WINTER 2021 | THE FAMILY OFFICE REAL ESTATE INSTITUTE MAGAZINE

FAMILY OFFICE REAL ESTATE *MAGAZINE*

The Launch of the Nations Only University Family Office Real Estate Program

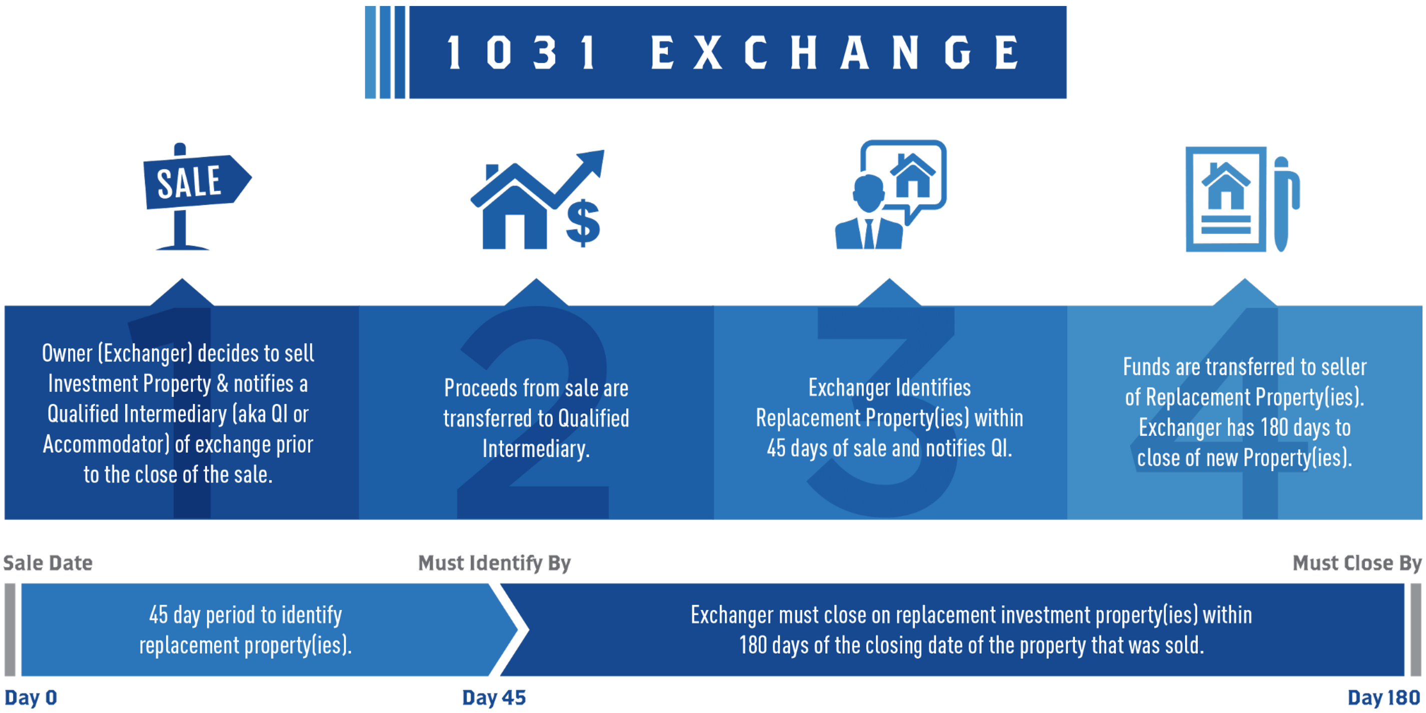
at the Franklin L. Burns School of Real Estate & Construction Management, University of Denver

FO RE

VAN KEUREN INSTITUTE *for* FAMILY OFFICE REAL ESTATE

1864

UNIVERSITY *of* DENVER



Section 1031 IRS Regulation - Tax Deferred Program

An Imperative Tax Strategy in Commercial Real Estate

By Richard Leider - Trinity Real Estate

Publisher's Insight: For the last two years, only 20% of family offices have utilized IRC rule 1031, known as a 1031 exchange. This investment and tax strategy is one that family offices need to used more readily. Here Richard does a good job at providing the specifics on 1031 exchanges. As one of the only companies that I have run across that focuses on real estate portfolios for family offices, this must-read article also gives some actual case studies.

Direct ownership of commercial real estate assets not only offers a well-established means to accumulate wealth but can also provide investors with the unique ability to defer taxes that would otherwise be due on gains from a property's sale. A 1031 exchange is the process of deferring capital gains taxes on a sold, directly owned commercial property by "exchanging" the sold property for a newly acquired property. However, the newly acquired property needs to meet the standards defined in *Section 1031* of the IRS regulations. The "*1031 exchange*"can provide material tax benefits resulting in significantly enhanced future income and value. In effect, if you sell a property and use the proceeds to purchase a like-kind property of the same or greater value through a*1031 exchange*, no taxes on the gain(s) are due or payable from the sale. To foster your understanding of the*1031 exchange* process, we provide below a high-level review of the rules, items for consideration, and family office investment examples of lessons learned along the way.

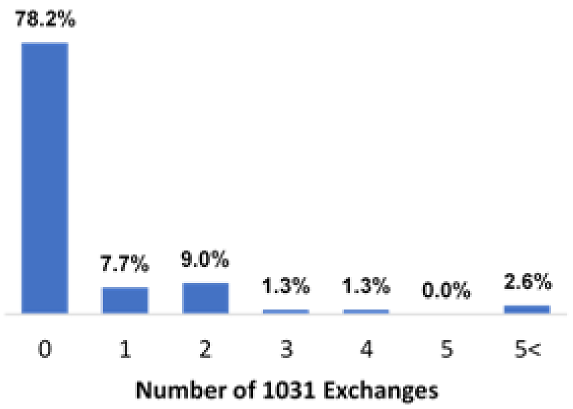
1031 EXCHANGE RULES

It is essential when implementing a *1031 exchange* to have a thorough understanding of all the related rules associated with this process. Missing any one of these can put the transaction at risk to become a taxable event. Several of the *1031 exchange* rules below are to

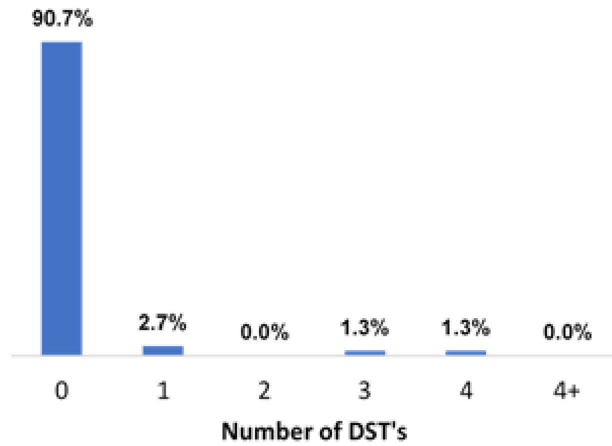
Family Offices and 1031 Exchanges

Tax efficiency has been high on the list for family office real estate investors.However, very few family offices have not taken advantage of one of the most important tax strategies in real estate – the 1031 exchange.

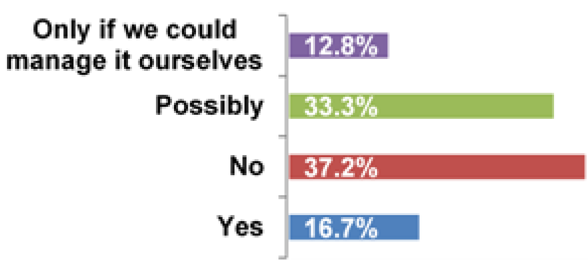
How Many 1031 Exchanges Were Completed By Family Offices In 2019



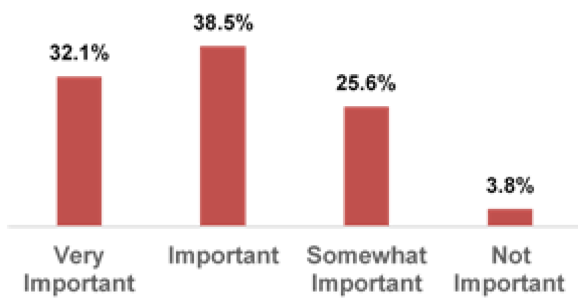
How Many Delaware Statutory Trusts (DSTs) Family Offices Completed in



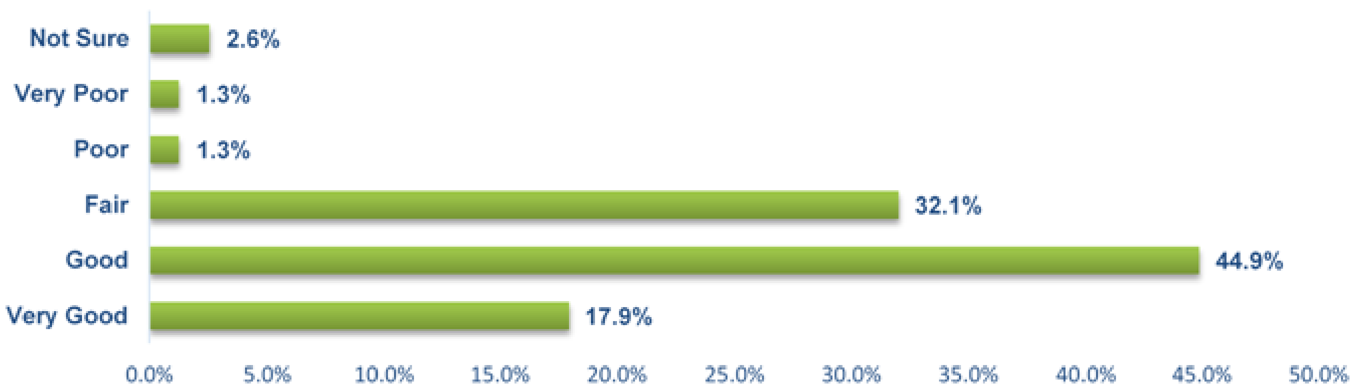
The Percentage Of Passive 1031 Exchanges Family Would Be Interested In From The Sale Of their Properties



How Important Tax Efficiency Is For Their Real Estate Investments



How Tax Efficient Family Offices Feel Their Real Estate Investments Are



provide you a feel for their breadth of complexity.

Timing

Once the sale of the existing property is complete, you ***only have 45 days*** to identify the potential property(ies) to acquire. The new property acquisition needs to be completed ***within 180 days*** of the closing of the sold property.

Identification

The IRS places limitations on the number and/or value of properties identified for the 1031 exchange. Identifying and choosing one of the following rules below are required:

200% Rule: You can specify as many properties as you wish; however, the sum-total of the new properties expected purchase price cannot exceed 200% of the sales price of the exchanged property; OR

3 Property Rule: You can identify a total of any three properties, regardless of their expected cumulative purchase price.

New Property

There is several restrictions that the newly acquired properties require to qualify as an appropriate *1031 exchange*.

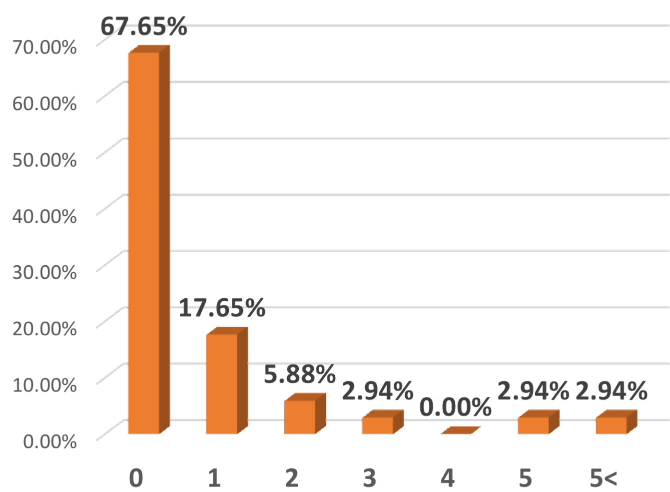
The properties ***must***:

- be on your list of identified properties.
- Use, at least, the same dollar amount of debt that the sold property had at the time of sale.
- Be owned by the same entity as the sold property.
- Use all the money in the exchange account.

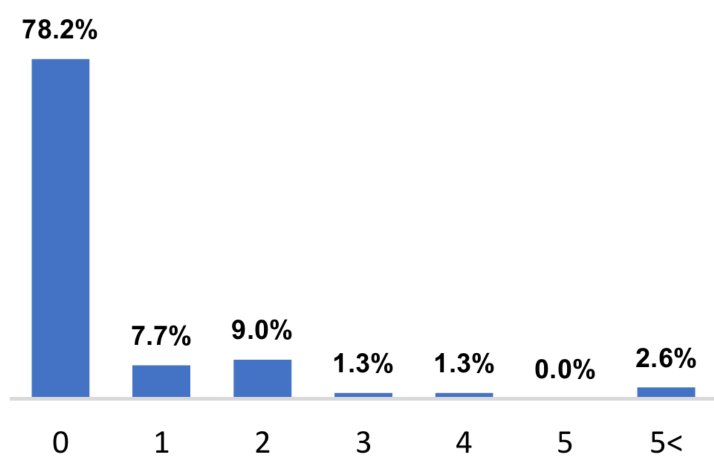
Exchange Facilitator

To qualify for a *1031 exchange*, all sales proceeds of the exchanged property need to be placed with a qualified intermediary, or Exchange Facilitator, who will hold your proceeds until you are ready to put into escrow for your acquired property. You cannot touch the sold property's sales proceeds before exchanging it into another property as the seller. The Exchange Facilitator firms, or qualified intermediaries, need to meet specific IRS

How Many 1031 Exchanges Were Completed by Family Offices in 2018



How Many 1031 Exchanges Were Completed by Family Offices in 2019



Source: 2019 & 2020 Family Office Real Estate Study

requirements. However, these facilitators are not governed by any regulations concerning the funds' custody; thus, requiring great care in their selection and account controls.

Use of Exchange Funds: The IRS does not have defined rules regarding the use of exchange funds to cover certain expenses (such as exchange fees, title insurance, attorneys, appraisals, etc.) Your tax advisor can guide the creation of taxable income.

Reverse Exchange: If you acquire new property and subsequently sell a different one(s), it may qualify as a "Reverse Exchange." The same rules apply noted above, however, in reverse:

- Once you buy a new property, you have 180 days to sell the current one.
- The new purchase price must equal or exceed the sales price of the sold property.
- The new debt must equal or exceed the amount of debt in the exchanged property.
- Since you have, in effect, already identified the property, the identification rules noted above do not apply.

1031 EXCHANGE PROCESS RECOMMENDED CONSIDERATIONS

Given the potential for significant tax benefits, the rules noted above for a *1031 exchange*, and the importance of making sure you sell for the right reasons, the family office should carefully analyze before embarking on the process. This analysis includes, among other items:

Determining the taxable gain estimate: Family Office investors need to determine the tax ramifications should the property be sold outright. If the tax is not material, investors should consider to re-invest outside the exchange process.

Completing a "Hold-Sell" Analysis: Before making any commitment to sell a property, it is essential for the completion of a hold-sell analysis. The purpose of doing an analysis is to ensure the property's sale is the right decision. Included is comparing the asset's risk/return profile in question against the family offices portfolio's risk/return expectations.

Identifying replacement property: Identifying potential replacement properties should be done before hand as much as possible by working with trusted advisors, brokers or identifying opportunities through research of the family office.

> ***"Tax efficiency has been high on the list for family office real estate investors. However, very few family offices have taken advantage of one of the most important tax strategies in real estate - the 1031 exchange."***
>
> **-2020 Famly Office Real Estate Study**

Underwriting/Due Diligence: Upon identifying the replacement property, a complete and thorough underwriting of the perspective property must be completed before submission of a purchase bid. This underwriting includes estimates of market rent, operating expenses, and capital improvements and encompasses assessing any debt needed for acquiring the property. Finally, once a property is under contract, a thorough due diligence assessment of the property, including studying the properties' physical, environmental, and legal characteristics. A reduction in unanticipated future problems can be accomplished by investing and establishing a reasonable timeline and resources in the due diligence process.

Creating a timeline: Being aware of the timeframe of accomplishing a 1031 exchange is very important. All too often, decisions are made at the last minute due to the time restrictions that the 1031 exchange imposes. Creating a timeline for the transaction can relieve some of the pressure of investing within the tight timeframe of a 1031 exchange for the family office. This often translates to beginning the search for a replacement property well in advance of the anticipated closing date.

Forming an Advisory Team: Given the complex nature of a *1031 exchange*, the family office should create a qualified team of advisers that include the following components:

- ***Accounting Firm*** (assist/confirm the calculating depreciable basis of your property and potential tax liabilities)
- ***Legal Firm*** (help with legal documents)
- ***Real Estate Brokers*** (sourcing new properties)
- ***Real Estate Advisory firm*** (when available to assist with coordinating the entire process, team, and conduct property analysis and due diligence).

1031 EXCHANGE PROCESS - CASE STUDIES

While the 1031 program benefits are clear, here are two examples of *1031 exchanges* with positive and negative results.

Case Study 1

Improve Portfolio Diversification– A family office had a real estate portfolio dominated by a single-tenant building. It was concluded, based upon a "Hold-Sell" analysis on the building, it would be best to sell the property based on potential market pricing. Plus, selling the building would allow the family office to diversify its portfolio better. With the engagement of an investment sales team (broker) to market the property widely, and as part of the sale, a 6-month closing extension was negotiated. As a result, the family office could invest in two multi-tenant properties that better fit the family office's investment parameters and met all the *1031 exchange* requirements.

Case Study 2

Time Pressured Outcome– One of the challenges that can come with a 1031 exchange is the limited 45-day window available to identify potential replacement options for a 1031 exchange. Unfortunately, this happens quite often and was the case of a family who had previously acquired two of their properties under the *1031 exchange* timeline's compulsion. In both cases, the family had not completed a strategic plan and was pressured into buying the noted assets to avoid the taxes otherwise due. The properties purchased were at odds with their risk tolerance and have significantly underperformed.

If the family office created a 1031 strategic investment plan before completing a sale, it would have allowed the family office to avoid poor real estate investment decisions to avoid taxes.

SUMMARY

In summary, for family offices, *1031 exchanges* are an effective and beneficial way to defer capital gains taxes when selling directly owned commercial real estate assets. The process can be challenging, but with solid planning and an effective team to manage the exchange transaction, it can result in a replacement property that meets the *1031 exchange* rules and the family office's long-term investment objectives.

GET IN TOUCH NOW. trinityre.com | (206) 957-9600

TRINITY
REAL ESTATE
Wealth Advisors to Family Offices