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# Simplifying a 1031 Exchange

# What is a 1031 Exchange?

A 1031 exchange is a tax rule that allows investors to defer capital gains taxes when selling a property and reinvesting the proceeds into a “similar” property.

Defers not only federal taxes, but also state taxes, AMT, and depreciation recapture

Investors must follow several IRS guidelines in order to defer most/all taxes associated with the sale

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# Four options when selling commercial real estate:

1. Pay any capital gains taxes and depreciation recapture, and the remaining proceeds may be spent or reinvested.

2. Utilize a 1031 Exchange by purchasing conventional commercial real estate as the replacement property, deferring any taxes on the appreciated property.

3. Utilize a 1031 Exchange by purchasing Delaware Statutory Trusts (DST's) as the replacement property, deferring any taxes on the appreciated property.

4. Combine options #2 and #3

# What is the benefit of deferring taxes on real estate gains via 1031 exchange?

In a properly executed 1031 exchange, with the taxes deferred, more investment dollars are available for the new investment property.

With more dollars available for re-investment, there is far more wealth accumulation before taxes are owed.

1031 exchanges can occur over and over, with the compounding effect of tax-deferred growth having an increasingly significant effect over time.

# A comparison: paying vs. deferring taxes

| | Scenario A<br>Paying Taxes on Property Sale | Scenario B<br>Completing a 1031 Exchange |
|---|---|---|
| Purchase Price | $300,00 | $300,00 |
| Capital Improvements | $50,000 | $50,000 |
| Depreciation | $150,000 | $150,000 |
| Adjusted Cost Basis | $200,000 | $200,000 |
| Sale Price cost of Sales | $440,000 | $440,000 |
| **Total Taxable Gain** | $240,000 | $240,000 |
| Long Term Capital Gain Liability (20%) | $48,000 | $0 |
| State Tax (Q-13.3%) | $0 - $31,920 | $0 |
| Net Investment Income Tax (3.8%) | $9,120 | $0 |
| Depreciation Recapture Tax (25%) | $37,500 | $0 |
| Total Taxes Due | $94,620 - $126,540 | $0 |
| **Net Proceeds for Investment** | $345,380 - $313,460 | $440,000 |

## What are the steps in a 1031 exchange?

**DAY 0** The investor sells relinquished property to a third party buyer. Identification period begins, sales proceeds are held by Qualified Intermediary (QI)

The investor identifies (documents) possible replacement properties with the QI

**DAY 45** Identification period ends.

The QI uses the proceeds to purchase the replacement property on behalf of the investor.

**DAY 180** The investor must close on the replacement property no later than 180 days after selling.

## What type of properties qualify as a replacement?

Replacement properties can be any of the following:

- Rental Home(s)
- Apartment building
- Condominium
- Shopping Center
- Office Building
- Raw ground, farms, ranches
- Water/air/mineral rights
- Leases of >30 years, such as cell tower leases

## Replacement Property identification rules:

1. Three Property Rule: the rule most often uses, allows identifying up to three properties regardless of their value.

2. 200% Rule: may identify any number of replacement properties, as long as their combined value is not more than 200% of the relinquished property

3. 95% Rule: may identify any number of properties regardless of value, but must close on 95% of those properties. Rarely used.

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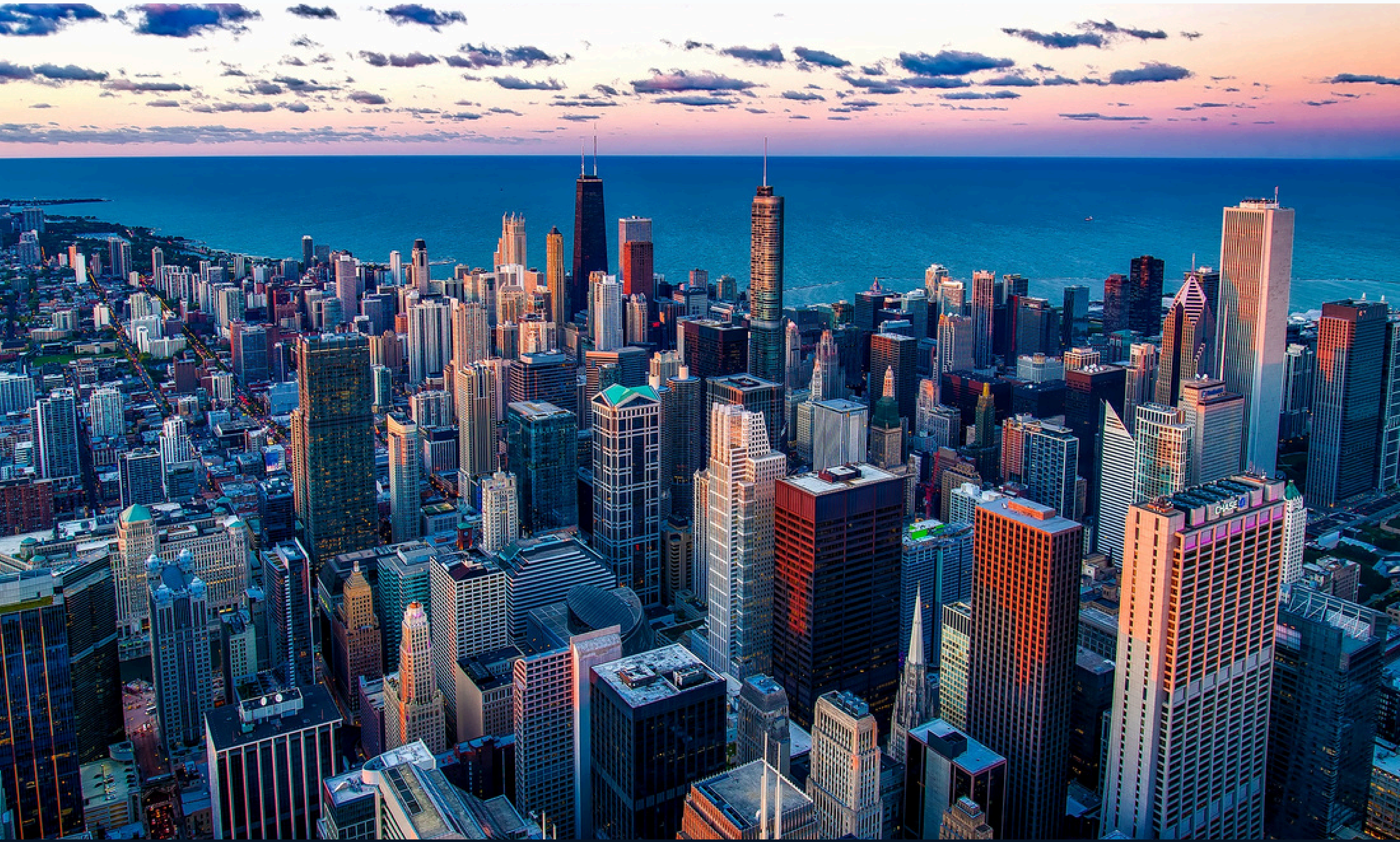

## Whatever you need regarding commercial real estate, I can help!

We'll help with your:

- 1031 Exchange
- Equity Raise
- Tax reduction/tax credits
- Non-traditional borrowing
- On/off market CRE
- Joint Venture partnerships

Every 1031 exchange is unique. This material provides an overview of the 1031 requirements. You should always discuss your 1031 exchange with a tax and/or legal advisor.

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