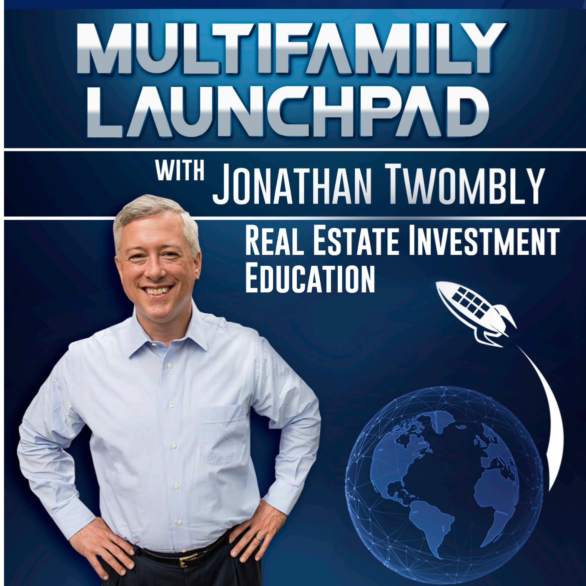

Section 1031
Like-Kind Exchanges

Module 9 - Video 3

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Video Overview

What's covered:

- What is a Section 1031 like-kind exchange?
- The rules governing Section 1031 like-kind exchanges
- Some rarely-discussed strategic considerations for real estate investors
- Section 1031 & Syndication

Disclaimer

Disclaimer

- I’m NOT a CPA
- I’m a lawyer, but I’m not a tax lawyer and I’m not YOUR lawyer
- This presentation is based on my layman’s working understanding of the tax laws as they affect my profession
- It’s very confusing, and I cannot even guarantee I’m getting it all right
- You MAY NOT rely on anything herein as tax or legal advice
- You MUST consult your CPA and tax lawyer before making any real estate investment decisions


What Is a Section 1031 Exchange?

Section 1031 Exchange Defined

- A Section 1031 like-kind exchange is named for the section of the US Tax Code that allows them
- Section 1031 allows the seller of real estate to *defer* paying tax on depreciation recapture and capital gains (appreciation)
- To take advantage of the benefit, seller must purchase another property meeting certain requirements, within a certain amount of time
- You can defer taxes indefinitely through repeated exchanges


The Rules
Governing
1031 Exchanges

Rules Governing Section 1031 Exchanges

To qualify for section 1031:

1. The seller must buy "like-kind" property with the sale proceeds
2. Only investment/business property is eligible
3. The second property must be of equal or greater value than the first
4. Seller must not receive "boot"
5. The same taxpayer must be seller of Property 1 and buyer of Property 2
6. Seller must identify a replacement property within 45 days of first sale
7. Seller must close on replacement property within 180 days of first sale
8. Seller must use a Qualified Intermediary to conduct the exchange

1. "Like-Kind Property"

What does "like-kind" property mean?

1. Property of the "same nature and character, even if they differ in grade or quality"
2. Essentially, you can exchange any real estate property for any other real estate property
   - ✓ Duplex for multifamily
   - ✓ Residential for industrial
   - ✓ Actively-managed multifamily property for NNN-leased retail, etc.
   - ✓ One property for multiple properties
   - ✓ Multiple properties for a single property
3. First and second properties must both be in the United States

2. Investment Property Only

Only investment property qualifies for the exchange:

- Neither the sold property nor the purchased property may be for personal use
  - ✓ This includes second homes – unless the first property was rented out enough to qualify as an investment property
- Both properties must be for investment or business use to qualify

3. Equal or Greater Value

The replacement property must be of equal or greater value than the exchanged property

1. The second property must be of equal or greater value than the first property
2. The equity down-payment on the replacement property must be at least equal to the equity in the exchanged property
3. Example:
   - You purchase a property for $1,000,000 with a $750,000 mortgage
   - When you sell, you receive $1,500,000 and the remaining mortgage balance is $600,000, so you have equity of $900,000
   - The replacement property must cost at least $1,500,000, and you must put at least $900,000 of equity into the property to receive the full tax deferral benefit

4. Seller Must Not Receive "Boot"

What is "boot"?

- "Boot" is essential sale proceeds from the exchanged property that do not go into the replacement property
- On the last example, if you sold the property for $1,500,000 and received $900,000 in equity
  - If the replacement property cost only $1,200,000, you would have $300,000 of "boot"
  - If the replacement property cost $1,500,000 but you put in only $600,000 of equity, you would have $300,000 of "boot"
- Receiving "boot" is perfectly legal, but you must pay tax on the "boot"

5. SAME TAXPAYER

- The seller of the exchanged property and the purchaser of the replacement property must be the same
- No issue when the seller and buyer is a natural person
- When the seller is an entity, such as in a syndication, potential problems arise – the same entity, with the same partners, must be on both ends of the transaction
- Exception exists for single-member LLCs, because they are tax-passthrough entities
  - ✓ If Jonathan Twombly LLC sells the exchanged property, then Jonathan Twombly (person) may buy the replacement property and benefit from the exchange

6. Identify Replacement Property within 45 Days

- To effectuate the exchange, the seller must identify a replacement property within 45 days after the closing on the exchanged property, in writing
- Seller may choose one of three following rules for identifying replacement property:

1. "Three-property rule": seller identifies up to three potential properties within 45 days
2. "200 percent rule": seller identifies an unlimited number of potential replacement properties as long as their cumulative value does not exceed 200% of the exchanged property
3. "95 percent rule": seller can identify property worth more than 200% of the property sold, but only if seller actually acquires at least 95% of the property so identified, by value

- 3-property rule is the easiest to comply with, so it's most often used

7. Seller Must Close Within 180 Days

- The seller must close on the purchase of the replacement property within 180 days of closing on the sale of the exchanged property, or taxes won't be deferred

8. Seller Must Use a Qualified Intermediary

- Seller of exchanged property does not sell and buy the properties directly
- Must use a Qualified Intermediary instead
- Pursuant to a written agreement with the seller, the QI:
    - ✓ Acquires the exchanged property from the seller
    - ✓ Transfers the exchanged property to the buyer
    - ✓ Acquires the replacement property from the seller
    - ✓ Transfers the replacement property to the buyer (i.e., the seller of the exchanged property)
- Yes, there is a fee involved


Strategic
Considerations
for
Section 1031
Exchanges

Strategic Considerations of S. 1031

- In this section, we will discuss some strategic considerations of Section 1031, including:
  - ✓Why do a Section 1031 exchange?
  - ✓Why market timing is critical
  - ✓Some suggestions for employing Section 1031 strategically to build your real estate empire

Why Do a Section 1031 Exchange?

- Two primary reasons:

1. Avoid devastating tax consequences
2. Use Section 1031 to increase the equity you have available for empire-building

Avoiding Devastating tax Consequences

- Imagine this scenario:

1. Property has been held long-term and depreciation recapture amount is significant
2. Owner refinanced to take advantage of appreciation

Avoiding Devastating tax Consequences

Assume long-term hold scenario:

- $5,000,000 purchase price, with $4,000,000 depreciable
- 30 year hold
- Property refinanced at $9,000,000 valuation at 75% LTV ($6,750,000)
- Sells for $10,000,000
  - ✓Recapture: $4,000,000 @ 28.8% = $1,152,000
  - ✓Capital gain: $5,000,000 @23.8% = $1,190,000
  - ✓Proceeds after loan repayment and 4% closing fees: $2,850,000
  - ✓Total tax = $2,342,000 (82% of your gain, not including state taxes)
- Taxes would be even <u>higher</u> if accelerated depreciation used

AVOIDING DEVASTATING TAX CONSEQUENCES

Assume short-term value-add scenario:

- $5,000,000 purchase price, with $1,000,000 in upgrades
- $4,000,000 + $1,000,000 = $5,000,000 depreciable
- 75% LTV loan = $3,750,000
- Sells for $8,000,000 after 3 year hold
  - ✓Recapture: $545,454 @ 28.8% = $157,090
  - ✓Capital gain: $2,000,000 @23.8% = $476,000
  - ✓Proceeds after loan repayment and 4% closing fees: $1,680,000
  - ✓Total tax = $633,090 (38% of your gain, not including state taxes)
- Taxes would be even <u>higher</u> if accelerated depreciation used

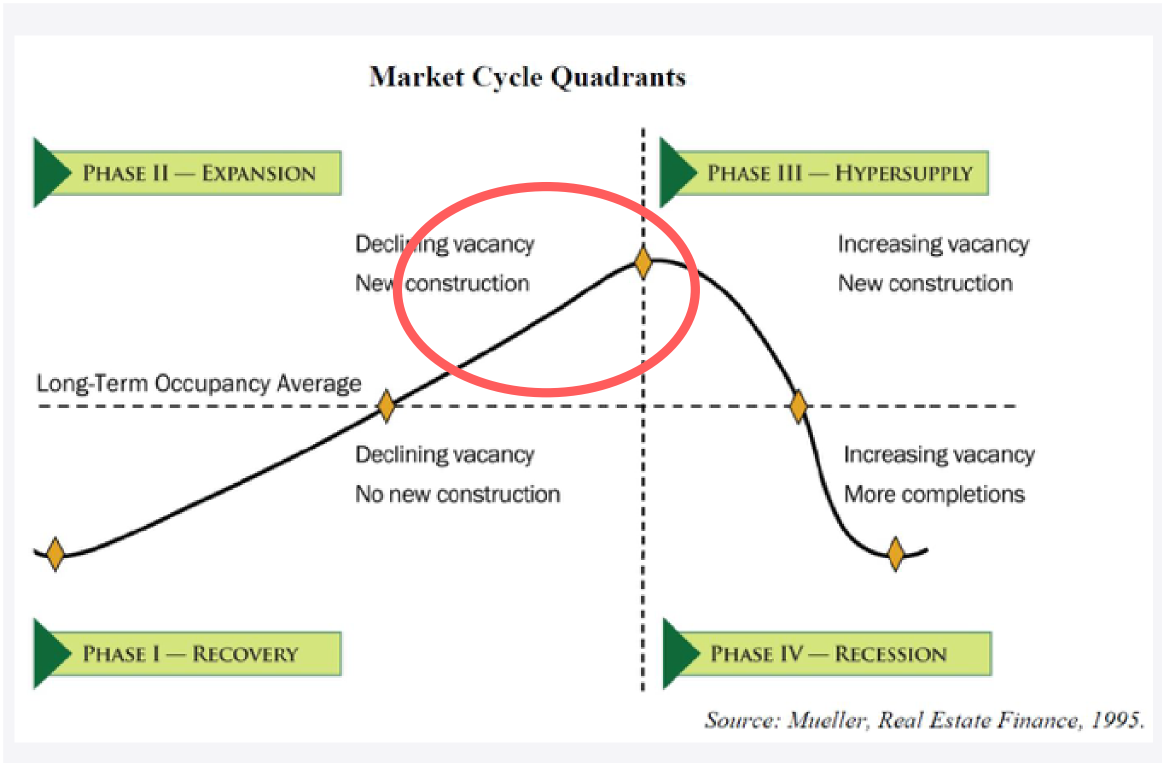
Using Section 1031 for Empire-Building

- You can see how much using Section 1031 can accelerate your holdings
- With a fully depreciated long-term hold property you would have an additional $2,342,000
- After a 3-year value-add play, you would have an additional $633,090 for growing your real estate empire
- (However, note that even if you don't use Section 1031, OVERALL the investment has been very tax-efficient, because you did not pay tax on that income up front)

The Importance of Market Timing

- Many investors use Section 1031 to avoid paying taxes, and then give it right back with bad market timing
- Because they sell at the top to maximize profit on the exchanged property, but then overpay for the replacement property out of desperation because of the 45-day rule
- If this happens right before a correction, it can have devastating effects on your business
- So you need to understand market timing to make the most of Section 1031

The Importance of Market Timing



The Importance of Market Timing

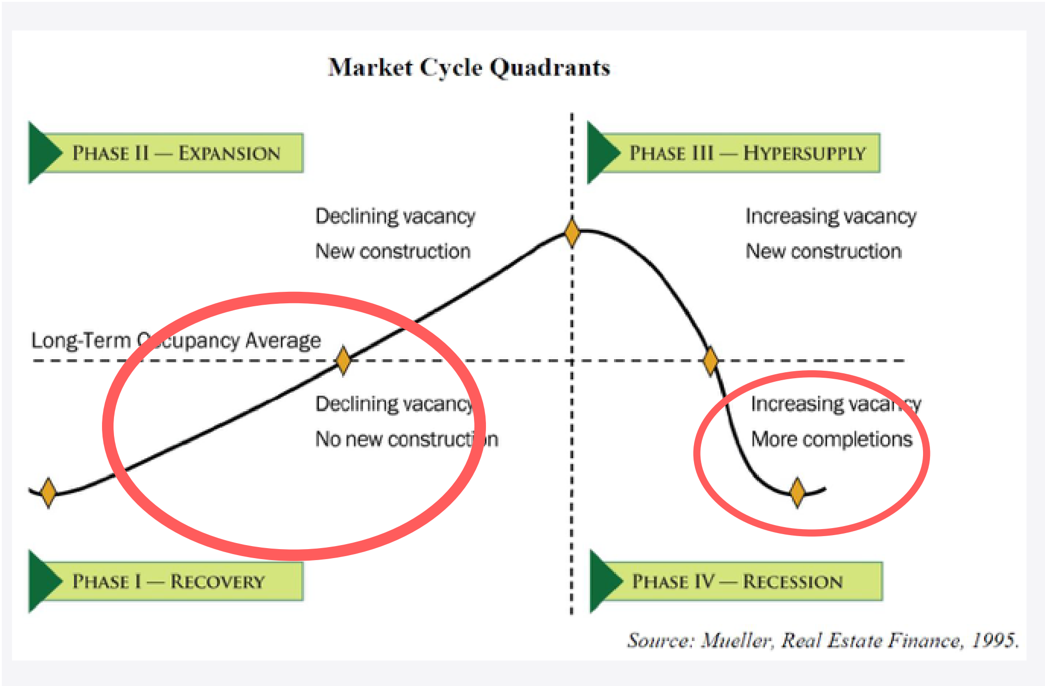
- In previous example, after 3-year rehab, you have $1,680,000 in proceeds
- You do Section 1031 to avoid $633,090 (38%) in federal tax
- At top of the market, you purchase a property for $6,720,000 at a 6% cap rate ($403,200 in NOI) with 25% down-payment ($1,680,000)
- If market corrects and cap rate rises to 8%, your property value drops to $5,040,000 – a loss of $1,680,000 (100%)
- If you can ride out, you will be fine
- But if recession caused the correction and you cannot make your debt service, then you could lose the entire investment

Strategic Selling with Section 1031

- For this reason, many sophisticated investors employ Section 1031 differently
- They look to sell not at the top of the market, but earlier in the cycle
- That way, they can free capital to use when there are bargains available
- And it's easier to find a good replacement property within 45 days
- These investors are looking to take advantage of cap rate compression, riding the cycle up, rather than fight off cap rate decompression

STRATEGIC SELLING WITH SECTION 1031

- They are looking to sell and buy at these points in the cycle:



Strategic Selling with Section 1031

- How does this work?
- Properties you have held for a long time, that are mostly or fully depreciated
- Because of the long-term hold, you have capital gains as well, even if you sell in a softer market
- Unless you refinanced at higher levels, you also have a lot of accumulated amortization (loan principal paydown) to use
- You can sell, take all the proceeds tax-free, and then deploy them into a newer, better property when the market is soft and bargains are available

Strategic Selling with Section 1031

- On the last example, if you used your $1,680,000 to buy a 75% LTV property at a 10% cap rate rather than 6% cap:
- You'd be able to buy a property for $6,720,000 that produces $672,000 of NOI rather than $403,000 at a 6% cap
- And when cap rates reverted to the normal 8%, your property value would increase to $8,400,000 even if NOI stayed the same
- That's equity growth of $1,680,000 on top of the $1,680,000 you put in

Strategic Selling with Section 1031

- The big picture:
- Selling at the top of the market to do Section 1031 is not necessarily the best thing to do
- Selling for less in a softer phase of the market could be better in the long run
- Especially with a property that you've held for a long time, with a lot of built-in capital gains, that's fully depreciated
- The most sophisticated investors aren't just thinking about maximizing the price they get for Property 1
- They are thinking strategically about both ends of the transaction
- And using 1031 to move into bigger, newer, better properties

Section 1031 Exchanges & Syndications

Section 1031 & Syndications

- Section 1031 becomes complicated when you a syndication is involved, because of the “same taxpayer” rule
- In a syndication, the investors own shares in the entity
- They have no direct ownership of real estate, so they are not eligible for 1031
- They cannot take their earnings from the sale and do an exchange
- However, there are two ways you can do a 1031 exchange with a syndication:

1. The LLC buys the second property
2. The LLC does a “drop and swap” to a TIC before selling

LLC Buys the Property

- You can do a Section 1031 if the LLC sells the exchanged property and then buys the replacement property
- The ownership LLC must buy the second property
- This becomes a problem if you have investors who want to cash out
- Individual members cannot exit the LLC and do an exchange – only investors who stay in the LLC can benefit

Drop & Swap

- To avoid this problem, some syndications will do a “drop and swap”
- This is where they dissolve the partnership, drop the LLC entity and become a Tenancy In Common or TIC
- In a TIC, all the investors own a portion of the property
- They can freely sell their individual ownership shares to other people
- However, to sell the property, all investors must agree
- If they cannot agree, then legal action (partition) may be necessary
- Upside is that each investor can then use their proceeds to effect a Section 1031 exchange
- Downside is that you may have a recalcitrant investor who refuses to sell, necessitating legal action for partition
- Should do it at least a year before the planned sale in order to pass IRS muster

Section 1031 Exchange Into a Syndication

- It is possible to do a Section 1031 exchange *into* a syndication
- In this case, the investor with the exchange funds enters into a TIC with the syndication LLC
- So, if the investor was bringing 25% of the equity, it would be a 25%-75% TIC with the syndication LLC, and the syndicator would syndicate 75% of the deal.
- You would need to have a management agreement that allows you to earn management fees and a promoted interest from the 25% piece as well

Q&A in The Facebook Group

Next up:

Module 9 - Video 4
Special Tax Considerations for Syndicators