EVERYTHING YOU NEED TO KNOW ABOUT 1031 EXCHANGES

UNDERSTANDING
1031 EXCHANGES

Savvy Investors Use 1031 Exchanges. Learn Why.

Presented by REAL ESTATE TRANSITION SOLUTIONS

Thank you for your interest in Real Estate Transition Solutions. For over 20 years, we have helped investment property owners understand, select and acquire suitable 1031 Exchange properties that meet both their financial and lifestyle objectives.

Our approach is grounded in education, transparency and above all, putting our clients' best interests first. We strive to provide real estate investment owners with as much information as possible so that, with our help, their investment real estate is best positioned to meet their unique individual objectives.

We hope you enjoy reading our free guide and welcome any questions you have regarding 1031 Exchanges and how they are structured. To schedule a complimentary consultation to discuss your specific situation and what tax-deferred 1031 Exchange options are available to you, simply call us at **206-909-0037** or email us at info@re-transition.com.

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What is a 1031 Exchange?

You've heard of them... but what exactly are they and how do they work?

A 1031 Exchange is a transaction approved by the IRS through Internal Revenue Code section 1031. Essentially, a 1031 Exchange allows an owner of investment real estate to sell their property (referred to as “relinquished property”) and acquire new property (referred to as “replacement property”) without paying capital gains tax on the sale of the relinquished property.

1031 Exchanges can be used in many ways and can be highly customizable, however there are a few rules that all exchanges must adhere to in order to qualify for tax deferral. To ensure your 1031 Exchange is done correctly, it is best to consult a professional that specializes in 1031 Exchanges and can make sure all guidelines and time restrictions are followed.

Benefits of a 1031 Exchange

Defer Capital Gains Tax

A 1031 Exchange is undeniably one of the most generous sections of the tax code and presents a tremendous opportunity to grow a real estate investor's wealth. Paying taxes on the sale of an investment property can be very expensive. In some states, the total amount of tax can be as high as 37%.

Federal Capital Gains Tax: 15% - 20%
State Capital Gains Tax: 0% - 13.3%
Depreciation Recapture Tax: 25%
Net Investment Income Tax: 3.8%

However, by utilizing a 1031 Exchange, an investment property owner can defer their tax, as long as they acquire a replacement property or properties of equal or greater value.

Maximize Cash Flow & Investment Dollars

A 1031 Exchange allows an investor to retain all of the proceeds of their relinquished property to be reinvested in new property. In effect, the deferred tax can be viewed as an interest free loan from the government. More dollars invested in property means greater potential cash flow and future appreciation potential.

A Simplified 1031 Exchange Illustration

Sell ➡ Pay Tax ➡ Reinvest		vs.	Sell ➡ Defer Tax ➡ Exchange Reinvest	
Gain from Existing Property Sale:	$500,000		Gain from Existing Property Sale:	$500,000
Tax Rate:	37%		Tax Rate:	Deferred
Total Tax Paid:	$185,000		Total Tax Paid:	$0
Net Proceeds:	$315, 000		Net Proceeds:	$500,000
	⬇			⬇
New Investment Purchase Price:	$315,000		New Investment Purchase Price:	$500,000
Capitalization Rate:	5%		Capitalization Rate:	5%
Available Cash Flow:	$15,750		Available Cash Flow:	$25,000

Eliminate Tax for Estate Beneficiaries

The benefit of increasing cash flow and invested dollars is clear, but perhaps the biggest benefit of a 1031 Exchange is that it allows for a "step-up in basis" upon the death of an owner. “Step-up in basis” refers to the IRS’s elimination of Capital Gains, Depreciation Recapture, and Net Investment Income Tax upon the death of an owner. In "community property" states, a surviving spouse receives a full step-up in basis to the properties fair market value.

Give more...

Options to Meet Investor Objectives

As property owners grow older, their financial and lifestyle objectives inevitably change. Rarely do long-held investment properties continue to meet the owner's current and future goals.

1031 Exchanges help bridge the gap between real estate investments and lifestyle objectives by allowing investors to reposition their investment property, while deferring capital gains tax.

Allows for Passive Property Management

Another benefit of a 1031 Exchange is that it allows real estate investors that are heavily involved in managing their investment property the ability to transition out of their existing property into a passive management real estate investment, called a DST (Delaware Statutory Trust).

Delaware Statutory Trust (DST) real estate investments have become increasingly popular with real estate investors tired of managing property because not only do DSTs qualify for 1031 Exchanges, they also focus on preservation of capital and there may be potential for higher income.

To learn more about investing in a Delaware Statutory Trust (DST) replacement property and how they work, download our **FREE Guide: Investing in Delaware Statutory Trusts (DSTs).**

Reduces Risk Through Diversification

As owner's age, often their focus shifts from growing their portfolio to preservation of capital. You would not own only a few stocks in your 401K or investment portfolio – so why would owning a few properties or one property type make sense if preservation of capital is high on your objectives list?

1031 Exchanges enable investment property owners to build a diversified portfolio of multiple different property types (e.g. Multi-family Apartments, Net-Lease Properties, Self-Storage, Medical Office, etc.) in multiple different geographic areas. Diversification does not guarantee returns or eliminate risk completely, but it does provide downside protection as different property types behave differently during market cycles.

One way to achieve a significant amount of diversification is through fractional ownership in Delaware Statutory Trusts. Utilizing DSTs, investors can own a fractional interest in a customized portfolio of multiple property types. Furthermore, real estate as an asset class behaves differently than stocks and bonds in economic cycles. Portfolio theory touts investment diversification as one of the key components of preserving overall portfolio value.

How do 1031 Exchanges work?

A potential 1031 Exchange should always start with determining whether an exchange is the right decision for an investor. This decision is based on the owner's objectives and the tax liability that would result from selling the property. Tax liabilities are not only property specific, but also must consider the owner's personal financial situation such as other income, other asset sales and any unused loss carry-forwards.

1031 Exchange Process

Step 1

Enter into a contract to sell the investment property

Step 2

Before closing on the sale, open an exchange with a "Qualified Intermediary" – this is the entity that will hold onto the exchange proceeds while the replacement properties are identified, then release the funds to acquire the replacement property.

Step 3

Within 45 days of the close of the investment property, identify replacement properties to potentially exchange into. The Qualified Intermediary must be notified of the identified replacement properties no later than Day 45 following the sale. You do not need to acquire all properties identified, however you cannot identify and acquire any properties not named on the identification following Day 45. Note there are certain IRS mandated identification rules that must be adhered to which we will discuss below.

Step 4

Within 180 days of the close of the investment property, close on the replacement properties.

Step 5

Notify your tax advisor that you performed a 1031 exchange during the tax year so that the tax deferral report can be prepared.

1031 TIMING

1031 Exchanges must adhere to a strict timeline

There is a defined timeline for 1031 exchanges. The key dates are largely immovable and there is little opportunity to request an extension barring a Federally declared disaster. Do not forget the following key dates:

- Before the sale of an investment property - The exchange must be opened with a Qualified Intermediary before the closing of the sale of the relinquished property.

- 45 Days Following the Sale - The exchanger has 45 days to identify their replacement properties.

- 180 Days Following the Sale - Following the close of the sale, the exchanger has 180 days to close on the replacement properties.

- Do not file your annual taxes for the year in which the relinquished property was sold until the exchange is complete.

Replacement Property Must Be Equal or Greater Value

This is is a very important concept that trips up many exchangers, so read carefully and, if you have any questions, do not hesitate to contact us. If an exchanger wants complete tax deferral, the replacement properties acquired must, in aggregate, do the following:

- Utilize all remaining sales proceeds after paying off one-time closing costs, brokerage fees and any debt on the property, if applicable.
- The total value of the replacement properties, in aggregate, must exceed the total value of the relinquished property.

Essentially, meeting these two requirements ensures that an exchanger has not received an “economic benefit” (either cash proceeds withheld from an exchange or a reduction in outstanding debt) without paying tax on that benefit. Remember, the goal of 1031 exchanges from the IRS’s standpoint is to ensure there is continued investment in real estate.

Not exchanging to an equal or greater value does not invalidate your exchange, however it does create an economic benefit for the exchanger, referred to as “taxable boot.” Unfortunately, taxable boot can be very costly as the IRS will first apply the most expensive tax rate to the dollars withheld from the exchange which is depreciation recapture at 25%. Should you receive taxable boot from an exchange, we strongly recommend that you do so with cash sales proceeds received and not by failing to match the debt on your property. Failing to match the debt on the property will not provide you cash to cover the tax liability that will be charged for the boot and thus the taxes will need to be paid from other sources.

1031 Exchange Property Identification Rules

Another component of 1031 exchanges that must be considered is how to identify replacement properties within the IRS' rules. The IRS provides three different identification rules and a legal identification must adhere to one of the three rules:

- **Three Property Rule:** An exchanger may identify up to three replacement properties, regardless of the value of the property.
- **200% Rule:** An exchanger may identify any number of replacement properties, as long as the aggregate value of the properties identified does not exceed 200% of the value of the relinquished property.
- **95% Rule:** An exchanger may identify any number of properties with any aggregate value, as long as they close on 95% of the aggregate value of the replacement properties.

If an exchanger does not satisfy one of the three rules, the exchange runs the risk of being invalidated by the IRS. This results in a situation in which an exchanger may have already acquired replacement property, but still must pay tax resulting from the sale of their relinquished property. No one wants this.

The Legal Ownership Entity on Title of The Relinquished Property Must Also Acquire the Replacement Property.

While this sounds complicated, it really is not for most exchangers. All this means is that whatever entity is on title when the property is sold and is exchanged, the replacement property must have the same entity on title. If the property is owned by an LLC, sold and exchanged, the replacement property must have the same LLC on title. Where this does get complicated is in situations in which there are multiple owners of a property who want to go their separate ways. Perhaps some members of the LLC want to perform an exchange and others do not or perhaps the exchangers want to exchange into separate properties. Both these problems are solvable; however, it does require expertise in working through legal entity reorganizations in advance of an exchange. For further details, see our article entitled "**Property Co-Ownership and 1031 Exchanges**."

Exchangers Cannot Take Possession of Their Exchange Funds

Another very important consideration is the fact that an exchanger cannot take possession of their exchange funds, nor can they have access to their exchange funds. This is a concept referred to as “constructive receipt.” Therefore, an exchange must be opened with a “Qualified Intermediary” in advance of the sale of the relinquished property. The Qualified Intermediary (“QI”) effectively serves in the role of exchange escrow. The QI receives the sales proceeds from the close of escrow, hold the proceeds, and releases the proceeds to the seller of the replacement properties the exchanger has identified. Selecting the right Qualified Intermediary is very important as they will be holding all your sales proceeds during the duration of the exchange. See our "**How to Select The Right Qualified Intermediary**" handout.

1031 Exchange Property Types

There are many misconceptions around what type of property qualifies for 1031 Exchanges. The IRS states that in order to qualify for a 1031 Exchange, both the relinquished property and replacement property must be “Like-Kind.” Just what does “Like-Kind” mean? According to the IRS, “Like-Kind” is any property that is held for investment or business purposes. Note, this does not mean the property needs to be of the same type or function, just that it is held for investment or business purposes. Therefore, rental homes can be exchanged for commercial property, agricultural land can be exchanged for hotels/motels and so on:

Additionally, different forms of ownership can be exchanged into, such as a fractional interest in a Delaware Statutory Trust or a Tenant-in-Common. The four main categories of 1031 Exchange replacement property are as follows:

Fee-Simple Property

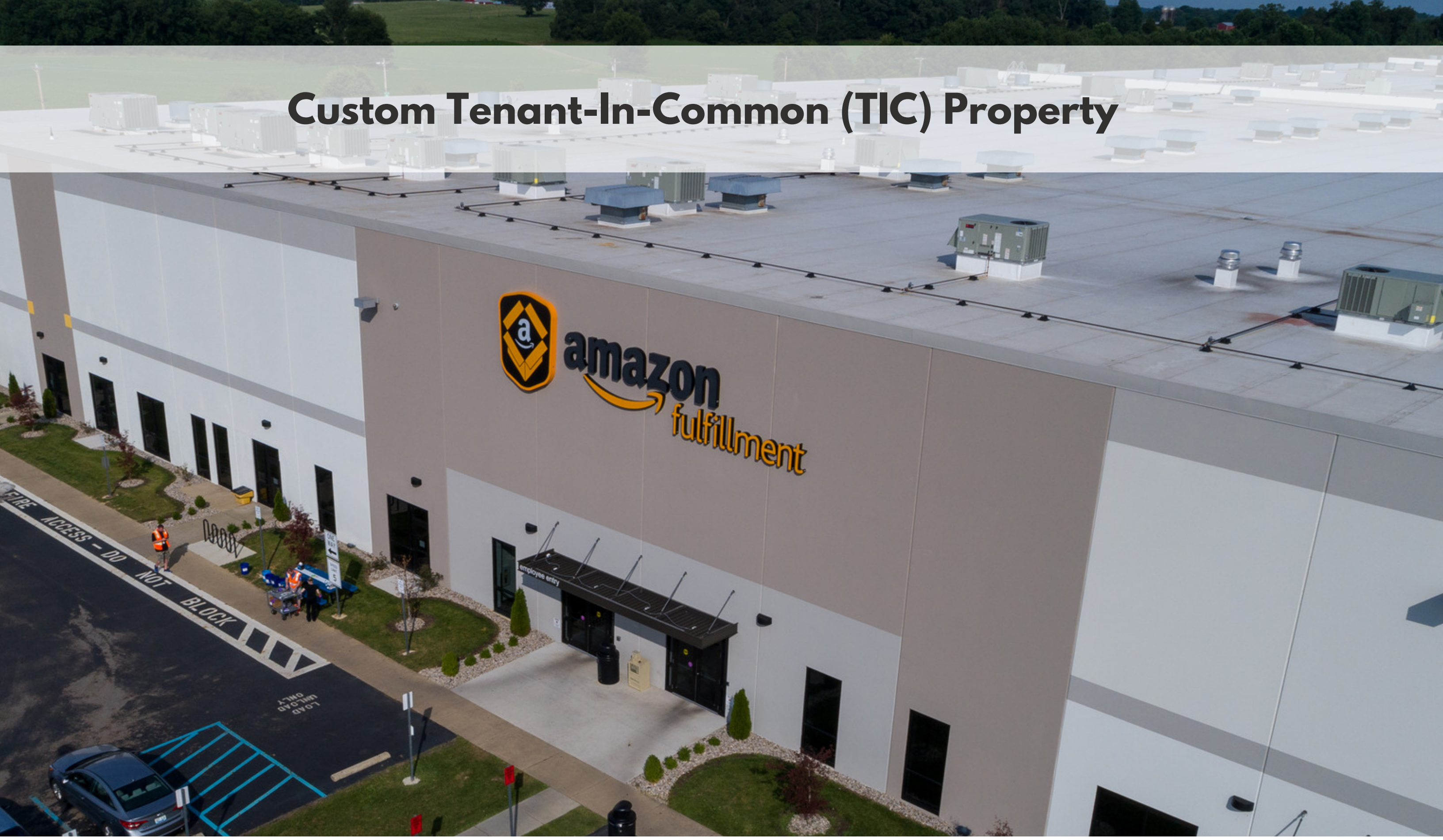
Fee-Simple Property is a broad category that includes all real estate owned outright by an investor. Fee-Simple Property is best suited for investors who value control of their real estate and are not opposed to the effort and time required for active management. There are no restrictions on the property types included within Fee-Simple Property. Investors exchange into rental homes, apartment buildings, commercial office, retail, hotel/motels, agricultural land, self-storage, industrial property, etc. Additionally, Fee-Simple Property includes properties acquired with the intent of performing a 1031 exchange from a rental property to a primary residence or vacation home.

Fee-Simple Net Lease Property

Fee-Simple Net Lease Property is a sub-category of fee-simple that refers to the structure of the lease on the property. Specifically, it means that the tenant holds a long-term lease and is usually responsible for the majority, if not all, of the maintenance required to operate the property. This replacement property can be a fit for investors who value control of their real estate assets but do not want to put forward the effort required for active management. We work with single net lease, double net lease, and triple net lease properties that have high credit worthy tenants to provide stable predictable income. Generally, Net Lease Properties, owned Fee-Simple, range in value between $1M - $15M.

Delaware Statutory Trust (DST) Property

Delaware Statutory Trust 1031 property is an increasingly popular replacement option which allows DST investors to own a “fractional interest” in high-quality institutional real estate that is acquired and managed by large professional real estate firms. DST investments can be combined to create a diversified portfolio of passive property for an investor. Additionally, if desired, DST real estate can allow for an eventual 1031 exchange into a REIT. If you are interested in learning more about DST replacement property, download our **FREE Guide: Investing in DSTs.**



Custom Tenant-In-Common (TIC) Property

Tenant-In-Common Property is another form of fractional ownership that allows investors to own a percentage interest in a large institutional property with added flexibility beyond what is available within DST property. Generally, we work with TIC properties that have a value-add component and place a greater focus on appreciation versus current cash flow. TIC properties can allow for refinancing following an exchange and have investment minimums of $1M.

What are the risks?

There are many things to consider when executing a 1031 exchange. We strongly encourage investment property owners to have a strategic plan in place before an exchange begins. First to make sure an exchange is the best decision for the investor, then to make sure the exchange is executed smoothly and serves to strategically position the investor to realize their objectives. We work with investment property owners to establish these plans, ensuring that every option is considered, the best replacement properties are selected, and the acquiring of the replacement property is transacted smoothly. There are two scenarios we work diligently to avoid. First, is an exchange that was not suitable for an investor. Second, a failed exchange.

Is a 1031 Exchange Right for You?

The answer to this question lies in the tax liability associated with the property the investor is considering selling as well as the financial and lifestyle objectives of the investor. We always prefer working with an owner before the decision to sell is made so that we can be sure all the options have been considered. Additionally, consulting a tax advisor is recommended so that an accurate tax liability can be calculated. Interested in seeing what your tax liability might be, should you decide to sell your property? Download our **Tax Basis Tool** and calculate for yourself.

Fee Structure

Traditional exchanges, also referred to as “delayed exchanges”, in which the relinquished property is sold, and replacement properties are then identified to be closed on are not costly (especially relative to the taxes that are being saved!). There are generally two types of fees associated with every exchange:

Qualified Intermediary Fee

Generally this is a flat rate of ~$1,000 that includes one relinquished property and one replacement property. Each additional replacement property may incur an additional nominal fee.

Brokerage Fee

Depending on the replacement property selected, generally there are costs associated with representation in the acquisition of the replacement property. Fees may vary depending on the property type selected and size of exchange. Additionally, the seller may incur these fees as opposed to the exchanger.

What Type of Replacement Property is Best For Me?

Exchanges offer a tremendous opportunity to grow an investor’s real estate portfolio, realign their investment properties with their financial and lifestyle objectives, increase diversification within a portfolio and stage an owner to realize the benefit of a step-up in basis.

Determining the best replacement property option depends on the owners' objectives and financial situation. We work extensively with investment property owners to determine their objectives, educate them on all available options, match them with the most fitting options and help them acquire replacement properties best suited to their situation. If you are interested in discussing your specific situation and what options you have available to you, call for a free consultation at 206-909-0037.

How to Get Started

Schedule a Complimentary Consultation

A 1031 Exchange is undeniably one of the most generous sections of the tax code and can be used in many ways, however 1031 Exchange rules are very strict and must be followed in order to qualify for tax deferral. That is why it’s important to work with highly respected 1031 Exchange companies that can help you navigate the complex process of understanding, vetting, and acquiring 1031 Exchange properties.

With over 20 years’ experience working with 1031 Exchanges, complex real estate investments, securitized real estate, and tax planning strategies, Real Estate Transition Solutions is one of few fully integrated 1031 Exchange companies in the Pacific Northwest. Our team of dedicated Exchange experts will help you select and acquire suitable 1031 Exchange properties that meet both your financial and lifestyle objectives.

If you have real estate investment property and would like to discuss your 1031 Exchange options, contact us to schedule a complimentary consultation.

Call 206-909-0037 today.

1031 Key Terms

Relinquished Property: The property or properties to be sold in which the sales proceeds and associated tax liabilities are to be exchanged.

Replacement Property: The property or properties acquired through an exchange in which the deferred tax liability is rolled into.

Exchange Identification (ID): The 45-day window following an exchange in which an individual must select and submit their identified properties in accordance with the exchange identification rules.

Equal or Greater Value: The IRS requirement that if an exchange is to have complete tax deferral, the replacement property or properties must have equal or greater value than the relinquished property or properties.

Qualified Intermediary: The entity that serves as “exchange escrow” and holds on to the exchange proceeds until the replacement properties have been identified and funds are released to purchase them.

Capital Gains Tax: The tax liability assessed at the Federal level for any increase in investment value. The tax liability comes due upon the sale of an asset unless asset is real estate and is exchanged. This tax rate ranges from 15-20%.

Depreciation Recapture: The tax liability assessed at the Federal level for any calculated depreciation on investment property, whether the owner benefitted from the depreciation or not. This tax rate is applied at a flat 25%.

Tax Liability: The total aggregate tax bill associated with the sale of a property. The liability can be comprised of Federal Capital Gains, State Capital Gains, Depreciation Recapture and Net Investment Income Tax.

Step-up in Basis: The concept that the tax liability associated with an appreciated and/or depreciated property is eliminated, either in part or in full, upon the death of the owner.

Like-Kind: The IRS’ requirement that for a property to qualify for an exchange, both the relinquished (sold) and replacement (purchased) property must be held for investment or business purposes.

Fractional Interest: An undivided percentage ownership in a larger property.

Identification Rules: There are three rules the IRS allows to identify replacement properties – one of which must be met. They are: the three-property rule, the 200% rule, the 95% rule.

Constructive Receipt: The concept that the IRS will not allow an exchange to occur if the seller had the ability to direct the sales proceeds following the close of the sale – hence the need for the Qualified

Information and numerical examples are for educational purposes only and do not constitute an offer to purchase or sell securitized real estate investments. DST 1031 properties are only available to accredited investors (typically have a $1 million net worth excluding primary residence or $200,000 income individually/$300,000 jointly of the last three years) and accredited entities only. If you are unsure if you are an accredited investor and/or an accredited entity please verify with your CPA and Attorney. There are risks associated with investing in real estate and Delaware Statutory Trust (DST) properties including, but not limited to, loss of entire investment principal, declining market values, tenant vacancies and illiquidity. Potential cash flows/returns/appreciation are not guaranteed and could be lower than anticipated. Photo examples do not represent current offerings. Future offerings will vary and may be significantly different than pictures shown. Because investors situations and objectives vary this information is not intended to indicate suitability for any particular investor. This material is not to be interpreted as tax or legal advice. Please speak with your own tax and legal advisors for advice/guidance regarding your particular situation.

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