

IRC SECTION 1031 TAX DEFERRED  
EXCHANGES OF REAL PROPERTY



# Death & Taxes

PREPARED FOR FPA



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- DST 1031 properties are only available to accredited investors.



# OUR PRESENTER: LOUIS ROGERS, FOUNDER & CEO

- Influential tax lawyer who helped commercialize TIC and DST structures for 1031 exchanges
- Nationally recognized authority in structuring securities offerings for real estate investments
- Often serves as a consultant and expert witness on Section 1031 exchanges, DSTs, Regulation D private placements, non-traded REITs, and more
- Has over three decades of experience in real estate securities and investments
- Named Entrepreneur of the Year 2017 Mid-Atlantic Finalist and recipient of Power List Virginia 500 in 2020 - 2023, as published by Virginia Business Magazine.
- Published author of *Section 1031 Exchanges: How To Swap Till Ya' Drop, Building Family Wealth While Minimizing Taxes*
- Member of the Virginia Commonwealth University Real Estate Circle of Excellence
- Honored by the National MS Society as the 2022 recipient of the Frank N. Cowan Silver Hope Award.



# MATRIX

## TAX-ADVANTAGED REAL ESTATE INVESTING

Sale of Real Estate (not principal residence)	Any Capital Gains (including real estate)	Discretionary Cash (\$) to Invest		Qualified Funds (tax-exempt pension plans, IRAs, 401(k)s, etc.)
Section 1031 Exchange for tax deferral	Opportunity Zone Fund for tax deferral and exclusion   Special distribution to pay taxes	REIT   Diversified real estate portfolio	Development LLCs   Develop new apartment communities	Qualified funds from tax-exempt plans, IRAs and 401(k)s   Tax exempt no tax (no UBTI)
Stable income	Stable income	Stable income	Higher returns from development/stable income	Stable income
Growth	Growth	Growth	Growth	Growth
Tax benefits	Tax benefits	Tax benefits	Tax benefits	Tax benefits

# SECTION 1031 EXCHANGES/DST AGENDA

- Introduction
- 1031 Exchange Summary
- Estimate the Tax Consequence
- How Does a DST Work?
- DST Rules and Opportunities
- DST v. TIC
- Summary
- Questions and Answers

# INTERNAL REVENUE CODE: SECTION 1031

“No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.”

## **Summary:**

- No gain shall be recognized
- Trade or business/investment property
- Not a principal residence

## **Note:**

§ 1031 – Defers taxes; does not forgive them (but step up in basis on death)

§ 1033 – Involuntary conversions (casualty/condemnation)

§ 121 – Tax is forgiven on sale of principal residence (\$250,000/\$500,000)

# VESTING

- Same taxpayer
- Whether an individual (person) or a legal entity (LLC, LP, corporation or trust), the same taxpayer (person or entity) must acquire the replacement property
  - but not if single member LLC (disregarded entity for tax purposes)

# TAX CUTS AND JOBS ACT OF 2017

- Eliminated Section 1031 for personal property
- No impact on real property exchanges
- Several favorable new tax provisions
  - Bonus depreciation
    - 100% in 2022
    - 40% in 2025
  - 20% pass-through deduction



# BENEFITS OF 1031

## Goals/Opportunities

- Defers taxes (federal and state); does not forgive taxes
- Build family wealth over time
- Acquire higher quality replacement property
- Diversify to reduce risk by acquiring several replacement properties
- Potential tax forgiveness (step up) on death (“swap ‘til you drop”)

# RATIONALE/THEORY OF 1031

## Continuity of Investment

Taxpayer

- Started with real estate
- Ended with real estate
- Never received anything except “like-kind” property (no boot – cash or non like-kind property)
- Note: any boot received will be taxable

# WHY EXCHANGE?

## 1. Tax Deferral:

- The tax that would be paid in a taxable transaction is deferred until the replacement property is sold in a taxable transaction (tax may continue to be deferred over and over again in subsequent exchanges and may be forgiven on death – “swap till you drop”)

## 2. Change Type of Real Estate, for example:

- Non-income producing property (for example, land) can be exchanged for income-producing property (for example, rental house, office building or shopping center) to generate income
- Management intensive property (for example, apartments) can be exchanged for passive property (for example, net leased property or DST interest) to eliminate active management

## 3. Offer Too Good to be True:

- Sell for high price and look for bargain priced replacement property



# EXCHANGE MYTHS

# EXCHANGE MYTHS

- Exchangers have to find someone with property who will swap property with them.
- Exchangers have to buy the same type of real estate that they are exchanging.
- Exchangers have to complete the exchange in one simultaneous transaction.
- Exchanges are expensive, difficult, and only for large property owners.
- An exchanger will be audited if they exchange property instead of selling it.
- An exchanger who lives on part of his or her property can not exchange.
- Exchangers do not need to hire an intermediary, they can simply have their attorney hold the exchange funds until the replacement property is purchased.



# SECTION 1031: NOT A RED FLAG FOR AN IRS AUDIT

- In 2018, the IRS audited just 0.59% of individual tax returns
- Based on 2017 IRS statistics, out of 150 million taxpayers:

TAXPAYER TYPE	RETURNS AUDITED
Taxpayers with gross income before deductions of over \$1 million	4.35% (1 in 23)
Sole proprietors with gross income before deductions between \$200,000 and \$1 million	1.56% (1 in 64)
Sole proprietors with gross income before deductions between \$100,000 and \$200,000	2.08% (1 in 48)
Taxpayers with self-employment income under \$25,000 who claim the EITC	1.39% (1 in 72)
Wage earners who make under \$200,000 and don't claim the EITC (65% of taxpayers fit this category)	0.27% (1 in 364)
Overall individual audit rate	0.62% (1 in 161)

- NOT an audit risk
  - unless a “related party exchange” reported on Form 8824

# WHAT IS LIKE-KIND PROPERTY?

The exchanger may exchange real property for any other **like-kind** real property located in the United States or its possessions if the replacement property is held for productive use in a trade or business or for investment.

Apartments | Single Family | Duplexes | Medical | Retail | Industrial | Commercial | Raw Land

# LIKE-KIND REAL PROPERTY

1. “Like-kind” refers to the nature or character of the property and not its grade or quality.
2. Generally, all real property is “like-kind” to all other real property.
3. Real property can be improved or unimproved because this only relates to the grade or quality, not its kind or class.
4. The exchanger’s intent must be to hold the replacement property for investment or productive use in a trade or business.





# ESTIMATE THE TAX CONSEQUENCE

# ESTIMATE THE TAX CONSEQUENCE

1. Adjusted Basis
2. Capital Gain
3. Appreciation v. Depreciation
4. Federal Capital Gains Tax
5. State Capital Gains Tax
6. Total Capital Gains Tax
7. **Potential Return on Deferred Taxes**



# AMOUNT OF CASH FLOW + APPRECIATION ON DEFERRED TAXES

## Overview: Calculate Cash Flow Plus Appreciation

Tax Deferral (the tax that is deferred).....	\$1,898,068
at 5% cash flow per year (on the tax that is deferred).....	\$94,903
10 year holding period.....	\$949,034
Assume 10% appreciation.....	+ \$1,000,000
<b>Total.....</b>	<b>\$1,949,034</b>

# ESTIMATE THE TAX CONSEQUENCE ON THE SALE OF INVESTMENT PROPERTY

## Step One: Calculate the adjusted basis in the property

Original purchase price of the property <i>plus</i> capital improvements.....	\$5,000,000
<i>Minus</i> depreciation on improvements and building (27.5 year for 10 years on capital improvements and building.....	\$1,636,362
<b>Equals Adjusted Basis.....</b>	<b>\$3,363,638</b>

Assume land value (\$500,000) + improvements (\$4,500,000) =  
\$5,000,000

# ESTIMATE THE TAX CONSEQUENCE ON THE SALE OF INVESTMENT PROPERTY

**Step Two:** Use the adjusted basis to determine the capital gain on the sale

Sales price of property.....	\$10,000,000
<i>Minus</i> transaction costs (closing costs, commissions, etc.) .....	\$490,000
<i>Minus</i> adjusted basis.....	\$3,363,638
<b>Equals Total Gain.....</b>	<b>\$6,146,362</b>

# ESTIMATE THE TAX CONSEQUENCE ON THE SALE OF INVESTMENT PROPERTY

**Step Three:** Determine how much of the capital gain is due

- a) Due to appreciation; and
- b) The recapture of depreciation taken during ownership.

Total gain.....	\$6,146,362
<i>Minus</i> depreciation taken.....	\$1,636,362
<b>Equals Capital Gain Due to Appreciation.....</b>	<b>\$4,510,000</b>

# ESTIMATE THE TAX CONSEQUENCE ON THE SALE OF INVESTMENT PROPERTY

**Step Four:** Calculate the federal capital gain tax Due to appreciation; and

a) Multiply the capital gain due to appreciation times exchanger’s federal tax rate

Capital gain from appreciation.....	\$4,510,000
<i>Times</i> exchanger’s federal tax rate* .....	23.8%
<b>Equals Federal Capital Gain Tax on Appreciation.....</b>	<b>\$1,073,380</b>

\*Includes net investment income tax  
of 3.8%



# ESTIMATE THE TAX CONSEQUENCE ON THE SALE OF INVESTMENT PROPERTY

**Step Four:** Calculate the federal capital gain tax Due to appreciation; and

- b) Multiply the capital gain due to depreciation recapture times the federal tax rate of 25%

Capital gain from depreciation recapture.....	\$1,636,362
<i>Times 28.8% federal tax*</i> .....	28.8%
<b>Equals Federal Tax on Depreciation Recapture.....</b>	<b>\$471,272</b>

\*Includes net investment income tax  
of 3.8%

# ESTIMATE THE TAX CONSEQUENCE ON THE SALE OF INVESTMENT PROPERTY

**Step Five:** Calculate state tax on capital gain (if applicable); multiply total capital gain times exchanger’s tax rate

Capital gain.....	\$6,146,362
<i>Times</i> exchanger’s tax rate (assume 5.75%*).....	5.75%
<b>Equals State Capital Gain Tax.....</b>	<b>\$353,416</b>

\*Income tax rates vary from state to state. A number of states do not impose an income tax.

# ESTIMATE THE TAX CONSEQUENCE ON THE SALE OF INVESTMENT PROPERTY

**Step Six:** Calculate exchanger’s total combined state and federal capital gain tax

Capital gain tax from appreciation.....	\$1,073,380
<i>Plus</i> federal tax on depreciation recapture.....	\$471,272
<i>Plus</i> state capital gain tax.....	\$353,416
<b>Equals Total Combined Federal and State Tax.....</b>	<b>\$1,898,068</b>

# ESTIMATE THE TAX CONSEQUENCE ON THE SALE OF INVESTMENT PROPERTY

## Step Seven: Calculate cash flow plus appreciation

Tax Deferral (the tax that is deferred).....	\$1,898,068
at 5% cash flow per year (on the tax that is deferred).....	\$94,903
10 year holding period.....	\$949,034
Assume 10% appreciation.....	+ \$1,000,000
<b>Total.....</b>	<b>\$1,949,034</b>



# EXCHANGE RULES



# BASIC 1031 EXCHANGE RULES

## **To obtain complete deferral, the exchanger must:**

1. Purchase replacement property that is equal to (or greater than) the value of the relinquished property
  - Reinvest all of the net proceeds from the relinquished property into qualifying replacement property
  - Any cash received will be taxable
2. Offset debt from relinquished property with equal or greater debt on replacement property
  - Reduction in debt may be offset with additional additional cash from another source
  - Receive nothing in the exchange but like-kind property
  - No boot

# DEFERRED/DELAYED EXCHANGES

## **Starker v. United States (9th Cir. 1979)**

- Five years to “identify” replacement property (delayed exchange)
- “Growth” factor (interest)
- Holding: good § 1031 **delayed** exchange

# EXCHANGE SAFE HARBORS

## TO AVOID TAXATION FROM ACTUAL/CONSTRUCTIVE RECEIPT

**Four Safe Harbors are provided in the Treasury Regulations that protect the exchanger from being taxable as a result of constructive receipt (control or benefit) of the exchange funds:**

1. Use of Qualified Intermediary to create the exchange
2. Use of Qualified Escrow or Trust to hold the proceeds from the exchange
3. Use of a Guarantee or Security Arrangement to secure the exchange proceeds
4. Interest paid on exchange proceeds
5. Revenue Procedure 2000-37 now provides a safe harbor for reverse exchanges

# EXCHANGE STRUCTURES WITH QUALIFIED INTERMEDIARY

1. Simultaneous
2. Delayed
3. Build-to-Suit
4. Reverse
5. Reverse Build-to-Suit

# 1031 EXCHANGE WITH QUALIFIED INTERMEDIARY OVERVIEW



# DELAYED EXCHANGE IDENTIFICATION RULES

## FOR MULTIPLE REPLACEMENT PROPERTIES WHERE THE TAXPAYER HAS NOT CLOSED ON ALL REPLACEMENT PROPERTIES WITHIN 45 DAYS

1. **45-Day Identification Rule:** The exchanger must identify potential replacement property or properties within 45 days of closing the relinquished property.
2. **180-Day Closing Rule:** The exchanger must acquire replacement property or properties within 180 days of closing the relinquished property or the due date of the exchanger's tax return (including extensions) for the year of transfer of the relinquished property (whichever occurs first).
3. **There are no extensions for any reason** (other than presidentially-declared emergency).
4. **The time limits begin** to run on the date the exchanger transfers the relinquished property to the buyer. The "date of transfer" is when the benefits and burdens of ownership have transferred for tax purposes (not necessarily the date on the settlement statement).
5. **The time limits are strictly construed.**

# DELAYED EXCHANGE IDENTIFICATION RULES

1. **Three Property Rule:** The exchanger may identify up to three properties of any value.
2. **200% Rule:** The exchanger may identify more than three properties if the gross unencumbered fair market value of what is identified does not exceed 200% of the gross unencumbered fair market value of the relinquished property.
3. **95% Exception:** If the exchanger identifies properties in excess of both rules 1 and 2, then the exchanger must acquire 95% of the value of all properties identified.

# PROCEDURES FOR PROPERTY IDENTIFICATION

1. The identification must be delivered to a party to the exchange that is not a disqualified party (typically, the qualified intermediary).
2. The identification must be in writing and signed by the exchanger.
3. The identification must be “unambiguous” (site specific).
4. The identification must be delivered, mailed, faxed, or “otherwise sent” within the 45 days.
5. An identification may be revoked within 45 days, but the revocation must also follow steps 1 through 4.



# SAFE HARBOR QUALIFICATION

## TO AVOID TAXATION FROM ACTUAL/CONSTRUCTIVE RECEIPT

**To qualify for the Safe Harbor against actual or constructive receipt of the exchange funds, the Exchange Agreement must limit the exchanger's right to receive, pledge, borrow, or otherwise receive the benefit of money or other property\* except:**

1. After the end of the 45-day Identification Period, if exchanger has not identified any replacement property; OR
2. If exchanger has identified replacement property, then upon or after receipt by exchanger of all replacement property to which exchanger is entitled under the Exchange Agreement; OR
3. If exchanger has identified replacement property, then upon or after the occurrence, after the end of the Identification Period, 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 exchanger and of any disqualified party, other than the party obligated to transfer replacement property to exchanger; OR
4. After the end of the 180-day Exchange Period.

\* The so-called "(g)(6)" restrictions, which are critical in a property drafted Exchange Agreement.

# § 1031 EXCHANGES VS. § 1033 INVOLUNTARY CONVERSIONS

COMPARISON	1031 EXCHANGES	1033 INVOLUNTARY CONVERSIONS
Sales Type	Private sale	Involuntary conversions: destruction; theft; government seizure or condemnation; sale under “threat or imminence” of condemnation
Replacement Property Qualifications	“Like kind” replacement property	“Like kind” replacement property or “similar or related in services or use”
Identification Period	45 days	None
Closing Period	Up to 180 days	Up to 3 years after close of tax year
Qualified Intermediary	Must use a qualified intermediary. Taxpayer MAY NOT receive exchange proceeds	No need for qualified intermediary. Taxpayer MAY receive proceeds
Replacement Amount Requirements	Equal or greater value (must reinvest net cash proceeds plus equal or greater debt)	Equal or greater value (may replace equity with debt)
Conclusions	STRICT RULES: prohibition on receipt of proceeds plus strict identification and replacement period	LIBERAL RULES: Taxpayer may receive proceeds and reinvest later



# DST: DELAWARE STATUTORY TRUST

The entity of choice for fractionalized 1031 programs.

A legal entity formed under Delaware law owned by multiple beneficial owners. The real estate is owned by the trust.

# INTRODUCTION

1. History
  - Trust relationships have existed under common law for centuries
  - A fiduciary would hold legal title to property on behalf of the equitable owner  
= a fiduciary relationship, not a legal entity
2. Delaware Statutory Trust  
= a legal entity
  - **DST has become trust of choice for business activities, including Section 1031 exchange programs**
3. Formation
  - **Trust Agreement** is the governing document regarding rights and obligations
  - **Certificate of Trust** is filed with Office of the Secretary of State of Delaware to form DST
  - **Delaware Trustee** is required; at least one of the trustees must be a Delaware resident

# FRACTIONALIZED REAL ESTATE LANDSCAPE

## TIC vs. DST

### **Tenants in Common (TIC)**

- Rev. Proc. 2002-22 (technically, advance ruling guideline)
- No longer in use; hard to finance; disfavored after 2008

### **Delaware Statutory Trust (DST)**

- Rev. Rul. 2004-86 (statement of substantive law)
- Entity of choice for fractionalized 1031 exchange programs

# BENEFITS OF A DST STRUCTURE

- **Liability Protection**

Beneficial owners of the Trust have the same liability protections that Delaware law provides to stockholders of a Delaware corporation (generally, no personal liability).

- **Asset Protection**

Creditors of a beneficial owner cannot attach investor or trust assets.

- **Contractual Flexibility**

Provides maximum freedom of contract. The Trust Agreement sets forth management rights, economic rights, liability, indemnification, etc.

# BENEFITS OF A DST STRUCTURE

- **Ease of Formation and Maintenance**

Simple process to form. Reasonable fees to form and maintain the DST. A Certificate of Trust is filed with the Office of the Secretary of State of Delaware. A Trust Agreement must be drafted but is not required to be filed with the State of Delaware. There are no annual fees in Delaware; not subject to Delaware's franchise tax.

- **Confidentiality**

Provides privacy for the beneficial owners.

- **Flexible Tax Treatment**

A DST can be taxed as a:

- corporation,
- partnership,
- trust, or
- **disregarded entity for 1031 programs (see Rev. Rul. 2004-86)**

# DSTs AT A GLANCE

- **Structure:** Delaware Statutory Trust (DST)
- **Tax Deferral:** qualifies as Section 1031 replacement property; issued with high-level tax opinion
- **Asset Classes:** multi-family, medical, office headquarters and industrial asset classes
- **Debt:** 40% to 50% loan-to-value, fully nonrecourse (lenders do not underwrite investors); all cash (no debt)  
DSTs are available along with highly leveraged DSTs
- **Cash Flow:** varies depending on asset class
- **Holding Period:** Typically **7** to 10 years
- **Liability Protection:** no personal liability under Delaware law; no liability on debt (fully non-recourse)
- **Minimum Investment:** only \$50,000 per DST; encourages diversification to reduce risk



# DSTs AT A GLANCE

- **Tax Advantages:** typically, DST cash flow is tax-sheltered; plus, deductions can be accelerated with provided cost segregation and bonus depreciation, to further shelter cash flow
- **Due Diligence:** completed and available; all in a Dropbox, including title, survey, appraisal, property condition report, environmental, zoning, etc.
- **Diversified DST Portfolio:** reduces risk compared to investing in a single property (concentration risk)

# DSTs AT A GLANCE

- **DST Portfolio:** reduces risk/increases opportunities
  - Housing:
    - Multifamily – Class A and B (value-add)
    - Multifamily – build-for-rent (BFR)
    - Multifamily – manufactured housing communities (MHCs) in Florida
    - Age-Restricted – active adult living
  - Other asset classes:
    - Medical facility
    - Headquarters/office facilities (NFL training facility)
    - Industrial facilities (Amazon distribution facility)

# WHY A DST?

## Advantages

- Tax efficiency
- Turn-key financing
- Diversification of real estate portfolio = risk reduction
- Puts investor's money to work more quickly than a “whole” property
- Appreciation potential
- Tax deferral under Section 1031 plus stepped-up basis at death (“swap ‘til you drop”)

# QUALIFYING FOR 1031 DST EXCHANGE

REV. RUL. 2004-86

## **“Seven Deadly Sins”**

Trustees may not:

1. Accept capital contributions after the offering is closed
2. Renegotiate existing loan terms or borrow new funds
3. Sell real estate and use the proceeds to obtain new real estate
4. Make more than minor repairs or non-structural improvements
5. Invest cash between distribution dates, except short-term debt obligations
6. Retain cash other than necessary reserves
7. Enter new leases or renegotiate the current lease, unless states in master lease

# REVENUE RULING 2004-86

On January 1, 2005, A, an individual, borrows money from BK, a bank, and signs a 10-year note bearing adequate stated interest, within the meaning of Section 483 of the Code. On January 1, 2005, A uses the proceeds of the loan to purchase Blackacre, which is rental real property. The note is secured by Blackacre and is nonrecourse to A.

## NNN lease

Note: if the property is active (≠ NNN lease), use Master Lease to make this property passive (NNN).

Immediately following A's purchase of Blackacre, A enters into a net lease with Z for a term of 10 years. Under the terms of the lease, Z is to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, Z is to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre, and Z may sublease Blackacre. Z's rent is a fixed amount that may be adjusted by a formula described in the lease agreement that is based upon a fixed rate or an objective index, such as an escalator clause based upon the Consumer Price Index, but adjustments to the rate or index are not within the control of any of the parties to the lease. Z's rent is not contingent on Z's ability to lease the property or on Z's gross sales or net profits derived from the property.

Also on January 1, 2005, A forms DST, a Delaware statutory trust described in the Delaware Statutory Trust Act, Delaware Code Annotated Title 12, Sections 3801 through 3824, to hold property for investment. A contributes Blackacre to DST. Upon contribution, DST assumes A's rights and obligations under the note with BK and the lease with Z. In accordance with the terms of the note, neither DST nor any of its beneficial owners are personally liable to BK on the note, which continues to be secured by Blackacre.

## Non-recourse loan

The trust agreement provides that interests in DST are freely transferable. However, DST's interests are not publicly traded on an established securities market. DST will terminate on the earlier of 10 years from the date of its creation or the disposition of Blackacre, but will not terminate on the bankruptcy, death, or incapacity of any owner or on the transfer of any right, title, or interest of the owners. The trust agreement further provides that interests in DST will be of a single class, representing undivided beneficial interests in the assets of DST.

# REVENUE RULING 2004-86

## CONCLUSIONS

The IRS reached the following conclusions in the Ruling:

1. The Delaware statutory trust described in the Ruling is an investment trust, under Section 301.7701-4(c) of the Treasury Regulations, which will be classified as a trust for federal tax purposes.
2. A taxpayer may exchange real property for an interest in the Delaware statutory trust described in the Ruling without recognition of gain or loss under Section 1031 of the Code, if the other requirements of Section 1031 of the Code are satisfied.

# DST TAX OPINION EXAMPLE

**DST Best Practice** – “**should**” tax opinion from a national law firm – the DST offering in question “**should qualify**” for Section 1031 exchange tax treatment.



# DST TAX OPINION EXAMPLE

## APPLIES FACTS TO LAW TO REACH “SHOULD QUALIFY” FOR 1031 EXCHANGE TREATMENT TAX OPINION

*Dear Sponsor:*

*Sponsor Company, LLC, (the “Sponsor”) High Quality Property, LLC (the “Signatory Trustee”) and High Quality Property, DST, a Delaware statutory trust described in Chapter 38 of Title 12 of the Delaware Code (the “Trust”), have retained Tax Opinion Law Firm, PLC to address certain income tax issues in connection with a transaction related to the acquisition of that certain net leased property located at 555 High Quality Property Drive.*

*Specifically, this letter sets forth our opinion as to whether:*

- the Trust should be treated as an investment trust described in Section 301.7701-4(c) of the Treasury Regulations that is classified as a “trust” under Section 301.7701-4(a) of the Treasury Regulations,
- the owners (the “Beneficial Owners”) of beneficial interests in the Trust (the “Interests”) should be treated as “grantors” of the Trust,
- the Interests should not be treated as a “security” under Section 1031 of the Internal Revenue Code of 1986, as amended (the “Code”),
- as “grantors,” the Beneficial Owners should be treated as acquiring and owning a direct interest in real property for federal income tax purposes. (An Interest must be treated as an interest in real property to qualify as a replacement property in a real estate Section 1031 exchange.)



# TIC VS. DST STRUCTURE COMPARISON

TICs	DSTs	DST Advantages
Only 35 investors	Up to 2,000 investors	<b>Provides access for more investors</b>
Higher investment minimums	Lower investment minimums	<b>Provides smaller investment amount</b>
Up to 35 separate real estate closings	Lender only needs to make one loan because the DST owns 100% of the real estate	<b>Provides more efficient investment process (frequently 24-hour turn-around)</b>
Investors may have personal liability	Loan guarantees apply to sponsors, not investors	<b>Provides investors protection against personal liability under loans</b>
All major decisions require unanimous agreement by investors	Sponsor makes all decisions. Sponsor is better equipped to deal with crises than 35 individuals	<b>Provides the ability to act quickly when issues arise</b>
Investors can be liable for the actions of their co-investors	Investors cannot cause a default on the entire loan	<b>Provides investors greater security against rogue investors</b>
Each investor must set up an individual LLC	Investors do not need separate LLCs	<b>Provides a less complex structure for investors</b>
Lender underwrites each investor	Lender does not underwrite the investors	<b>Eliminates need for investors to provide tax returns to lenders</b>



# ADVANCED 1031 TOPICS

# ADVANCED 1031 TOPICS

## BIFURCATION OF COMBINED PRINCIPAL RESIDENCE AND INVESTMENT/BUSINESS PROPERTY



# ADVANCED 1031 TOPICS

1. IRS Form 8824 and instructions (handout)
2. Debt Issues
  - Basic rule
  - Debt Reduction techniques
  - Adding debt to increase basis and shelter income
3. Use of cost segregation study to shelter income



# DEPRECIATION, COST SEGREGATION & BONUS DEPRECIATION

# BACKGROUND ON DEPRECIATION

Real estate owners are allowed a deduction called “depreciation” that reduces taxable income from their property.

The deduction is intended to compensate property owners for wear, tear and obsolescence. This increases the after-tax returns from real estate and is not available for financial assets, such as stocks and bonds.

# BACKGROUND ON DEPRECIATION

## Computation of Depreciation:

The Tax Reform Act of 1986 introduced the Modified Accelerated Cost Recovery System (MACRS). Under MACRS, a class life is assigned to each asset class, as follows:

Asset Class	Class Life
Nonresidential Real Property	39 years
Residential Real Property	27.5 years
Land improvements	15 years
Personal Property (Affixed to Real Property)	7 and 5 years

# BACKGROUND ON DEPRECIATION

The owner's basis in the property (typically cost) is recovered over the assigned class life of the asset. Residential property has a 27.5-year recovery life, which means that the owner is allowed an annual depreciation deduction computed as follows:

## **Residential Real Property**

cost basis x 1/27.5 per year

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= 3.63% depreciation deduction per year

Nonresidential property has a 39-year recovery life, which means that the owner is allowed an annual depreciation deduction computed as follows:

## **Nonresidential Real Property**

cost basis x 1/39 per year

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= 2.56% depreciation deduction per year



# DEPRECIATION

## Example

Assume a property owner has a \$1.1 million cost basis in real estate with a \$100,000 land value. The first step is to exclude the \$100,000 land value because land is not depreciable (land does not wear out). If the property is residential, the owner is entitled to \$36,300 per year in depreciation deductions. If the property is nonresidential, the owner is entitled to \$25,600 per year in depreciation deductions. This means that 100% of the property's cost basis (excluding land value) is recovered over the assigned life for the asset:

$\$36,300 \text{ per year} \times 27.5 \text{ years} = \$1 \text{ million, the original cost basis and}$

$25,600 \text{ per year} \times 39 \text{ years} = \$1 \text{ million, the original cost basis}$

## Non-Cash Deduction

Depreciation is a “non-cash” tax deduction. Most tax deductions, such as taxes, insurance, maintenance and repairs, require a cash payment to obtain the deduction. However, depreciation is a non-cash deduction, computed based on the cost (purchase price) for the property.

# DEPRECIATION

## Depreciation Deductions Increase Returns From Real Estate

Depreciation deductions increase after-tax returns from real estate investments by generating after tax additional cash flow. Financial assets, such as stock and bonds, do not qualify for depreciation deductions. Also, residential property is depreciated more quickly than nonresidential property (27.5 years vs. 39 years). This added tax benefit encourages tax sensitive investors to focus on residential property.

# INTRODUCTION TO COST SEGREGATION

**Cost segregation is a tax-planning tool used to accelerate depreciation deductions by allocating costs to shorter-lived assets and assets that qualify for bonus depreciation.**

## How Does Cost Segregation Work?

The property owner engages a qualified engineering firm to allocate their cost basis (typically purchase price) for the property into the class lives shown above. The goal is to increase the allocation to the following shorter-lived assets to accelerate depreciation deductions by qualifying for bonus depreciation:

Land improvements	15 years
Personal Property (Affixed to Real Property)	7 and 5 years

## Conclusion

Allocating to shorter-lived assets with a cost segregation study can dramatically accelerate (increase) depreciation deductions. This will increase after-tax returns for real estate investments by generating additional cash flow.

# INTRODUCTION TO BONUS DEPRECIATION

**Bonus depreciation accelerates depreciation deductions. Assets with a MACRS recovery life of 20 years or less qualify for bonus depreciation.**

## 100% Bonus Depreciation

The Tax Cuts & Jobs Act of 2017 increased the bonus depreciation percentage to 100% for assets placed in service before January 1, 2023 and **40% starting on January 1, 2025.**

## Section 1031 Exchanges

Cost segregation does not limit Section 1031 exchanges. The cost segregation study only impacts depreciation deductions, not the qualification of “like kind” property as required by Section 1031.

# STRATEGY FOR BOOT

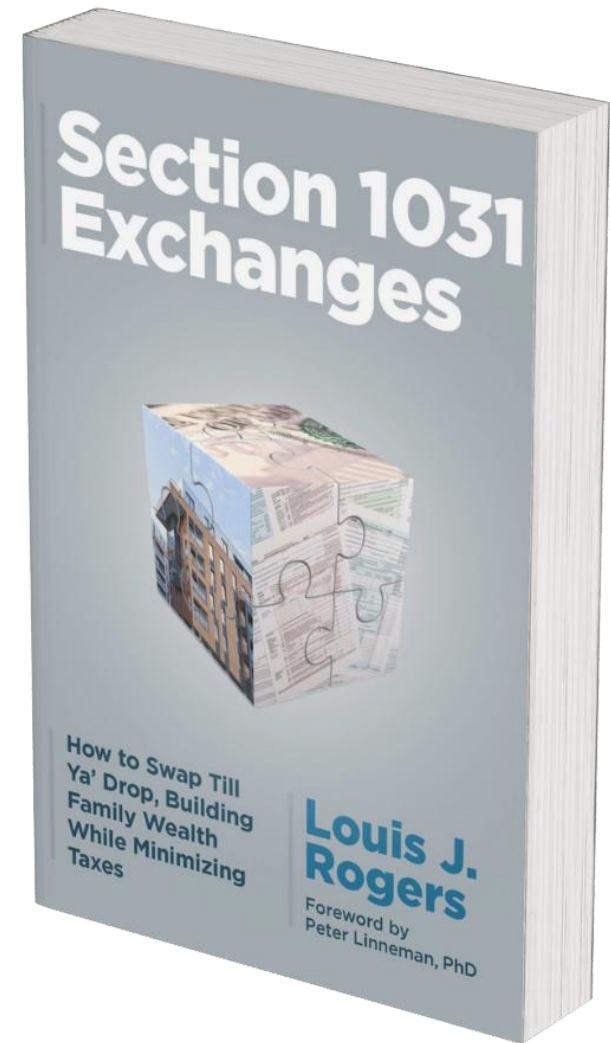
## **Depreciation Deductions Reduce Taxable Income**

Depreciation deductions reduce taxable income from real estate. In addition, depreciation deductions can be used to offset taxable income from other real estate. This is true of standard MACRS depreciation and bonus depreciation.

## **Bonus Depreciation Deductions Reduce Section 1031 Boot**

In addition, depreciation deductions can be used to offset taxable boot in a Section 1031 exchange. Under Section 1031, any cash received or reduction in liabilities in the exchange will be taxable. Bonus depreciation deductions can be used to offset Section 1031 boot. In this way, taxpayers can use bonus depreciation to cash out of an exchange or reduce liabilities without gain recognition. This is an excellent strategy for exchangers who would like to cash out of an exchange or deleverage.

# SECTION 1031 EXCHANGES: HOW TO SWAP TILL YA' DROP, BUILDING FAMILY WEALTH WHILE MINIMIZING TAXES





# QUESTIONS?

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