



# **Tax-Deferred Strategies for Real Estate**

1031 EXCHANGES & DSTs



# What is a 1031 Exchange?

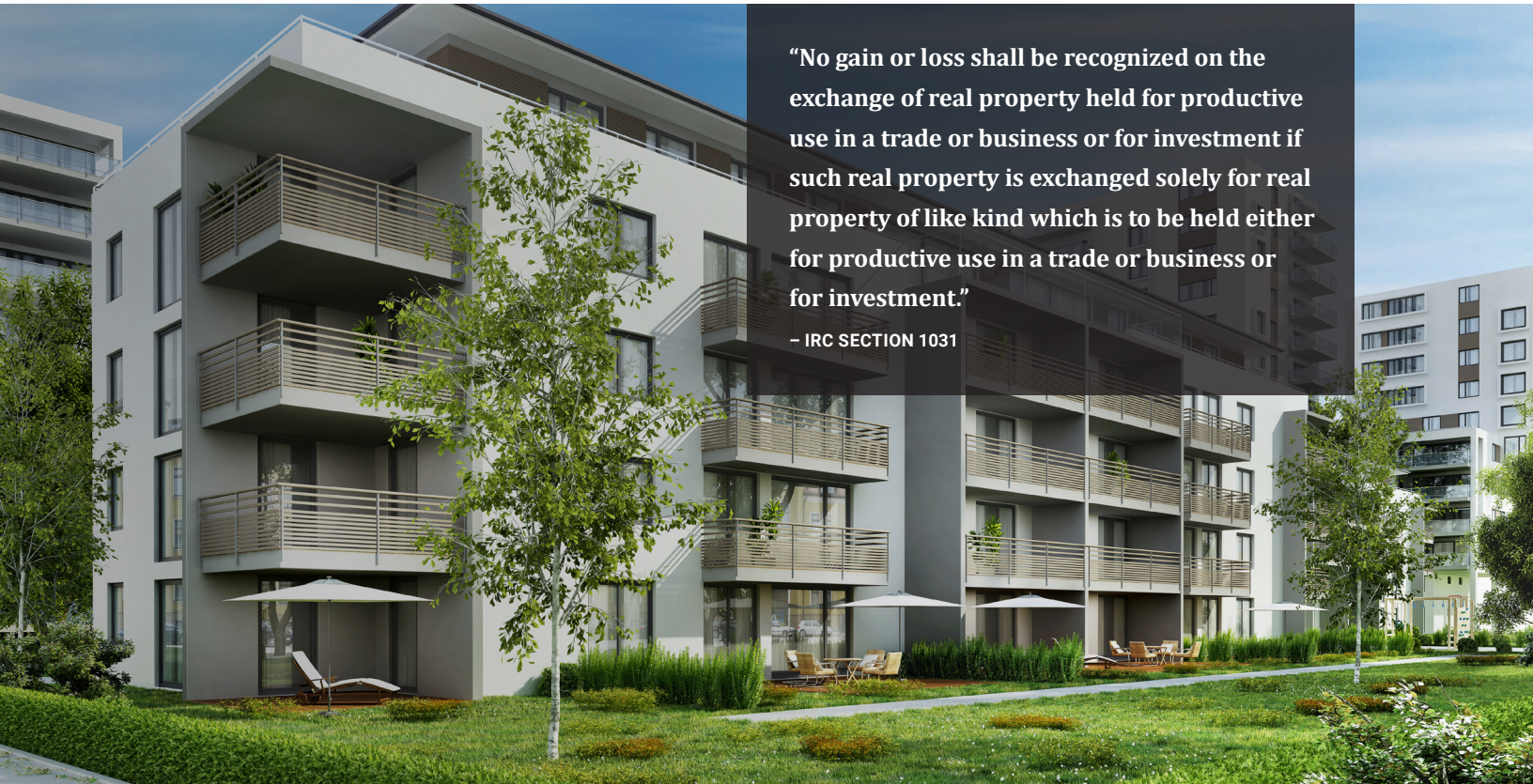
A 1031 Exchange, also called a like-kind exchange, allows you to sell your real estate property, reinvest the proceeds in “like-kind” real estate, and defer the payment of capital gains taxes on that sale.

The Internal Revenue Service (IRS) defines like-kind as property that is similar in nature or character, regardless of differences in grade, property type or quality. Tax-deferred exchanges have been part of the tax code in one form or another since 1921, however the term gets its name from IRS code Section 1031, created in 1954.

When conducting a 1031 Exchange you can change the form of your investment without cashing

out or recognizing a capital gain, meaning your investment will continue to grow tax-deferred. There are NO limits on how many times you can do a 1031 – you can continue to rollover the gain from one piece of investment real estate to the next, again and again. Profit made on each swap is not taxed until you finally sell for cash down the line. Ultimately you pay ONLY ONE TAX, at the more beneficial long-term capital gains rate.

**1031 Exchanges are an effective tax strategy used by savvy real estate investors for tax deferral, as part of wealth building and succession and estate planning.**



“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 real property of like kind which is to be held either for productive use in a trade or business or for investment.”

– IRC SECTION 1031

**The many, complex moving parts not only require real estate investors to understand the rules, but also mean enlisting professional help – even for seasoned investors.**



## Like-kind Properties

To complete a successful Section 1031 tax-deferred exchange, the replacement property must be like-kind to the relinquished property.

Examples include:

- Office Buildings
- Retail Centers
- Warehouses
- Vacant Land
- Duplexes & Triplexes
- Single-Family Rentals
- Multi-Family Rentals
- Apartment Buildings
- Condominiums
- Industrial Property
- Rental Resort Property
- Hotels & Motels
- Mineral Rights
- Water Rights
- Air Rights
- Development Rights
- Easements
- TIC Interests<sup>1</sup>
- DST Interests<sup>2</sup>
- Leasehold Interests<sup>3</sup>
- New York Cooperative



Any real estate held for productive use in a trade or business or for investment purposes is considered like-kind. Personal use property like a primary residence does not fall into this category, however, vacation homes or rental properties may qualify. Additionally, the following do NOT qualify: land under development for resale, construction or flips for resale, REITs.

### Basic Requirements

Reinvest 100% of net sales proceeds into the replacement property<sup>4</sup>

Acquire an equal or greater amount of both debt & equity on the replacement property<sup>5</sup>

Identify potential replacement property within 45 days from the date of sale

Close on the replacement property within 180 days from the date of sale

Use a Qualified Intermediary (QI) - investors must NOT accept constructive receipt of the sale proceeds

### Identification Rules

3 Property Rule: Taxpayer may identify up to 3 properties of any fair market value (FMV) & purchase any 1, or all, regardless of total value. (Most commonly used.)

200% Rule: Identify an unlimited # of properties provided the total FMV of all does not exceed 200% of the FMV of the relinquished property. Taxpayer may purchase any 1, or all.

95% Rule: If the identified properties are in excess of both the above rules, then the taxpayer must acquire 95% of the value of all properties identified.

<sup>1</sup> TIC = Tenancy-In-Common

<sup>2</sup> DST = Delaware Statutory Trust

<sup>3</sup> Leasehold Interests with 30 years remaining on the lease

<sup>4</sup> Any proceeds not invested into the replacement property is considered "boot" and will be taxed as a capital gain.

<sup>5</sup> Any reduction in debt can be offset with additional cash from the exchanger (investor selling the relinquished property).



# 1031 Exchange Basic Steps

1

## Exchanger sells relinquished property

Proceeds are escrowed with a Qualified Intermediary (QI)

2

## QI transfers funds

For purchase of replacement property or beneficial interest in a DST

3

## Exchange completed

Exchanger receives replacement property or DST interest

## Timeline

Day 1

**Closing of relinquished property**

Day 2-44

**ID Period: Exchanger identifies replacement properties (and/or DSTs)**

Day 45

**DEADLINE to identify candidates for replacement property**

Day 46-179

**Exchanger pursues acquisition of replacement properties (or DST interest)**

Day 180

**DEADLINE to close on 1 or more of the ID'd replacement properties - Exchange complete**

DEADLINE

DEADLINE

### Pre-Exchange Plan

Gather your team: Financial Advisor, CPA, Real Estate Broker & QI

### Important to Note

**Day 180:** End of the exchange period. Closing on the replacement property must be the earlier of either 180 calendar days from the date of sale or the due date for filing the tax return for the year in which the relinquished property was sold.

**QI Required:** Choosing an experienced QI is important. The QI serves as a middleman to hold (escrow) the cash after the relinquished property is sold and uses it to “buy” the replacement property for the taxpayer.

Constructive receipt (by the taxpayer, by anyone related to the taxpayer or who has a financial relationship with the taxpayer) of any proceeds from the sale of the relinquished property will terminate the exchange.



# Selling property VS. 1031 Exchange: A hypothetical example

	SCENARIO A	SCENARIO B
1. CALCULATE NET ADJUSTED BASIS	Sell Property, Pay Taxes	1031 Exchange w/Tax Deferral <sup>1</sup>
Original Purchase Price	\$1,000,000	\$1,000,000
<b>plus</b> Non-Expensed Improvements	\$100,000	\$100,000
<b>minus</b> Depreciation Taken <sup>2</sup>	\$200,000	\$200,000
<b>= NET ADJUSTED BASIS</b>	<b>\$900,000</b>	<b>\$900,000</b>

<sup>1</sup> Investors should consider their anticipated investment horizon and income tax bracket when making an investment decision as this illustration may not reflect these factors.

<sup>2</sup> This assumes straight-line depreciation.

## 2. CALCULATE CAPITAL GAIN

Sale Price	\$2,500,000	\$2,500,000
<b>minus</b> Net Adjusted Basis	\$900,000	\$900,000
<b>minus</b> Costs of Sale (est 6% of Sale Price)	\$150,000	\$150,000
<b>= CAPITAL GAIN</b>	<b>\$1,450,000</b>	<b>\$1,450,000</b>

## 3. CALCULATE TAX DUE

Depreciation Recapture Tax (25% of Depreciation) <sup>3</sup>	\$50,000	\$0
<b>plus</b> LT Federal Capital Gain Tax (20% of Gain excl. Depreciation) <sup>4</sup>	\$250,000	\$0
<b>plus</b> Net Investment Income Tax (3.8% of Gain excl. Depreciation) <sup>5</sup>	\$47,500	\$0
<b>plus</b> State Capital Gain Tax (e.g. NY 8.82% of Gain)	\$127,890	\$0
<b>= TOTAL TAXES DUE</b>	<b>\$475,390</b>	<b>\$0</b>
% of Capital Gain	33%	n/a

<sup>3</sup> This assumes the taxpayer is in the highest applicable federal income tax brackets. If your tax rate is lower you could have a reduced benefit.

<sup>4</sup> The Federal capital gain tax rate is generally 15% or 20% depending upon taxable income.

<sup>5</sup> The Medicare surtax only applies to "net investment income" as defined in IRC §1411.

## 4. CALCULATE NET PROCEEDS

Sale Price	\$2,500,000	\$2,500,000
<b>minus</b> Costs of Sale	\$150,000	\$150,000
<b>minus</b> Loan Balance	\$1,000,000	\$1,000,000
<b>minus</b> Taxes Due	\$475,390	\$0
<b>= NET PROCEEDS FOR INVESTMENT</b>	<b>\$874,610</b>	<b>\$1,350,000</b>

<sup>6</sup> Tax laws vary by state and locality. For example, NYC residents will also have to pay city income tax on the gain, in addition to the state capital gain tax illustrated here.

This formula is provided to help determine approximate gain and any amounts that may be deferred under Internal Revenue Code §1031. This is an illustration only; individual situations vary.

**Note:** Failure to reinvest all your net proceeds and/or replace all your existing debt, may result in taxable "boot". Additional equity (not derived from the replacement property) and/or additional debt can be used to offset debt, but debt cannot be used to offset equity.

# What is a Delaware Statutory Trust (DST)?

DSTs are legal entities that allow for fractional ownership of real estate assets by accredited investors.<sup>1</sup>

Beneficial interest in a DST is treated as direct interest in real estate for tax purposes, qualifying as “like-kind” property in a 1031 Exchange. Investors can defer taxes by exchanging real property for an interest in a DST, rather than investing in another whole property.

## IRS CLASSIFICATION:

DSTs are classified as investment trusts for federal tax purposes, under IRS § 301.7701-4(c). A beneficial interest in a DST is recognized by IRS Rule 2004-86 as qualified replacement property for real property.

## Benefits of a 1031 Exchange into DST

Tax Deferral & Offset	A properly executed 1031 into DST allows investors to defer capital gains & other taxes upon the sale of appreciated real estate – allowing for equity preservation & maximization of total return – while taxable DST monthly income may be offset by depreciation deductions.
Income	Investors receive monthly distributions of passive income based on their ownership percentage, as well as proceeds from the eventual sale of the property which may be positively impacted by appreciation. (Most DSTs have a holding time of 7-10 years.)
Passive Management	Owners do not have onerous property management duties – the “toilets, tenants & trash” – as DSTs are a passive vehicle for investors. Properties are professionally managed by affiliates of the DST sponsor, which handles day-to-day decisions & the eventual sale of the property.
Non-Recourse Debt	It can be difficult for individuals to obtain favorable financing on their own, especially during economic challenges. But DSTs often come with pre-arranged financing; the DST sponsor is the sole borrower & takes on 100% of the debt liability so loans are non-recourse to the investor.
Diversification	DST investment can achieve diversification by geographic region, tenant industry, asset class, capitalization structure, etc. An investor can even achieve diversification by investing in a single DST that holds multiple properties.
Simplicity	Easy closings & efficient investment process.
Lower Minimum Investment	Investment minimums are typically \$100,000, made possible by the fractional ownership model (up to 499 investors can hold interest in a single DST).
Access to High Quality Property	Investors have access to higher quality, institutional & commercial real estate with long-term appreciation potential. Tenants are often recession-proof with investment grade credit. (Think NNN leases, multifamily apartments, industrial warehouses, self-storage, essential health & retail, etc.)
Estate Planning	“Swap until you drop” allows the investor to continue to exchange over & over again until death, at which point the 1031 investments receive a step-up in cost basis. Heirs do not inherit capital gain liabilities or the burden of hands on management, while gaining the investment’s professional real estate management.
Insurance Policy	If for some reason the investor can’t acquire the original property they identified, a secondary DST option specified during the ID period allows them to meet exchange deadlines & still defer the capital gains tax.
Eliminate Boot	Any remaining profit on the sale of your relinquished property is considered “boot.” This remainder becomes taxable unless it is eliminated. The excess cash (boot) can be invested in a DST to avoid incurring tax.

<sup>1</sup>Must be an “Accredited Investor” to invest – defined in Regulation D under the Securities Act as a natural person satisfying 1 of the following: (1) individual net worth, or joint net worth with his/her spouse, or spousal equivalent, of more than \$1,000,000, subject to certain criteria for calculating net worth (excluding the value of a personal residence); or (2) individual income in excess of \$200,000, or joint income with his/her spouse, or spousal equivalent, in excess of \$300,000, in each of the 2 most recent years and has a reasonable expectation of reaching the same income level in the current year.

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## 1031 EXCHANGE & REAL ESTATE RISK

1031 Exchanges are highly complex and failure to comply with the stringent requirements may result in a complete loss of the desired tax deferral. Investors should carefully consult with independent tax and legal counsel prior to initiating, and while performing, a tax-deferred exchange.

There are numerous section 1031 rules and requirements including, but not limited to: seller cannot receive or control the net sales proceeds, replacement property must be like-kind to the relinquished property, the original replacement property must be identified within 45 days from the sale of the property, the replacement property must be acquired within 180 days from the sale of the original property, and the debt placed or assumed on the replacement property must be equal or greater than the debt encumbering the relinquished property.

All forms of real estate investing are speculative and involve a high degree of risk, including potential lack of return, loss of principal and tax consequences. Investors should be able to bear the complete loss of an investment. All real estate is generally subject to the risks of increased and ongoing vacancy, problematic tenants, economic downturns, physical damage or loss, unexpected repairs and maintenance, eminent domain, negative rezoning, blight, environmental damage and liability, and overall valuation fluctuations that may be outside of the owner's control.

## DST LIMITATIONS

- Beneficial owners do not have voting rights; all decisions of the trust are made by the manager (an affiliate of the sponsor) and the trustees. Properties will be liquidated at the discretion of the DST, which may encounter difficulty in selling any or all of them.
- Illiquidity: No public market exists, nor is likely to develop, for DST interests. Transfer of these interests may also be legally restricted. Investors should carefully consider both their ongoing liquidity needs and estate planning goals prior to investing in such an interest.
- Diversification: Some offerings are for ownership interests in a single property, and any desired diversification must be achieved with other real estate investments.
- No Guarantee of Performance: Safe Harbor Asset Management, Inc. does not guarantee ongoing distributions or overall investment performance. The performance of a DST will depend on the tenant's ability to pay rent.
- Sponsor-Related Fees: There are significant fees related to the acquisition, syndication, ongoing management, and eventual disposition of any DST real estate offerings. These fees could materially impact the performance of an investment and should be carefully considered prior to any such investment. Fees and expenses are outlined and disclosed in the private placement offering memorandum that is required to be presented prior to any offer of securities.
- Leverage-Related Volatility: The use of leverage in real estate investments may increase volatility and the overall risk of loss.
- Time frames typically fall within five to seven years, at which point the property is sold and the investor must either exchange into a different DST (known as a rollover) or a new property, or cash out and pay taxes.

## DST GUIDELINES

- All cash, other than necessary reserves, must be paid out to investors
- May not reinvest proceeds from the sale of its real estate
- May not invest accrued cash, from rental income or investment proceeds, between distribution dates in anything other than short-term securities
- May not accept additional capital to the DST
- May not renegotiate terms of debt or enter into new financing
- May not renegotiate leases or enter into new leases (except in the case of a tenant's bankruptcy or insolvency)
- Limited to making minor, non-structural improvements



**Want to learn more about 1031 Exchanges & DSTs?**

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