

1031 Exchange Transaction



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Why should I consider a 1031 Exchange?

Currently, the seller of a property used for business, income or investment purposes can be taxed from 15% up to 20% at Federal level, plus 3.8% (ObamaCare tax aka NIIT) surtax, plus Depreciation Recapture at 25% rate plus your home state's Income Tax rate (ex: CA = 13.3%, CO = 4.25%, TX = 0.0%) for a **total, effective capital gains tax rate of approximately 30% - 40%**.

ADVANTAGES AND DISADVANTAGES OF A 1031 EXCHANGE

The primary advantage of completing a 1031 Exchange is that, through the deferment of capital gain taxes, the seller/ exchanger can acquire more valuable and/or more leveraged investment properties. If seller/exchanger intends to reinvest the proceeds from a property sale into a real estate purchase, the 1031 Exchange can provide full tax deferment on the sale of property held for productive use in trade, business or investment. This tax deferment provides many benefits, including 100% preservation of equity.

Investors can take advantage of 1031 Exchanges to meet other objectives including:



- A. Leverage: Exchanging from a high equity position or "free and clear" property to a more valuable property, with financing, in order to increase the yield on investment.



- B. Diversification: Exchanging into other geographical regions or diversifying by property type, such as exchanging several residential units for a retail strip center and/or light industrial property.



- C. Management Relief: Relinquishing multiple owner-managed properties, then reinvesting in a replacement property, like a medical-office complex, with an on-site manager or a tenant-in-common ownership program.

Disadvantages are: proceeds from property sale must remain invested & there is a small fee.



What are the 1031 Exchange Structures?

There are numerous structures, however, the most common are the “delayed exchange” and the “reverse exchange”.



DELAYED 1031 EXCHANGE

Most 1031 Exchange transactions are structured as “forward” or “delayed” 1031 Exchange transactions, where the seller/exchanger relinquishes property first, then subsequently acquires and closes on replacement property within the prescribed 1031 Exchange deadlines. The “delayed exchange” is affordable and best suited for owners that have identified a motivated buyer for their current property.



REVERSE 1031 EXCHANGE

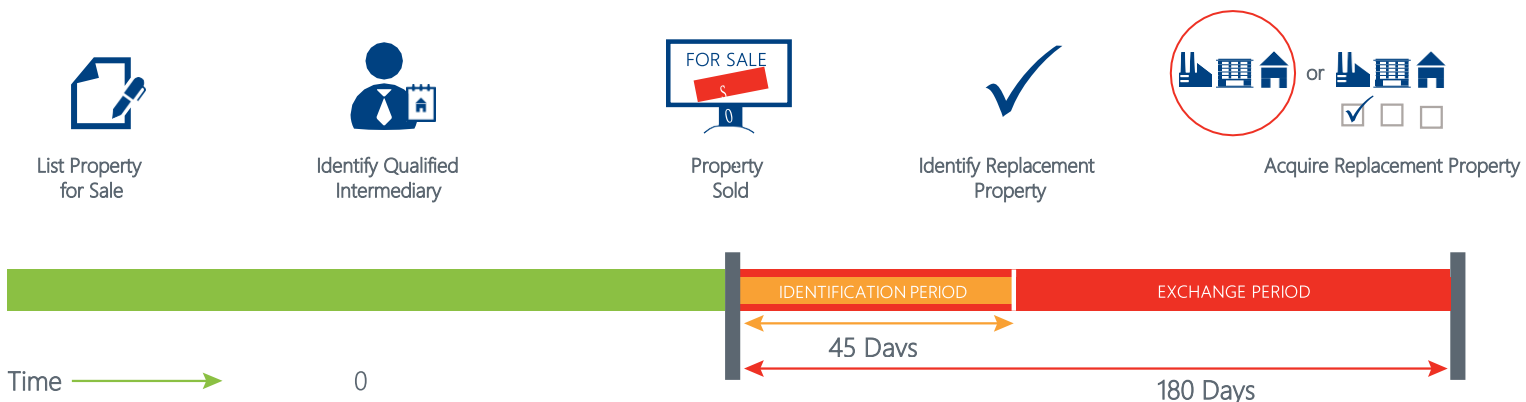
A seller/exchanger may either want or need to acquire a replacement property before selling a relinquished property via 1031 Exchange. This can be accomplished by structuring a “reverse exchange”. A “reverse exchange” is more expensive (up to 10X more charged by Q.I.), but is better for investors considering a specific property for purchase or if a viable, qualified buyer has not been identified. “Reverse exchange” transactions are structured pursuant to Revenue Procedure 2000-37.



What is the 1031 Exchange Process?

This process must be strictly adhered to, in order to avoid the wrath (and huge tax liability) of the IRS. The following dates, conditions and restrictions are not negotiable, and the IRS will not be 'flexible' with you. The following steps outline the delayed 1031 Exchange process.

1. A commercial real estate broker is engaged to procure a Purchase & Sale Agreement, which transfers the seller/exchanger's asset(s) to the buyer, also known as the "relinquished property" or "down-leg" transaction.
- 2a. Prior to the "down-leg" property closing, the seller/exchanger retains a Qualified Intermediary (Q.I.).
- 2b. Broker begins preliminary identification of the "replacement property" or "up-leg" asset(s).
3. At "down-leg" property closing, the exchange sale proceeds are wired to the designated Q.I. where funds are held temporarily.
4. Seller/exchanger completes the Identification of Replacement Property Exhibit and returns it to the Q.I. **WITHIN 45 DAYS** after sale of the relinquished property.
5. A **MAXIMUM OF 180 DAYS**, from closing date of the "down-leg" property, will be used to acquire "up-leg" asset(s).
6. At closing of "up-leg" property purchase, the Q.I. wires the exchange funds to complete the 1031 Exchange and defer 100% of capital gain taxes.





How does the identification and closing on the replacement property work?

There are several regulations that must be adhered to during the 45-day identification period for the replacement asset(s). The major IRS rules for seller/exchanger are listed below:

3-PROPERTY RULE

In most cases, sellers/exchangers use the “3-property rule”. The seller/exchanger may identify up to three replacement properties, and may acquire one, two or all three

200% RULE

If the seller/exchanger wants to identify more than three properties, they can use the “200% rule”. This rule states that the seller/exchanger can identify any number of replacement properties, so long as the total fair market value of replacement properties is not greater than 200% of the fair market value of the relinquished property.

95% RULE

Another uncommon strategy used by investors, the “95% rule” says that a seller/exchanger can identify more than three properties with a total fair market value in excess of 200% of the value of the relinquished property, but only if the seller/exchanger acquires at least 95% of the value of all properties identified. Essentially, the seller/exchanger must acquire every asset identified...the reason it is seldom utilized.

PROPERTY ACQUIRED WITHIN 45 DAY PERIOD

Any property that is acquired during the 45-day identification period is deemed to be “properly identified”. It is important to note that if a property is acquired during this period and another property is acquired later, using another 1031 Exchange identification rule, the property acquired during the first 45 days needs to be counted as an “identified property”.

For example, if the investor acquires one property during the first 45 days and plans to use the “3-property rule” and acquire more properties after the first 45 days, seller/exchanger can only identify two more properties, because seller/exchanger already used up one property.



MANNER OF IDENTIFICATION

The identification of replacement property must be made in writing, signed by seller/ exchanger and be unambiguously described. This generally means that the seller/ exchanger identifies the address, legal description, purchase price, building size, etc.

WHO MUST RECEIVE THE IDENTIFICATION?

The seller/exchanger must send the identification notice to either:

- A) The party obligated to transfer the replacement property to the exchanger (such as the seller of the replacement property) or;
- B) Any other person “involved” in the exchange (such as the Q.I., escrow agent or title company), other than a “disqualified person,” such as an agent or family member of the exchanger. Most identification notices are sent to the seller/exchanger’s designated Q.I.

REPLACEMENT PROPERTY MUST BE SAME AS WHAT WAS IDENTIFIED

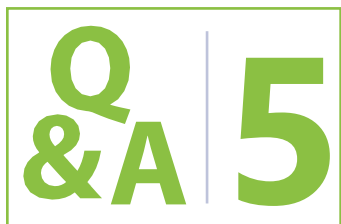
The seller/exchanger must receive “substantially the same” property as is identified. The IRS regulations contain examples to illustrate what “substantially the same” means. In one example, the seller/exchanger identifies two acres of unimproved land and then acquires 1.5 acres of that land. The property acquired is substantially the same because what the seller/exchanger received was not different in nature or character from what was identified, and the seller/ exchanger acquired 75% of the fair market value of the property identified. In another example, the seller/exchanger identifies a barn and two acres of land, but then acquires the barn with the land underlying the barn only. The IRS says that the property acquired was not substantially the same as the property identified because it differed in its basic nature or character.

PROPERTY TO BE CONSTRUCTED

If the replacement property is under construction at the time of identification, the seller/exchanger must include not only the address or legal description of the property, but also a detailed description of what is to be constructed.

REVERSE EXCHANGES

If the seller/exchanger is completing a “reverse exchange”, where the Q.I. acquires the replacement property before the seller/exchanger closes the sale of relinquished property, the seller/exchanger must identify, in writing, what seller/exchanger intends to sell and that identification must be sent no later than 45-days after the Q.I. closes on the replacement property.



Frequently Asked Questions?

The 45-day identification period, the process of Closing the 'up leg' acquisition does not differ from a typical commercial real estate investment purchase except all funds must be distributed by your Q.I. If you have questions, the following FAQs should be helpful.

HOW DOES THE CLOSING PROCESS OF THE "UP-LEG" TRANSACTION DIFFER FROM A TYPICAL PURCHASE?

Other than the 45-day identification period and requirement that all funds being distributed by the Q.I., the process of closing the "up leg" transaction does not differ from a typical commercial real estate investment purchase.

CAN I EXCHANGE AN LLC MEMBER INTEREST OR PARTNERSHIP INTEREST?

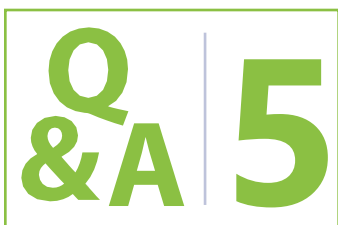
No, an LLC member interest, where the LLC elects to be treated as a partnership or a partnership interest, are considered personal property and cannot be exchanged. IRC Section 1031(a)(2)(D) specifically prohibits the exchange of partnership interests. However, an LLC or partnership (or any other entity) can complete a 1031 Exchange on the entity level, meaning the entire partnership relinquishes a property, stays intact and purchases a replacement property. If an individual is in a situation where some LLC members or partners want to complete a 1031 Exchange, but others don't, consult a tax or legal advisor to discuss the issues involved. Performing what are known as "drop and swap" or "swap and drop" alternatives may be feasible. In community-property states only, a husband and wife who are the sole principals of a two-member LLC may be considered a single-member disregarded LLC for federal tax purposes.

HOW LONG DOES A PROPERTY NEED TO BE HELD TO BE CONSIDERED "HELD FOR INVESTMENT"?

The central IRS issue is whether or not the seller/exchanger has the intent to hold for investment. There is no "safe" holding period to automatically qualify as being "held for investment". Time is only one of the factors the IRS considers in determining the seller/exchanger's intent. Every investor has unique attributes and circumstances, and it is up to seller/exchanger and their tax or legal advisors to substantiate that their primary intent was to hold property for investment purposes.

WHAT IS "LIKE-KIND" PROPERTY?

Any property held for productive use in trade/business or for investment can be exchanged for any other property held for the same purpose. These properties are considered "like-kind" to one another. Examples of "like-kind" investment real estate transactions include: exchanging unimproved for improved property; exchanging vacant raw land for a commercial building; or exchanging a single-family rental for a small apartment complex.



WHAT IS BOOT?

The “boot” is any unlike-kind property received by the seller/exchanger and is taxable to the extent there is a capital gain. “Cash boot” is the receipt of 1031 Exchange proceeds by the seller/exchanger. “Mortgage boot”, also sometimes referred to as “debt relief”, occurs if the seller/exchanger acquires less debt on the replacement asset(s) than seller/ exchanger had on the relinquished asset(s). “Cash boot” or “mortgage boot” can be

offset by the seller/exchanger adding outside cash to the replacement property purchase. If the seller/exchanger wants to receive “cash boot”, it must be received either at the closing of the relinquished property or after they have purchased all property they are entitled to under the exchange agreement, generally at the end of the 1031 Exchange period.

HOW IS THE CAPITAL GAIN TAX AMOUNT I OWE CALCULATED?

1. Calculate the net adjusted basis, by adding the original purchase price to any capital improvements and subtracting the depreciation taken.
2. Subtract the net adjusted basis and cost of sale from the current sale price to determine the capital gain.
3. The third step is determining the capital gain tax owed. Under this formula, the recaptured depreciation is all taxed at 25%. The remaining capital gain is taxed at either 15% or 20%, plus 3.8% (ObamaCare tax).
4. Finally, the state tax rate, when applicable, is also applied to the capital gain. All three of these amounts, the depreciation recapture, federal tax and state tax are added to arrive at the total capital gain tax due.

WHAT IS THE REQUIREMENT FOR FULL TAX DEFERRAL?

Seller/exchanger must reinvest all of the sale proceeds in “like-kind” replacement property and have the same or greater amount of debt on the replacement property. In other words, purchase a replacement property of equal or greater value than the relinquished property and reinvest all of the net equity.

ANY RECENT TAX LAW CHANGES?

The new Section 1031 law, effective January 1, 2018, eliminated the opportunity to defer taxes for transactions involving personal property. Always consult your tax advisor for to discuss any changes to that could impact your investment decisions.



Who should I contact to discuss how a 1031 Exchange will impact or complement my investment portfolio?



LOWREY BURNETT, CCIM

EXPERIENCE

Lowrey's extensive career consists of over 450 commercial real estate transactions. His core strength is representing office and industrial owners and occupiers of commercial real estate. His career began in 1998 in Dallas, Texas where he worked at the largest commercial real estate firm in Texas, Henry S. Miller Commercial. Lowrey later worked for one of the most successful privately-held commercial real estate investment firms, Gaedeke Group. Lowrey's final project in Dallas was with H.I. REIT as their Vice President responsible for the firm's Dallas real estate portfolio. In Denver, Lowrey worked as Vice President at Avison Young for over 6 years before he founded Fountainhead Commercial in 2019.

Lowrey received the distinguished Certified Commercial Investment Member (CCIM) designation in April 2014. CCIM is the global leader in commercial and investment real estate education and services.

EDUCATION

University of Kansas (USA) - Bachelor of Art in Communication Studies; Kanagawa University, Japan - Japanese Studies; CCIM Institute

AFFILIATIONS

CCIM - Colorado Chapter
Youth Basketball Coach
KU Alumni Association
Firestorm – Golden
Wheat Ridge Biz Assoc.
Golden Chamber
Front Range Bible
Saving Carolina Dogs
Freedom Service Dogs

SPECIALIZATION

- Investment Sales
- Tenant Representation (office/industrial)
- Landlord Representation (office/industrial)

NOTABLE CLIENTS (SELECTED LIST)

SourceCorp	Fina/Alon.
New Times Media	Teksystems
Wells Fargo	New World Real Estate
Viacom/CBS Radio	Primerica
First American Title Corp.	Max Radio of Denver
MacBain Properties Ltd.	Tata Consultancy
UFG Insurance	Medeiros & Son