1031 EXCHANGES

A GUIDE TO

TAX-DEFERRED PROPERTY INVESTMENT STRATEGIES

SAFE HARBOUR EXCHANGE, LLC
A TM Holdings Inc. Company

Safe Harbour Exchange, LLC, and TM Holdings, Inc., do not provide legal or tax advice. We recommend you consult with your independent tax or legal advisor to determine if a 1031 tax-deferred exchange is right for you.

SECURITY POLICY

We understand that security and integrity are two legitimate concerns when choosing a Qualified Intermediary to facilitate your exchange transaction. Safe Harbour Exchange, LLC, is owned by TM Holdings, Inc., one of the nation's largest independent title insurance agencies. We provide separate bank accounts for exclusive use by Safe Harbour Exchange, LLC. Our internal controls include monthly internal audits, as well as an annual independent audit. Safe Harbour Exchange, LLC, also carries a fidelity bond, as well as Errors and Omissions Insurance in the amount of $1 million per occurrence.

INTRODUCTION

Safe Harbour Exchange, LLC (Safe Harbour) is a subsidiary of TM Holdings Inc. (TMH). TMH has grown from the purchase of a single title insurance agency in 1997 to a multistate group of companies which provide title and escrow closing services, construction disbursement services, contract servicing and 1031 Exchange services. TMH has invested in state-of-the-art technology, which supports over 70 locations in seven states. This technology has enabled TMH to be an industry leader and provide ***service beyond expectation*** to our customers.

Safe Harbour employs **experienced** professionals throughout the Midwest. Safe Harbour's **experts** are available to assist with your exchanges nationwide through every step of the transaction. We have a team of trusted **experts** who have a proven track record of providing **unmatched expertise** and **customer satisfaction**. We will work with your tax advisor to ensure your exchange transaction is completed accurately.

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TABLE OF CONTENTS

1031 Exchanges

Section 1031 of the Internal Revenue Code provides that gain or loss is not recognized when property held for productive use in a trade/business or for investment is exchanged for like-kind property to be held for productive use in a trade/business or for investment.

BASICS

Terminology

Taxpayer or Exchanger – The party seeking nonrecognition treatment in an exchange.

Relinquished Property – The property which the taxpayer seeks to dispose of in the exchange.

Replacement Property – The property which the taxpayer seeks to acquire in the exchange.

Qualified Intermediary – The entity which facilitates the exchange. Any person serving as a Qualified Intermediary for the taxpayer cannot be a disqualified party. Examples of disqualified parties include the taxpayer's attorney, accountant, real estate agent/broker and employees.

Rules

In order for an exchange to be completely tax-deferred, the taxpayer must **trade up in value and up in equity**.

The Replacement Property must have a fair market value equal to or greater than the Relinquished Property.

AND

The taxpayer's equity in the Replacement Property must equal or exceed the taxpayer's equity in the Relinquished Property.

Sample Contract Provision

Purchase and sale contracts for Section 1031 transactions should contain cooperation language. The following sample language should be modified to fit the specifics of the particular transaction:

> Either party may elect to qualify this transaction as part of a tax-deferred exchange under Section 1031 of the Internal Revenue Code. Either party's rights and/or obligations under this Agreement may be assigned to a Qualified Intermediary for the purpose of completing an exchange. The parties agree to cooperate with each other to enable completion of an exchange. Such cooperation shall be at no additional cost or liability to the nonexchanging party.

REQUIREMENTS FOR A VALID EXCHANGE

1. **Real Property –** Property excluded from nonrecognition treatment includes:
   - Real property held primarily for sale *(dealer property)*
   - Personal property
   - Stocks, bonds or notes
   - Interests in partnerships or multi-member limited liability companies
   - Interests in a Real Estate Investment Trust (REIT)

2. **Qualified Purpose –** The property must be for productive use in a trade/business or for investment.
   - Property held primarily for personal use, such as a personal residence, does not meet the requirement.

- To meet the investment requirement for vacation rental property, the taxpayer must (i) own a dwelling unit for 24 months prior to the exchange for Relinquished Property and 24 months after the exchange for Replacement Property, and (ii) rent it for at least 14 days for each of those two years and the taxpayer's personal use per year may not exceed the greater of 14 days or 10% of the number of days rented during the year.

3. Like-Kind Requirement

- All real property is like-kind, improved or unimproved, and regardless of type of improvement or use.
- Fee interest in land is like-kind to a leasehold interest in land with a remaining term of 30 years or more *(including renewal periods).*

4. Same Taxpayer Requirement

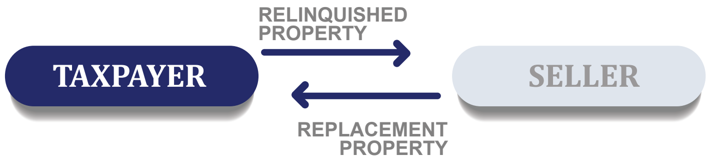
- If Relinquished Property is held by a married couple, Replacement Property should also be held in the name of both spouses.
- If Relinquished Property is held as a spouse's separate property, the Replacement Property should also be held as his or her separate property.
- If a taxpayer dies during the exchange period, the taxpayer's estate or trustee may complete the exchange.
- If a taxpayer elects to have a single-member LLC treated as a disregarded entity for federal tax purposes, the sole member and the LLC are considered the same taxpayer. The taxpayer could hold the Relinquished Property as an individual and the Replacement Property as a single-member LLC, or vice versa.
- A grantor trust and the grantor are also treated as the same taxpayer by the IRS.

FORWARD EXCHANGES

Types

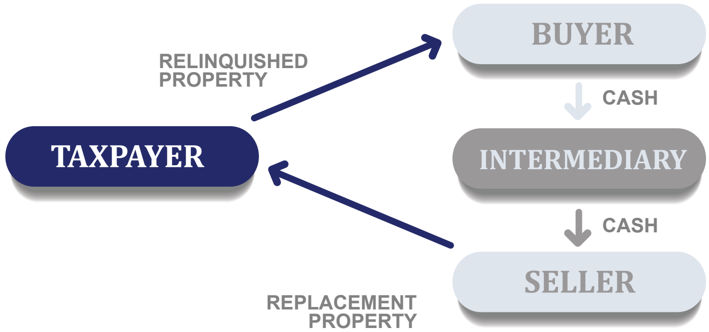
Two-Party Exchange

The two-party exchange, or swap, is rare since the seller of the Replacement Property is not typically the buyer of the taxpayer's Relinquished Property.



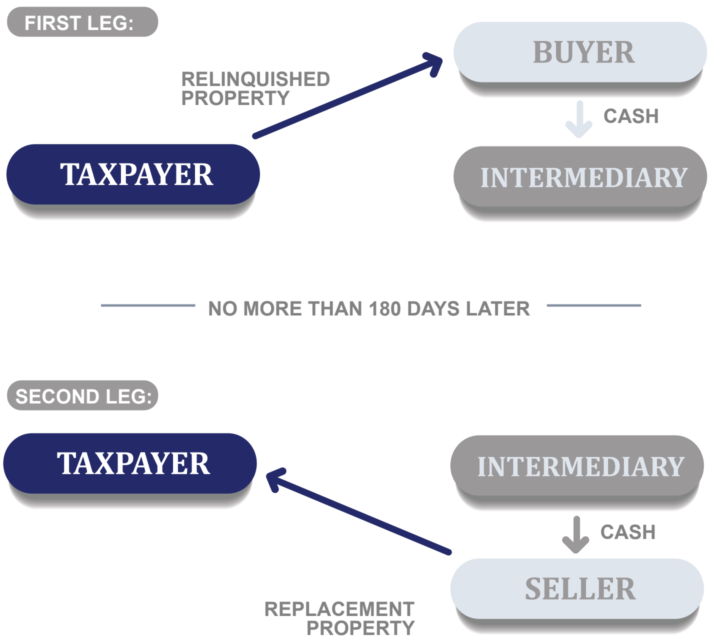
Simultaneous Exchange With Qualified Intermediary

In a simultaneous exchange with a Qualified Intermediary, title to the Relinquished Property is transferred directly to the buyer. The buyer pays cash to the Qualified Intermediary. The Qualified Intermediary pays cash to the seller who transfers title to the Replacement Property directly to the taxpayer.



Deferred Exchange With Qualified Intermediary

The structure of the deferred exchange with a Qualified Intermediary is essentially the same as the simultaneous exchange, except that the two legs of the exchange take place at different times.



Time Limits for Deferred Exchange

Taxpayer is required to identify the Replacement Property within 45 calendar days after the transfer of the Relinquished Property;

AND

Taxpayer must close on the Replacement Property before the earlier of (i) 180 calendar days after the transfer of the Relinquished Property, or (ii) the due date of the taxpayer's federal income tax return (including extensions) for the year in which the Relinquished Property is transferred.

NOTE*: The deadlines are exactly 45 and 180 calendar days. If the 45th or 180th calendar day lands on a Saturday, Sunday or legal holiday, the deadline is not extended to the next business day.*

Identification of Replacement Property

The number of properties that may be identified is:

Up to three properties, without regard to fair market value (3 Property Rule);

OR

More than three properties, if the total fair market value of all properties identified does not exceed 200% of the total fair market value of all Relinquished Properties (200% Rule);

OR

Any number of properties as long as the Replacement Properties acquired amount to at least 95% of the fair market value of all identified properties (95% Rule).

NOTE*: You may change your mind by formally revoking or amending the identification at any time during the 45 calendar-day identification period. The identification cannot be amended after the 45th day.*

Identification Requirements
Replacement Properties must be clearly and unambiguously identified using one or more of the these property descriptions:

- **Street address**
- **Legal description**
- **Assessor's parcel number**

NOTE*: The identified Replacement Properties do not need to be under contract or in escrow when identified.*

Access to Funds

IRS Treasury Regulations and Rulings allow the taxpayer to access 1031 Exchange funds only when one of the following conditions has been met:

The 45-day identification period has expired and the taxpayer did not identify any Replacement Property;

OR

The taxpayer has purchased all of the Replacement Property(ies) identified and the 45-day identification period has expired;

OR

The 180-day exchange period has expired.

IMPROVEMENT EXCHANGE

Construction or improvements may be included in the value of the Replacement Property provided the work is completed prior to the date the taxpayer acquires title to the Replacement Property.

Improvement exchanges are similar to reverse exchanges in that an Exchange Accommodation Titleholder (EAT) must take title to the Replacement Property while it is under construction. The exchange funds may be used to pay for the Replacement Property and the construction. Construction must be completed and title to the Replacement Property conveyed to the taxpayer before the expiration of the 180-day time period.

REVERSE EXCHANGE

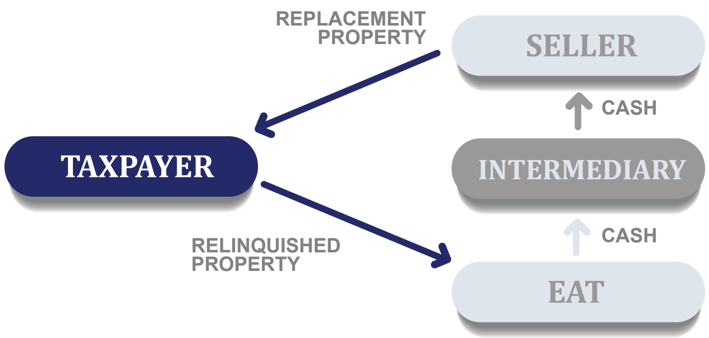
A reverse exchange occurs when a taxpayer, utilizing the services of a Qualified Intermediary and an EAT, acquires the Replacement Property before disposing of the Relinquished Property.

Revenue Procedure 2000-37 provides for a parking-style exchange and allows the EAT to acquire either the Relinquished Property or the Replacement Property in an exchange and hold it for up to 180 days.

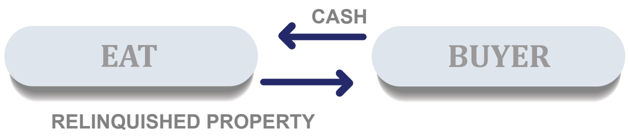
Types

Relinquished Property Parked

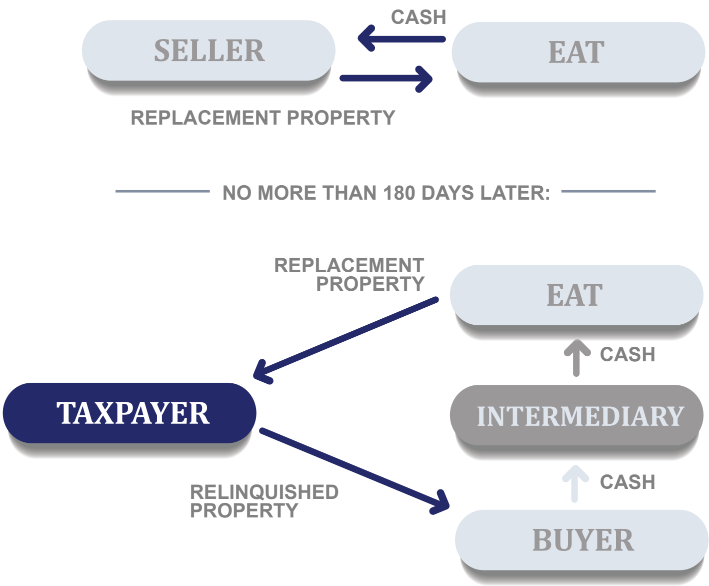
In this structure, the exchange occurs with the taxpayer acquiring the Replacement Property and conveying the Relinquished Property to the EAT using a Qualified Intermediary.



NO MORE THAN 180 DAYS LATER:



Replacement Property Parked
In this structure, the EAT acquires the Replacement Property. The EAT may construct improvements on the Replacement Property if needed. When the taxpayer's Relinquished Property is ready to close, the taxpayer will exchange the Relinquished Property for the Replacement Property through a Qualified Intermediary.



Mechanics

The EAT cannot be the taxpayer or a disqualified person (a person related to the taxpayer, including an entity in which the taxpayer owns 10% or more, or the taxpayer's attorney, CPA, real estate agent or employee).The taxpayer and EAT must enter into a written agreement under which the property is held in a Qualified Exchange Accommodation Arrangement (QEAA). The EAT must be treated as the beneficial owner of the property for all federal income tax purposes. The EAT may lease the parked property to the taxpayer or the taxpayer may manage it.

The taxpayer must identify Relinquished Property within 45 days after the EAT's acquisition of the Replacement Property (3 Property/200% Rules apply). The reverse exchange period under the safe harbor is a maximum of 180 days.

COMBINATION EXCHANGES

A reverse exchange may be combined with a deferred exchange.

For example, the taxpayer may exchange into a 50% Tenants in Common (TIC) interest in a Replacement Property in a deferred exchange. The EAT can then acquire the remaining 50% TIC interest and hold it for up to 180 days while the taxpayer sells a second Relinquished Property to exchange for the remaining 50% TIC interest as Replacement Property.

EXCHANGING MULTIPLE PROPERTIES AND FRACTIONAL INTERESTS

You may sell multiple Relinquished Properties and/or purchase multiple Replacement Properties as part of your 1031 Exchange transaction. The Relinquished and/or Replacement Properties may also involve the sale or purchase of a fractional interest, which means you do not have to acquire and/or own 100% of the property. You must, however, purchase an undivided interest in the property as a TIC (not a partnership or membership interest in and partnership or limited liability company that owns the property).

EXCHANGE EXPENSES

Certain expenses paid at closing are considered "exchange expenses." The regulation states that exchange funds may be used to pay "transactional items that relate to the disposition of the Relinquished Property or to the acquisition of the Replacement Property and appear under local standards in the typical closing statement as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees)."

There are few clear rulings, but most tax advisors agree that the following expenses are exchange expenses and may be paid at the closing of the Relinquished or Replacement Properties:

- **Broker's commissions**
- **Exchange fees**
- **Escrow fees**
- **Transfer taxes**
- **Recording fees**
- **Title insurance fees for owner's title insurance policy**
- **Attorney's fees in connection with the sale or purchase of the property**

Other expenses are not exchange expenses, so although exchange funds might be used to pay them, the exchange may be partially taxable. For example, security deposits and prorated rents are not considered exchange expenses. This arises when the seller of Relinquished Property gives the buyer a credit at closing for the security deposits and prorated rents. To avoid the tax, the seller should deposit his or her own funds to pay the security deposits and prorated rents to the buyer. In addition, some tax advisors believe fees and costs in connection with getting the loan to acquire the Replacement Property are costs of the loan, not costs of the purchase, and therefore under tax law are not exchange expenses.

Some nonexchange expenses create a tax liability, but are offset by a deduction taken by the taxpayer. The following expenses are typically found on a closing statement but are generally not considered exchange expenses:

- **Loan costs and fees**
- **Security deposits**
- **Prorated rents**
- **Insurance premiums**
- **Title insurance fees for lender's title insurance policy**
- **Property taxes**

TAX CONSEQUENCES

Step 1. Determine the taxpayer's "basis" in the Relinquished Property. In most cases, a taxpayer's basis is the cost of the property.

Step 2. Establish the "adjusted basis" of the Relinquished Property. To determine adjusted basis, take the basis (the cost of the property) and add the cost of any capital improvements made to the property during the taxpayer's ownership, then subtract any depreciation taken on the property during that same time period.

Step 3. Determine the gain. There are two types of gain: "realized gain" and "recognized gain."

- **Realized Gain** = Purchase Price – Adjusted Basis (closings costs such as commissions and recording fees may be deducted from realized gain)
- **Recognized Gain** = that portion of the realized gain that is taxable

Realized gain is not taxable until it is recognized. Gain is usually, but not always, recognized in the year in which it is realized.

Boot

A 1031 Exchange allows the taxpayer to defer the tax that otherwise would be due on the realized gain. However, realized gain is recognized to the extent that "boot" is received by the taxpayer. Any consideration received by the taxpayer other than real property is boot. There are two types of boot – "cash boot" and "mortgage boot."

- **Cash Boot** – Cash or anything else of value received.
- **Mortgage Boot** – Any liabilities assumed in the exchange.

Basis in Replacement Property

In an exchange, the tax is deferred by carrying over the taxpayer's adjusted basis in the Relinquished Property to the Replacement Property. The realized gain is deferred until the Replacement Property is transferred in a later taxable transaction.

MISCONCEPTIONS ABOUT EXCHANGING

MYTH: Exchanges require two parties who want each other's properties.

FACT: Two-party exchanges are possible but in reality two-party swaps rarely occur. An exchange is typically accomplished with the help of a Qualified Intermediary and usually involves four principal parties: the Exchanger (the taxpayer), a buyer for the Relinquished Property, a seller of the Replacement Property and the Qualified Intermediary. The parties often do not know each other, and their properties may even be located in different states.

MYTH: The like-kind requirements limit an Exchanger's options.

FACT: Property must be exchanged for like-kind property. However, like-kind simply means real property must be exchanged for real property. All real property is like-kind, so a whole interest may be exchanged for a TIC interest; one property may be exchanged for multiple properties or vice versa; vacant land may be exchanged for an office building; agricultural land may be exchanged for commercial property, etc.

MYTH: In an exchange, title on the exchanged properties must pass simultaneously.

FACT: The properties do not have to close at the same time. However, in a deferred exchange the Replacement Property must (i) be identified in writing to the Qualified Intermediary within 45 days after the closing on the Relinquished Property and (ii) close within 180 days after closing on the Relinquished Property.

OTHER TAX EXCLUSION STRATEGIES

1033 Exchange (Involuntary Conversion)
Section 1033 of the Internal Revenue Code provides that real or personal property subject to an involuntary conversion, either from an eminent domain proceeding (condemnation by the government) or destruction by natural disaster, can be exchanged on a tax-deferred basis for like-kind real estate or personal property that is similar or related in service or use.

121 Exclusion (Primary Residence)
The Taxpayer Relief Act of 1997 repealed and replaced the tax-deferral "rollover" provision of Section 1034 with the tax-free exclusion provision under Section 121 of the Internal Revenue Code. Generally, you can sell you primary residence and exclude from gross income up to $250,000 in capital gains ($250,000 per taxpayer, $500,000 for a married couple). You must have owned and lived in the property as your primary residence for at least a total of 24 months out of the last 60 months.

453 Installment Sale (Seller Carry-Back Note)
Section 453 of the Internal Revenue Code allows you to sell real property and help your buyer finance the purchase of your property by carrying back an installment note ("seller carry-back financing") while deferring the recognition and payment of your capital gain income tax liability until you receive principal payments. Depreciation recapture income tax liabilities cannot be deferred under Section 453 and are due and payable in the year in which you sold your Relinquished Property.

721 Exchange (upREIT or 1031/721)
Section 721 of the Internal Revenue Code allows you to exchange investment real estate for an interest in a Real Estate Investment Trust. This is also referred to as an upREIT, or a 1031/721 Exchange.

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