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1031

BREAKWATER 1031's GUIDE TO

1031 Exchanges

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LEGAL:

1031 RISK DISCLOSURE:

- 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 – Because 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

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HELPING YOU MAKE SENSE OF 1031 EXCHANGES

Breakwater 1031 specializes in guiding investors through the process of performing a 1031 exchange through a Delaware Statutory Trust (DST). 1031 exchanges exist for a single, simple purpose: to mitigate the tax impact of transferring or exchanging investment property. However, successfully performing a 1031 exchange requires carefully identifying and selecting properties that meet all requirements. Even with rigorous research, deadlines for a 1031 exchange can heavily hamper investors. Breakwater 1031 helps its clients by keeping an actualized catalogue of matching properties, and offering the benefits of turn-key financing, liability protection, and the other significant benefits DSTs provide.

Delaware Statutory Trusts allow multiple commercial real estate investors to invest in managed properties, rather than exchanging their property for another like-kind piece of real estate that they would have to continue to manage. This means that, through Breakwater 1031, you can continue to grow and manage your investment wealth like never before, while dropping the hassle of working with tenants and worrying about the everyday chores and tasks of property management. For our clients, DSTs mean lower risk, a diversified portfolio, and access to higher quality commercial real estate at a lower minimum investment.

Neither 1031 exchanges nor DSTs are new legal inventions, but there are changes to navigate, and complex rules to consider. We believe strongly in working with our investors to help keep them in the loop, and ensure they understand where and how their money is working for them. Through this book, we will guide you, the reader, through the 101s of 1031 exchanges and DSTs. We will address our most frequently asked questions, and by the end, hope that you will consider this a valuable resource to refer to in the future.

If you have any other questions, or want more information on commercial real estate investments, 1031 exchanges, or DSTs, do not hesitate to contact us at (310) 940-9430, or visit breakwater-cap.com. We look forward to your hearing from you.

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SECTION 1:

WHAT IS A 1031 EXCHANGE?

A 1031 exchange is a method for deferring capital gain taxes or depreciation recapture taxes during the sale of investment property, in cases where the proceeds of that sale are used to purchase another investment property. This is made possible through Section 1031 of the Internal Revenue Code, which defines and restricts this tax deferral through a few simple rules, the most important of which are that only "like-kind" property can be exchanged, and that the replacement property must be of equal or greater value.

This tax deferral can open the doors to even greater investment opportunities for real estate investors who are looking to grow their real estate investment portfolio without carving off a chunk for the IRS each and every time.

How 1031 Exchanges Started

The practice of deferring taxes on exchanged properties is about a century old and began with The Revenue Act of 1921. But tax-deferred exchanges at the time were different and followed a ruleset that necessitated same-day exchanging — which meant both parties had to come to an agreement and physically exchange deeds on the same day for the tax-deferral to count.

This didn't change significantly until 1977, due to Starker v. United States. This case set a precedent for delayed 1031 exchanges.

In this case, the Starker family exchanged timberlands in Oregon to a company called Crown Zellerbach Corporation, in exchange for credit on the corporation's books, to be paid off via the purchase of other properties around Washington and Oregon. As part of the exchange contract, the corporation agreed to provide suitable properties within the next five years or pay the outstanding balance in cash.

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Three individuals had separate interest in the Starker family timberlands – these were T. J. Starker, with an interest worth about $1,502,500, and his son and daughter-in-law, Bruce and Elizabeth Starker, who had an interest of $73,000. Properties to match their interest were found and exchanged within four months. But closing the exchange with T. J. Starker took much longer.

Because the process was significantly delayed and the Starkers didn't take capital gains on the timberlands into account at the point of sale, the IRS took the transaction to court. This led to a change in the Internal Revenue Code made in 1984, officially recognizing delayed 1031 exchanges.

What is a Delayed 1031 Exchange?

Whereas an original tax-deferred property exchange had to occur immediately, a delayed exchange provides set deadlines for the identification of suitable replacement property, and an additional deadline for the complete transfer of properties between two parties (leaving room for financing and payment).

Since the change to the Internal Revenue Code made in 1984, the delayed exchange has become the predominant type of 1031 exchange because it gives investors much more breathing room to identify suitable properties and complete the sale. Prior to the change, exchange transactions required both parties to work within an extremely tight timeline to ensure simultaneous exchange of deeds and documents, and the more parties were involved, the harder it was to keep all parties cooperating, and the risk of an incomplete exchange would rise, giving way to substantial capital gains taxes and defeating the purpose of the entire exchange.

By delaying the exchange and allowing it to occur within a less strict timeframe, all parties involved have more time to identify and explore their investment options. Simultaneously, delayed exchanges eliminate the restriction of only being able to work with a limited number of investors looking to specifically swap their property for yours.

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The original case that set in motion the change to the Internal Revenue Code was an exchange that took years — today's delayed exchanges have a much stricter timeframe. Delayed exchanges must occur within a maximum period of 180 days (or the exchanger's upcoming tax return filing deadline, whichever is sooner), from the closing of the relinquished property (i.e., sale) to the closing of the replacement property.

Today's delayed 1031 exchanges must also observe other rules, such as a separate timeline for identifying exchange property. This identification period must be a maximum of 45 days, during which time either party must identify an investment property to serve as a viable like-kind replacement property for theirs. This 45-day period must fall within the 180-day total timeline for the exchange and begins on the first day of the 180-day timeline.

Once the 45 day have run their course, either exchanger can only acquire properties identified during said period. And yes, under specific circumstances, investors can identify multiple potential properties as candidates for their exchange. It is recommended that investors begin looking for candidate properties before the sale of their exchange property, just to buy themselves a little more time to explore the market.

In short, here is a review of the entire 180-day timeline:

Day 1 — The original investment property is sold, and the deal is closed.

Days 2-45 — The exchanger must identify replacement investment property that is equal to or greater in value than the sold investment property. The identification period ends on the 45th day. Exchanger should have set their eyes on concrete options at this point.

Days 46-180 — This period gives both parties time to acquire any necessary financing, begin the sale/purchase of both properties, and close the exchange. The 180th day (or exchanger's tax return filing deadline, whichever comes first) is the final day for the completed acquisition of exchange property.

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What is a Reverse 1031 Exchange?

There are cases where an exchanger might acquire replacement property before having sold the original relinquished investment property. In this case, it wouldn't make much sense for an investor to "identify" an investment property that they already own as a replacement to property they are planning to sell. However, through an experienced intermediary, a sort of "reverse exchange" can be made possible.

In a reverse exchange, another party known as the accommodator would acquire the replacement property through a loan from the exchanger and hold the property title until the exchanger has closed the deal (sold) their original/ relinquished investment property. Once said property is sold, the accommodator can accept the proceeds from the sale to "sell" the replacement property back to the exchanger, alongside the title and repayment of the loan. While this is the gist of the process, careful planning and even more careful implementation is needed to pull it off properly. An experienced and qualified intermediary is critical.

What is a Qualified Intermediary?

More than just a descriptor for someone with years of experience, a qualified intermediary is a title held by professionals who specialize in facilitating the 1031 exchange process. Also known as a 1031 Exchange Qualified Intermediary (QI), a 1031 Exchange Accommodator, or a 1031 Exchange Facilitator, a QI is necessary for validating a 1031 exchange in the eyes of the IRS. Without a QI providing the necessary supervision and guidance, the IRS can still charge capital gain taxes and depreciation recapture taxes, as even the simplest clerical error can potentially invalidate an exchange.

QIs must be independent entities, either individuals or firms who have no ties to either party. During the exchange process, a QI signs into an agreement with the investor to complete the exchange as per all necessary requirements and regulations.

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One of the larger aspects of this job is ensuring that the proceeds from the sale of the relinquished property are managed and used solely for the acquisition of replacement property and aren't directly received by the exchanger.

The reason this is important is because, to avoid a taxable event, the exchanger cannot directly receive nor access the proceeds of their investment property's sale, as this would make it income in the eyes of the IRS. A QI can hold these funds in escrow, under the Safe Harbor rules of the IRS, and restrict access to them until the exchange is complete. This is one of the most crucial parts of avoiding unnecessary taxation during a 1031 exchange.

The process for doing so begins with a transfer of the property to the QI, who oversees the sale and manages the proceeds until the identified replacement property has been fully acquired, at which point said replacement property will be transferred into the control and ownership of the investor. This way, the investor only ever remains in control of property, and at no point has access or control over exchanged funds.

While being a QI is an important fiduciary role, there are no regulatory bodies overseeing the position. Any agent can become a QI for an investor, as long as they meet the requirements and restrictions set by the IRS. This means that QIs cannot simultaneously act as an investor's accountant, attorney, or realtor, now or at any previous point within the last two years. While QIs have a fiduciary duty to the investor, there is little to no recourse for an investor should a QI become bankrupt during the exchange process, thereby losing the investor's funds. Careful research and due diligence are very important when picking a QI. There are differences in price and services, and how funds are held, managed, and/or invested during the exchange process.

1031 Exchange Deadlines

There are two major deadlines to any 1031 exchange. These are the identification period deadline, and the exchange period deadline.

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The Identification Period Deadline

During the 45-day identification period, the exchanger must identify any and all properties viable for the exchange process and provide a list to their qualified intermediary before or on midnight of the 45th day following the close of the sale of the original/relinquished investment property.

The Exchange Period Deadline

During the 180-day exchange period, the exchanger must complete the acquisition of their replacement investment property (or multiple properties) either on/before midnight of the 180th day, or the due date of their income tax return for the same year in which the relinquished property transaction was closed.

It should be noted that taxpayers do have the option of delaying the deadline for their income tax return by six months. Filing for a 6-month extension when the current deadline for your income tax return is in less than 180 days from the date of your relinquished property sale can help you extend your exchange period to the full 180 days. Filing for a 6-month extension on your income tax return does not increase the maximum length of the exchange period.

Keeping Track of Your 1031 Exchange Deadlines

Another important note is that 1031 exchange deadlines are calculated based on calendar days — not working days. This means holidays, weekends, and otherwise excluded dates are still taken into account when talking about the 45-day and 180-day periods given for a 1031 exchange.

Furthermore, the first day of the exchange period is the day after the transaction for your relinquished property has closed. This means if you completed the sale of your property on March 3rd, then the first day of the exchange period (and identification period) is March 4th. This means April 18th would be the deadline for your identification period, and August 31st would be the deadline for your exchange period.

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Keeping track of these deadlines is vitally important. Missing them even by a day would invalidate the exchange and open you up to substantial losses due to owed taxes, diminishing your investment opportunities and growth potential.

Identifying Replacement Property

When attempting to organize a 1031 exchange, it's important to be aware of what properties do and do not count as like-kind. The IRS specifies, through Section 1031 of the Internal Revenue Code, that all investors wishing to perform a 1031 exchange must identify like-kind replacement investment property of equal or greater value to their relinquished investment property within the first 45 days after the sale of the relinquished property, to defer taxes on the transaction.

We have mentioned previously that, under specific circumstances, investors are allowed to identify multiple potential replacement investment properties and prepare a list to provide to their qualified intermediary (QI). Let us go over these rules and circumstances and explain how you might be able to narrow your choice down to multiple potential replacement properties, rather than putting all eggs in a single basket.

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Crucial Identification Rules for Multiple Properties

The Three Property Identification Rule

The first rule is the Three (3) Property Identification Rule. This states that you can identify a maximum of three properties, regardless of what these properties are worth (as per their Fair Market Value).

This strategy is ostensibly the most popular and most used strategy in modern delayed 1031 exchanges and acts as an insurance to help those interested in identifying and purchasing a single replacement property, picking the second and third choice simply as alternatives or "backups" should the first transaction or exchange fail.

This way, investors can still benefit from the tax deference of a 1031 exchange even if they aren't able to acquire the replacement property they originally planned on.

The 200% of Fair Market Value Identification Rule

The second rule is the 200% of Fair Market Value Identification Rule. This rule states that you can pick an unlimited number of potential replacement investment properties, so long as the total value of your picks combined does not exceed the limit of 200% of your relinquished property's (or properties) Fair Market Value. Your property's (or properties') fair market value is determined by the price the property (or properties) would have fetched at the end of the identification period. Fair market value itself is defined as the price of a property or asset on the open market after both buyer and seller have had reasonable time to evaluate the transaction, were under no pressure or compulsion to come to a swifter agreement, and mutually agreed upon the price.

The justification behind choosing to pick multiple properties under this rule rather than the Three Property Identification Rule is to further diversify your investments and ensure that your portfolio has varied properties in it. There is no real benefit to

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choosing only three properties under the 200% of Fair Market Value Identification Rule. Investors are usually advised to consider this option only if they are looking at investing into more than three properties.

Alternatively, investors who only want to invest in two or three properties might feel uncomfortable having only one or no alternatives should any of their preferred investment exchange transactions fall through, in which case this rule is preferable to the first one. Because this rule is limited by total value rather than number of properties, it also gives undecided investors more room to explore their options and incorporate a greater number of potential replacement picks into their list, even if they then subsequently plan on narrowing their choices down further.

An experienced real estate investment professional can further guide you on how either strategy might best apply to your specific circumstances and preferences. Alternatively, under certain circumstances, you might want to consider the third rule.

The 95% Identification Rule

The third rule is the 95% Identification Rule, which states that you can pick an unlimited number of replacement properties with an unlimited total value, so long as you can acquire and close with at least 95% of the total value of the identified properties. In this case, your limit is your own financial capabilities.

This option is best seen as an insurance policy in cases where an investor has strategically chosen multiple properties while remaining barely within the 200% limit, only to exceed it unintentionally when the value of the exchange properties rose during the last few days of the identification period.

Remember, the fair market value calculated for each exchange property is determined on the last day of the identification period, which means property values can rise or fall, affecting your exchange's eligibility for a tax deferral. Through the 95% rule, investors can still save an exchange derailed by an unforeseen rise in value by acquiring at least 95% of the total value identified.

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Alternatively, this rule is ideal for investors who feel the need to identify more than three properties at more than 200% the total value of the relinquished property's fair market value, from the beginning. It is also a dangerous rule, as the exchange falls through completely if the investor fails to secure 95% of the property's total value before the deal has to close, at the end of the exchange period.

Important Details

To wrap things up, there are a few important notes to keep in mind when considering the best approach for a 1031 exchange. These include:

- Exceeding the Three Property Rule or the 200% Fair Market Value Rule without managing to apply the 95% exception within the 45-day identification limit will count as though no property was identified, thus invalidating the exchange.

- Identified properties must be acquired before the end of the 180-day exchange period to qualify as replacement properties and thereby trigger a 1031 exchange.

- Properties not provided to a qualified intermediary before the end of the identification period cannot be exchanged in a 1031 exchange and are not valid.

- Any property identified AND acquired during the 45-day identification period counts as replacement property and does not count towards the identification rules/limits imposed at the end of the identification period.

This means if property was identified and acquired before the end of the identification period, the investor can identify yet another three properties within the Three Property Rule or leave that property's fair market value out of the 200% Rule. Neither will that property's value count towards the total true value needed for the 95% exception. It is effectively removed from the rules and limitations imposed by the identification period, while still counting as a replacement property.

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Officially Identifying Your Replacement Property

Simply finding properties that you might want to acquire isn't enough. To effectively identify them as part of the 1031 exchange process, you must draft a signed legal document that definitively describes the property you want to identify, utilizing any or multiple descriptions including the property's dimensions and purpose, street address, legal description, and, if applicable, its name. This document must be given to your qualified intermediary.

Similarly, taking any property off the list during the identification process requires its own written and signed document, once again describing the document in question and unambiguously confirming that you would like to remove it from your shortlist of potential properties for the 1031 exchange. Again, this too must be given to your qualified intermediary. You could work with a legal professional to create these documents.

What is a "Boot"?

Ever heard of the phrase, "to boot", to describe something being added on top in a bargain? While used rarely in that context in modern conversation, "boot" was once a term used to denote added incentive or relief in a situation, and in 1031 exchanges, a boot is a form of additional value defined during the exchange. Value is critical, because depending on the surrounding circumstances, any additional value could create a taxable event. In this sense, a boot might be an unforeseen financial benefit attached to an investment property that is not in itself part of the property, and thus not "like-kind", thereby separate from the terms of the exchange.

The IRS requires that only like-kind property be acquired in exchange for relinquished investment property when an investor is trying to pursue a tax deferral. Furthermore, a 1031 exchange must involve the replacement of investment property with property that is at least equal in value, if not more valuable. "Trading down", so to speak, would mean that the remainder of the value not exchanged into real estate would be received as cash, and thereby count as direct income

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(which is taxable).

If you fail to respect these two rules, then the additional value you are getting — the boot — may end up costing you. There are a few different kinds of boot.

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DIFFERENT TYPES OF BOOT

Mortgage Boot

A mortgage boot or debt reduction boot describes an event wherein the debt owed on the replacement property is lower than the debt owned on the relinquished property. In this event, despite the property itself being more valuable, you are effectively reducing your total debt liability. Like other forms of debt forgiveness, the IRS sees reduced debt liability as income, and will tax you accordingly.

Cash Boot

A cash boot describes money in your bank account generated as a result of the exchange. This can occur if the value of the property you are acquiring is less than that of the property you have relinquished. Another way in which a cash boot can occur is if the exchange includes more than just the transfer of real estate titles. If you receive payment, a promissory note, or other financial instruments as part of the exchange, these will count as direct income, translating into a taxable event. Had you simply chosen a higher value property rather than just agreeing to sweeten the deal, that additional value in the other property would be effectively tax-deferred.

Sale Proceeds

There are certain administrative fees that go into the 1031 exchange process, including the payments made to the qualified intermediary. However, if any money gained from the sale of the relinquished property is misused to make payments wholly unrelated to closing the sale, these count as a boot. Put the money from the sale aside completely for the essential services of closing the sale, and for the acquisition of your exchange property, and pay everything else out of pocket.

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Excess Borrowing

If you seek financing to acquire your exchange property but borrow more than you actually need to pay for your new investment, then the remainder of your credit will count as a taxable boot. Be sure to only borrow as much as you need to make the purchase, and not a penny more.

Non-Like-Kind Boot

The definition of like-kind property is not very rigid. The IRS does not want you to trade an investment property for a personal residence without some kind of taxable event, and 1031 exchanges can only be made between different forms of investment real estate. But there are clear examples of non-like-kind assets and property that may get tangled into a 1031 exchange, thereby constituting a taxable event. This type of boot can easily be avoided, and can include furniture and appliances, farming equipment, and other forms of personal property. If vehicles and machinery are included in the purchase, for example, the smartest thing to do would be to create a separate agreement to purchase them, so the property in and of itself remains entirely like-kind, and everything else is bought in another deal.

Personal Residence Boot

As previously mentioned, you cannot buy a personal residence with the proceeds of the sale of your investment property and expect deferred taxes. If you decide to use a portion of, say, a new apartment building as your own residence, the value of that portion will be counted as personal property if the remainder of the apartment does not equal or exceed the value of your relinquished property.
These individual differences may seem minute but can have a considerable tax impact and affect your financial and investment plans. Be sure to discuss these concerns and possibilities with your QI and find appropriate ways to work around them in order to make your 1031 exchange possible.

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Offsetting Boot

Offsetting boot requires paying boot. In other words, you can prevent or eliminate a taxable event by carefully planning and managing your transaction to avoid and offset potential additional value that does not count as like-kind or causes the value of your relinquished property to exceed the value of your exchange property. Work with your QI to identify ways to offset boot and avoid a taxable event. Examples may include:

- Exchange expenses, which can offset cash boot received.
- Debt incurred on the new replacement property, which can offset a mortgage boot on the relinquished property.
- Cash boot paid at the closing table (additional value added to your relinquished property) can offset cash boot received. This offset will have to occur at the point of exchange/closing of the exchange.
- While cash boot paid can offset a mortgage boot, additional debt (i.e., debt boot paid) cannot offset a received cash boot.

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SECTION 2:

WHY USE A 1031 EXCHANGE?

The Advantages of a 1031 Exchange

The clearest and most immediate advantage of any investment is to build capital. But what do you do with capital? You could cash out and enjoy your wealth. But know that for every penny of profit you have managed to earn through the sale of your investment, a portion will be reserved for the taxes on that growth. If you then plan on reinvesting what is left in order to build more capital — perhaps to save the cash-out for retirement, or your child's tuition, or some other financial goal — you are limited by what profit you end up with after repaying loans and after taxes.

A 1031 exchange lets you immediately reinvest the entire sale value into your next real estate investment and defer those taxes. Investors who are not interested in cashing out, and who are planning on reinvesting anyway, should prioritize a 1031 exchange as the most efficient and effective way of making sure every penny goes towards your next investment.

By completing a 1031 exchange, you defer any capital gains taxes typically incurred when relinquished property is sold. Instead of receiving any income, a third party holds the sales proceeds in escrow and invests them into another piece of commercial or like-kind real estate. You get to keep the entirety of your relinquished property's equity within your balance sheet and continue to grow your own wealth. By deferring taxes, you also unlock the opportunity to purchase more valuable real estate than had you cashed out and reinvested the income in some other way, after taxes.

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	Sell and Reinvest	1031 Exchange
Cost Basis	$300,000	$300,000
Sale Price	$500,000	$500,000
Closing Costs	$35,000	$35,000
Capital Gains	$165,000	$165,000
Capital Gains Tax (20% rate)	$33,000	-
Sale Proceeds for Reinvestment	$432,000	$465,000
Potential Annual Cash Flow (7%)	$30,240	$32,550

Take note:

For the sake of this example, regular taxable income was not subtracted from the sale proceeds. Loan to be repaid also wasn't taken into consideration.

Despite the same sale price, the potential annual cash flow is higher in the 1031 exchange example. An investor who had sold and reinvested the proceeds of their property without a 1031 exchange is only receiving a portion of what they would have been able to earn on an annual basis, had they deferred their taxes. Also note that your capital gains tax amount will depend on your income tax bracket, and other factors.

The net gain may not be much at a glance, but can become very significant over time. Being able to reinvest the full equity of your investment property means having access to higher quality property to invest into, which translates into appreciably higher potential returns. The sell and reinvest investor would be able to match this annual yield by taking out a loan to buy a similar property — but that would mean much of their cash flow would go towards paying off that loan. Naturally, you would build more wealth if you can manage to finance the purchase with your own cash.

Last but certainly not least, consider how these gains might further accumulate as the investor continues to "trade up" to better and better property, or utilize

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the proceeds of a particularly high value investment to purchase multiple well-paying investments, thus reducing risk and diversifying their portfolio. A 1031 exchange allows a tax-smart approach to long-term investments, and thus much more efficient growth potential.

Hypothetical #1

Judy owns a second home out on the country, which she had purchased years prior as a means to get away from the hectic city life and escape into the more comfortable and cozy trappings of a smaller lodge. But after her husband passed away, leaving her with full ownership over both the primary residence and the vacation home, she couldn't bear going back to it alone — thus resolving to sell it. But once Judy began running the numbers, she realized something strange. No matter what way she'd cut it, despite appreciating considerably, after taking into account taxes and repaid loans, the money the house would ultimately fetch her at its current fair market value would barely recoup the costs of the initial investment. What was going on?

Capital Gains and Depreciation

Capital gains taxes and depreciation recapture can, under certain circumstances, lead you to effectively take a loss where you should have made a profit.
While you might know that capital gains taxes and depreciation recapture can cost you money whenever you sell property, you might not have known that these costs could be so steep so as to cost you more than your initial investment. Understanding how these costs ramp up is important to understanding why you might take a loss on your property.
There are three parts to this equation: capital gains, depreciation, and equity.

Explaining Capital Gains

Capital gains are any profits earned after taking a property's sale price and subtracting the cost of sale plus the adjusted basis.

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Capital gains are NOT just the property's sale price. Capital gains are NOT the money you have after subtracting the closing costs. Capital gains are NOT the difference between the property's value at the point of purchase and the point of sale. Capital gains, or more accurately net capital gains, are the money you made after taking into consideration the cost of the sale itself, as well as the adjusted basis of the property.

What is an Adjusted Basis?

The adjusted basis of a property is determined by the purchase price of the property, plus any value added to is (or removed from it) over time. For example, if you have made several improvements to a piece of rental property, then the original purchase price of the property, plus the costs of those improvements, minus the depreciation on the property, should be taken into consideration when determining the net adjusted basis.

Considering the Cost of Sale

You cannot sell a large investment property without incurring any additional costs. These may range from just one or two percent, to 7%, as well as other fees, depending on the fees charged by the real estate agent, closing costs, and other transactions. These are all deducted from the sales price before you can accurately determine taxable capital gains.

The Taxation of Capital Gains

There are different tax rates for different levels of income, as well as different durations of ownership. Properties held short-term before sale (less than a year) are taxed based on your income tax bracket, while properties held over much longer periods of time have only three different tax rates (0%, 15%, and 20%) based on taxable income. There are other factors that also affect whether your investment property will be taxed through short-term capital gains tax rates, or long-term capital gains tax rates. Other taxes, such as self-employment taxes, also

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play a role. Your specific capital gains tax rate could be as high as 40%.

Explaining Depreciation

Depreciation is the natural loss of value in a property as it ages. Properties of any nature cost money to maintain due to wear and tear, and this translates roughly into depreciation, which can be written off as an income tax deduction. Property can also appreciate in value, as neighborhoods become more desirable in live in, industrial areas are heavily invested into, or as market conditions change.
Any depreciation on investment property is calculated based on the costs that the property's buildings incurred for maintenance, upkeep, and improvements, over the estimated "useful life" of the property. For commercial property, this is an average of about 39 years. It is shorter on average for residential property — about 27 years. This lifetime, based on the state and nature of the property, provides the basis for the calculation of a property's annual depreciation deduction, whenever applicable.

Calculating Your Depreciation

Accurately determining your cost basis and the useful life of your property is the key to determining your property's annual depreciation. For commercial property, this is an average of about 39 years. It is shorter on average for residential property — about 27 years.

This lifetime, based on the state and nature of the property, provides the basis for the calculation of a property's annual depreciation deduction. If the property is not in service throughout the year, this can affect the calculation.

The Taxation of Depreciation

Depreciation recapture, which occurs when an investment property is sold after years of ownership, is determined through the total depreciation of the property as well as its cost basis. A property's cost basis is its purchase price. If an investor

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made a profit on the sale of a property even after taking into account the property's depreciation, the IRS will want to recapture some of the depreciation that the investor wrote off as a deduction on their income.

This can be a complicated tax process. Because individual factors can greatly affect the calculation, it's best to review the process with a tax professional. Different types of property have different rules on depreciation, and their own individual IRS tax publications to cover them.

Property Equity

Equity represents value. A property's value, i.e., the money it is worth after the trouble you went through to sell it and pay off its debts, is its equity. If a property worth half a million at the point of sale, costed you $30,000 to sell, and you had $100,000 left in mortgage loans, then the property's equity was $370,000.

Equity is an important number, as it represents the start of the calculation you need to make to determine just how much you have left to reinvest after you part with your investment property. Obviously, the more you can sell a property for, the more you can reinvest. But taxes matter too. Equity left untouched by depreciation recapture and capital gains taxes can be put to use investing into a higher quality property, for even greater annual growth.

Without a 1031 exchange, taxes will eat into your property's equity — and under certain circumstances, depending on the loan-to-value ratio, capital gains taxes, and depreciation recapture, some investors can find themselves with so little equity that they cannot even fully repay the loan and the taxes they owe.

How 1031 Exchanges Salvage Equity

1031 exchanges do not eliminate taxes. They simply defer them. But in doing so, they allow you to leverage the total equity of your investment property, putting it towards the purchase of another property that you otherwise would not have been

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able to finance.

Rather than settling for reduced equity, you can utilize a 1031 exchange to transfer equity directly into a better investment and pursue a better future. Even after repaying your loan, a 1031 exchange would allow you to salvage more from your investment property to rebuild your portfolio than if you were to cash out and reinvest in something else.

But what if you don't necessarily have investment real estate, but you do own a second property you don't really use anymore? Then you may still be luck. Changes to the IRC have allowed second homes and even vacation properties to be exchanged for a replacement second home or property, so long as certain rules are followed.

A vacation home or second home can be exchanged as relinquished property in a 1031 exchange, so long as:

- The property has been owned for at least 2 years before the start of the 1031 exchange.
- The property was rented to others for at least two weeks at some point during the last two years.
- he property has only been used by the owner a maximum of two weeks in each of the last two years, or a total of ten percent or less than the number of days the property has been rented out to others in each of the last two years.
- The same rules apply for the exchanged replacement property.

It should be noted that these are general guidelines, and that there are circumstances under which other property which may have been used in a different way can still qualify for a 1031 exchange. Consider discussing the specifics around your property with an expert, to find out if you can opt for a tax-deferred exchange on your vacation home.

The gist that these guidelines is trying to convey is that certain property that may register as personal or residential property can still, in fact, be considered for an

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exchange if it is at least partially used in business. Alternatively, these guidelines also allow investors to, on certain occasions and to a limited capacity, enjoy property that they own and manage for at least a few days per year.

The reason this change is so recent (2008) is because it stems from an internal dispute within the government on the scope and limitations of 1031 exchanges, and how they relate to investment property and things like vacation homes. A Private Letter Ruling issued by the IRS in 1981 stated that properties used at least partially for investment or business purposes could be exchanged and tax-deferred, for example. But the Deferred Exchange Regulations issued by the Treasury in 1991 contradicted this by stating that only properties held entirely for investment purposes or for business could be exchanged.

Then, Revenue Procedure 2008-16 clarified the specific guidelines under which second homes and other properties might be made eligible for qualification in a 1031 exchange, depending on how the owner uses said property, regardless of the owner's intent for said property.

For some aspiring real estate investors with access to property they haven't touched in a while, making their property rentable for a time in order to qualify it for a 1031 exchange and begin investing in higher quality real estate may be absolutely worth the effort. For others, upon closer inspection, it might not be. It is important to go over these details with your financial and/or tax professional if you are thinking about selling your property.

1031 Exchanges and Estate Planning

An estate plan is a set of documents and contingencies set up to prepare for one's end-of-life, and for the distribution of one's assets (estate) after death. Without an estate plan, nearly everything you own (that hasn't already been assigned a designated beneficiary) will go towards your estate and will be distributed as per your state's intestate laws.

But with simple and comprehensive estate planning documents, you can ensure

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that your family is not only going to be able to make the best of your investment efforts and capital, but you can also see to it that the tax liability you were slated to pay on the property you had invested in throughout your life won't have to pass onto your heirs.

The best and most efficient way to keep your investment wealth in the family is to keep exchanging properties again and again, until you die.

This isn't a viable option for every investor — some want to see the fruits of their investment before they pass away, or don't have children or partners to bequeath their property onto. But in cases where leaving a financial legacy is of key importance to an investor, the estate planning implications of a 1031 exchange become critical.

By continuing to exchange properties again and again, an investor can continue to defer capital gains taxes and continue to deduct any depreciation without risking recapture taxes.

Those taxes would be owed if the investor cashed out without properly reinvesting the funds into another property through a QI — but if it's death's door that brings an investor's ownership over their property to an end, then any capital gains associated with the property will not be passed onto the heirs, due to a step up in basis.

When a person inherits property, the property they inherit will receive a new cost basis determined by the property's fair market value at the investor's point of death. Heirs need to worry about neither the IRS's depreciation recapture nor the capital gains taxes.

This also means that it is not a good idea to add a family member's name to the title of your investment property if you wish for them to make the most of it during their lifetime, or even sell the property and use it as capital for their own dreams. Adding your heir to the title of an investment property will effectively make them the property's co-owner, and then full owner upon your death, thereby inheriting

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the full tax liability (unless they continue to exchange the property on and on).

To create the set-up in cost basis, the property must pass through probate and into the heir's hands after death. The decedent's investment history becomes irrelevant to the heir. If the investor purchased property at $200,000 and, after years of exchanges and investments, ended up passing a property worth $600,000 at their death to their only child, then that child will inherit property worth $600,000 that they can subsequently sell with no associated capital gains tax, or depreciation recapture. Or they can use that pure equity and invest in even more valuable real estate, or multiple investment properties, or set up an entirely different investment portfolio – all without worrying about the impact of capital gains taxes.

Property that passes through the estate, and thus through probate, can be subject to state and federal estate taxes. State estate taxes differ from state to state, and some states do not have estate taxes. Federal estate taxes only matter for estates larger than the current estate tax exemption limit, which as of the Tax Cuts and Jobs Act of 2017, has been $11.4 million (adjusted for inflation every year). This act expires in 2025, however, and changes to the estate tax exemption limit may be introduced by a different administration before then.

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SECTION 3:

DELAWARE STATUTORY TRUST

Hypothetical #2

Marco is a local businessman and works 12-hour days keeping his business running, providing detailing and surface technology services to companies producing machinery and automobile parts. On the side, he takes care of several rental properties he had inherited from his grandfather, each of which comes with its own list of weekly headaches. He has thought multiple times about just selling the properties – but after inheriting them nearly three decades ago, they had appreciated significantly in value, and the overall financial losses he would incur seemed substantial. He would also need to consider how throwing away the family investment might negatively impact his retirement, cutting him or his potential heirs out of a passive source of income.

He turned to his friend, Armin, who had investment property of his own, and ran another business in the nearby industrial park. Unlike Marco, Armin rarely seemed to struggle with difficult tenants or maintenance costs. Marco was surprised to learn that his was because Armin hadn't actually managed any of his investment properties in nearly a decade.

Instead, he turned to a financial planner for help, and learned about Delaware Statutory Trusts (DST), which would allow him to reinvest in the proceeds from a single investment property into partial ownership on multiple high-quality properties, while deferring taxes, maximizing the equity of his previous investments, and wholly removing the headaches and risks associated with directly owning and managing rental properties.

Through DSTs, all Armin had to worry about was what to do with his regular distributions. He could either cash out or reinvest them into other DSTs to continue to reap the benefits of the tax deferment.

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After listening to his friend, Marco decided he needed to learn more about what DSTs were, and whether they might be just the thing he was looking for.

What is a Delaware Statutory Trust?

A Delaware Statutory Trust is a separate legal entity (a trust) created for the express purpose of holding investment real estate "in trust" for multiple participating investors, under the management of a trustee (either an individual or a firm). While it is called a Delaware Statutory Trust, it is not exclusive to the state of Delaware, and applies throughout the US. It is named after the Delaware Statutory Trust Act of 1988, under which statutory trusts became legal entities within their own right, free from corporate law, and independent from their managing trustees. Like an LLC or a limited partnership, a statutory trust or business trust can be structured to benefit all those involved while providing liability protection, as management over the trust is separated from ownership.

The Delaware Act saw to it that these statutory trusts would allow beneficiaries to benefit from the trust while enjoying the same limited liability granted to stockholders in a Delaware corporation.

In the context of real estate investments and 1031 exchanges, a Delaware Statutory Trust is an investment trust wherein the trust acquires and holds securities, residential real estate, and commercial real estate, while allowing investors to purchase a beneficial interest in the trust and thereby become beneficiaries of said trust. Through a Delaware Statutory Trust, an investor can purchase and hold interest in investment real estate without directly managing or owning said property, thereby limiting their liability and allowing for greater diversification, while still greatly benefiting from the quality of the trust's investments.

IRS Revenue Ruling 2004-86 enabled eligible DSTs to exchange property under the rules of the 1031 exchange, so long as the same rules are respected as in other 1031 exchanges. In the eyes of the IRS, holding interest in a DST indirectly equates to holding a title on real estate – but instead of managing a property

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directly and solely, and holding onto all the risk, investors can limit their liability and take advantage of the trust's ownership structure to purchase and hold much higher quality real estate despite smaller starting capital. The exchange occurs after the sale of the DSTs contents – managing trustees give investors the option of either cashing out, or reinvesting their distributions into another DST.

When looking into DSTs, it is important to understand the basic structure of the trust and keep in mind one's responsibilities and liabilities. Investors who buy into a DST can receive distributions – these count as income, and may occur in the form of rental income, or income generated from sales proceeds when an investor decides not to reinvest their interest in the trust. Like any business, both profits and losses can occur. In the case of losses, however, each investor has limited liability – this means distributions are not guaranteed, but the investors themselves do not need to shoulder the responsibility of a failed investment, as they do not actually hold any title to the properties within the trust.

Actual management of the property is also limited. Each investor acts as a beneficiary to the trust, but the management of the trust and its contents is a job left to the trustees, who deal with the ongoing responsibilities of property management and upkeep, as well as the sale and exchange of properties.

When an investor decides against an exchange and takes home their share of the profits, those profits are taxed as income. The interest you hold in the trust will determine what distributions you earn and choosing not to reinvest these distributions means receiving them as income. This counts as a taxable event.

While trustees manage and control the DST, they are greatly limited in their actions by both their fiduciary duty to each and every beneficiary (investor), as well as the prohibitions and rules dictated by the IRS through the Revenue Ruling 2004-86. Breaking any of these rules can lead to very severe consequences for the trust, and those who hold an interest in it. Basic rules include upholding responsible management and acting in the interest of the beneficiaries, but there are seven so-called cardinal sins that must be heeded and avoided.

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Seven Simple DST Rules

These rules are outlined to protect beneficiaries from maligned or misguided trust management, ensuring that a DST continues to exist for the purpose of benefiting its beneficiaries (its shareholders, effectively). These rules are:

- There is a limited period during which a DST can accept contributions. After this period (offering), no future contributions can be accepted from neither current nor new investors and beneficiaries.

Very simply, any investor purchasing an interest in a DST is effectively purchasing a percentage of ownership in the trust. Any contributions made to the DST after the initial offering would only serve to dilute that percentage for every other investor. Future contributions might be considered to save a dying fund, but it is unlikely at that point that such contributions would help the trust turn a profit. In general, all the equity generated by the trust should come from income generated by its investments, and growth generated by the continued exchanging of investment properties as per the rules of a 1031 exchange.

- Managing trustees of a DST cannot renegotiate existing loans nor create new loans (i.e., no borrowing of funds from other parties, no creating new liabilities).

Investors buying into a DST must do their due diligence to understand the risks and liabilities the trust itself faces. These liabilities may not translate directly onto them, but they do translate into the trust's potential to turn a profit, and thereby one day provide distributions. It makes no sense to invest in a trust with liabilities it cannot pay. Therefore, trustees are prohibited from expanding or creating new liabilities after investors have begun buying into the trust.

This is because trustees, as the managing party of the trust, must act in the interest of their beneficiaries, as these have no say in how the trust is managed. Creating new liabilities after a beneficiary has already decided to invest in the DST would effectively be acting against the beneficiary's interests. Sure, there is

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the possibility that taking out another loan could help the trust survive. But that possibility represents a risk, a risk of even greater liabilities that would guarantee the trust's demise, risk that the investor had no chance of considering before they bought into the trust.

- A DST cannot directly reinvest sales proceeds into another investment property.

This portion might seem contradictory, but it's important to bear with us here. Trustees managing a DST must give each beneficiary the choice to cash out or reinvest.

In this case, investors are given the option of simply reinvesting their interest in the trust into another DST. The previous DST's sponsor will create a new offering, and each co-investor and beneficiary is given the choice of simply transferring their interest into said DST rather than receiving the distribution as income.

Alternatively, each investor can decide to reinvest their income into a completely different DST, or purchase like-kind property of their own, and complete their own 1031 exchange. This flexibility is an important part of what makes a DST such a reliable and effective investment vehicle, as it can suit the needs of many kinds of investors, each with different goals.

- The managing trustees are limited in their expenditures to manage the properties within the trust and may only a.) utilize capital for repair and maintenance, b.) minor improvements (non-structural), and c.) expenditures required explicitly by law.

This rule effectively limits how a trustee manages the properties within the trust to minimize expenditures and risk. In essence, this limitation is meant to ensure that the trustees do not create additional risk by making improvements that the property may not be able to recoup. By keeping improvements and expenditures to a conservative minimum, trustees reduce risk and maximize the longevity of the investment.

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- Liquid cash held by the trust between distributions can only be reinvested through short-term debts.

The point of a DST is to generate a profit that can be paid out to its beneficiaries. If such a profit is held in cash form before the next distribution date, it can be invested in order to create an even greater distribution — but only through low-risk short-term debt obligations.

These provide little to no risk of a change in value for the DST, while allowing managing trustees to further increase the value of the trust, and thereby create even larger distributions for the trust's beneficiaries, without endangering their investment. Long-term debt obligations, on the other hand, open the trust up to further liabilities (as it is uncertain whether they can be fulfilled before the distribution date), and are thus avoided.

- The trust can only hold cash reserves necessary for repairs and unexpected costs. The rest must be distributed to investors within the expected timeframe.

This rule effectively clarifies that a trust's managing trustees are limited to holding only minimal cash reserves to ensure that the properties in the trust can be repaired and maintained, both as part of regular upkeep and for emergency situations. All other cash must be kept safe for distributions, aside from short-term debt obligations designed to create value with little risk. In other words, it continues to define the limits of a trustee's expenditures within the trust and define the trustee's priorities as ensuring that the investors maximize their profits.

- Managing trustees in a DST cannot renegotiate leases or enter new ones.

Trustees in a DST will usually focus on acquiring and managing properties with long-term commercial and residential leases, such as hospitals and healthcare providers, corporate offices, and master leases for landlords managing student and senior housing, multifamily apartments, and the hospitality industry.
These strong multiyear leases provide much lower risk and greater long-term profitability than year-to-year leases, which may be much more volatile, and

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produce more vacancies. Master-lease structures mean that the burden on paying the lease lies with the landlord, and the risk of vacancies does not directly translate to lower income for the trust.

Because this rule forces trustees to rely on secure leases only, investors can be assured that their investment won't ride on the fickle nature of a short-term lease. Should a long-term lease be prematurely canceled due to insolvency, an exception may be made to try and secure another lease.

The primary role for each of these rules is to prevent a trustee from overstepping against the common interest of the trust's beneficiaries, and to prevent trustees from invalidating a DST's qualifications for a 1031 exchange. What makes DSTs different from other trusts is that they allow investors to buy interest in real estate that can benefit from the equity-sparing tax-deferral benefits of a 1031 exchange, without taking on the considerable risk and responsibilities associated with controlling and wholly owning investment real estate (such as rental properties).
DSTs can be converted into springing LLCs in cases where these seven rules are restricting the DST from potentially saving its beneficiaries' investments. Under such circumstances, the distributions made by the trust CANNOT be reinvested without incurring capital gains taxes, meaning the tax deferral benefits of a DST vanish, but it may still be a good idea to consider converting failing DSTs into LLCs to give trustees greater flexibility in negotiating new leases or securing new funds in order to evade substantial losses.

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DSTS VS. TICS. VS. REITS

DSTs vs. TICs

Before the IRS changed the rules in the early 00s and before the Great Recession of 2008, real estate investors who utilized 1031 exchanges to grow their wealth would rely on tenant-in-common (TIC) structures to achieve partial ownership of a high-value property. The main benefit of being a co-investor through a TIC was that you could work together with other investors to purchase and own property that would otherwise be out of your financial reach, and thereby achieve an annual growth rate you might not otherwise be able to conceive. But this method had and continues to have considerable drawbacks and trade-offs, particularly for investors. The biggest drawback was the fact that every investor in a TIC property held a deeded title to the property. This meant more responsibilities and liabilities than with more modern DSTs. Some of the other advantages of a DST over a TIC include:

DSTs do not require a long decision-making process through unanimous approval. Unlike TICs, which require that all investors come to a total agreement on nearly any major decision regarding the investment (as each investor is a co-owner of the property in their own right), DSTs sign over all decision making to a fiduciary trustee, who acts under limited restrictions to do whatever is necessary to maximize the profits of the trust, make the most of the investment, minimize or eliminate risk, and act in the interest of each beneficiary.

DSTs are easier to finance and require lower financial commitments from each involved beneficiary (investor). DSTs can have hundreds of beneficiaries, but the managing trustees are a small party of people, often represented through one individual or firm. It is much easier to secure financing for a single trustee than in a TIC involving over two dozen independent investors (a limit of 35), each of whom must be approved before a loan can be given. Similarly, because far more beneficiaries can buy into a DST, DSTs are generally cheaper to invest into (i.e., they have a lower minimum investment).

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DST investors are not directly involved nor liable for loans and enjoy limited liability. The investor's role in a DST is to buy interest in the trust and act as a beneficiary. Their interest is represented by a trustee. Like an LLC, investors enjoy limited liability and are not personally responsible for loans and carrying risk. Even if the trust fails and becomes insolvent, the absolute worst case is that an investor would not receive back their initial investment. The most they would have to lose is whatever they invested in the first place. Contrast this to TICs, wherein each investor/co-owner can have much more skin in the game, unless an LLC is set up.

DSTs do not require the setup of an LLC. TICs may set up an LLC to protect each co-owner from personal liabilities, but setting up an LLC can incur major costs, both initially and through maintenance (annual costs and dissolution fees). DST investors need only worry about the costs of an LLC in cases where a trust is truly reaching rock bottom, and exceptional measures need to be taken to save the investment.

Investors involved in a DST do not need to front the closing costs for the exchange. Whenever a property is sold, there are closing and sales costs to consider. Realtors want to be paid, and there are other upfront expenditures that cut into the property's equity. Investors do not need to personally contribute to these expenditures, unlike in a TIC, where each investor might need to additionally pitch in several thousand dollars to finance the closing of their property before they can transfer and reinvest their interest.

DSTs do not have the same one-year term limits as TICs. Trusteeships involved in a TIC must be renewed every year. DST trustees can continue to manage a trust for years, which reassures lenders who prefer that the sponsor they negotiated with continues to play a role in managing the investment and paying back the loan.

DSTs vs. REITs

Real estate investment trusts (REITs) are another type of investment trust that can be used to allow multiple investors to pitch into a real estate investment and enjoy the

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benefits of limited personal liability, and no direct management requirements. As with a DST, in an REIT the trust itself owns the property, and is managed through a fiduciary. The beneficiaries of the trust are the investors that bought an interest in it, much like shareholders of a corporation. Upon turning a profit, the REIT distributes income to each investor, according to their share.

The main difference is investors in an REIT do not hold title the same way investors in a DST do. While DSTs allow investors to hold interest in the title of investment real estate, and thereby benefit from the tax deferral made possible through a 1031 exchange, the investors (or shareholders) of an REIT do not hold any direct interest in the property owned by the trust and cannot make use of the same tax deferral benefits. This might seem like a minor difference, but it is the main difference that disqualifies REITs from 1031 exchanges. REITs remain a viable option for investors who are not interested in keeping their investments inside real estate – but are ill-suited to investors looking to defer capital gains taxes.

If you are looking for tax deferral, DSTs are your best option. Much like an REIT, a DST can:

- Remove the need for direct operational decision-making.
- Remove the need to manage property and tenants.
- Provide interest in a title, but not a deeded title, limiting risk without the need to create an LLC.
- Distance the investor from the lender, thereby eliminating the investor's past and capital for consideration of the loan.

DSTs as a Backup

DSTs can act as a sort of insurance policy to real estate investors who are already in the process of transferring their investment through a 1031 exchange by guaranteeing that none of their investment funds will be subject to capital gains tax, by securing additional options through a DST.

DSTs can be bought into in as little as three days and give investors the option of

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placing their investment funds in a DST with like-kind property if their first options for reinvestment fall through before the end of the identification period.

One of the pitfalls of the delayed 1031 exchange process is that the identification period may be too short to find the right property. A DST can be a backup option if you fail to find property to reinvest into in order to complete your exchange, so you can rest easy knowing that no matter what, you will be able to defer your capital gains taxes and make the most of your money.

DSTs can also help 1031 exchange investors avoid boot, which may invalidate their exchange and open them up to a taxable event.

Say you found the ideal investment property, but after taking all financial decisions into account, you realize that it would only cost you about half of what your previous investment was worth, and if you don't find another property to invest into, a portion of your sales proceeds will become taxable. Rather than spending that portion on a mediocre last-minute investment you might not necessarily want, you could invest it into a DST and ensure that every penny of it goes towards your interest in high-quality investment real estate, without incurring any taxes.

By treating DSTs as an alternative to property you might not be able to invest in, or an alternative to dump an excess cash boot into to avoid unnecessary capital gains taxes, you can effectively utilize them as an insurance policy and diversify your investment portfolio in one fell swoop.

Diversification in 1031 Exchanges

Speaking of diversification, the ability to split your sales proceeds among multiple different properties in different locations and of different classes is one of the other great benefits of a 1031 exchange, and a DST in particular. While 1031 exchange rules dictate that you must invest in like-kind property, this just means that the proceeds from the sale of investment property or business property must go towards the purchase of another investment or business property, rather than a personal residence or some other investment.

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This means you can effectively split the proceeds from the sale of your single largest asset between different assets to avoid having all of your eggs in a single, risky basket. Bringing diversity into your portfolio naturally reduces the risk of capital loss.

Rather than losing part of your sale proceeds to taxes due to investing in several different lower-value properties with diverse tenants, purposes, and locations, you can place the remainder in a DST and completely avoid a taxable boot.

Or you could place the entirety of your investment capital from the sale of your asset into one or more DSTs and obtain interest and distributions from the income of several high-quality investment properties that you would otherwise be unable to invest into — all while further reducing personal liability and distancing yourself from the managerial responsibilities of full ownership. By investing into a DST with a minimum of $100,000, you can acquire interest in a property worth many times that, and still afford to invest in several other DSTs or lower-value properties of your choice.

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SECTION 4:

WRAPPING UP

After learning about 1031 exchanges, Judy realized that she would be able to defer the substantial capital gains taxes and depreciation recapture on her late husband's property, by learning how to qualify and repurpose the long-used second home into residential rental property and exchange it for other like-kind property that might serve as a better investment for her retirement.
Marco learned, through his friend, that a DST would allow him to reinvest the equity of the properties he had inherited years ago into a trust that would allow him to continue to claim income on his investment without the risk of direct ownership, and the headaches that come with managing multiple rental properties and finding good tenants.

1031 exchanges and DSTs can help countless investors and property owners find a better way to manage their wealth and turn headaches and liabilities into paying retirement plans. Now Marco could focus wholly on his business and his family and leave something behind for his children, while Judy would be able to save up for retirement and repurpose a lodge she hadn't used for years into a sense of financial security.

How Breakwater 1031 Can Help You

Whether your investment is eligible for a 1031 exchange, or you are simply interested in sensibly transferring capital into investment real estate and want to learn more about the ins-and-outs of the process, it's important to partner up with a firm that not only offers 1031 exchange services but specializes in them.

Breakwater 1031 will work with you to create a comprehensive investment plan that incorporates DSTs into your portfolio, helping you diversify your investments, minimize risk, and maximize profits. Whether you're saving up for retirement,

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are tired of dealing with tenants, or want to ensure that you can leave something behind for your children, Breakwater 1031 offers an exclusive focus on 1031 exchanges and DSTs to your benefit.

As a smaller firm, we also assure you that our attention on you and your financial interests is undivided. We pride ourselves on providing financial planning and advisory services that allow us to put the best of our talents to work for our clients. Through Breakwater 1031, our clients can browse and explore the DST investment market, close in as few as three days, and work hand-in-hand with us to ensure every last step of the process goes by the book. We work hard, so you don't have to. For more information or an initial consultation, do not hesitate to contact us through (310) 940-9430, or visit breakwater-cap.com.

At its heart, real estate investment is still speculatory in nature, and even the most calculated and lowest risk investment has no guarantee of going as planned. Losses are always a possibility. No investment is absolute or sure. In the case of DSTs, an investor's interest in the trust counts as a private placement of securities and is thus only accessible to accredited investors. The requirements for being an accredited investor differ and are largely based on income and net worth.

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Appendix: Common Terms and Definitions

1031 Exchange: A 1031 exchange is a tax-deferred sale and acquisition of investment property as per the rules and regulations outlined by Section 1031 of the Internal Revenue Code. Under normal circumstances, the sale of property would result in a taxable event, recapturing depreciation deductions and taxing capital gains. But by wholly reinvesting the equity of sold property into like-kind property of equal or greater value, an investor can defer these taxes.

Accommodator: An alternative term for a Qualified Intermediary (QI). See definition below.

Adjusted Cost Basis: An alternative or expanded term for Adjusted Basis. See definition below.

Agent: Someone who acts on behalf of you. Usually named and given certain privileges through a power of attorney document.

Adjusted Basis: The original basis of a property, plus the cost of capital improvements, minus depreciation.

Asset Class: The broad characterization of investment real estate. Different examples of asset classes include retail property, raw land, student housing, healthcare property, and so on.

Appreciation: Real estate can appreciate through improvements or changes in the value of the land or surrounding area. Appreciation is measured through an increase in price. The goal of real estate investment is, usually, to realize appreciation and create a profit.

Basis: The purchase price of a property.

Boot: Assets, non-like-kind property, and cash received during the exchange. This includes a lowered debt, as the IRS recognizes this as income. A boot is

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generally not wished for as it incurs a taxable event, and steps should be taken to separate it from the replacement property.

Build-to-Suit Exchange: A tax-deferred exchange wherein the replacement property must be improved or altered to qualify for tax-deferral (by raising the value of the replacement property or changing its purpose).

Business Assets: Any type of property or asset included in a business. Section 1031 does not cover nor allow the exchange of businesses – only property.

Capital Gain: The difference between the selling price of a property and its adjusted basis is either capital gain or capital loss. Capital gains are taxed based on whether they count as short-term or long-term gains and depending on the seller's income tax bracket.

Capital Improvements: Improvements that permanently raise the value of a property rather than just maintaining or repairing it. Capital improvements increase the basis of a home (leading to an adjusted basis). They are also a primary means of achieving appreciation.

Cash-On-Cash: Annual net cash earned through a property versus total cash invested, not including appreciation. This value is expressed as a percentage.

Collectibles: Collectibles can be exchanged through Section 1031 of the Internal Revenue Code, same as investment property. Collectibles are defined as personal property held for investment purposes and are usually taxed at a higher capital gains tax rate than other assets.

Commercial Mortgage-Backed Securities (CMBS): These are tradable financial instruments with a fixed-income that are backed/collateralized by mortgages (loans) on commercial real estate.

Community Property: Community property is property acquired and co-owned by a husband and wife during marriage, in community property states.

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Property acquired before marriage is separate property. Separate property can be transmuted into community property. Inheritances received by one spouse remain separate property even during marriage.

Concurrent Exchange: A tax-deferred exchange of like-kind investment property occurring without a delay, through the physical swapping of deeds.

Constructive Receipt: A concept whereby taxpayers may continue to be held accountable for property that they no longer directly own, but still control. An example of constructive receipt would be controlling property held in a revocable trust, which may be exempt from probate, but will continue to count towards the value of a person's estate.

Delaware Statutory Trust (DST): A statutory trust or business trust that holds property for up to 499 accredited investors. All investment property held in a DST is controlled and managed by its trustees, and all investors have limited personal liability, while earning distributions on the sale proceeds of the property representative of their share of the trust. Proceeds from a DST can be held and reinvested into another trust, without incurring capital gains taxes on the investment.

Delayed Exchange: A tax-deferred exchange of like-kind investment property occurring over a set period, as per the Internal Revenue Code. Delayed exchanges must begin and conclude over a maximum period of 180 days after closing (selling) the relinquished property.

Depreciation: The loss of value over time, usually due to wear-and-tear and a property's usable life.

Depreciation Recapture: Taxable gain calculated based on depreciation expenses previously deducted by the investing taxpayer.

Equity: The value of an investment property, minus any outstanding liabilities.
Exchange Period: A period of 180 calendar days after the closing of a relinquished property wherein the investor can complete their purchase/acquisition of a

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replacement property, within the rules of the 1031 exchange.

Exchanger: The investor selling relinquished investment property and transferring the proceeds through a middleman into the acquisition of replacement property to maximize the equity of their investment and defer taxes. An exchanger may also be a legal entity, LLC, or business.

Excluded Property: Property that does not count as like-kind investment property for the purposes of a 1031 exchange, such as bonds and stocks, personal property, property owned for own use, and more.

Fair Market Value: The price at which a property would be sold if both parties are given ample time to negotiate and research all the facts and come to an agreement without coercion or pressure from either side.

Fractional Interest: A partial interest in a single property (such as through a trust or tenancy-in-common).

Identification Period: The 45-calendar-day period after the closing of a relinquished investment property wherein the investor must identify a potential replacement property to complete a 1031 exchange.

Intermediary: An alternative term for a Qualified Intermediary (QI). See definition below.

Internal Revenue Code 1031: The section of the IRS's Internal Revenue Code that details how a tax-deferred exchange of like-kind investment property may be executed.

Improvement Exchange: An alternative term for a Built-to-Suit Exchange. See definition above.

Like-Kind Property: Vaguely defined by a property's intended use, rather than class or quality. For example, like-kind property in a 1031 exchange must be other

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investment real estate. You can exchange across asset classes and real estate grades.

Loan-To-Value (LTV): The ratio of a loan to the property's value, expressed as a percentage.

Mixed Property (Multi-Asset) Exchange: An exchange that mixes several types of property (such as investment real estate, personal property, and financial instruments), rearranged so like-kind property is exchanged for like-kind property to mitigate the tax impact.

NNN Lease Investments: Also known as a triple-net-lease investment. In a triple-net-lease investment, the owner is only responsible to pay off the mortgage on their property. The tenant is responsible for everything else.

Partial Exchange: A 1031 exchange that still incurs a tax liability due to non-qualifying elements in the exchange, such as financial boot or non-like-kind mixed property.

Personal Property Exchange: A 1031 exchange (like-kind, tax-deferred exchange) of personal property, rather than real property. Examples include the exchange of collectibles for collectibles.

Principal Residence Exemption: When selling your principal residence, the IRS allows you to exempt $250,000 from your capital gains for tax purposes ($500,000 for couples filing jointly). There are specific requirements for a property to be one's principal residence.

Qualified Intermediary (QI): Any person who facilitates the sale of relinquished property and acquisition of replacement property on behalf of the exchanger. The qualified intermediary must hold the sales proceeds of the relinquished property in escrow for the exchanger and must not be in any way affiliated to either party. QIs are entitled to an exchange fee.

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Qualified Use: Defines the requirements property must fulfill for a 1031 exchange. Examples include intent of use, such as holding property for investment and income production rather than personal use.

Real Property: Broadly speaking, real property consists of lands and buildings, either separately or together. State law further refines that definition.
Real Estate Exchange: An alternative term for a 1031 Exchange. See definition above.

Relinquished Property: The property an exchanger is selling.

Replacement Property: The property an exchange is buying.

Reverse Exchange: A 1031 exchange wherein the accommodator purchases and holds property in the interest of the exchanger before they have sold their relinquished property. In these cases, the exchanger will usually provide a loan for the accommodator to purchase and hold the replacement property until the exchange is complete.

Securitization: The practice of pooling different types of debt into a tradable financial instrument. Because the nature of individual debts bundled into a single security can differ, the nature of investing and trading in securities can be volatile, without significant research and due diligence.

Simultaneous Exchange: An alternative term for a Concurrent Exchange. See definition above.

Starker Exchange: An alternative term for a 1031 Exchange. See definition above. Based on the Starker v. United States case that led to the creation of Section 1031.

Tax-Deferral: Postponing taxes to a later time, usually another taxable event. Taxes owed on capital gains can be deferred through a 1031 exchange.

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Tax-Deferred Exchange: An alternative term for a 1031 Exchange. See definition above.

Tenancy-In-Common Interest (Co-Tenancy): Interest in property co-owned with other investors. TIC exchanges were popular for a time as a way to split the cost (and income) of a high-quality investment real estate, allowing several smaller investors to pool their resources and benefit from better, lower risk investments. However, TIC exchanges still bear considerable risks and drawbacks compared to modern alternatives like the DST.

Three Property Rule: One of the major rules to follow during the identification period of a 1031 exchange. This dictates that an investor can narrow their choice down to up to three different properties to acquire as replacement property in an exchange, regardless of their fair market value.

The 200% Rule: One of the major rules to follow during the identification period of a 1031 exchange. This dictates that an investor can choose an unlimited number of properties, so long as the total value of their choices combined does not exceed 200 percent of the relinquished property's fair market value at the end of the identification period.

The 95% Rule: One of the major rules to follow during the identification period of a 1031 exchange. This dictates that the taxpayer can identify as many properties as they like, so long as they acquire 95 percent of the total fair market value of their picks.

UPREIT: UPREIT means Umbrella Partnership REIT. An REIT is a Real Estate Investment Trust. An UPREIT allows the exchange of investment property for an equal value of shares in an REIT. In this specific case, the property is added into the trust, and the investor receives shares equal to the value of their contribution, versus the total value of the trust. There are pros and cons to an UPREIT, including potential for greater diversification, as well as the greater risk associated with the stock market.

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Yield: The return on an investment (ROI). In cases of investment real estate, yield usually refers to the effective annual income or cash flow of an investment property, versus the cost of the property. Yield can be represented in different way, including cash-on-cash (see above).

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