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Tax Advantages of 1031 Exchanges

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Tax laws are subject to change. Investing in a Delaware statutory trust ("DST") involves a high degree of risk. Some of the risks relating to an investment in a DST include:

Risks Related to Holding Interests in a DST ("DST Interests")

There are limitations on the actions that the manager and trustee of a DST can take relative to the real estate. IRS Revenue Ruling 2004-86, which sets forth the IRS standards for DST Interests acquired in an IRC Section 1031 exchange, provides, in part, that in order for investors in the DST to be treated as acquiring a direct interest in the DST's real estate for tax purposes, the DST must impose significant prohibitions on the powers of the DST's manager and trustee.

If the manager and trustee are required to take action to conserve and protect the property held by the DST but are unable to do so due to the prohibitions imposed on their powers, they may determine to terminate (or be required to terminate) the DST and transfer the property to a limited partnership (a "Transfer Distribution"). An interest in a limited partnership, unlike a DST Interest, is not treated as a direct interest in the underlying real estate for tax purposes.

In addition to the U.S. federal income tax consequences described above, you should consider the state tax consequences of acquiring, owning, holding and disposing of a DST interest. You must seek the advice of your own independent tax advisor as to state and local tax issues.

Risks Related to Debt Financing

The effect of a financing (where a Transfer Distribution has occurred) or sale of the property owned by the DST could affect the rate of return to the investors in the DST with respect to that property and the projected time of disposition of the property. In an environment of increasing mortgage rates, if mortgage debt is placed on properties (if a Transfer Distribution has occurred), there is the risk of being unable to refinance such debt if mortgage rates are higher at the time a balloon payment is due.

Risks Related to a Master Lease Structure

If the Master Lease is terminated or expires, the economic success of an investment in the property will depend upon the results of operations of the property, which will be subject to those risks typically associated with investments in real estate. Fluctuations in vacancy rates, rent schedules and operating expenses can adversely affect operating results or render the sale (or financing, where a Transfer Distribution has occurred) of the property difficult or unattractive. In such case, the poor performance of such property may adversely affect the overall returns to the investors in the DST.

There is a potential risk that the Master Tenant can default on its obligations under the Master Lease.

Risks Related to Adverse Changes in General Economic Conditions

An economic downturn could adversely affect rental income generated from end tenants. From time to time, an economic downturn could occur that would result in slowed economic activity.

Risks Related to Investments in Real Property

Real properties are illiquid investments, and property owners may be unable to sell, refinance or reposition a property or properties in response to changes in economic or other conditions.

Each prospective purchaser should be advised to consult with his / her own tax advisor regarding the specific tax consequences to him / her of a contribution of property to a partnership, including the federal,

What is a 1031 Exchange?

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Hold, Sell or Exchange?

Clients who own investment real estate with built-in gains have various options:

Hold
Taxpayers may continue to own and manage their own real estate and assume the risks and rewards.

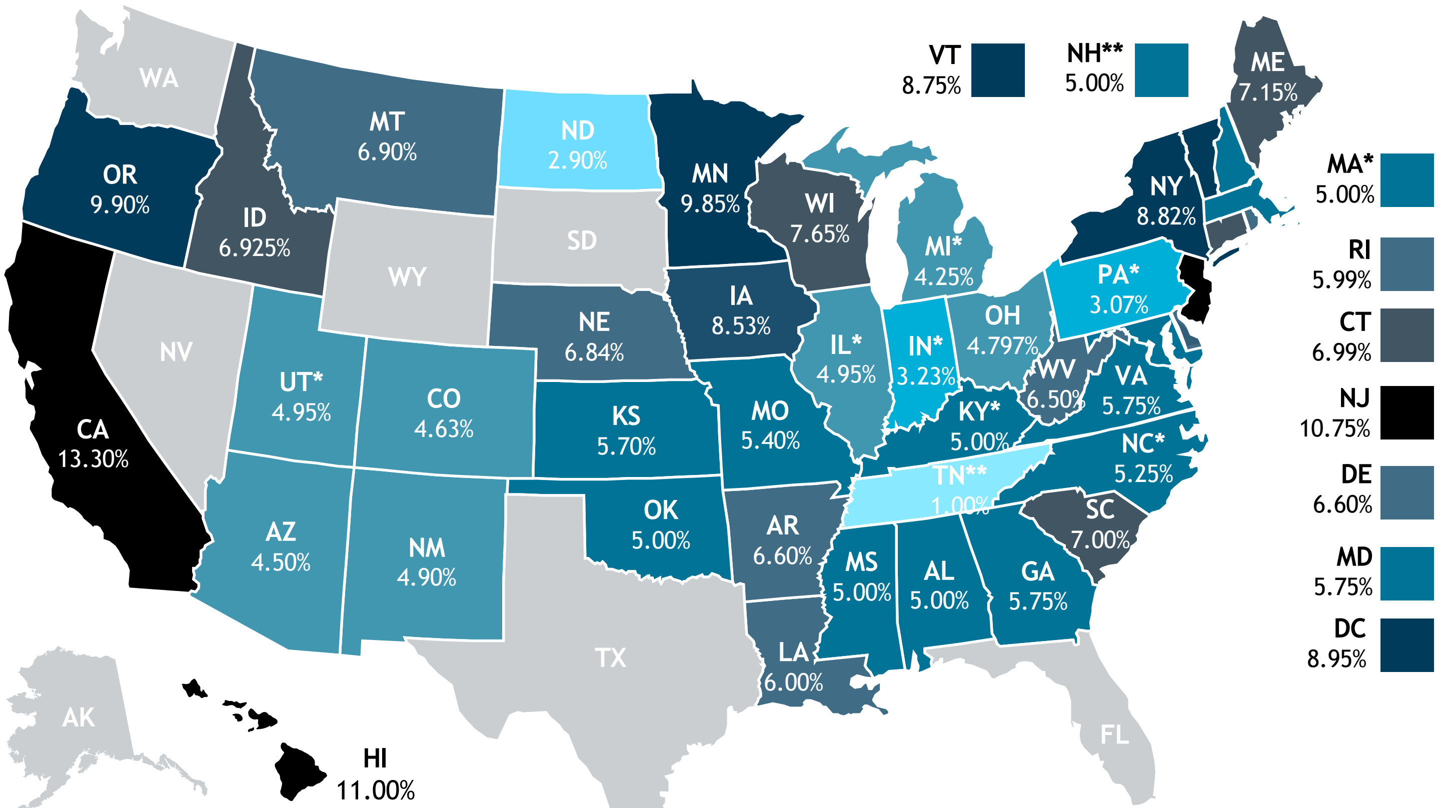
Sell
Taxpayers may sell, pay taxes and reinvest the remaining equity in other types of investments.

Exchange
Another option is for taxpayers to sell, defer taxes under IRC Section 1031, and invest the full amount of equity in other investment real estate that is better aligned with the client's investment objectives.

Total Taxes on the Sale of Property Can Exceed 37%

How high are individual income tax rates in your state?

Top state marginal individual tax rates, 2020



Note: Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.

* State has a flat tax.

** State only taxes interest and dividends income.

Sources: Tax Foundation; state tax statutes, forms and instructions; Bloomberg BNA.

Total taxes include

Federal tax rate

15-20%

State tax rate up to

13.3%

Net investment income tax

3.8%

Top state marginal individual tax rates

Lower Higher

IRC Section 1031 Exchanges

What is a 1031 Exchange?

IRC Section 1031 allows investors to defer capital gain taxes on the exchange of certain types of real estate.

Qualifying Use

- Only properties held for either investment purposes, which can include income and/or appreciation, or for the productive use in a trade or business

Like-Kind Property

- Most real estate is like-kind to each other as long as it is held for investment or use in a trade or business

Exchange

- An exchange of properties must occur through the use of a qualified intermediary and the investor cannot have actual or constructive receipt of the cash

Examples of Eligible Properties

Like-Kind Property

NOT like-kind to real property

~~Bonds~~	~~Securities~~	~~Partnership interests~~	~~Treasury notes~~	~~U.S. property for foreign property~~

Other NON-qualifying property

~~Dealer property and other property held primary for resale~~	~~Property held primarily for personal use~~

Residences and Vacation Homes

Both the relinquished property and replacement property must be held for use in trade or business or for investment. Must not be held primarily for personal use.

Residences (IRC Section 121)

Gain exclusions (not deferral)

- $250,000 (or $500,000 jointly) can be excluded if owned and lived in for at least two out of the last five years

Converting a residence to a rental

- Investors can convert a residence with a gain in excess of $250,000 (or $500,000 jointly) to a rental property, sell it and benefit from IRC Sections 121 and 1031

Converting a rental to residence

- Investors can convert a rental home acquired through a 1031 exchange to a primary residence and benefit from IRC Section 121 when selling it

Vacation Homes

IRS Revenue Procedure 2008-16

- A residence is considered an investment if (1) it is owned for at least two years; and (2) the investor rents the property at fair market rent for at least 14 days each of the two years; and (3) the investor's personal use of the property does not exceed the greater of 14 days or 10% of the time it is rented

1031 Exchange Process

PRE-SALE PERIOD →	DISPOSITION PERIOD →	IDENTIFICATION PERIOD (45 DAYS) → / EXCHANGE PERIOD (180 DAYS) →		
Engage Qualified Intermediary (1)	**Sale of the Property** (2)	**Exchange Account Established** (3)	**Identify New Property** (4)	**Reinvest in New Property** (5)
A qualified intermediary must be engaged prior to the closing of the relinquished property	Property is sold to a buyer	The qualified intermediary holds the proceeds of the property sale until the replacement property is purchased	Replacement property is identified within 45 days of the sale	Replacement property is identified within 45 days of the sale[1]

TIMING IS KEY

To complete the 1031 exchange investors must comply with the 45-day identification and 180-day exchange time deadlines

[1] Must also replace debt paid off upon the sale of the relinquished property with new debt to acquire the replacement property or by adding cash to make up the difference.

Potential 1031 Exchange Benefits

Potential Investor Benefits

- ☑ Capitalize on the value of appreciated assets
- ☑ Deferral of capital gains tax
- ☑ Reinvest the entire amount of sale proceeds vs after-tax proceeds
- ☑ Continue to potentially build wealth through passive real estate investments
- ☑ Diversify, consolidate or upgrade real estate holdings
- ☑ Potentially reduce ongoing management burdens
- ☑ Accomplish retirement and estate planning objectives

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Case Study and Tax Benefits of a 1031 Exchange

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1031 Exchange Case Study Illustration

Building Sale	Real Estate Valuation	Identify Options	Purchase	Taxes Deferred
Client sells medical practice building for $5 million (**Planning Idea**: the gains from the sale of the medical practice itself could be invested in an opportunity zone fund)	Real estate is valued at $5 million • Tax basis is $1 million • Capital gain is $4 million	Client identifies like-kind properties with QI within 45 days	Client buys $5 million building or percentage interest in a DST	Client defers taxes on original $4 million capital gain and the $1 million basis transfers to replacement property

1031 Exchange Tax Advantages

Deferral of Original Gains Tax	Deferred until exchange asset is sold
Reduction of Original Gains Tax	None unless passed to heirs with a step-up in basis
Liquidity for Tax Benefits	Passed to heirs for full tax benefits
Capital Gains Liability on Exit	Full capital gain liability on original deferral and incremental value on exit, basis resets if passed to heirs
Tax Reporting	Income and deductions continue to be reported on the investor's tax return

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What is a Delaware Statutory Trust?

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What is a Delaware Statutory Trust?

Delaware Statutory Trust (DST)

What is a DST?

An investment structure available for investors seeking institutional-quality replacement property as a part of a 1031 exchange

How are DSTs sold?

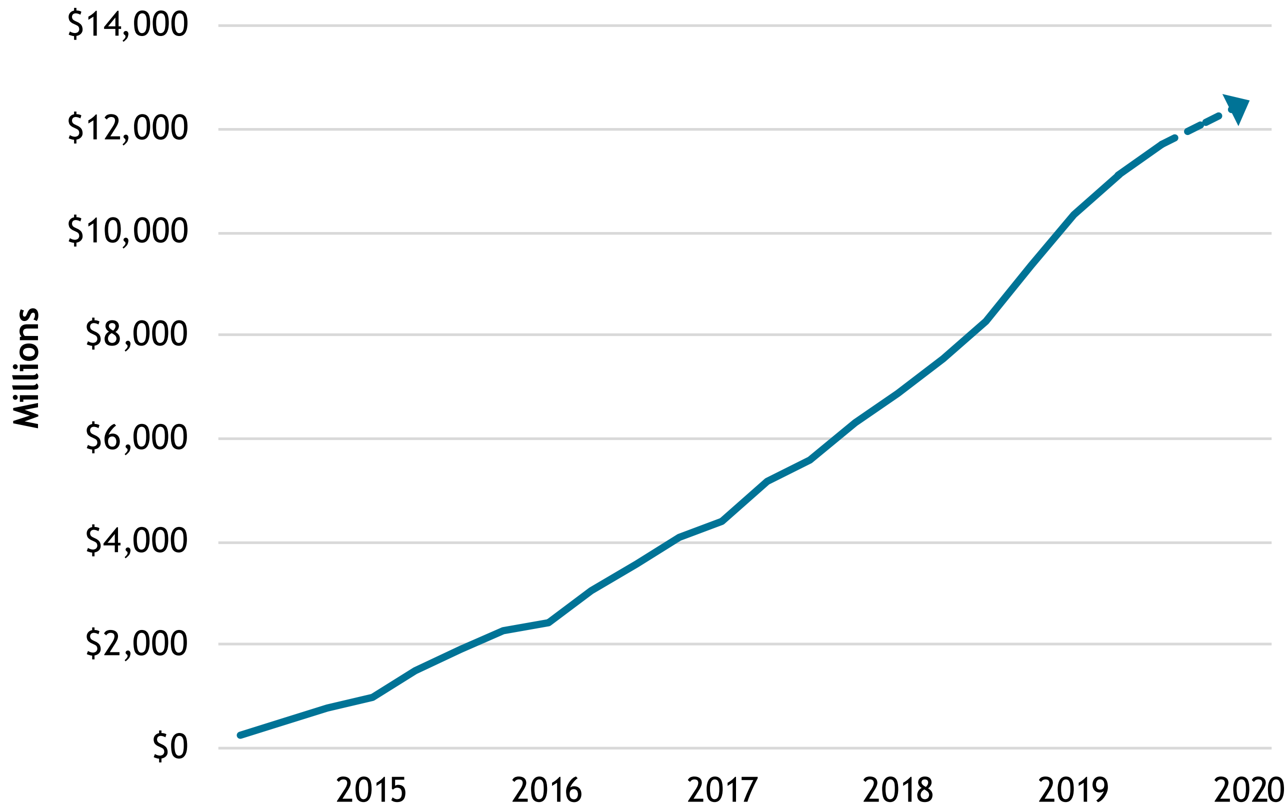
- While a DST is considered real estate for 1031 exchange purposes, it is considered a security for SEC purposes
- Only licensed broker-dealers or investment advisors can offer these products to investors and receive compensation

1031 DST Industry[1]

Significant 1031 Exchange Growth

- **50%[2]:** of HNW investors hold more than 10% of net worth in direct real estate
- **10-20%[3]:** of all commercial real estate transactions involve a 1031 exchange
- **$13.6B[1]:** 1031 exchange transactions occurred in the broker/dealer led DST market since 2015
- **26%[1]:** Average YoY securitized DST capital raise growth rate since 2015
- **$3.2B:** invested in broker/dealer led DST offerings in 2020;
- **$5.2B** trajectory for 2021

Cumulative DST Broker/Dealer 1031 Exchange Transactions Since 2015



[1] "Market Report Securitized 1031 Industry 2020 Year-End Report (Q4 2020)" by Mountain Dell Consulting, LLC
[2] Statistics sourced from National Real Estate Investors 2017 HNWI Research Report :HNWI's defined as individuals with more than $1 million in liquid financial assets.
[3] "The Tax and Economic Impacts of Section 1031 Like-Kind Exchanges in Real Estate" submitted to The Real Estate Research Consortium by David C. Ling and Milena Petrova, October 2020.

Benefits of Investing in a DST

Potential Investor Benefits

- ☑ Client does not have to search and locate replacement property
- ☑ Passive ownership
- ☑ Access to larger institutional quality property
- ☑ Can diversify and invest in multiple DSTs
- ☑ Easy to right-size the investment amount by acquiring a percentage interest in the DST that is equal to or greater than the value of the relinquished property
- ☑ The DST can have debt on the property, allowing the investor to offset debt that was paid off upon the sale of the relinquished property
- ☑ A DST can be a great option for investors who have some exchange proceeds leftover after purchasing other like-kind real estate

Dealing with Debt in a 1031 Exchange

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Requirements for a Fully Tax-Deferred Exchange

To defer capital gain tax in its entirety, the investor must:

- Reinvest all net proceeds from the sale of the relinquished property
- Acquire replacement property with an equal or greater amount of mortgage debt than was paid off on the relinquished property
- Receive nothing in the exchange but like-kind property
  - Partially tax-deferred exchanges are possible where the investor receives some like-kind property and either receives some cash or does not replace the full amount of debt that was secured by the relinquished property
  - “Boot” is anything received or given in an exchange that is not like kind

Rule of Thumb:
Investors must use all the net proceeds from the sale of the relinquished property to acquire a replacement property for equal or greater value

Balancing the Exchange — Examples[1]

Replacement Property					
		Example #1:	Example #2:	Example #3:	Example #4:
	Relinquished Property	Replacement property with an equal value, debt and equity	Replacement property with a lower value and investor keeps some cash	Replacement property without debt	Replacement property with no debt — investor adds cash in to offset debt
Value	$1,000,000	$1,000,000	$900,000	$900,000	$1,000,000
Debt	$100,000	$100,000	$100,000	$0	$0
Equity	$900,000	$900,000	$800,000	$900,000	$1,000,000
Result		No tax due	Tax is due on $100,000 of cash boot received	Tax is due on $100,000 of mortgage (debt-relief) boot received	No tax is due. The $100,000 debt relief (mortgage boot received) is offset by the $100,000 cash added in (cash boot paid)

[1] For illustrative purposes only. Investors are responsible for seeking their own tax advice.

What are the exit options out of a 1031 exchange?

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Exit Options

Sell and Pay Taxes

Client can sell property and pay the applicable taxes

- Taxes can be as high as 37% with state and federal capital gains taxes, depreciation recapture and Medicare Contribution or Net Investment Income Tax
- Net proceeds remaining after debt and taxes paid can be reinvested however the client sees fit

1031 Into Other Property

Client can complete another 1031 exchange into like-kind replacement property

721 Exchange

Under Section 721 of the Tax Code, client can contribute property to a partnership in exchange for an interest on a tax deferred basis

- Most REITs own real estate inside an operating partnership
- If a client owns a property that a REIT wants to acquire, the client can transfer it directly to the REIT's operating partnership in

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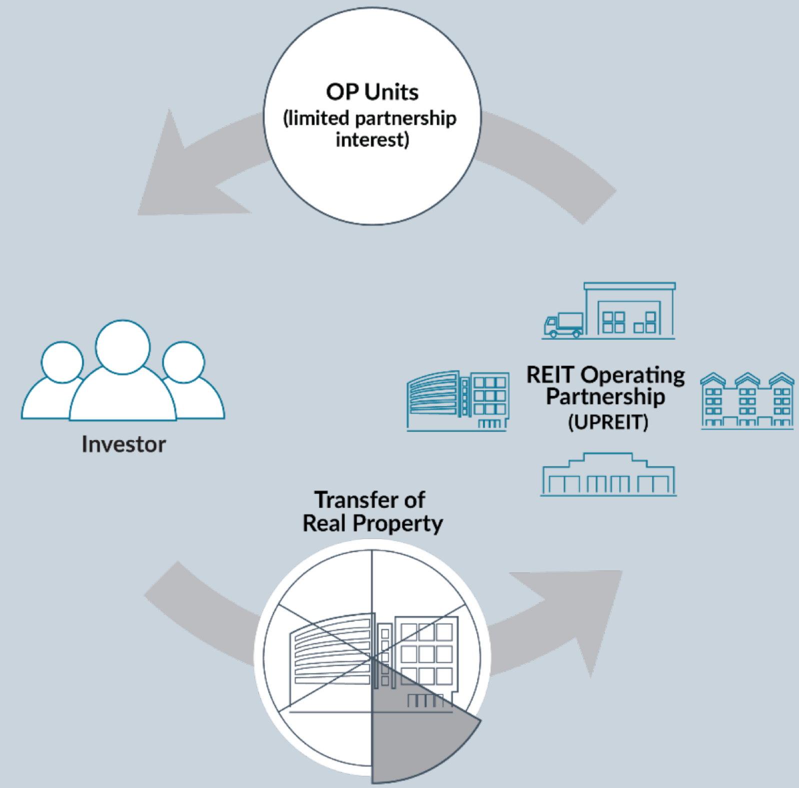
721 Exchange — UPREIT Transaction

Contribution of Property to a REIT Partnership

What is a Section 721 exchange or UPREIT transaction?	721 EXCHANGE (UPREIT Transaction)
• Section 721 of the Internal Revenue Code allows an investor to exchange property held for investment or business purposes for shares in a Real Estate Investment Trust (REIT Operating Partnership) without triggering a taxable event • This type of transfer of property to a partnership is tax-deferred under Internal Revenue Code Section 721 and is also known as an UPREIT transaction	

Potential 721 Exchange Benefits

Potential Investor Benefits

- ☑ Deferral of capital gains tax
- ☑ Continue to potentially build wealth through passive real estate investments
- ☑ Diversification
- ☑ Access to institutional quality portfolio and management team
- ☑ Potential liquidity
- ☑ Ease in transferring ownership units for estate planning purposes
- ☑ No longer necessary to repeat the 1031 exchange process

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Questions?

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