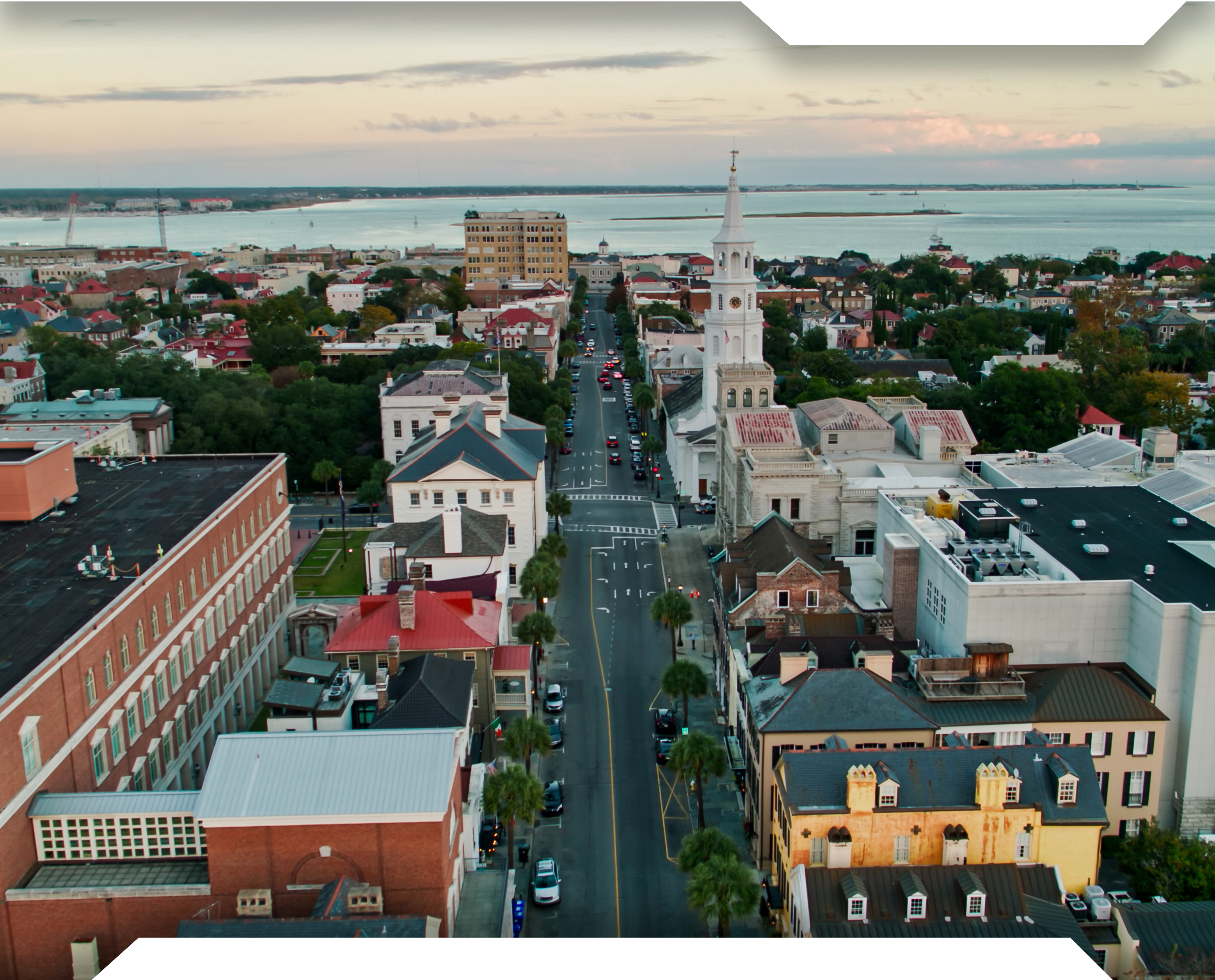
Baker Avenue
WEALTH MANAGEMENT



Tax Mitigation Strategies When Selling Your Investment Properties

Learn About Deferring Taxes, Reinvesting and Growing Assets & Income

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Understanding Exchanges and Trust Structures for Tax Deferment

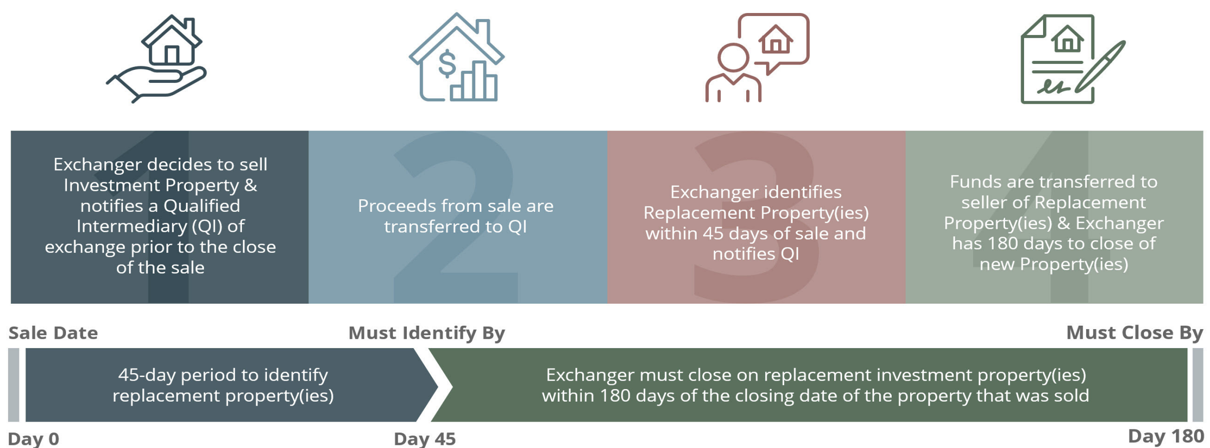
Using exchanges and trust structures, such as a 1031 exchange and a Delaware Statutory Trust (DST), to diversify your real estate investments – while deferring taxes – are some of the most strategic financial planning tools allowed under the US tax code. These instruments can help you defer gains or losses, create a sustainable stream of income, and potentially offer estate and liquidity advantages.

While 1031 exchanges can be executed using a Qualified Intermediary (QI), DSTs require additional third-party affiliations. BakerAvenue can provide access to these third-parties and the necessary guidance for initial set up.

However, it's important to first understand the basics of the 1031 exchange and DST to determine the right solution for you.

What Is a 1031 Exchange?

A 1031 exchange is a tax-free exchange of "like-kind" property (for example, apartment buildings). These exchanges have been permitted by the tax code for many years, most recently reaffirmed under the Tax Cut and Jobs Act passed in 2017. A qualified 1031 exchange allows investors to defer recognition on the gain or loss from a sale of investment or commercial property if it is exchanged solely for a like-kind of investment or commercial property. 1031 exchanges are not available to sellers of homes that are primary residences.



Benefits of 1031 Exchanges:

- Tax deferral – taxes can be deferred until the replacement property is ultimately sold
- Potential income tax shield from depreciation – subject to depreciation recapture upon taxable sale
- Income – potential for steady cash flow
- Growth – potential for real estate to increase in value
- Institutional quality – Delaware Statutory Trust (DST) creates opportunity for multiple owners to purchase fractional units (subject to certain rules) that may allow investors to exchange into higher-quality real estate
- Professional management (DST) – potential to eliminate ongoing property management responsibilities, including taxes, repairs, and leasing

Basic 1031 Rules:

- **Like-Kind Property** – the IRS requires that the property being sold is "exchanged" for a new property that is the same type. Properties are of like-kind if they're of the same nature or character (e.g., apartment buildings), even if they differ in grade or quality, or are improved or unimproved. However, real property in the US is not like-kind to real property outside the US.

- **Equal or Greater Value** – the IRS requires that for an exchange to provide a complete tax deferral, the new property being purchased must be the same or greater value as the property being sold.

- **Time Limits** – there are two key time frames to understand when managing a 1031 exchange:

  - **45-Day Identification Rule** – an investor has 45 days from the date of the sale of the property to identify a potential replacement property. There is no requirement to complete a transaction – the investor must simply identify the replacement property with specific information.

  - **180-Day Deadline** – the exchange must be completed within the lesser of 180 days from the date of sale of the property being exchanged and the next tax filing. This period runs concurrently with the 45-day rule period, so if an investor waits until day 45 to identify a replacement property, there are only 135 days remaining to complete the transaction.

    There are scenarios where an investor may have less than 180 days, such as tax filing deadlines. The IRS requires that the 1031 exchange be completed prior to filing that year's taxes. For example, if a property was sold on November 30, the 1031 would need to be completed by April 15 of the following year. This would create a window of only 136 days. This may be avoided by filing a tax extension but should be monitored closely.

  - If either of these deadlines are missed, the 1031 exchange will not be valid and the investor will be required to pay any capital gains on the sale of the original property. The IRS doesn't have provisions for extensions or exceptions – not even to the next business day if the deadline falls on a weekend or holiday – unless there is a state or federally declared disaster.

- **Property Identification Rules** – there are three tests for identifying a new replacement property:

  1. **The Three Property Rule** – the IRS recognizes the challenges of finding a suitable replacement within the exchange eligibility window. Therefore, investors are allowed to target three different properties. There is no requirement to purchase all three properties, only one needs to be closed, but it must be of equal or greater value.

  2. **The 200% Rule** – if a seller decides to target more than one property, the combined values of the replacement properties cannot exceed 200% of the value of the property that was sold. For example, if an investor sells a property valued at $3 million, they would be able to target up to three properties with an aggregate value of $6 million.

  3. **The 95% Rule** – this allows an investor to identify more than three properties with a total value greater than 200% of the original property as long as the investor purchases at least 95% of the value of the properties. If the investor does not acquire 95% of the value identified, the tax-free 1031 exchange will not be allowed.

- **Qualified Intermediary (QI)** – the QI plays a crucial role in the 1031 exchange process. The IRS requires a QI unless the exchange is completed on the same day, which is rare. The intermediary facilitates the exchange by entering into an agreement with the seller of the relinquished property to transfer the property to the buyer, and then transfers the replacement property to the investor. The QI establishes an escrow account for the proceeds to prevent "constructive receipt" of the proceeds from the property that was sold. (Constructive receipt requires taxes on income even though money has not been actually received.)

- **Boot** – this is not an official term used by the IRS but is commonly used when evaluating 1031 exchanges. It is any "non like-kind" property that is received during the exchange process. Effectively, Boot is anything of value received that is not the same type of property being exchanged.

  The three most common forms of Boot are (1) cash received during the exchange and / or (2) debt reduction. Debt reduction occurs when the mortgage (debt) on the new property is less than the debt on the property being relinquished. And (3) personal property that is received during the exchange that is not business- or investment-related.

  Boot is generally taxable and can be mitigated by focusing on exchanging into properties with the same or greater value or by exchanging all of the equity.

Can a Beach House Qualify?

Many investors wonder if the sale of a second home or vacation property is eligible to use a 1031 exchange. While a second property may be bought with the expectation it will increase in value, the IRS has determined that properties purchased for personal use are not eligible for a like-kind exchange.

However, with a 1031 exchange in mind, you can set up your financial plan accordingly by pivoting your second property into a rental property when the time is right:

For rental properties, the IRS has issued rules that can provide a safe harbor for investors seeking to complete a 1031 exchange:

- The property must be owned by the seller for a minimum of 24 months if the property is being relinquished OR held by the purchaser a minimum of 24 months if it is replacement property.

- The property must be rented a minimum of 14 days each year at fair market value rates.

- The personal use of the property does not exceed 14 days or 10% of the number of days it is rented.

What Is a Delaware Statutory Trust (DST)?

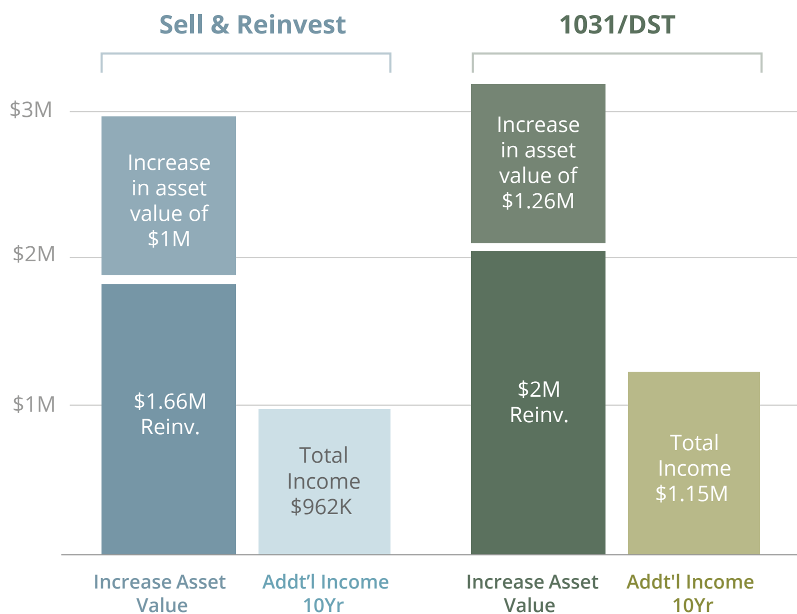
A Delaware Statutory Trust (DST) is a legal entity that is often used as an investment vehicle for real estate holdings. The DST structure creates the ability for multiple owners to purchase fractional units. DST investments are eligible for use in 1031 exchanges subject to certain rules.

Benefits of DSTs:

- DSTs often have accessible minimums that can enable an owner to create a diversified portfolio.
- Individual investors can invest in large institutional-style real estate projects via fractional interests, effectively gaining the same benefits and risks as large institutional real estate investors.
- Professional management may eliminate the investor's ongoing property management responsibilities.
- As an owner, each investor will receive a pro rata share of income and appreciation in value.
- Investors have the benefits of depreciation and cash flow.
- DST investments are available throughout the US, with properties in major commercial real estate asset classes, including apartments and other multifamily units, industrial, medical, office, and retail.
- DSTs are particularly attractive for meeting the aggressive 180-day dealine of a 1031 exchange.

Sell Rental Property vs. Set Up a 1031 Exchange / DST

Benefits of Setting Up a DST



Potential DST Advantages Over 10 Years:

- Defer your Long-Term Capital Gains Tax
- Reinvest $338K more, $2M vs. $1.66M Cash Yield
- Generate $550.6K additional return from DST vs. sale
- Increase asset value in additional income by $212K
- **Earn $425K total return by setting up a DST vs. sale**

Increase Asset Value	Sell Property	1031 / DST	The DST Advantage
Proceeds from Rental Sale	$2,000,000	$2,000,000	$0
Cost Basis	-$1,000,000	-$1,000,000	$0
Re-Investment in 1031/DST	$0	$2,000,000	$2,000,000
2022 Long-Term Capital Gain	$1,000,000	$0	-$1,000,000
LTCG Tax (20% Fed + 3.8% Medicare + 10.0% State)	-$338,000	$0	
Net After Tax Proceeds	$662,000	$0	
Total Reinvestment	$1,662,000	$2,000,000	$338,000
Increase in Asset Value*	$1,045,223	$1,257,789	$212,566
Asset Value in Year 10	**$2,707,223**	**$3,257,789**	**$550,566**
Increase in Asset Value	$1,045,223	$1,257,789	$212,566
Expected Year 1 Income (5% of Reinvestment)	$83,100	$100,000	$16,900
Generate Income	**Sell Property**	**1031 / DST**	**The DST Advantage**
Cumulative 10 Year Income^	$1,045,223	$1,257,789	$212,566
Total Return (Income from Asset Value + Cumulative 10 Year Income)	**$2,090,446**	**$2,515,579**	**$425,133**

Assumptions:

- Example: 2022 LTCG Tax (20% Fed + 3.8% Medicare + 10.0% State)
- *Expected value of the asset in 10 years compounded at a 5% annualized return
- ^Assume a 5% compounding yield on total income from a balanced portfolio received at the end of each year
- Total return is based on the income from the increase in asset value plus the cumulative 10-year generated income

Advantage of 1031 Exchanges, DSTs, 721 Exchanges, and UPREITs

The combination of a 1031 exchange via a DST can provide significant real estate investment and tax advantages. Investors can collect income on the DST and, after a seasoning period, be further eligible for a 721 exchange of the DST interest (on a tax-deferred basis) into an UPREIT (Umbrella Partnership Real Estate Investment Trust). UPREITs have the advantage of providing fractional liquidity to the investor allowing either staged capital gains recognition or division of the interest among family members and heirs via gifting, or, a combination of both.

When you need financial advice for your personal and professional life transitions, BakerAvenue is here for you. Please contact us to see how we can help you navigate through the strategic advantages of exchanges and trusts for your real estate investments.

Additional Resources

Like-Kind Exchanges Real Estate Tax Tips

Return Correlations between REITs and the Broad Stock Market by Property Type

Helping You Embrace Life's Transitions.

Since 2004, BakerAvenue has guided clients through personal and professional life transitions. Our firm provides comprehensive wealth management and investment expertise for high-net-worth individuals, families, trusts, foundations and endowments. Driven by our purpose, we strive to make a positive impact on society alongside financial return. We're headquartered in San Francisco with offices in New York, Dallas, Seattle, San Diego and Sun Valley.

For more information, please contact us or visit us at bakerave.com.

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