

CHICAGO DEFERRED EXCHANGE COMPANY

FORWARD (DEFERRED) EXCHANGES

The Final Regulations to Section 1031 (generally effective for transfers occurring after June 10, 1991) provided long overdue guidance on the application of amendments to Section 1031 made by Section 77 of the Tax Reform Act of 1984 (“Act”). Section 77 of the Act limited the application of Section 1031 to non-simultaneous exchanges by providing specific time limits for the identification and receipt of replacement property. In addition, Section 77 of the Act provided that Section 1031(a) does not apply to any exchange of interests in a partnership.

Definition of Forward Exchange

The Regulations define a forward exchange as an exchange in which, pursuant to an agreement, the Taxpayer transfers property held for productive use in a trade or business or for investment (the “relinquished property”) and subsequently receives property to be held either for productive use in a trade or business or for investment (the “replacement property”).

In order to constitute a forward exchange, the transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money).

The Regulations do not apply if the Taxpayer received the replacement property prior to the date on which the Taxpayer transfers the relinquished property. The IRS has determined that the forward exchange rules of Section 1031(a)(3) do not apply to reverse-Starker transactions. In September of 2000, the IRS did issue guidance in the form of Rev. Proc. 2000-37 to deal with “parking arrangements” in certain reverse exchange transactions.

Identification and Receipt Requirements

The Regulations provide that, in the case of a forward exchange, any replacement property received by the Taxpayer will be treated as property which is not of a like-kind to the relinquished property if:

- A. The replacement property is not “identified” before the end of the “identification period,” and
- B. The identified replacement property is not received before the end of the “exchange period.”

The identification period begins on the date the Taxpayer transfers the relinquished property and ends 45 days thereafter. The exchange period begins on the date the Taxpayer transfers the relinquished property and ends on the earlier of 180 days thereafter or the due date (including extensions) of the Taxpayer’s tax return for the taxable year in which the transfer of the relinquished property occurs. Because the timing requirements relating to the identification and exchange periods are statutory, requests for extensions of the identification and exchange periods will not be granted.

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3-Property or 200 Percent Rule

The Taxpayer may identify more than one property as replacement property. However, regardless of the number of relinquished properties transferred by the Taxpayer as part of the same forward exchange, the maximum number of replacement properties that the Taxpayer may identify is:

- A. Three properties of any fair market value, or
- B. 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.

With certain exceptions, if, as of the end of the identification period, the Taxpayer has identified more properties as replacement properties than is permitted, the Taxpayer is treated as if no replacement property had been identified.

Revocation of Identification

An identification of property as a replacement property may be revoked at any time prior to the end of the identification period. The revocation must be made in a written document that is signed by the Taxpayer and hand delivered, sent by certified mail, or faxed before the end of the identification period to the person to whom the identification was sent.

Constructed Property: Real Estate for Services

The transfer of real estate in exchange for services rendered in the construction of replacement property will not fall within the non-recognition provisions of Section 1031.

The Regulations provide special rules for the identification and receipt of replacement property where the replacement property is not in existence or is being produced or constructed at the time the identification is made.

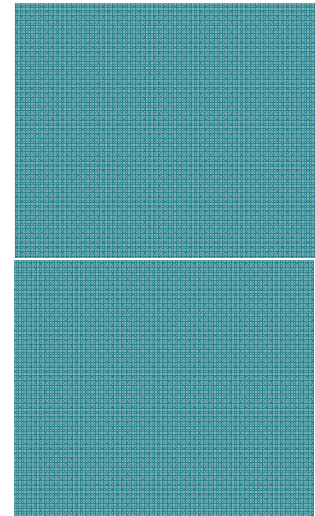
Constructed property will be treated as identified if a legal description of the land is provided with "as much detail as is practicable" for construction of the improvements.

Any construction that occurs after the replacement property is received by the Taxpayer will not be deemed qualifying replacement property for purposes of the exchange.

Constructed Property: Personalty

If identified replacement property is personal property to be produced, production must be completed on or before the date the property is received by the Taxpayer.

If production of the personal property is not complete at the time the property is transferred to the Taxpayer, the personal property will not be deemed "substantially the same" as the property that was identified.



SAFE HARBORS

In an attempt to provide clear rules for “typical” forward exchange transactions, the Regulations provide four safe harbor tests. These safe harbors define the edges of the envelope of safety. Transactions structured within the safe harbors will result in a determination that the Taxpayer is not in actual or constructive receipt of money or other property for purposes of the Regulations.

1. Transferee's exchange obligation secured by a mortgage, a standby letter of credit, or a third party guarantee.

Under the first safe harbor, the obligation of the Taxpayer's purchaser to transfer the replacement property to the Taxpayer is permitted to be secured or guaranteed by:

- A. A mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent),
- B. A standby letter of credit which satisfies all of the requirements of Section 15A.453-1(b)(3)(iii) and which does not allow the Taxpayer to draw on such standby letter of credit except upon a default of the purchaser's obligation to transfer like-kind replacement property, or
- C. A guarantee of a third party.

In practice, this safe harbor is rarely used. This security arrangement can be compared to the unsecured promise that T.J. Starker received from his purchaser, Crown Zellerbach Corporation. Crown agreed to acquire and convey replacement property to Starker, that Starker would designate, over an agreed upon period of time.

2. Qualified Trust or Escrow

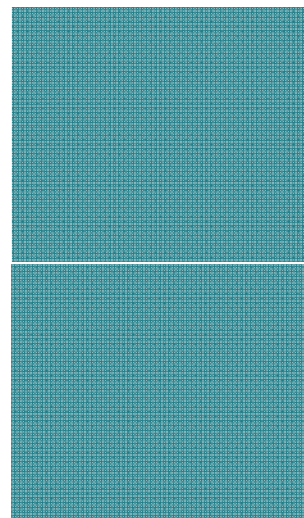
Under the second safe harbor, the obligation of the Taxpayer's purchaser to transfer the replacement property is permitted to be secured by cash or a cash equivalent if such cash or cash equivalent is held in a qualified trust or a qualified escrow.

A trust or escrow is “qualified” if the trustee or escrowee is not a “disqualified person,” and the Taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in escrow or trust are limited to certain specified circumstances described at Reg. §1.1031(k)-1(g)(6) (also referred to as the “(g)(6)” Restrictions).

3. Qualified Intermediary

Under the third safe harbor, forward exchanges are permitted to be facilitated by the use of a Qualified Intermediary if the Taxpayer's rights to receive money or other property are limited to those circumstances described at Reg. §1.1031(k)-1(g)(6).

A Qualified Intermediary is a person who is not the Taxpayer or a disqualified person and who, for a fee, acts to facilitate a forward exchange by entering into an agreement with the Taxpayer for the exchange of properties pursuant to which the Qualified Intermediary acquires the relinquished property from the Taxpayer, transfers the relinquished property to a purchaser, acquires the replacement property, and transfers the replacement property to the Taxpayer.



The Qualified Intermediary may be deemed to have acquired property even if the Qualified Intermediary never acquires legal title to the property. Consistent with Revenue Ruling 90-34, LR.C. 1990-16 (April 16, 1990), the transfer of property in a forward exchange that is facilitated by the use of a Qualified Intermediary may occur via a “direct deed” of legal title by the current owner of the property to its ultimate owner.

Acquisition by Qualified Intermediary

A Qualified Intermediary is treated as acquiring and transferring property if the Qualified Intermediary:

- A. Acquires and transfers legal title to that property.
- B. Either on its own behalf, or as the agent of any party, enters into an agreement with a person other than the Taxpayer for the transfer of property to that person.
- C. Either on its own behalf, or as the agent of any party, enters into an agreement with the Owner of property for the transfer of that property and, pursuant to that agreement, the property is transferred to the Taxpayer.
- D. Accepts the assignment of the rights to an agreement and all parties to the agreement are notified in writing of the assignment on or before the date of the relevant transfer of property.

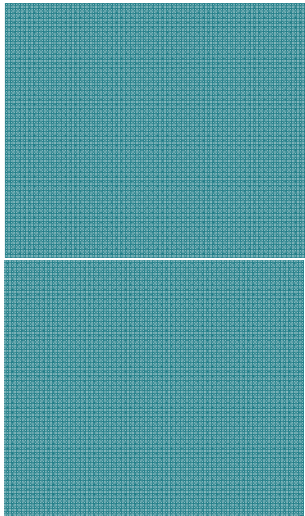
4. Investment Income

Under the fourth safe harbor, the Taxpayer is permitted to receive interest or a growth factor with respect to the forward exchange, provided that the Taxpayer’s rights to receive such interest or growth factor are limited to certain specified circumstances (see Restrictions on Safe Harbors — The “(g)(6)” Restrictions). Such interest or growth factor will be treated as interest regardless of whether it is paid in cash or in property (including property of a like-kind).

Restrictions on Safe Harbors — The “(g)(6)” Restrictions

In order for an escrow or trust account to be a “qualified” account for purposes of the Regulations, and to avoid the issue of constructive receipt of funds by the Taxpayer, the account must contain restrictions on the Taxpayer’s rights to receive the cash. Specifically, the Regulations require that the Taxpayer not have the right to receive money or other property until:

- A. After the end of the identification period if no replacement property is identified, or
- B. After the Taxpayer has received all of the identified replacement property to which the Taxpayer is entitled, or
- C. If replacement property has been identified but not received, after the later of the end of the identification period and the occurrence of a material and substantial contingency that:
 - a. Relates to the exchange,
 - b. Is provided for in writing, and
 - c. Is beyond the control of the Taxpayer or a related party, or
- D. The end of the exchange period.



Dealing with the Consequences of the “(g)(6)” Restrictions

These restrictions can be frustrating for and seem arbitrary to Taxpayers and their advisors when they find they are unable to acquire an identified property and wish to take the cash out of their exchange account prior to the end of the exchange period.

In the spring of 2000, CDEC applied to the IRS for a private ruling [PLR 200027028] in an attempt to clarify the definition of “material and substantial contingency.” In the ruling request, two possible scenarios were set forth:

1. Taxpayer identifies three replacement properties with the intent of acquiring all three properties. Taxpayer acquires two of the properties, but is unable to negotiate the acquisition of the third property, leaving a balance in the exchange account.
2. Taxpayer identifies one replacement property but is unable to reach agreement for the purchase of that property.

Question: Can the cash be released from the qualified account prior to the end of the exchange period?

Question: Is the Taxpayer's inability to negotiate the acquisition of replacement property a “material and substantial contingency” that relates to the exchange, is provided for in writing, and is beyond the control of the Taxpayer or any disqualified person?

The IRS concluded that neither of these scenarios would justify early release of the cash in the exchange account and that the only contingencies that would meet this criteria of the Regulation are:

- i. A government agency's seizure, requisition, or condemnation of the replacement property or a government agency's failure to approve a request to rezone or approve the transfer of the replacement property, or
- ii. An act beyond anyone's control (i.e. destruction of the replacement property).

