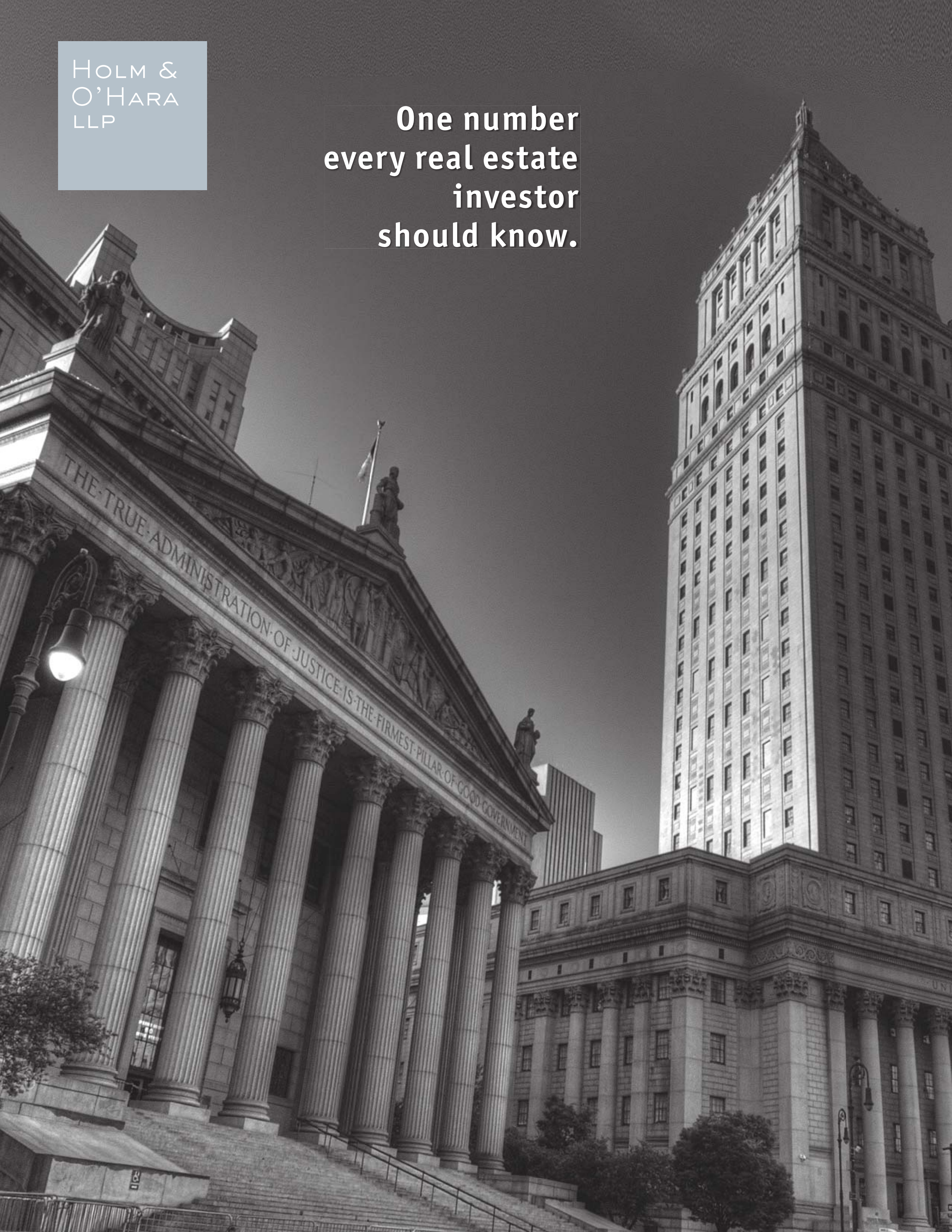
Holm & O'Hara LLP

One number every real estate investor should know.



An Established Tax Planning Strategy

Although it is not as widely known as some other provisions of the tax code, §1031 has been part of the IRC for several decades and has clear precedents going back even further.

A §1031 like-kind exchange is a tax planning device. It can be used for many different classes of assets, although real estate is one of the primary applications.

According to the Internal Revenue Service's Statistical Information Services, individuals, corporations and partnerships have reported between 100,000 and 200,000 §1031 like-kind exchanges every year for the past 15 years.

Is a §1031 Like-Kind Exchange Right for You?

There are several circumstances in which a §1031 like-kind exchange can be particularly beneficial. If one or more of the following applies to your situation, it may make sense to explore the possibility of a §1031 with your advisors:

- Has your property significantly increased in value?
- Have you owned your property for a long time?
- Has there been considerable depreciation?
- Are you interested in one or more of the following:
  - Expanding into new local areas or consolidating your holdings in one region?
  - Purchasing more of a certain type of property, or diversifying your holdings into several different types of property?
  - Exiting the business of day-to-day property management?
  - Acquiring a retirement or vacation home for your limited or future use?

Essentials of the §1031 Like-Kind Exchange:

1. **Proceeds must be reinvested in a "like-kind" asset.** Careful planning is important. If your goal is to defer 100% of the capital gains tax, then you must reinvest 100% of the proceeds.
2. **There are strict time limits for completing each phase of the exchange.** Replacement properties must be identified within 45 days of the sale of the original (relinquished) property. Title to the replacement property(ies) typically must close within 180 days of the sale of the relinquished property.
3. **The definition of "like-kind" allows for substantial flexibility.** In general, real estate is considered "like-kind" with real estate, regardless of its commercial purpose or state of improvement. Any income-producing property — including single family homes, two family homes and condominiums — can qualify for exchange with other income-producing property. However, REITs (real estate investment trusts) and other investment vehicles are not generally considered "like-kind" with actual property.
4. **Only business or investment property is eligible.** You cannot typically use a §1031 like-kind exchange to immediately purchase a primary residence, secondary residence or vacation home in some circumstances. With proper planning, however, many types of property can qualify at a later date.

Potential Advantages of a §1031 Like-Kind Exchange:

1. **Deferment of capital gains taxes.**
2. **Increased flexibility for retirement, tax and estate planning.**
3. **Improved cash flow.**
4. **Reduced property management responsibilities.**

The potential advantages of a §1031 like-kind exchange will, however, depend on your particular circumstances.

Your advisors will help you evaluate your options and work out detailed scenarios before you make final decisions.

Things to look for before you commit:

Just like any type of investment, the returns for real estate are based on the risk. In the case of a net lease property, the aspects to consider are value of the real estate, terms of the lease, credit worthiness of the tenant and health of the business at that location. You will particularly need to:

1. **Confirm the type of net lease.** Some properties have single or double net leases. These may produce greater returns, but require more direct management and involvement on your part. Any of these investments could be good, but you will want to determine whether they match your specific goals.
2. **Evaluate the tenant.** Commercial leases have a long lifespan, so you want to ensure that your tenant is someone you feel comfortable — and confident — in doing business with. The same applies to the lease guarantor, if there is one.
3. **Make sure it is not subject to other transactions.** Net leases may give tenants the right of first refusal when the owner decides to sell. It is also possible for a net lease property to be in contract with another potential buyer. Neither of these obstacles is insurmountable, but both will add to your timeframe and potentially increase costs.
4. **Consider your lender's requirements.** Lenders have specific requirements that may or may not be met by the tenant's lease. It is necessary to carefully review the lender's requirements. To the extent that you can, it is a good idea to look at this beforehand, as it could be an additional expense.

Triple Net Leases

Investors who desire to reduce their day-to-day roles in property management will often use a §1031 like-kind exchange to release capital from a management-intensive property (such as a multi-family apartment building) and reinvest it in property(ies) that do not require active management.

Many of these properties are referred to as **"triple net lease"** properties because they are occupied by commercial tenants who are obligated to make specified rent payments.

These tenants are also obligated to assume all of the costs associated with operating the property and keeping it in good repair (taxes, insurance and building maintenance are the three "nets").

While triple net lease properties are by no means the only investment properties eligible for §1031 exchange, it may be worth exploring whether this type of property meets your particular investment needs.

A versatile strategy for investing real estate gains

Holm & O'Hara LLP

The Team

Successful execution of the transactions involved in a §1031 like-kind exchange requires a team of professionals, each with a specific role.

Attorney: Most people begin by retaining a law firm with §1031 experience. The law firm's attorneys become the lead professionals on your team. **Your attorneys will:**

- Negotiate agreements.
- Evaluate existing legal documents, such as the purchase agreement and commercial lease.
- Prepare new legal documents.
- Advise you proactively at every stage of the process.
- Recommend and oversee the work of other team members.
- Coordinate sale and purchase with qualified intermediary.

Primary role: Ensuring legal protection of your best interests.

What to look for: ▸ Has legal support (associate attorneys, paralegals, etc.) ▸ Has §1031 experience ▸ Is a good personal "fit" for you

Broker: the real estate broker is likely the first team member you will recruit (although sometimes the broker will recruit clients first). **The broker will help you:**

- Understand overall market conditions.
- Determine the sales price range for your property.
- Maximize price and terms of the property sale by generating multiple competing offers.
- Provide flexibility for the sale and guarantee buyer performance.
- Identify potential replacement properties that meet your specifications.
- Establish the condition of the replacement property.
- Negotiate the purchase price for the replacement property.

Primary role: Closing the deal.

What to look for: ▸ Knows your market ▸ Has exchange experience ▸ Has a consistent track record

Qualified intermediary: Nearly all §1031 like-kind exchanges require a qualified intermediary (QI) or facilitator. **The QI will:**

- Take receipt of the proceeds from your sale.
- Retain proceeds in escrow account.
- Monitor timeline for your §1031 exchange.
- Prepare the documents necessary to structure the transaction as a §1031 exchange.
- Facilitate purchase of replacement properties.

Primary role: Assuring compliance with §1031 rules and preserving eligibility for tax deferral.

What to look for: ▸ Fidelity bonded ▸ Recommended by your attorney

Accountant: An accountant experienced with §1031 like-kind exchanges should be retained before sale of the original ("relinquished") property. **The accountant can:**

- Calculate likely cash flow.
- Perform tax computations.
- Evaluate financing options.
- Allocate expenses between those that can be covered as part of the exchange and those that must be paid out of pocket.
- Ensure compliance with IRS regulations regarding §1031 filings.

Primary role: Evaluating your financial options and maintaining tax protection.

What to look for: ▸ Recommended by your attorney ▸ Has a consistent track record of producing detailed §1031 scenario evaluations

Types of property: A wide range of commercial and investment property can qualify for a §1031 like-kind exchange, including, but not limited to:

- Income-generating residential property (single and multi-family).
- Commercial and residential condominiums.
- Commercial and retail buildings.
- Manufacturing and industrial facilities.
- Undeveloped or partially developed land.

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§1031

Internal Revenue Code §1031 permits investors to defer capital gains taxes.

Compliance with **Internal Revenue Code (IRC) §1031** allows investors to defer up to 100% of the gain realized on the sale of investment property. Accordingly, no capital gains tax is triggered by the sale and depreciation recapture is deferred.

§1031 authorizes a "like-kind exchange," in which investment property is sold and the proceeds are used to purchase similar property within a designated period of time. The *full* value of the sold property must be reinvested, and debt may figure into both the sale and replacement transactions.

Specific rules must be followed carefully, but when everything is done properly, little or no capital gains tax is due at the time the transactions are completed.

This can result in significant immediate savings. For example, in New York City, the tax bite on the sale of an investment property can be around 40%. This includes federal, state and city taxes, as well as depreciation recapture.

There is also the potential to lock in tax savings over a longer term, as current inheritance tax laws do not require payment of capital gains on step-up in basis *(increase in net value)*.

A properly strategized §1031 exchange can also increase income by exchanging low-yield property for higher performing property.

Sequence of Events:

The successful completion of a §1031 like-kind exchange is contingent on a specific timeframe. Here is the general sequence of events:

1. **Find market expert/broker** to evaluate current property, and explore the potential replacement properties that may meet your particular needs.
2. **Retain attorney, qualified intermediary and accountant** to calculate various §1031 scenarios and review tax basis and value of current property.
3. **Determine if §1031 exchange makes financial sense** based upon tax analysis and potential available replacement properties in consultation with attorney and accountant.
4. **Hire broker in submarket** (neighborhood and building class) to market current property.
5. **Authorize broker to accept best offer** and attorney to send out contract of sale. Broker and attorney will negotiate noncontingent terms on current property with mechanism for flexibility of closing date.
6. **Engage qualified intermediary** once current property is under contract. It will hold net proceeds from sale of current property in escrow until required for purchase of replacement property.
7. **Pursue and make offers** on potential replacement properties.
8. **Close on current/relinquished property** with attorney.
9. **Identify potential replacement properties** and notify qualified intermediary.
10. **Close on replacement property(ies) within 180 days** of closing on relinquished property.
11. **Work with accountant** to file appropriate tax return reflecting the §1031 exchange.

Holm & O'Hara LLP offers strategic legal support for complex real estate transactions and trusts and estates (and matters that include aspects of both), as well as comprehensive legal services for small corporations, closely-held businesses and their owners. Our labor law practice also represents the labor side in ERISA and related matters for government- and union-based pension and welfare funds. We work efficiently, using small teams to provide the personal attention our clients require. In every instance, we strive to secure the most favorable results for our clients; to apply our knowledge and experience to create solutions that endure beyond the immediate need; and to provide sound counsel to protect our clients' interests.

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