Introduction & Strategies to 1031 Exchange

Like-kind tax deferred exchange for investment property

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Today's Agenda

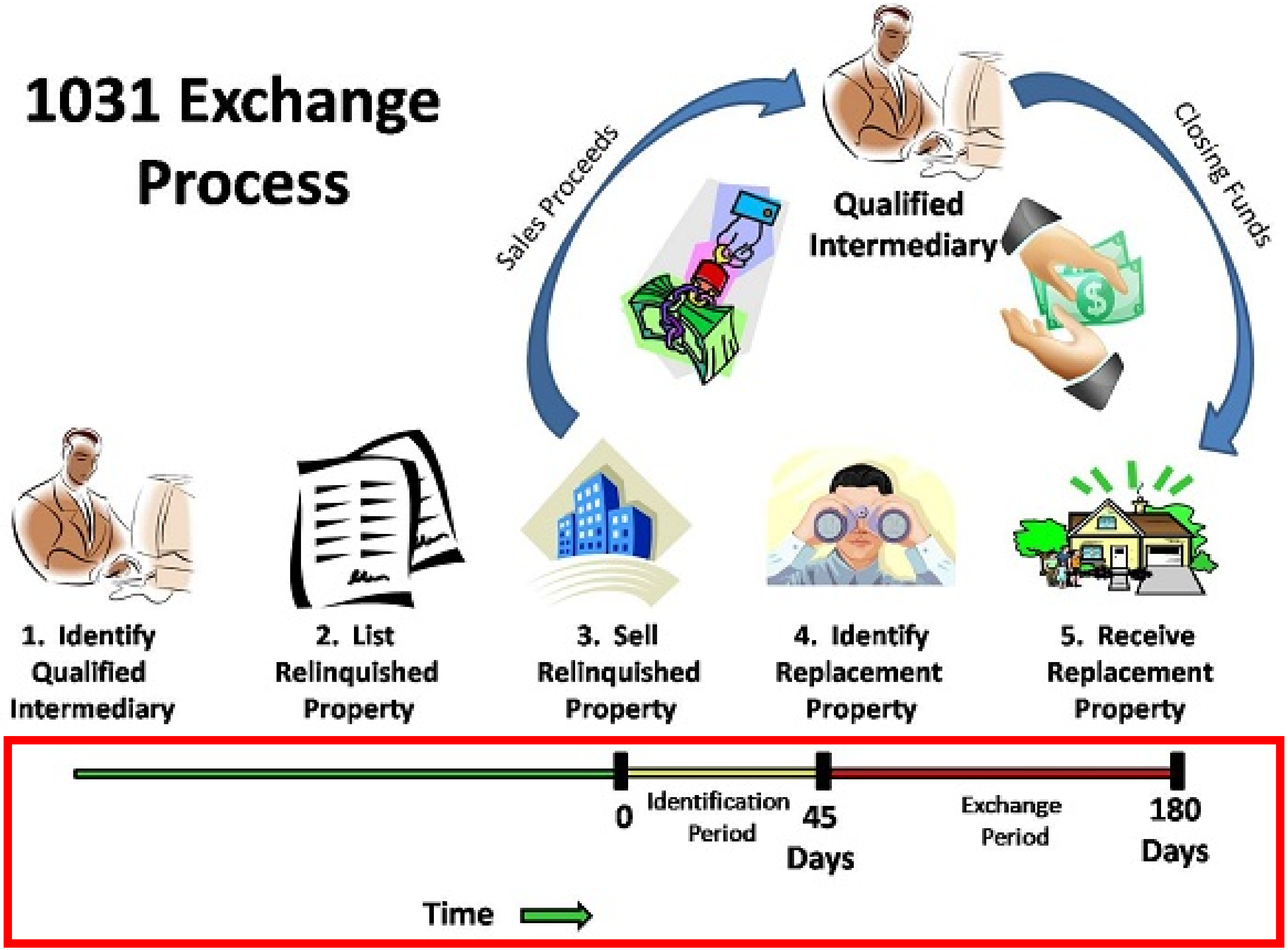
Section I

- Terminology
- A brief history
- Why do a 1031 exchange?
- Qualifying property

Break & Section II

- The 1031 exchange process & Qualified Intermediaries
- Specific situations and issues to consider
- 1031 and the broader financial plan
- Is a 1031 exchange right for you? What you need to know.
- Resources

1031 Exchange Process



Terminology

- *Boot* FMV of non-qualified property received in an exchange
  - You will pay tax on this amount, but it does not disqualify the entire exchange.
- *Constructive Receipt* Control of proceeds even if funds have not been transferred.
- *Exchanger* Property owner wanting to execute a 1031 exchange and defer taxes on their sale transaction.
- *Like-kind Property* Refers to the "nature or character" of the property, not is grade or quality.
- *Qualified Intermediary* The entity that facilitates the exchange on behalf of the exchanger.
- *Identification Period* 45 days, the time from sale the exchanger has to identify the replacement property.
- *Exchange Period* 180 days, the time period from the initial sale that the exchanger must close on the replacement property.

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History of the IRC Section 1031 Exchanges

- Introduced in the Revenue Act of 1921
  - Initially, the sell and buy transactions had to occur on the same day.
- Starker decision in 1979
  - Created the "forward exchange"
  - Allowed for replacement property to transact one day following sale.
- In 1984…
  - Identification period (45 days) and Exchange period (180 days) were imposed.
- In 1991…
  - Four "safe harbors" were created, including the use of a Qualified Intermediary (QI) to create the exchange and hold funds.

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Why Do a 1031 Exchange?

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WHY DO A 1031 EXCHANGE?

Defer (or possibly eliminate) ***capital gains taxes*** on the sale of qualified property.

Depreciation:

A reduction in the value of an asset over time, due to wear and tear.

	"Normal" Sale	1031 Exchange
Sale Price	$ 1,500,000	$ 1,500,000
Cost Basis	750,000	750,000
Depreciation	500,000	500,000
Adjusted Basis	250,000	250,000
Capital Gain	$ 1,250,000	$ 1,250,000
Taxes on Gain	297,500	-
Reinvestment Capital	$ 952,500	$ 1,250,000
Difference		$ 297,500
5 years @ 5%		$ 379,694
10 years @ 5%		$ 484,596
20 year @ 5%		$ 789,356
Capital Gains Tax Rate	23.8%	

Tiers of Taxation

› Capital Gains Tax: As high as 20% tax rate

› 3.8% Healthcare Tax:
  – 3.8% Medicare surtax on "net investment income"
  – Applies to individuals earning over $200,000 and married couples earning over $250,000

› 25% Depreciation Recapture Tax:
  – The part of the gain that is related to depreciation will be taxed at 25% upon sale

› State Taxes:
  – Certain states, such as California, have a 13.3% top tax rate

Why do a 1031 exchange? Another reason…

› *Generate more tax efficient income.*

- Exchange fully depreciated property with higher valued property that can be depreciated and offer additional tax savings.
- By adding cash or debt to your replacement property, new tax deductions can be created.
- Possibly utilize “trapped” passive activity losses (PALs) with new income from replacement property.

Example of improving income tax efficiency

- Own property that has been fully depreciated
- 1031 exchange for property with new/additional mortgage

Sales Proceeds (net)	1,000,000		Annual Income Yield %	6.50%
Loan-to-value on Replaement	50.00%		Annual Income	$ 65,000
New Mortgage Basis	1,000,000	→	Additional Depreciaton	$ 23,077
Depreciaton			Annual Taxable Income	$ 41,923
39 years				
90% building allocation				

Why do a 1031 exchange? A few more reasons…

- Improve Income
  - Trade non-income producing property for higher yielding income property.
- Diversification
  - Trade one property for a portfolio of properties.
- Consolidation
  - Trade multiple properties for one or a portfolio of properties centrally managed.
- Eliminate property management
  - Trade property for professionally managed DST portfolio.
- Move markets
  - Sell in California, buy in Texas.
- Estate Planning
  - Facilitate distribution of your estate.

Qualifying Properties

- ***Like-kind Property*** Refers to the "nature or character" of the property, not is grade or quality

Qualified and Non-Qualified 1031 Properties

No Properties "Held for Sale"

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Delaware Statutory Trust (DST)

What is a DST?

- A professionally managed portfolio of real estate assets that can be used in a 1031 exchange. (REIT)

Why use a DST in a 1031 exchange?

- Cannot find suitable replacement property within 45-day ID period
- Need additional property to complete 100% 1031 exchange
- Need to add debt to exchange and do not qualify individually
- Do not want to manage investment property anymore
- Better cash flow and tax benefits

DST – Benefits and Drawbacks

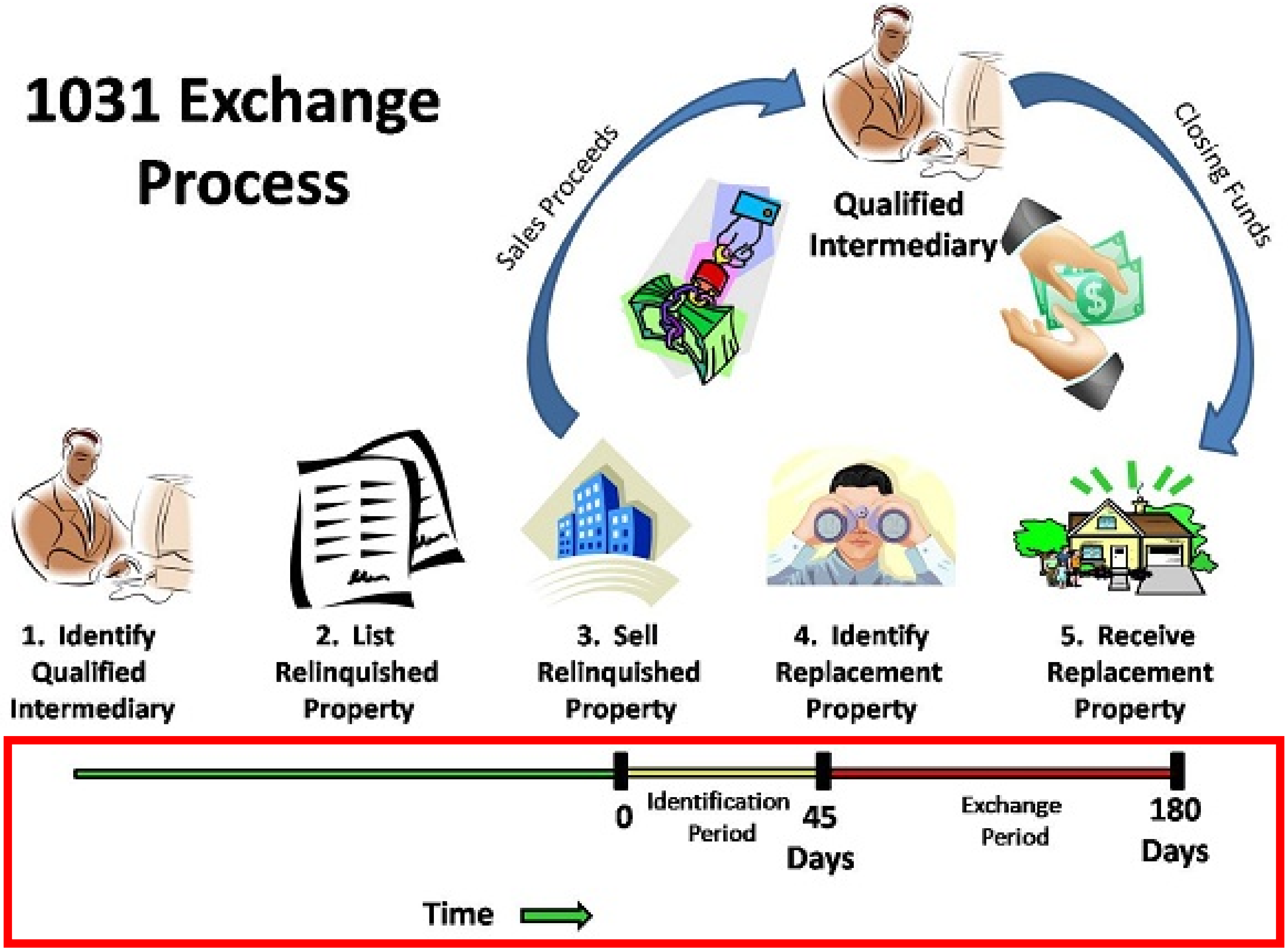
PRO'S	CON'S
› Simple structure – Diversification within one investment – Professionally managed – Passive ownership › Investment income – Tax efficient (depreciation exp) – Monthly distributions › One mortgage – No investor application – No personal liability to investor	› Illiquid › Accredited investors only – $200,000 annual income OR – $1,000,000 net worth (exclude home)

Types of DST's

PROPERTY TYPE	FINANCING & OTHER OPTIONS
› Necessity discount retail	› Leveraged or cash buy
› Multi-family housing	› Interest only or amortizing loan
› Student housing	› Lease escalations
› Office	› "Zero coupon"
› Industrial	
› Senior living facilities	
› "Big box" retail	
› Distribution centers	

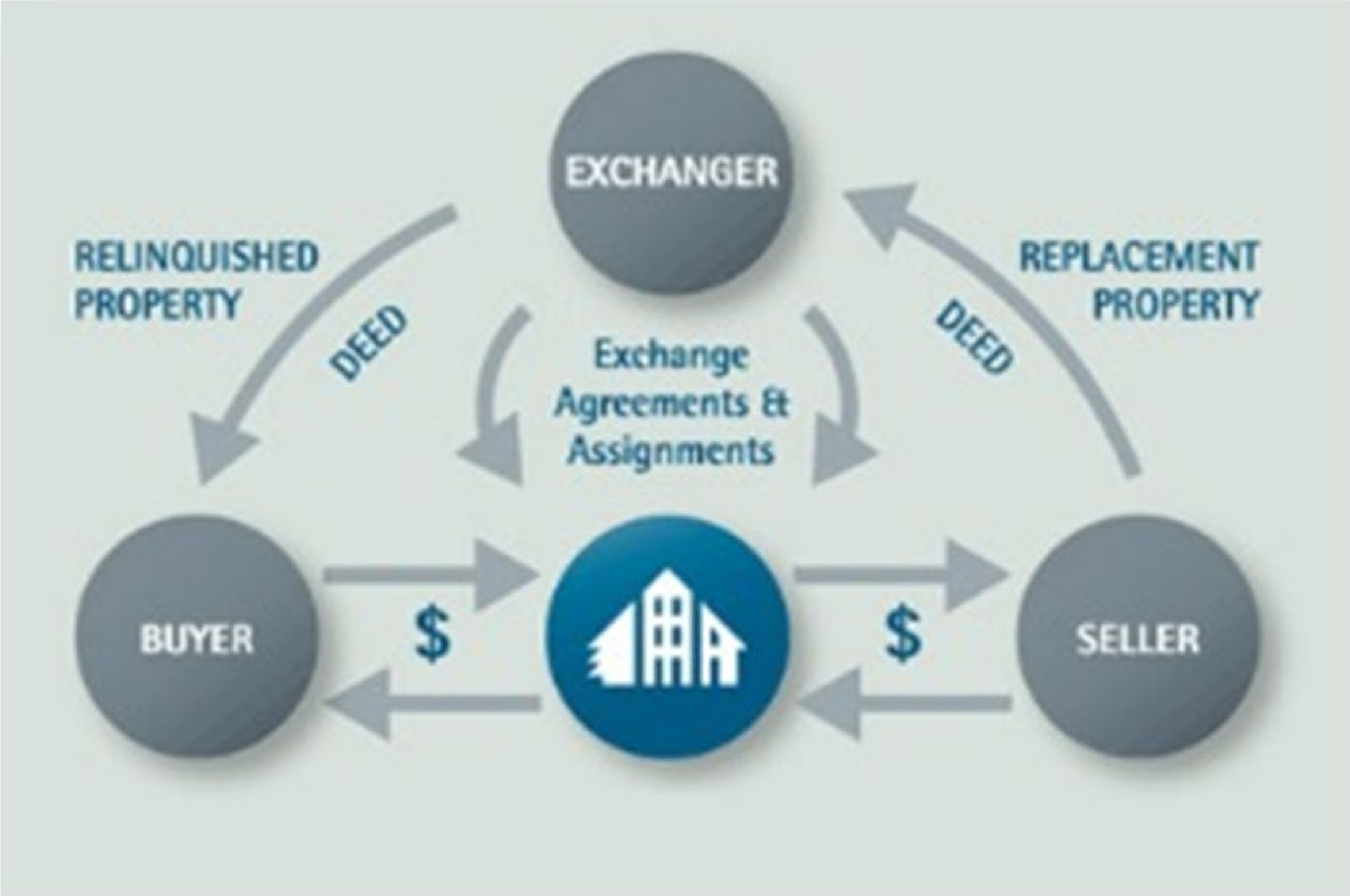
The 1031 Exchange Process

1031 Exchange Process



QUALIFIED INTERMEDIARY

- They create the "exchange"
- Hold exchange proceeds
- Prepare the legal documents
  - ✓ Exchange agreement
  - ✓ Purchase and sale agreement
- Look for CPAs and attorneys on staff.
- Ensure they are bonded!
  - ✓ Fidelity bond insurance coverage ($100 mil)
  - ✓ Professional liability coverage ($30 mil)



Selling Relinquished Property

› Include "**cooperation clause**" in selling document.

"Buyer hereby acknowledges it is the intent of the Seller to effect an IRC Section 1031 tax deferred exchange, which will not delay the closing or cause additional expense to the Buyer. The Seller's rights under this Agreement may be assigned to [Qualified Intermediary], for the purpose of completing such an exchange. Buyer agrees to cooperate with the Seller and QI in a manner necessary to complete the exchange."

Identifying the Replacement Property

- Identification must be made in a **written notice**.
  - Generally to the QI, sometimes to the seller of the replacement property.
  - Must contain description of ID'ed property.
  - Must be signed by the exchanger.

- Must be **within 45 days of the closing** of the relinquished property.

Replacement Property ID restrictions

Exchanger can ID more than one property.

- *__Three Property Rule__*: Any three properties without regard to FMV.
- *__200% Rule__*: Any number of property, FMV of all properties cannot exceed 200% of relinquished property at closing.
- *__95% Exception__*: Exchanger ID's property that does not comply with either of the rule, must receive 95% of FMV of *all* ID'ed property by the end of the exchange period.

How to Execute a Successful 1031 Exchange

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Three Rules to a Successful Exchange

1. Replacement property is **equal or greater in value** than relinquished property.

2. **Reinvest all exchange equity** into the replacement property.

3. Obtain the **same amount (or more) of debt** on the replacement property.

Example #1 – Exchanger goes up in value

- Increases value
- Increases mortgage
- Same equity
- No Tax is due

	Relinquished		Replacement
Value	$150,000		**$225,000**
Mortgage	$100,000		**$175,000**
Equity	$50,000	⟷	$50,000
Taxes Due			$0.00

Example #2 – Exchanger cashes out $10,000

- ❖ Increases value
- ❖ Increases mortgage
- ❖ Keeps $10,000 of net proceeds:
- ❖ Tax is due on $10,000 of Cash Boot

	Relinquished		**Replacement**
Value	$150,000		**$225,000**
Mortgage	$100,000		**$185,000**
Equity	$50,000	⟷	**$40,000**
Taxes Due			**($10,000) Cash Boot**

Example #3 – Exchanger reduces value & mortgage

- Decreases value
- Decreases mortgage
- Same amount of equity
- Tax is due on $25,000 of Mortgage Boot

	Relinquished		**Replacement**
Value	$150,000		**$125,000**
Mortgage	$100,000	⟵⟶	**$75,000**
Equity	$50,000		**$50,000**
Taxes Due			**($25,000) Mortgage Boot**

Specific Situations and Issues to Consider

1031 Exchanges and Debt

- Debt on **replacement property** must be **equal to or greater than** the debt on the **relinquished property**!
  - Exception: exchanger can add cash.

- Increasing debt on replacement property cannot offset a reduction in exchange equity.
  - This will result in excess exchange funds, which is boot.

- ***Refinancing***: Not a good idea immediately before or after exchange.
  - "Step Transaction Doctrine": IRS can say the refinance was part of the 1031 transaction, and any cash out is considering taxable boot.

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Vacation or Second homes

- Do second homes qualify for 1031 exchange status?
  - Yes, if you actively rent the property.
  - No, if primarily used for personal use.

- Specific rules:
  - Property must have been owned for the <u>prior 24 months</u> to sale.
  - For each 12-month period, owner must:
    - <u>Rent</u> property for at least <u>14 days</u>, AND
    - Restricted personal use to the greater of:
      - 14 days OR
      - 10% of the days rented in that 12-month period

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1031 and The Broader Financial Plan

Financial Planning with 1031 Exchanges

- What is the client's overall tax situation?
  - How does this transaction and resulting income fit into the bigger picture?

- Is there a bigger tax savings/retirement planning opportunity here?

- Can I eliminate the tax bill all together?

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What do I need to know about the client's property to make an informed recommendation?

- Property Tax Basis and Holding Period
- Property Estimated Market Value
- Debt Securing The Property
- Title, How is The Property Being Held?

What do I need to know about the client's suitability to make an informed recommendation?

- Client Future Plans for The Property
- Client Future Plans for Himself/Herself
- Estate Considerations
- Liquidity Concerns

Resources

› Per Stirling Capital Management
  – Wealth management, tax and cash flow analysis
› IPX 1031
  – Qualified Intermediary
› WWW.IRS.GOV
  – Search 1031

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Per Stirling Presentations

<u>Title: The Capital Markets & Macroeconomic Environment</u>

Presenter: Robert Phipps, Founding Partner, Per Stirling

Time: May 18th @ 12:00pm (central)

<u>Registration: Contact Sarah @ FPA-Austin (admin@austinfpa.org)</u>

This comprehensive webcast includes an overview of the current macroeconomic environment, currently monetary and fiscal policies, the geopolitical and legislative outlooks, capital market fundamentals and technical, investor sentiment and how this extraordinary array of factors is manifested itself in the capital markets. We also offer some thoughts on how these factors may continue to impact risk markets in the future.

Disclosures

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