PERCH
WEALTH

INVESTORS GUIDE TO

1031 EXCHANGES

WHAT IS A 1031 EXCHANGE?

A 1031-exchange is a tax-deferred exchange. It represents a simple, strategic method for selling one property and exchanging it for one or more like-kind properties within a specific time frame. The Internal Revenue Service allows an investment property owner to exchange their real estate on a tax-deferred basis.

It is within Section 1031 of the Internal Revenue Code that we find the core essentials necessary for a successful exchange. Additionally, it is within the Like-Kind Exchange Regulations, previously issued by The Department of the Treasury, that we find the specific interpretation of the IRS and the generally accepted standards and rules for completing a qualifying transaction.

KEYS TO EXCHANGING

When dealing with the transfer of multiple properties, understanding the 1031 process and having access to a trusted exchanging expert is the best strategy for a painless and successful exchange.

However, for those seeking a better understanding of the process, here are a few key “rules of the road” according to Internal Revenue Code Section 1031, and some select pitfalls that experienced exchangers always avoid.

REQUIREMENTS FOR A 100% TAX DEFERRED EXCHANGE

If you want a completely tax-deferred transaction, you must do these three things.

1. Buy replacement property which is equal or greater than the net selling price of what you sold.
2. Move all your equity from the old property into the new property.
3. Replace your debt.

THE PROPERTIES YOU EXPECT TO EXCHANGE MUST BE LIKE-KIND

Property that qualifies for exchange under Section 1031 must be "like-kind," which is defined in the regulations as follows:

1. Property held for productive use in a trade or business, such as income property.
2. Property held for investment.

Therefore, not only does rental or other income property qualify, so does unimproved property that has been held as an investment. Such unimproved property can be exchanged for improved property of any type, or vice versa. Also, one property may be exchanged for several, or vice versa. This means that almost any property that is not a personal residence or second home is eligible for exchange under Section 1031.

YOU MUST UTILIZE THE SERVICES OF A QUALIFIED INTERMEDIARY

The IRS requires that your exchange be completed with the assistance of a qualified intermediary or facilitator. This should be a well-established firm, so you know your exchange documentation will be correct, and your exchange funds will be safe between the time you buy and the time you sell.

TIME REQUIREMENTS

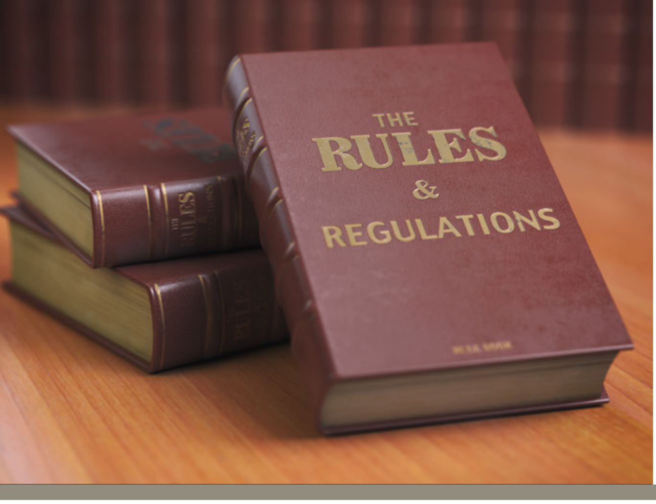
The exchanger has a maximum of 180 days from the closing of the relinquished property or the due date of that year's tax return, whichever occurs first, to acquire the replacement property. This is called the “exchange period.”

The first 45 days of that period is called the “identification period.” During these 45 days, the exchanger must identify the candidate or target property to be used for the replacement property. The identification must be in writing, signed by the exchanger, and received by the facilitator or other qualified party (faxed, postmarked, or otherwise identifiably transmitted through Federal Express or another dated courier service or via digital signature). This must all occur within the 45-day period. Failure to accomplish this identification causes the exchange to fail.

45-DAY IDENTIFICATION OPTIONS AND RULES

So, you’ve sold, or you’re considering selling, your investment property and you’ve decided to do a 1031 exchange. According to the Internal Revenue Code (IRC) §1031, anyone selling their investment property has 45 calendar days to identify the replacement property or properties. But do you understand the options and rules governing the 45 days?

While you will need to identify the new property or properties to your accommodator/qualified intermediary during the 45 days, they do not need to (yet) be under contract. The 45 days countdown begins after the close of the property that you just sold. You have a total of 180 days since close of your relinquished property to close on the new property or properties you identified.



3-PROPERTY RULE

Under the 3-property rule, the investor taxpayer can identify up to 3 properties, regardless of the fair market value of the properties. You do not have to acquire all 3 of the properties that you identify if you utilize this rule, but you will need to close on at least 1 of the properties.

If you are intending to diversify your real estate investment dollars, for example by investing in DSTs and want to identify more than 3 possible investments, than you will choose to not rely upon the 3-property rule.

200% RULE

Pursuant to the 200% rule, a 1031 exchange investor may identify and close on any number of properties, so long as the aggregate fair market value of the properties identified during the 45-days does not exceed 200 percent of the aggregate fair market value of the relinquished property when it was sold. For example, if you sold your property for $1,000,000, you could then identify as many properties as you wish, so long as the fair market value of those identified does not exceed $2,000,000.

95% RULE

If an investor finds herself/himself in need to identify more than 3 properties and more than 200% of the aggregate value, as noted in the options above, then that investor can rely upon the 95% rule. But be careful, because it is challenging to comply with the 95% rule since it requires the investor to close on at least 95% of the properties that were identified. Since it is practically difficult to satisfy the 95% rule, virtually all investors will normally fall within the 3-property or 200% rules noted above.

A 1031 EXCHANGE MAY BE SMART FINANCIAL PLANNING

When selling real estate investment property, investors generally have two options: 1) pay the taxes on any gains from the sale, or, 2) conduct a 1031 exchange and defer the taxes owed.

Recently, because of the financial uncertainty surrounding COVID-19 and the overall state of the economy, some investors are choosing to pay the taxes on any gain from the sale of their investment properties and hold on to their cash rather than acquire replacement real estate utilizing the 1031 process.

While every investor is different and should make their own determination of their specific financial landscape and rely on the advice of their professional financial and legal counsel, there are generally two major points to keep in mind before choosing to pay the taxes rather than defer.

Point #1: the amount of taxes you might have to pay

If you choose to pay the taxes on your gain, you might be responsible for the following:

- Long term federal capital gains tax rate may be as high as 20%, depending on your income bracket.
- State tax can also add to the financial tax hit, depending on the State in which you live. For example, in California, an investor could possibly also pay up to 13.3% in income tax.
- Depreciation recapture is taxed at a flat rate of 25%, which can be quite significant if you've held and depreciated your investment property for a long period of time.
- Net Investment Income Tax (NIIT) applies to certain net investment income of investors that have income above the statutory threshold, at a rate of 3.8%.

Point #2: opportunity cost of any amount you pay in taxes

When an investor pays taxes, that could otherwise be deferred, they’re left with less capital that could otherwise be used for investment purposes that could generate more return for them.

Let’s use a simple example: Suppose that an accredited investor sells an investment property for $1 million, and the total amount of taxes that they would owe on such sale is $200,000. That accredited investor then decides, for purposes of our example, that they will pay the taxes owed and take the $800,000 in cash remaining and invest it in some investment that pays 5% annual interest. That investor, based on our example, should make a return of $40,000 per year.

However, if that same accredited investor had completed a 1031 exchange, for example into a DST paying 5% annually, their annual return should be $50,000, a difference of $10,000. While the above is a simplified example, it helps illustrate the opportunity cost of paying the taxes rather completing a 1031 exchange.

Before an investor decides to pay any owed taxes on the sale of their investment property rather than completing a 1031 exchange and deferring those taxes, they should thoroughly understand the financial implications by consulting with their professional tax advisor.

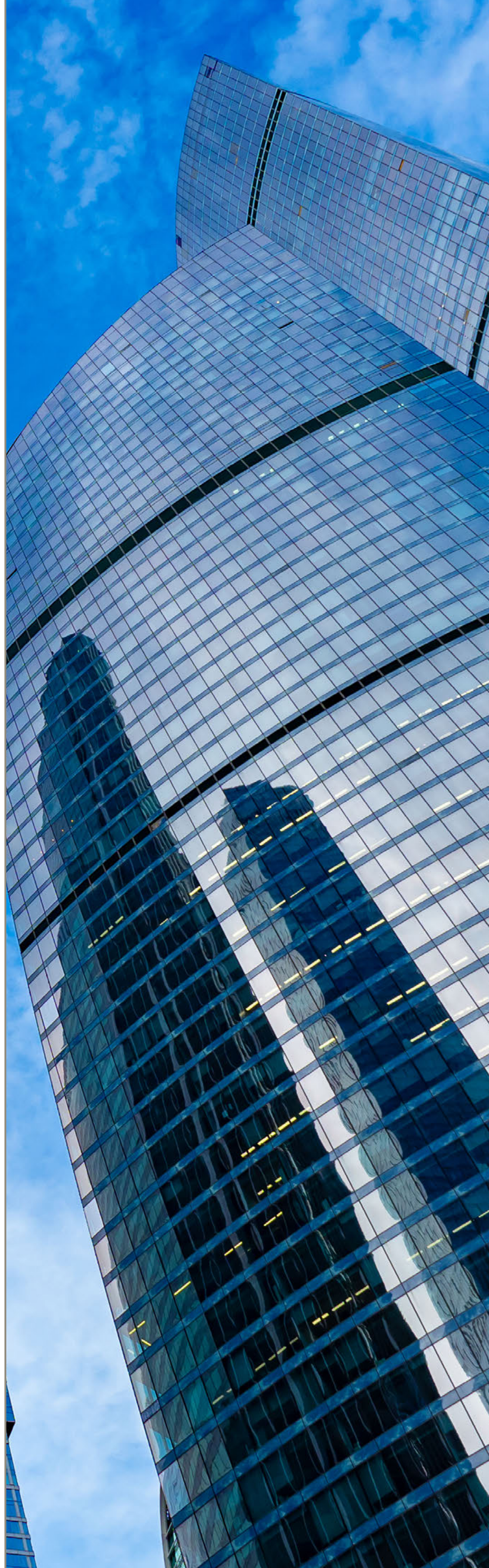
HAVING TROUBLE FINDING A REPLACEMENT PROPERTY?

In active markets where it is difficult to locate and identify replacement property, it might be helpful to consider identifying an institutional Delaware Statutory Trust (DST) investment as your replacement property backup strategy.

These are typically larger, professionally managed investment-grade portfolios which include individual property interests which are available to accredited investors. The DST model can provide tremendous flexibility, opportunity, and investment diversity for those looking to take full advantage of benefits typically associated with traditional 1031 exchanges.

What's more, DST investments can be closed upon quickly by investors – often in a matter of days. So if you're an accredited investor looking to put your cash to work for the first time, or someone who is under a tight deadline to deploy the proceeds from a 1031 sale, investing in a DST can be a great option.

If you have an interest in exploring what properties are available currently, contact us and one of our DST experts will be happy to assist.



1031 RISK DISCLOSURE:

- There is no guarantee that any strategy will be successful or achieve investment objectives;
- **Potential for property value loss** – All real estate investments have the potential to lose value during the life of the investments;
- **Change of tax status** – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- **Potential for foreclosure** – All financed real estate investments have potential for foreclosure;
- **Illiquidity** – 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- **Reduction or Elimination of Monthly Cash Flow Distributions** – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;
- **Impact of fees/expenses** – Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits

General Disclosure

Not an offer to buy, nor a solicitation to sell securities. Information herein is provided for information purposes only, and should not be relied upon to make an investment decision. All investing involves risk of loss of some or all principal invested. Past performance is not indicative of future results. Speak to your finance and/or tax professional prior to investing.

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