Deferring Capital Gains Taxes on Property Sales Utilizing 1031 Exchanges

FREQUENTLY ASKED QUESTIONS:

1. **What is a 1031 Exchange?**
2. **What Properties Qualify?**
3. **What are the Timing Requirements?**
4. **What are the Implementation Rules or Other Guidelines That Must Be Met in Order to Ensure Compliance?**
5. **What are the Alternatives to Direct Ownership? What is a TIC? A DST?**

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1. What is a 1031 Exchange?

Section 1031 of the U.S. Internal Revenue Code permits the owner of an investment property or business to defer the recognition of taxable gains on the sale of that asset by purchasing a "like kind" property within a permissible timeframe.

While there are specific time constraints (as detailed later in this document), the provision does permit both delayed and "reverse" exchanges, meaning that a replacement property may be identified after the sale or that tax basis from a legacy property may be subsequently applied to a purchased property.

Beyond their role in providing tax efficiency, some of the chief attributes of 1031 exchanges are as follows:

- **Enhanced quality** – 1031 provisions permit an investor to exchange lower quality assets for higher quality assets. Pooled investment vehicles including TICs and DSTs (both explained later) provide the alternative of pro-rata ownership of larger institutional-quality commercial properties that have traditionally been accessible only to very wealthy individuals, pension funds, insurance companies, and the like.
- **Diversification** – A single property can be exchanged for a proportionate ownership in a number of TIC or DST properties, allowing the investor to diversify across property classes (e.g. office, industrial, retail, etc.) and geographic locations.
- **Addressing obsolescence and property life cycle** - While commercial real estate tends to appreciate over time, some assets may have shorter peak lifespans than others, geographic markets may change, and use of certain property types may adjust. A savvy investor can use 1031 exchanges to replace property that is no longer growing at a strong pace for assets with upside in terms of income or capital appreciation.
- **Increased equity** - The deferral of capital gains provides the investor with greater net proceeds to deploy relative to a scenario in which the tax liability was paid on a current basis
- **Compounding effect** – An investor is permitted to complete multiple 1031 exchanges over time (IRS rules also govern the amount of time that the replacement property must be held before it may either be used to enter into a new tax deferred exchange). Unrealized gains on each subsequent exchange pass through to the next property. An investor who holds an exchanged property until death avoids the deferred tax liability (their heirs or estate will inherit the property with a "stepped-up" tax basis).
- **Professional management services** - If the investor elects a TIC or 1031, the asset will benefit from the operating expertise of the sponsor. Additionally, it is likely (although always worth confirming) that the deal has already been subject to initial due diligence and commissioned appraisals prior to the property being presented to investors.

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A potential disadvantage of a 1031 Exchange is that it may reduce the basis for depreciation on the Replacement Property. The Replacement Property thus includes a deferred gain that will be taxed in the future. Effectively the tax basis of the new asset(s) is reduced by the gain which was deferred on the sale of the relinquished property.

2. <u>**What Properties Qualify?**</u>

Certain criteria must be met to qualify for the tax deferral, these include:

1. Both the sold and the purchased properties must be held as either an investment or for productive use in a trade or business. Personal residences do not qualify.
2. The assets exchanged must be "like-kind." (Per the IRS: "Like-kind property is property of the same nature, character or class. Quality or grade does not matter. Most real estate will be like-kind to other real estate.") Real property can only be exchanged for real property; personal property can only be exchanged for personal property. There are some subtle nuances that may require a trained professional to sift through if the assets do not match closely. However, a broad definition of real estate applies so any combination of land and improvements should qualify if paired against similar assets. Generally, an investor is permitted to purchase replacement properties within different asset classes (e.g. industrial warehouses, shopping centers, multifamily, etc.), as long as those properties are held for investment. Real estate assets that may qualify for 1031 exchange include:

- Raw land
- 30-year or more leasehold interest
- Farm property
- Residential rental property
- Office Buildings (either purchased for investment or to house the investor's business activities)
- Multi-Family or Single Family Rentals
- Storage Facilities
- Retail Shopping Centers
- Industrial Facilities
- Tenant in Common (TIC) ownership
- Beneficial Interest in a Delaware Statutory Trust (DST)

3. <u>**What are the Timing Requirements?**</u>

a. Specific and strict timing criteria must be met. **The proceeds of the sale must be re-invested within** the <u>earlier</u> of the following: (1) **180 days from the sale** (as defined

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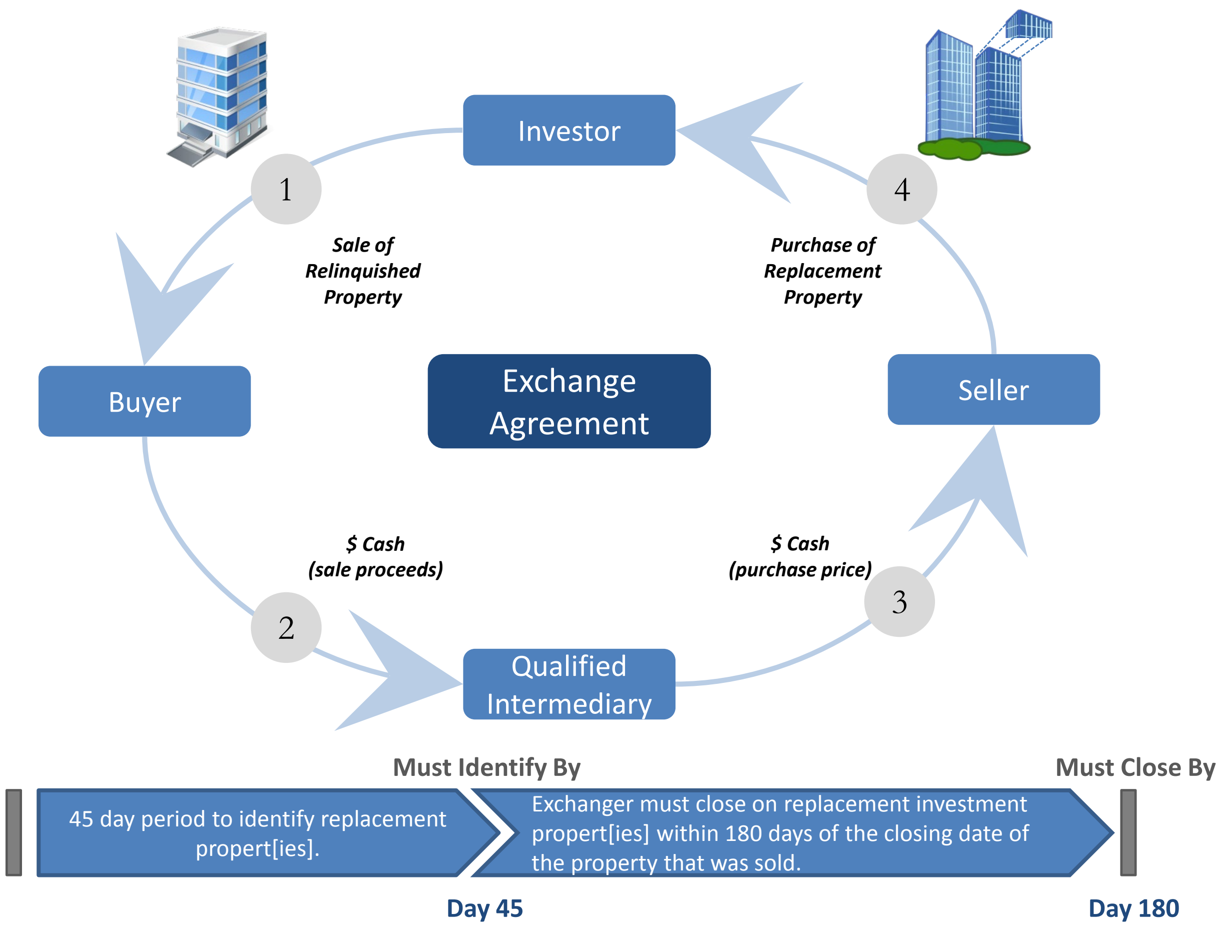
below), or (2) the date the exchanger's tax return is due, including extensions, for the taxable year in which the relinquished property is transferred. **Prospective replacement properties** (as subject to the criteria and restrictions detailed below) **must be identified within 45 days of the sale** – in writing.



b. For purposes of defining the window for exchange, the date of sale is considered the <u>earlier</u> of the following: (1) the date of record for the deed, or (2) the date of transfer to the buyer.
c. In identifying prospective replacement properties, at least one of the following rules must be met:
    - **The Three-Property Rule** - Up to three potential replacement properties may be identified, regardless of their market values. All identified properties are not required to be purchased to satisfy the exchange.
    - **The 200% Rule** – An unlimited quantity of potential replacement properties may be identified, so long as the aggregate fair market value does not exceed 200% of the aggregate fair market value (FMV) of all of the relinquished properties (as

of the initial transfer date). Again, all identified properties are not required to be purchased to satisfy the exchange.

- **The 95% Rule** - An unlimited quantity of potential replacement properties may be identified, so long as the FMV of the properties actually received by the end of the exchange period is at least 95% of the aggregate FMV of all the potential replacement properties identified.

d. It is worth noting that the aforementioned timing criteria are quite rigid and failure to comply may result in a failed exchange. If the deadline falls on a weekend day or holiday, it must be met no later than the last business day prior to the deadline date, i.e. the prior Friday. Mistakes are not grounds for an extension. Nor is destruction of the identified replacement property (by any means other than a Presidentially-declared disaster) after the expiration of the 45-day identification period.

4. <u>What are the Implementation Rules or Other Guidelines That Must Be Met in Order to Ensure Compliance?</u>

Additional guidelines which must be met to ensure compliance with the 1031 protocols are as follows:

- The FMV of the value of the replacement property must equal or exceed the value of the precedent property. Additionally, both of the primary sources of financing (cash/equity and debt must be equal to or greater than their respective absolute terms in the relinquished property).
- IRC rules require the investor to employ an independent third party as a Qualified Intermediary (QI), who is responsible for ensuring that all rules are followed. The QI must retain proceeds of the sale of the relinquished property until reinvestment. A written “exchange agreement” between the investor and the QI is required, and serves to protect the investor from having “constructive receipt” of the exchange funds during the exchange period.

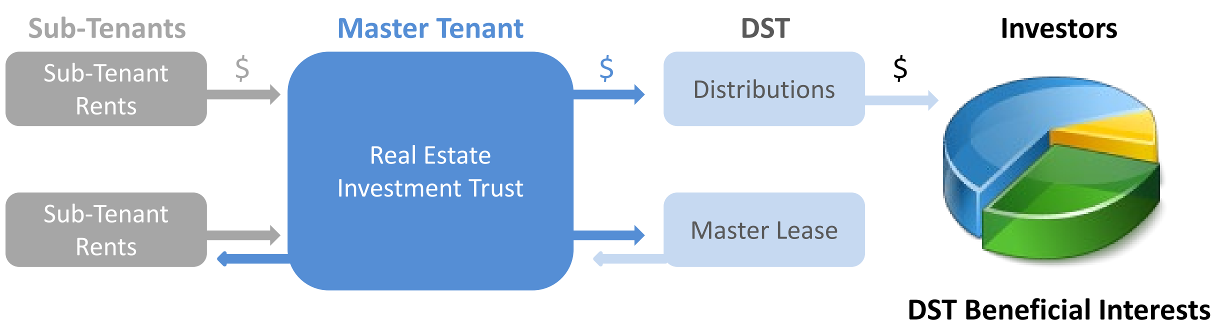
5. <u>What are the Alternatives to Direct Ownership? What is a TIC? A DST?</u>

Rather than identifying a specific property, the seller may also deploy sale proceeds toward a pooled investment vehicle which qualifies for 1031 exchanges. These vehicles may afford the investor greater flexibility in diversifying their investment and can alleviate the hassle of operating assets on their own. At present, the two most common alternatives to direct ownership are TICs (Tenants in Common) and DSTs (Delaware Statutory Trust).

- TICs are a form of real estate asset ownership in which multiple investors purchase interest in undivided, fractional shares of the asset. Ownership shares are not required to be equal and ownership interests can be inherited. Each co-owner holds an undivided fee interest in the property equal to his proportionate share of the entire property.

- DSTs are another platform that allows for pooled investment in real estate investment properties. In exchange for some fairly rigid criteria for operating the asset (for instance, the DST cannot re-negotiate leases unless the tenant is in default – hence a master lease structure is applied for shorter lease duration property types – or re-finance its mortgage debt or exact capital expenditures other than normal repair and maintenance or improvements required by law), investor's receive a bankruptcy-remote vehicle which shields the exchanger from any liabilities with respect to the property.

  The DST property ownership structure essentially offers the same benefits and risks that an investor would receive in a syndicated investment in an institutionally-sponsored commercial real estate deal. Smaller investors receive a fractional interest in large, professionally-managed commercial property along with other investors as individual owners (rather than limited partners) within a Trust. Each investor is entitled to their pro rata share of the cash flow income, tax benefits, and appreciation/depreciation of the entire property. Many DSTs are currently available with minimum investments as low as $100,000, with may provide an opportunity to diversify into several properties instead of a single, wholly-owned investment.



As with traditional commercial real estate investments, **DSTs offer the potential for ample cash flow during the holding period**. Sponsors are required to distribute all cash (other than reserves) on a current basis, and any cash accrued between distributions can only be invested in short term debt obligations.

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Disclosures:

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