# Deferred Exchanges

## 1031 and 1031-to-Fund

# 1031 Exchange Basics

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## How it Works

Under Section 1031 of the Internal Revenue Code, if certain criteria are met, capital gains taxes can be deferred when an investment property is sold, as long as the proceeds are reinvested into a similar "like-kind" property within a specific timeframe.

- Replacement property has a reduction in basis as a result of the deferred gain
- Both properties in an exchange must be held for use in a trade or business, or for investment. Property used primarily for personal use, like a primary residence, second home, or vacation home, does not qualify for like-kind exchange treatment.

## Tax-Deferred, Not Tax-Free

- A like-kind exchange under IRC Section 1031 is tax-deferred, not tax-free.
- We caution any investor to be very wary of real estate schemes that refer to “tax-free” exchanges.

## “Like-Kind” Property

- Like-kind property is property of the same nature, character, or class. Quality or grade does not matter
- Property within the United States is not like-kind to property outside of the United States.
- Improvements that are conveyed without land are not of like-kind to land.

## Safe Harbor Exchange Timeline (Forward Exchange)

- The investor has 45 days from the date they sell the relinquished property to identify potential replacement properties.
- The replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier.

# The 1031 Exchange Process (*Simplified*)

Before closing on the property you want to sell, you will **find a qualified intermediary** to help you with the exchange.

At closing of the property you are selling, the buyer will pay the proceeds to your intermediary and they will **put that money into your exchange account.**

You have **45 days to identify** your three replacement properties and **180 days to close.**

At closing on the replacement property, your intermediary will **wire the proceeds directly from your exchange account.**

You must **report the exchange to the IRS** in the year it took place. If there are excess proceeds distributed back to you then that will be taxable "boot" to you.

# 1031-to-Fund Strategy

## What is it?

- In a 1031-to-fund strategy, the proceeds from the sale of the property are reinvested into TIC, which is considered a replacement property.
- This option is attractive to real estate investors who would like to continue tax benefits, but don’t want to manage investment property.
- TIC involves direct ownership with shared management and decision-making among co-owners.

## Why use this strategy?

- **Deferred taxes:** By utilizing the 1031-to-fund strategy, the investor defers paying capital gains taxes on the sale of the original property.
- **Diversification:** Investors' money goes into a fund with various types of real estate assets across different locations.
- **Limited risk:** Investors' risk is confined to their investment in the fund; they're not personally liable for any debts.
- **Income:** Investors receive passive income from the properties held within the fund.

## What is a Tenant-in-Common (TIC)?

**Ownership sharing:** TIC lets multiple people own property together, like offices or apartments.

- Each owner is called a tenant-in-common and can use the whole property, not just part of it.
- Every TIC owner has their own share that they can sell, pass on, or buy more of.
- TIC comes with a written agreement that spells out who does what, how bills get paid, who gets the money, and how shares are sold or given away.

Careful consideration must be given to all steps of these processes. Please consult your own tax professionals before implementing these strategies..

# The 1031-to-Fund Process (*Simplified*)

The investor **sells a property** and generates capital gains from the sale.

However, to defer capital gains, the investor would follow the **1031-to-fund** process.

During the identification period, instead of identifying 3 replacement properties, our partners help the investor to find a replacement property which could be considered a tenant in common interest (TIC).

At a later date, (usually 6 months later) the investor contributes their TIC interest into **a closed end real estate fund** in exchange for units in the partnership.

Investors benefit from **professional management, diversification, and proportionate economic benefit** in the partnership.

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# 1031-to-Fund Strategy Considerations

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## Financial Considerations

- Capital commitment: Investors agree to put in a fixed capital commitment amount, which would be the fair market value of property at exchange date. They can choose to add more later if they want.
- Capital rebalancing: The nature of a fund allows for multiple capital closes and a change to commitments over time. At the end of the fund raising period the fund becomes fixed. Early investors in a fund may receive some interest.
- Income and expenses: Investors are responsible for their share of income and expenses from the beginning.
- Distributions: Distributions will follow the provisions contained within the limited partnership agreement, including their initial investment, excess income, and possible preferred return.
- End of fund life: At the end of the fund life, investors will receive their proportionate share of excess proceeds based on their final capital commitment percentage.

## Tax Considerations

- **Exchange requirement:** Investors must finish a Sec. 1031 exchange within a certain time and use proceeds held in escrow.
- **Timing regulations:** There's no bright line date required between buying TIC property and contributing it to the Fund.
- **Property contribution:** TIC property is added to the Fund at its current fair market value.
- **Lower basis:** The investor's starting value for tax purposes is reduced. The reduced value is the fair market value of their TIC interest minus any gain deferred.
- **Income and expenses:** Investors will be allocated their proportionate share of income and expenses from within the fund, on a K-1, from the year of contribution into the fund until the year of liquidation of their fund interest.

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