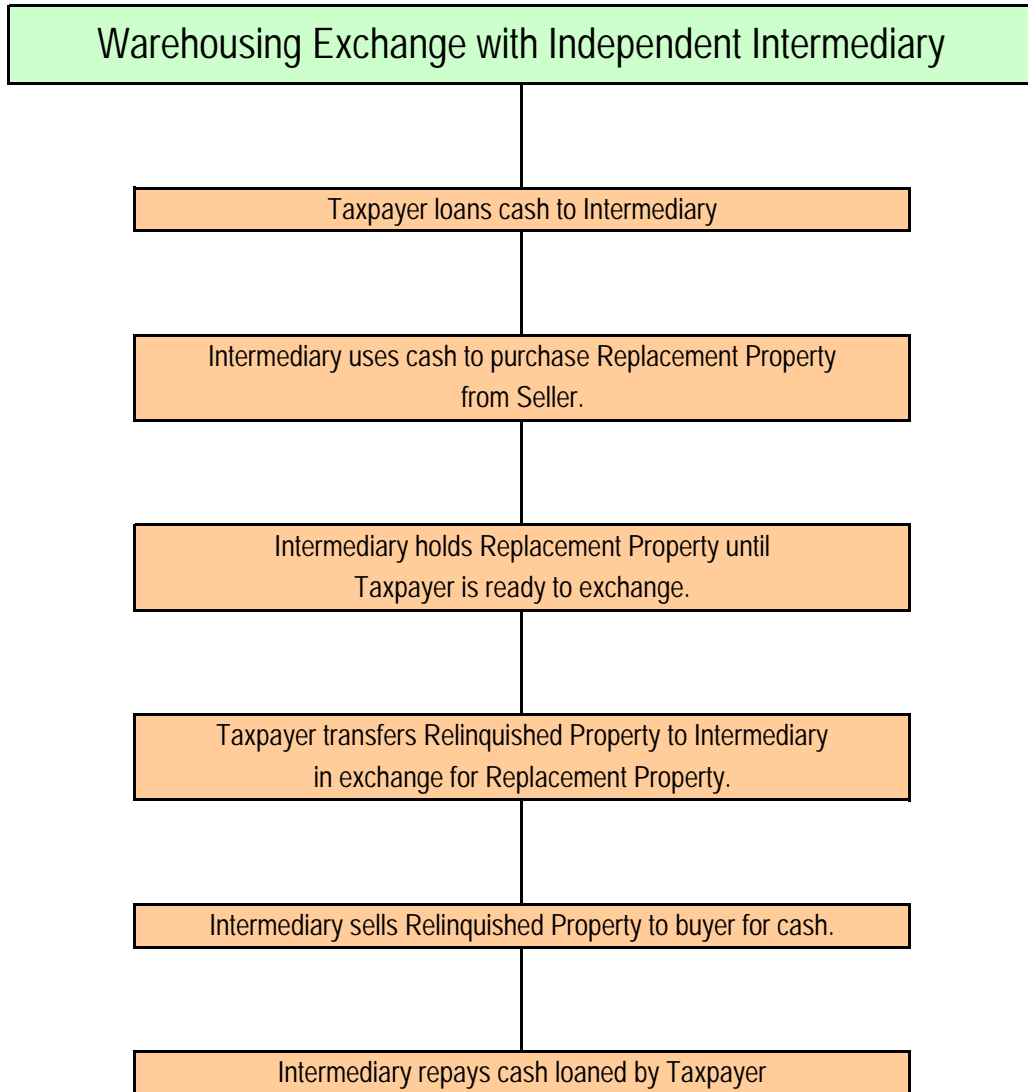
- Setup Fee (non-refundable): \$1,000.00 per relinquished property
- First three replacement (acquisition) properties are **free** - \$250.00 for each additional replacement property thereafter.
- Administrative Fee from the bank or savings institution with whom the Exchange Proceeds are deposited in the maximum amount of 75 basis points (0.75%) of the interest earned on the Exchange Proceeds

OR

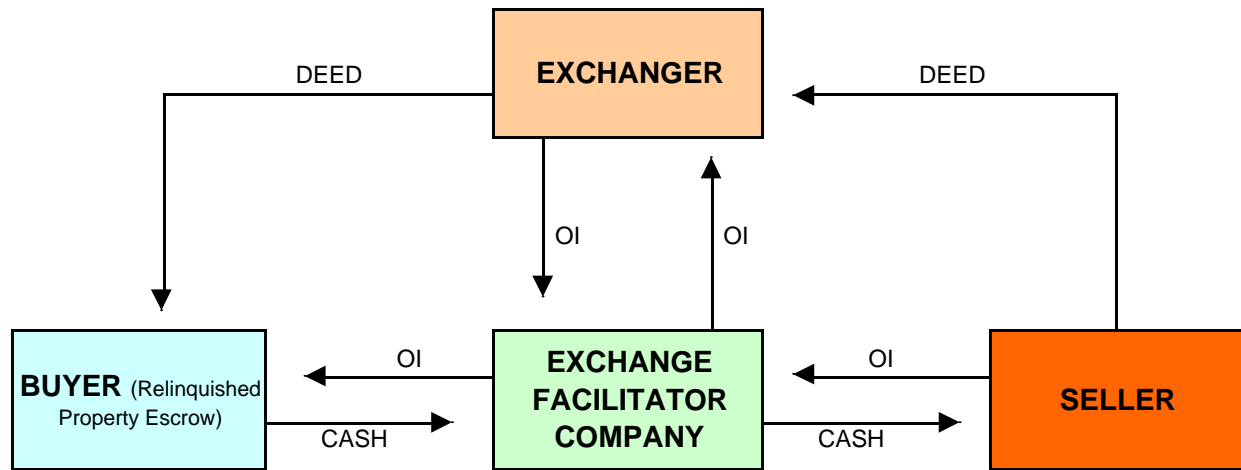
Schedule A+

- Setup Fee (non-refundable): \$1,500.00 per relinquished property
- First three replacement (acquisition) properties are **free** - \$250.00 for each additional replacement property thereafter.
- Administrative Fee from the bank or savings institution with whom the Exchange Proceeds are deposited in the maximum amount of 25 basis points (0.25%) of the interest earned on the Exchange Proceeds

Aiello & Associates cannot provide advice regarding specific tax consequences. Investors considering an IRC Section 1031 Tax-deferred Exchange should seek counsel of their accountant and attorney to obtain professional tax and legal advice.



DELAYED EXCHANGE



FOUR PARTY DELAYED EXCHANGE - with an Exchange Facilitator

Situation: Exchanger has located a cash Buyer for the relinquished property. Exchanger has not selected a replacement property.

SALE OF THE RELINQUISHED PROPERTY

- 1) Exchanger and Buyer open escrow for the sale of the relinquished property.
- 2) Facilitator prepares an exchange agreement. Exchanger transfers ownership interest (OI) to Facilitator. Facilitator sells the relinquished property to Buyer. The sale escrow between Facilitator and Buyer closes.

IDENTIFICATION

- 3) With funds held in trust by Facilitator, Exchanger identifies replacement property within 45 days from transfer of relinquished property.

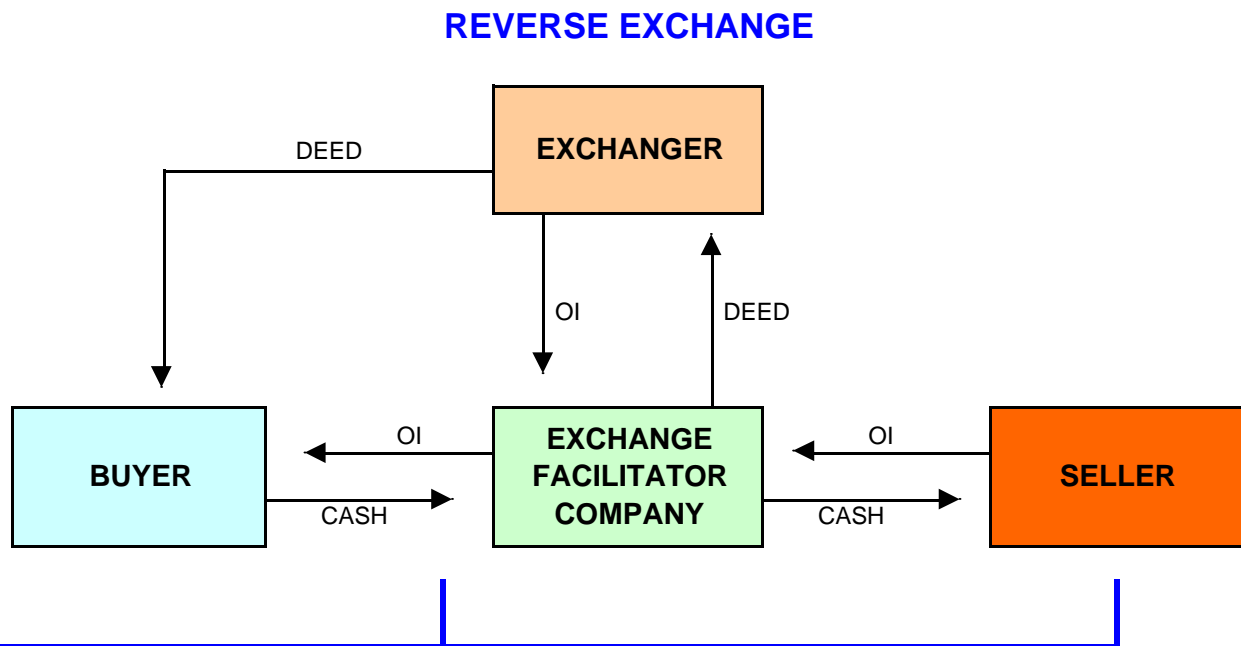
PURCHASE OF THE REPLACEMENT PROPERTY

- 4) Exchanger opens escrow with Seller for the purchase of the replacement property.
- 5) Using the funds held in trust, Facilitator purchases the replacement property from the Seller, and after the purchase, transfers (OI) in the replacement property, to Exchanger to complete the exchange transaction.

MAXIMUM REPLACEMENT PERIOD

The entire transaction must be completed by Exchanger within 180 days, or the due date of Exchanger's tax return, whichever is first.

OI = Ownership Interest



FOUR PARTY DELAYED EXCHANGE - with an Exchange Facilitator

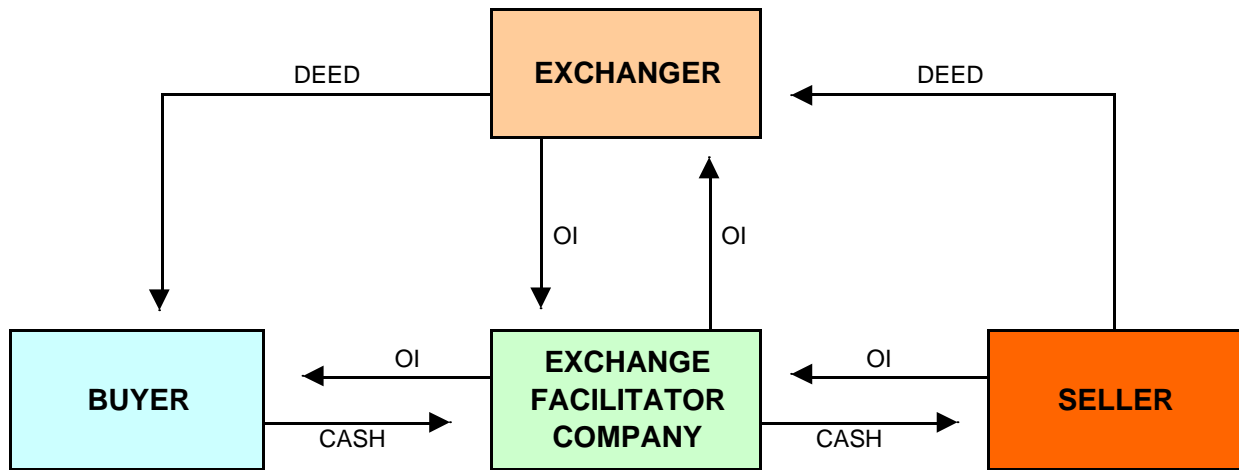
Situation: Exchanger has the relinquished property for sale, but has not located a Buyer. Exchanger has located a suitable replacement property to purchase from Seller. Seller is unwilling to wait (contingent offer) for the Exchanger to find a Buyer for the relinquished property.

- 1) Exchanger advances a loan to Facilitator for the purchase of the replacement property from Seller. With the advance in hand, Facilitator buys and takes title to the replacement property until Exchanger locates a Buyer willing to purchase the relinquished property.
- 2) When the cash Buyer for the relinquished property is ready to close, Facilitator and Exchanger enter into a simultaneous exchange. Exchanger transfers the relinquished property to Facilitator, and Facilitator transfers replacement property to Exchanger.
- 3) Immediately after the exchange, Facilitator sells the relinquished property to Buyer for cash. Any proceeds netted from the sale by Facilitator, are used by the Facilitator to repay the initial advance from Exchanger to start the transaction.

WARNING: REVERSE EXCHANGES HAVE NOT BEEN FORMALLY APPROVED WITHIN THE INTERNAL REVENUE CODE. REVERSE EXCHANGES ARE NOT FOR EVERYONE; THEY ARE CONSIDERED TO BE AN AGGRESSIVE APPROACH.

OI = Ownership Interest

SIMULTANEOUS EXCHANGE FORMAT



TIME LINE

45 DAYS

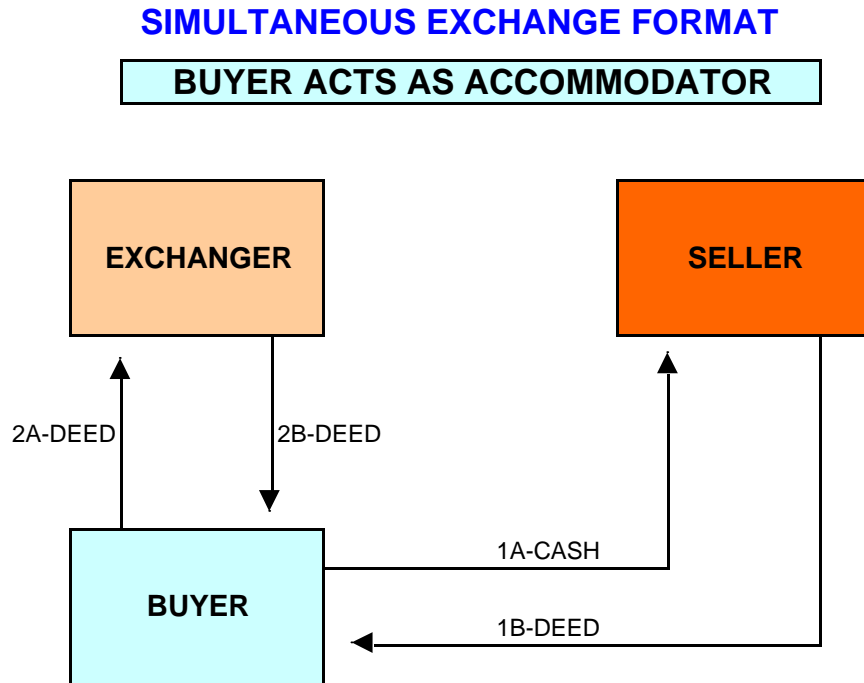
180 DAYS

FOUR PARTY DELAYED EXCHANGE - with an Exchange Facilitator

Situation: Exchanger has located a Buyer for the relinquished property. Exchanger has selected a suitable replacement property to purchase from a Seller. Both escrow's will close simultaneously. Buyer and Seller have agreed to cooperate with the exchange, but neither Buyer, or Seller is willing to act as the Accommodator.

- 1) Exchanger transfers ownership interest (IO) of the relinquished property to Facilitator.
- 2) Facilitator sells the relinquished property to Buyer for cash.
- 3) Using the cash, Facilitator purchases replacement property from Seller.
- 4) Subsequent to the purchase of the replacement property from Seller, Facilitator then transfers the replacement property to Exchanger to complete the transaction.

OI = Ownership Interest



THREE PARTY EXCHANGE - Buyer acts as Accommodator

Situation: Exchanger has located a Buyer for the relinquished property, and a suitable replacement property to purchase from Seller. Exchanger has entered into a contract to sell relinquished property to Buyer and Exchanger has a contract to purchase replacement property from Seller. Both escrows are scheduled to close simultaneously. Both parties have agreed with the Exchanger to cooperate, and the escrow officer has received written instructions from the parties on how the escrow should be drawn.

1) Sale/Purchase Escrow between Buyer and Seller

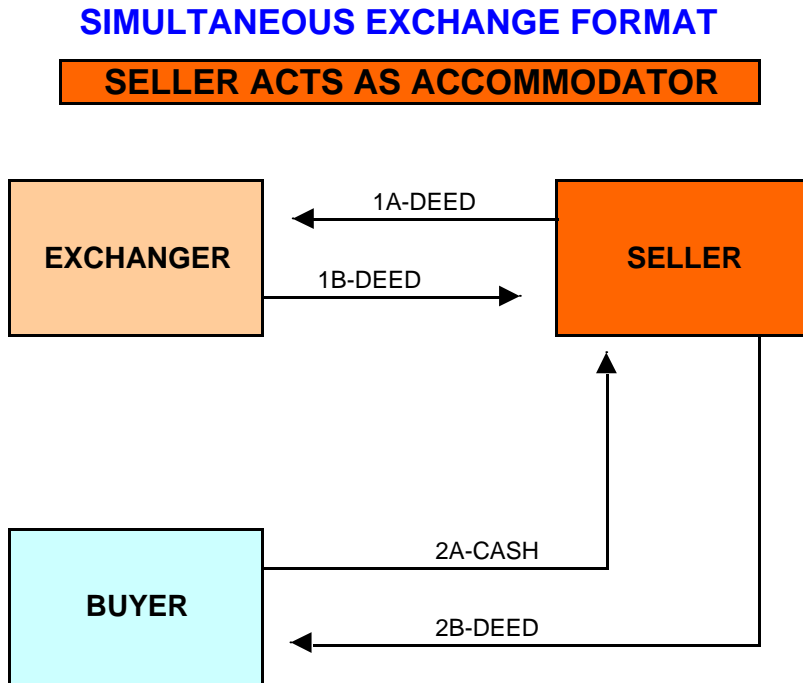
- 1A - Buyer uses cash to purchase replacement property from Seller.
- 1B - Seller transfers the replacement property to Buyer.

2) Exchange Escrow between Exchanger and Buyer

- 2A - Buyer transfers replacement property to Exchanger.
- 2B - Exchanger transfers relinquished property to Buyer. The exchange is complete. The Buyer ends up with the relinquished property, the Exchanger with the replacement property, and the Seller cashes out.

Possible Obstacles:

- 1) Potential liability to the Buyer.
- 2) No Exchange Agreement.
- 3) Invalid format, if both escrows do not close simultaneously.



THREE PARTY EXCHANGE - Seller acts as Accommodator

Situation: Exchanger has located a Buyer for the relinquished property and a suitable replacement property to purchase from the Seller. Exchanger has entered into contract to sell relinquished property to Buyer, and Exchanger has a contract to purchase replacement property from Seller. Both escrows are scheduled to close simultaneously. Both parties have agreed with the Exchanger to cooperate, and the escrow officer has received written instructions from the parties on how the escrow should be drawn.

1) Exchange Escrow between Exchanger and Seller

- 1A - Seller transfers the replacement property to Exchanger
- 1B - Exchanger transfers the relinquished property to Seller.

2) Exchange Escrow between Exchanger and Buyer

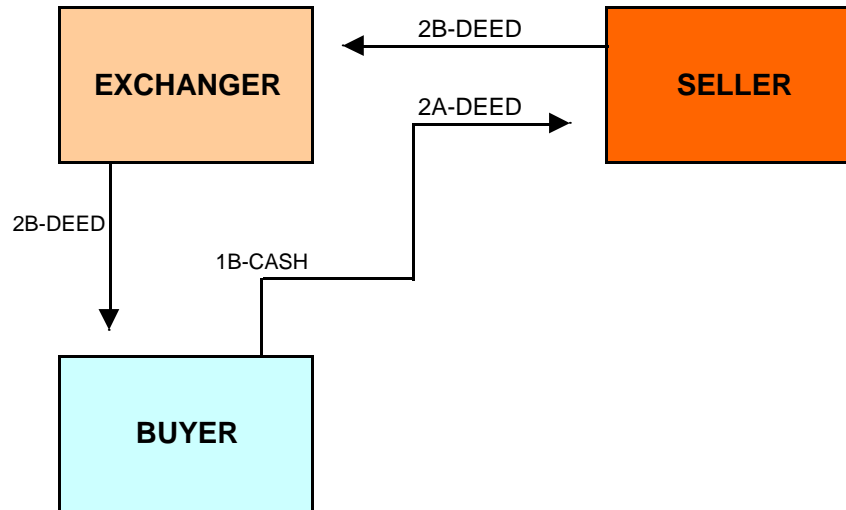
- 2A - Using cash, Buyer now purchases relinquished property from Seller.
- 2B - Seller transfers relinquished property to Buyer. The exchange is complete. The buyer ends up with the relinquished property, the Exchanger with the replacement property, and the Seller cashes out.

Possible Obstacles:

- 1) Potential liability to the Seller.
- 2) No Exchange Agreement.
- 3) Invalid format, if both escrows do not close simultaneously.

SIMULTANEOUS EXCHANGE FORMAT

INCORRECT



THREE PARTY PSEUDO EXCHANGE - No party acts as Accommodator

Situation: Exchanger has located a Buyer for the relinquished property and a suitable replacement property to purchase from Seller. Exchanger has entered into a contract to sell relinquished property to Buyer and Exchanger has a contract to purchase replacement property from Seller. Both escrows are scheduled to close simultaneously. Both parties have agreed with the Exchanger to cooperate, and the escrow officer has received written instructions from the parties on how the escrow should be drawn.

1) Sale/Purchase Escrow between Exchanger and Buyer

- 1A - Exchanger transfers the relinquished property to Buyer.
- 1B - Buyer uses cash to purchase relinquished property from Exchanger. Instead of physically receiving the cash, Exchanger directs the escrow holder to transfer the cash to the Seller.

2) Sale/Purchase Escrow between Exchanger and Seller

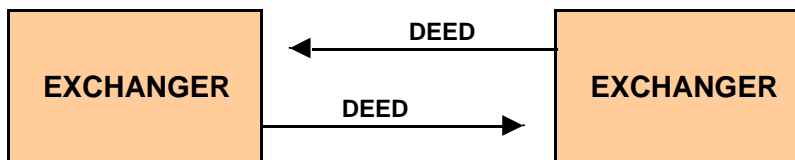
- 2A - Exchanger directs that the cash be transferred to Seller.
- 2B - Seller transfers replacement property to Exchanger. The transaction is complete. The Buyer ends up with the relinquished property, the Exchanger with the replacement property, and the Seller cashes out.

Possible Obstacles:

- 1) If challenged in an audit, it would be difficult, if not impossible, to prove that any exchange took place at all.
- 2) No Exchange Agreement.
- 3) Obviously, if this does not qualify for tax deferral on a simultaneous exchange, it will not work for a delayed exchange.

SIMULTANEOUS EXCHANGE FORMAT

TWO PARTY



Situation: Both parties want to swap properties. Exchanger-1 wants Exchanger-2's property and visa versa. Generally speaking, these transactions rarely occur. Additionally, these types of transactions often end up with one of the exchanging parties receiving Boot as a way to even out the trade. The exchanging party receiving Boot, whether in the form of cash Boot or mortgage Boot, will have to pay taxes on the Boot received.

- 1) Exchange escrow between the exchanging parties. Simultaneously, Exhcngager-1 transfers her property to Exhanger-2, and likewise, Exchanger-2 transfers his property to Exchanger-1.

Possible Obstacles:

- 1) Rarely do the values, mortgages and equities balance. For this reason, one of the parties ends up paying taxes on the Boot he or she receives in the transaction.
- 2) Investors usually have very specific criteria for reinvestment. In order for this type of transaction to work, both investors must have very broad investment criteria, or they must want out of their current investment so much, that they will be willing to take almost anything in trade.

1031 Exchange: 1031 is the section of the tax code that governs tax treatment of certain types of investment real estate transactions. There are several types of 1031 Exchange methods commonly used today, including, Delayed Exchanges, Simultaneous Exchanges and Reverse Exchanges.

Accommodator: A qualified intermediary (principal) who enters into a contract to assist the Exchanger to exercise a Tax-deferred Exchange. The Accommodator substitutes in place of the Exchanger and assumes the responsibility of transferring the Relinquished Property to a buyer, and completes the Exchange by purchasing the Replacement Property from the Seller before transferring the Replacement Property to the Exchanger. The Intermediary maintains the Exchange Trust Accounts to make sure that the proceeds are beyond the constructive receipt of the Exchanger. Also described as a Facilitator, or Intermediary, an Accommodator cannot be the taxpayer or a related party. (See Facilitator)

Accommodating Party: In an Exchange of properties, there is always a person or entity that steps in to accommodate or facilitate the Exchange transaction. Even in Simultaneous Exchange, without an Exchange Company involved, the Exchange transaction still requires the use of an accommodating party. Occasionally, the Seller of the replacement property or the buyer of the Relinquished Property will agree to act as an accommodating party in order to complete the Exchange. Depending on how the transaction is structured, the accommodating party may incur additional liability in their efforts to assist in the Exchange.

Accommodating Buyer: The Buyer of the Exchanger's Relinquished Property is the Accommodator.

In this type of Simultaneous, three-party Exchange, the Buyer first purchases the Replacement Property from a Seller seeking cash, and as soon as he/she acquires this property, he/she Exchanges for the Exchanger's Relinquished Property.

Accommodating Seller: The Seller of the Exchanger's Replacement Property is the Accommodator.

In this type of Simultaneous, three party Exchange, the Seller Exchanges the Replacement Property with the Exchanger from the Relinquished Property. After exchanging properties, the Seller the sells the Relinquished Property to a cash Buyer in a sale escrow transaction.

Acquisition Property: See Replacement Property

Actual Receipt: When the Exchanger actually receives the proceeds from the sale of the Relinquished Property. Receipt of cash by the Exchanger before he/she receives the Replacement Property, may be enough to destroy the Tax-deferred treatment of the transaction.

Adjusted Basis: Generally speaking in a standard purchase of real property, the adjusted basis is equal to the purchase price, plus capital improvements, less depreciation. Transactions involving exchanges, gifts, probates, and receiving property from a trust can have an impact on calculating the property's adjusted basis. The taxpayer's C.P.A. or tax advisor is the party to look to for these types of questions.

Boot: Boot is any type of property received or given up in an Exchange that does not meet the like-kind requirement. Generally speaking, receiving Boot will trigger the recognition of gain and taxes. If the Exchanger receives Boot, he/she will be taxed. Boot added or given up by the Exchanger, does not necessarily trigger a taxable event. In a real property Exchange, Boot received is any type of property received by the Exchanger, which is not, real property held for investment or productive use in a trade or business. If the Exchanger receives a boat, plane, a can of anchovies, cash or mortgage relief, he/she has received Boot. The Exchanger pays taxes on the Boot to the extent of recognized capital gain.

Cash Boot: Cash Boot consists of cash and nonqualified property. A yacht, a refrigerator and receipt of the beneficial interest in a promissory note, are all examples of Cash Boot in a real property Exchange. Generally speaking, Cash Boot received is taxable.

Mortgage Boot: Mortgage Boot consists of the secured debt given up and received as part of the same Exchange. If the Exchanger increases the amount of debt on the replacement property, versus the Relinquished Property, he/she has given Mortgage Boot. If the Exchanger decreases the amount of debt on the replacement property, versus the Relinquished Property, he/she has received Mortgage Boot. Generally speaking, Mortgage Boot received triggers the recognition of gain and it is taxable, unless it is offset by Cash Boot added or given up to the Exchange.

Boot-Offset Rules:

1. Cash Paid may offset mortgage Boot received.
2. Mortgage Boot given does not offset cash Boot received.

Capital Gain: Generally speaking, this is the difference between the sales price of the relinquished property, less selling expenses, and the adjusted basis of the property.

Concurrent Exchange: See Simultaneous Exchange.

Constructive Receipt: Even if the Exchanger does not actually receive the proceeds from the disposition of the Relinquished Property, the Exchange will be disallowed if the Exchanger is treated as having constructively received the proceeds. Thus, the critical question in every Delayed Exchange is whether the Exchanger has control over the proceeds during the Exchange period. In the most recent regulations regarding this issue, the Exchanger cannot have the right to pledge, borrow, or receive economic benefit from the proceeds before he/she receives all Replacement Property in the transaction. Any type of account to maintain Exchange proceeds must substantially limit and restrict the Exchanger's control to protect the Exchange.

Deeding:

Direct Deeding: At the direction of the Accommodator, Title passes directly to the ultimate owners without passing through the Accommodator (i.e. without the Accommodator being in the Chain of Title).

Sequential Deeding: Title passes through the Accommodator before passing to the ultimate owner.

Delayed Exchange: Also called Non-simultaneous, Deferred, and Starker Exchange. A Delayed Exchange is a Tax-deferred Exchange, where the Replacement Property is received after the transfer of the Relinquished Property. In a Delayed Exchange, the Exchanger must identify all potential Replacement Properties with 45 days from the transfer of the Relinquished Property, and the Exchanger must receive all Replacement Properties within 180 days, or the due date of the Exchangers tax return, whichever occurs first.

Disposition Property: See Relinquished Property.

Entity Concept: The entity that goes into the Exchange is the entity that must acquire the Replacement Property.

Exchanger: Taxpayer; the entity accomplishing the Exchange.

Facilitator: Also described as Accommodator, Intermediary or Qualified Intermediary. A Facilitator usually has the knowledge and ability to assist in structuring the transaction to ensure the guidelines are successfully met. A Facilitator is an instrumental party in the Exchange escrow, providing the Escrow Officer or Closing Attorney with guidance. A Facilitator facilitates the transaction instead of being a casual bystander to the Exchange.

Facilitator Exchange: Refers to an Exchange Transaction in which an Accommodator or Facilitator is used in the Exchange. Some of the services generally provided by the Facilitator include providing the Exchange Agreement(s), accepting transfers of ownership and title, and the maintenance of the Exchange trust accounts.

Four Party Exchange: A Simultaneous or Delayed Exchange using an Intermediary or Facilitator.

Holding Requirements: Property must be held for investment, not for sale. IRS goes by intent. There is no regulation as to the amount of time a property must be held.

Identification Period: In a Delayed Exchange, any potential Replacement Properties must be identified within a specified period of time. Currently, the Exchanger must identify within 45 days from the close of the Relinquished Property, by following one of three adopted rules: the Three Property Rule, the 200% Rule, or the 95% Rule.

1. Up to three properties of any value.
2. If over three properties, the aggregate fair market value of the replacement property can only be 200 percent of the fair market value of the relinquished property.
3. If the aggregate fair market value of the replacement property is over 200 percent, 95 percent of the identified property must be acquired.

Improvement Exchange: Also called a Construction Exchange (or Build to Suit Exchange). In this type of Exchange transaction, the Replacement Property needs substantial capital improvements before the Exchanger takes title to it. In order to avoid the receipt of Boot, in an Improvement Exchange, the Accommodator or Facilitator will take title to the Replacement Property, during the construction phase, and until the desired capital improvements are complete, at which time, the Accommodator then transfers the replacement property to the Exchanger. If all of the funds are used at the end of the 180-day period, the property can be transferred and the exchange will be valid, even if the improvements are not completed.

Intermediary: A party involved in the Exchange transaction, who substitutes in place of the Exchanger, and assumes the responsibility of transferring the Relinquished Property to a cash buyer, and completes the exchange by purchasing the Replacement Property from a seller before transferring the Replacement Property to the Exchanger.

Like-Kind Property: Refers to the nature of the property the Exchanger gives up, or receives as part of the same Tax-deferred Exchange transaction, such as real property for real property. Under Section 1031 in an Exchange of real property, in order to qualify as like-kind, the property given up or received must be held for productive use in a trade or business, or held for investment to qualify as like-kind. Under today's definition of the like-kind, the following examples qualify as like-kind Exchanges; Apartments for commercial, an office building traded for retail property, a rental house traded for industrial property, and even a trade of raw land for a hotel can qualify as like-kind.

Ninety-Five Percent (95%) Rule: Under the 95% Rule, as it relates to identification of replacement property in a Delayed Exchange, the Exchanger may identify any number of Replacement Properties before the end of the identification period, but only if the Exchanger receives, before the end of the Exchange period, Identified Replacement Property, the fair market value of which is at least 95% of the aggregate fair market value of all Identified Replacement Properties.

Passive Activities: Any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate. Losses from passive activities are generally deductible only to the extent of passive income.

Phase-I Property: See Relinquished Property.

Phase-II Property: See Replacement Property.

Realized Gain: Refers to gain that is not necessarily taxed. In a successful exchange, the gain is realized, but not recognized and therefore not taxed.

Recognized Gain: Refers to the amount of gain, which is subject to tax when property is disposed of, at a gain or profit, in a taxable transfer.

Relinquished Property: The property given up by the Exchanger, to start the 1031 Exchange transaction. This property usually passes through an Accommodator before transferring to the ultimate buyer. This is considered Phase-I of the transaction.

Replacement Property: The property the Exchanger acquires in a 1031, or Phase-II of the transaction.

Reverse Exchanges: An Exchange whereby the Exchanger acquires or gains control of the Replacement Property prior to disposition of the Relinquished Property.

Simultaneous Exchange: Also referred to as a Concurrent Exchange. A simultaneous Exchange is an Exchange transaction whereby the Exchanger transfers out of the Relinquished Property, and receives his/her Replacement Property at the same time.

Three Property Rule: As it relates to Identification in a Delayed Exchange, the Exchanger may Identify three properties without regard to the fair market value of the Replacement Properties.

Transfer Tax: A tax usually assessed by a City, County or State, on the transfer of property; it may be based on equity or value. When structuring a multi-party Exchange, an Exchange Agreement will usually call for direct deeding to eliminate additional transfer tax.

Two Hundred Percent (200%) Rule: As it relates to Identification in a Delayed Exchange, the Exchanger may identify any number of properties, as long as their aggregate fair market value, as of the end of the Identification period, does not exceed 200 percent of the aggregate fair market value of all Relinquished Properties, as of the date the Relinquished Properties were transferred by the Exchanger.