FIRST NATIONAL
REALTY PARTNERS

# HOW TO COMPLETE A 1031 EXCHANGE WITH A PRIVATE EQUITY SPONSOR

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## A NOTE FROM THE AUTHORS

It is common for real estate investors to put a tremendous amount of time and resources into the pre-purchase due diligence phase of a commercial real estate transaction. From analyzing the market to creating a financial projection of income and expenses, there is a lot of work that must be completed to maximize the chances for a profitable investment.

If the investment indeed turns out to be profitable, investors typically face a good news/bad news scenario. The good news is that they made a profit on the investment. The bad news is that those profits can come with a sizable tax bill that can have a material impact on the net return.

Fortunately, there is a strategy used by many investors to defer this tax bill indefinitely. It is known as a "1031 Exchange" and it is the subject of this e-book. If executed correctly, a 1031 Exchange allows commercial real estate investors to grow their investment capital and diversify their investment portfolio while deferring capital taxes over time.

As part of our commitment to world-class investor education, this e-book will review all aspects of a 1031 Exchange transaction. To do so, it is organized into four sections:

1. DEFINITION OF A 1031 EXCHANGE AND THE 4 TYPES COMMONLY USED
2. IRS REQUIREMENTS FOR COMPLETING A 1031 EXCHANGE
3. BENEFITS AND RISKS OF A 1031 EXCHANGE
4. HOW TO COMPLETE A 1031 EXCHANGE IN PARTNERSHIP WITH A PRIVATE EQUITY SPONSOR

In each section, we aim to cover the major topics of concern for any individual considering a 1031 Exchange as a way to defer taxes on the profitable sale of a real estate asset. We will point out key considerations and provide detailed explanations for deal structure and exchange requirements. By the time you finish reading, it is our hope that you will have the knowledge necessary to successfully complete a 1031 Exchange with a Private Equity sponsor and realize the potentially significant tax benefits that come with it.

Prospective investors are strongly urged to consult, and must depend upon, their own advisors with specific reference to their own tax situations, any resulting tax consequences of investing in commercial real estate, potential changes in applicable law, and the application of state and local, foreign and other tax considerations applicable to their individual circumstances.

# TABLE OF **CONTENTS**



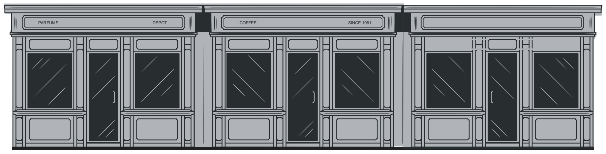
SCHEDULE A CALL

## SCENARIO SETUP

In order to demonstrate how a 1031 Exchange works, it is helpful to begin by setting up a scenario in which one could be used.

Suppose that an investor purchases a small retail shopping center for $3,000,000. Over a five year period, the property is cash flow positive and there is growing demand for space in the market. This combination of increasing rents, decreasing operating expenses, and low cap rates create the perfect environment for a profitable sale. After getting tired of the time required to maintain the property, the investor decides to sell into this market. After entertaining multiple offers, the investor sells the property for $5,000,000.

**$3,000,000 PURCHASE PRICE**



5
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**$5,000,000 SALES PRICE**

The difference between the property's "tax basis" and the sales price represents a "capital gain" and it is taxable. The calculation of tax basis can be complicated and it should be completed by a CPA, but it is generally calculated as the property's purchase price plus the cost of any improvements made during the holding period; minus depreciation taken. For the sake of this example, assume that the tax basis for the above property was calculated as $2,800,000. This means that the taxable capital gain is $2,200,000. There are two types of capital gains taxes, short and long term. The difference between the two depends on the length of time the property was held prior to sale.

- ✔ **Short term capital gains** taxes must be paid for properties held less than 12 months. Under IRS rules, short term gains are categorized as "ordinary income" and the tax rate depends on the individual's income tax bracket, which can range from 10% to 37%.

- ✔ **Long term capital gains** taxes must be paid for properties held more than 12 months. They are calculated based on the taxpayer's income and filing status and range from 0% - 20%.

*Individual taxpayers are strongly urged to consult, and must depend upon, their own advisors with specific reference to their own tax situations, any resulting tax consequences of investing, potential changes in applicable law, and the application of state and local, foreign and other tax considerations applicable to their individual circumstances.*

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## SCENARIO SETUP

In the example above, the property is held for 5 years, which means that the investor must lay long term capital gains taxes. For the sake of the example, assume the taxpayer is a single filer and that their income dictates a long term capital gains tax rate of 20%. This means that the $2,200,00 gain could be subject to a tax bill of up to $440,000 [1].

5
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- ✔ Long term capital gains tax rate of 20%
- ✔ $2,200,00 gain could be subject to a tax bill of up to $440,000.

Although there is still plenty of profit left after the tax bill, it is only rational for an investor to seek ways to reduce, defer, or eliminate the effects of taxes. This is where a 1031 Exchange comes into play. In the pages that follow, the example above will be utilized to illustrate what a 1031 Exchange is, how it works, and what benefits can be obtained from using one.

[1] NOTE: For illustrative purposes only. The actual tax bill may vary based on a number of factors and should only be determined by a qualified CPA.

# WHAT IS A 1031 EXCHANGE?

A 1031 Exchange is a specialized type of real estate transaction that allows an investor to defer taxes on the profitable sale of an investment property. The rules that sanction this transaction are described in section 1031 of the Internal Revenue Code (IRC), which state specifically that "...no gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind..." In other words, this section of code allows an investor to defer capital gains taxes on the profitable sale of a property so long as the sale proceeds are exchanged into a "like kind" property.

### Who Qualifies for a 1031 Exchange?

According to the IRS Fact Sheet on 1031 Exchanges, "owners of investment and business property may qualify for a Section 1031 deferral. Individuals, C corporations, S corporations, partnerships (general or limited), limited liability companies, trusts, and any other taxpaying entity may set up an exchange of business or investment properties for business or investment properties under Section 1031."

## 1031 Exchange Key Terms

In order to understand how a 1031 Exchange works and how to differentiate between the various types, there are four key terms that must be defined:

### RELINQUISHED PROPERTY

The Relinquished Property is the property that is sold in the transaction.

### REPLACEMENT PROPERTY

The Replacement Property is the property that is purchased with the proceeds from the sale of the Relinquished Property.

### BOOT

Money or fair market value of "other property" received in a 1031 Exchange. It is taxable.

### QUALIFIED INTERMEDIARY

A Qualified Intermediary is an individual or company that facilitates the 1031 Exchange transaction on behalf of the taxpayer. Their role is defined in US Treasury Regulation 1031(k) - 1(g)(4), which states that their duty is to: "acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property."

*Individual taxpayers are strongly urged to consult, and must depend upon, their own advisors with specific reference to their own tax situations, any resulting tax consequences of investing, potential changes in applicable law, and the application of state and local, foreign and other tax considerations applicable to their individual circumstances.*

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# TYPES OF 1031 EXCHANGES

With these terms in mind, there are four types of 1031 Exchanges, any one of which can be chosen to accommodate the unique needs of individual investors.

### Type #1: The Simultaneous Exchange

A **Simultaneous Exchange** is exactly what it sounds like, an investor executes the sale of the relinquished property and the purchase of the replacement property on the same day.

There are three ways this is accomplished:

1. **Two Party Trade:** In this instance, the owners of the relinquished and replacement properties literally swap deals.

2. **Three Party Exchange:** Instead of swapping deals directly, a three-party exchange includes an "accommodating party" that acts as an intermediary between the buyer and seller to facilitate the transaction.

3. **With a Qualified Intermediary:** A "Qualified Intermediary" is a third-party who facilitates the exchange on behalf of both property owners. Their most important job is to handle the exchange of funds.

For many investors, a simultaneous exchange is difficult because they have not yet identified the Replacement Property. As such, they may prefer a Delayed Exchange.

### Type #2: The Delayed Exchange

A **Delayed Exchange** - Sometimes called a "Deferred Exchange" - is the most common type of 1031 Exchange. In it, there is a "delay" between the sale of the relinquished property and the purchase of the replacement property.

In a Delayed Exchange, the exchanger sells the relinquished property first. Then, they have 45 days to identify a replacement property. Once they have done so, they have 180 days to make an offer and close on the transaction. This "delay" is what makes this type attractive to many investors. It allows them time to find a suitable replacement property and get the transaction closed. But, this extra time is a double-edged sword. There can be a lot of competition for the best replacement properties and it is common for investors to be rushing at the last minute to settle for any option. If they run out of time, the transaction could become taxable.

# TYPES OF 1031 EXCHANGES

### Type #3: The Reverse Exchange

A **Reverse Exchange** is the opposite of the Delayed Exchange. In it, the Replacement Property is identified and purchased first, then the Relinquished Property is sold.

In a Reverse Exchange, the time frame is the same, just in reverse. The Relinquished Property must be identified within 45 days and sold within 180 days. If an exchanger owns multiple properties, they need to decide which one they want to sell.

### Type #4: The Construction Exchange

A **Construction Exchange** - also called an "Improvement Exchange", occurs when the replacement property needs some sort of renovations or improvements. In it, the relinquished property is sold, the replacement property is identified, and the sale proceeds are placed with a Qualified Intermediary.

While the proceeds are in escrow with the Qualified Intermediary, improvements are made to the Replacement Property. Once complete, ownership of the Replacement Property is transferred under three conditions:

1. The property must be "substantially the same" as it was before the renovations
2. Construction must be completed within 180 days of the Relinquished Property sale date
3. The Replacement Property's value must be the equal to or greater than the Relinquished Property

It is up to the individual investor to decide which type of exchange they would like to pursue. Once this decision has been made, it is important to be aware of the 1031 Exchange Rules to ensure that the transaction is executed flawlessly, otherwise it could become taxable.

# REQUIREMENTS FOR COMPLETING A 1031 EXCHANGE

Under IRS rules, both the relinquished property and the replacement property must meet certain criteria.

**Property Use**: Both properties must be held for use in a trade or business or for investment. Property used primarily for personal use, like a primary residence or vacation home, does not qualify for like-kind exchange treatment.

**Like Kind**: Both the relinquished property and replacement property must be similar enough to qualify as "like kind," which is defined as "property of the same nature, character, or class." The quality or grade of the property does not matter. Most real estate is like kind to other real estate with one exception. Property within the United States is not like kind to property outside of the United States. It should also be noted that certain types of property are specifically excluded from Section 1031 treatment. They include:

- Inventory or stock in trade
- Stocks, bonds, or notes
- Other securities or debt
- Partnership interests
- Certificates of trust

**Diversification**: Properties do not necessarily have to be exchanged on a 1:1 basis. For individuals looking to diversify their investment portfolio, one property can be exchanged for many as long as the following rules are met:

- Rule of Three: The exchanger can identify up to 3 like kind replacement properties
- 200% Rule: The exchanger can identify unlimited properties as long as their cumulative value does not exceed 200% of the market value of the relinquished asset. Other securities or debt
- 95% Rule: The exchanger can identify more than three properties whose value exceeds 200% so long as they acquire 95% of the value of the replacement properties


BRANDYWINE CROSSING - BRANDYWINE, MARYLAND
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# REQUIREMENTS FOR COMPLETING A 1031 EXCHANGE

Under IRA rules, both the relinquished property and the replacement property must meet certain criteria.

**Property Cannot be Held for Sale**: IRS rules specifically state that the replacement property must be held for productive use in a trade or business or for investment. They cannot be "held for sale" meaning that they cannot be purchased for the tax benefits and then immediately sold. There is no specific time frame that the replacement property must be held, but it is generally agreed that 12-24 months is sufficient.

**Timing**: Again, there is a timing component to a 1031 Exchange transaction. The replacement property must be identified within 45 days and the transaction must be closed within 180 days after the sale of the relinquished property.

**Value and Equity**: The value of the relinquished property and the equity in it must be the same as or greater than the replacement property. For example, if the relinquished property has a value of $1,000,000 and equity of $250,000, the replacement property must have a value of at least $1,000,000 and equity of at least $250,000.

**Boot**: "Boot" is the fair market value of cash or "other property" received in a 1031 Exchange. If it is received, it is taxable.

**Same Taxpayer**: The taxpayer for the relinquished property and the replacement property must be the same.

If any of the above rules are broken in a 1031 Exchange, some or all of the gain could become taxable.


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# BENEFITS AND RISKS OF A 1031 EXCHANGE

Like any investment, a 1031 Exchange comes with both benefits and risks.

### 1031 Exchange Benefits

There are four primary benefits to a 1031 Exchange:

1. **Taxes**: The biggest and most obvious benefit of a 1031 Exchange is the tax deferral that comes with it. As long as the transaction meets IRS requirements, capital gains taxes are deferred for the duration of the holding period. Further, it is possible that an investor could complete a series of successive 1031 Exchanges to defer taxes indefinitely.
2. **Increased Purchasing Power**: In the example that opened this document, the theoretical tax bill was $440,000. By deferring taxes, this amount can instead be used towards the purchase of a bigger, more expensive replacement property. This allows a portfolio to continue growing tax deferred over time.
3. **Portfolio Diversification**: Because properties do not have to be exchanged on a 1:1 basis, a 1031 Exchange can be an effective way to diversify a real estate investment portfolio. For example, one large office building could be exchanged for smaller multifamily, retail, and industrial properties as long as all other valuation and IRS requirements are met.
4. **Upgrades**: Finally, a 1031 Exchange can be a tax-efficient way to upgrade a physically obsolete property. For example, if an existing retail property is aging and in need of expensive repairs, it could instead be exchanged for a newer property with little to no deferred maintenance.

While these benefits can be significant, there are offsetting risks that must also be considered.

### Risks of a 1031 Exchange

Likewise, there are four primary risks of a 1031 Exchange transaction that potential investors must consider:

1. **Time:** Again, the replacement property must be identified within 45 days, and the transaction must be closed within 180 days of the sale of the relinquished property. This is easier said than done. In the most attractive markets, there can be a significant amount of competition for the most desirable replacement properties. As such, it is not uncommon for investors to run out of time to identify a replacement property or to "settle" for identifying any replacement lest the transaction becomes taxable.
2. **Suitable Property:** In addition to the time constraint, it can also be very challenging to find a suitable replacement property in an investor's desired market. Properties could be too big, too small, too expensive, not expensive enough, not in the right asset class, or not the right property type. The most effective 1031 Exchanges occur when an investor is able to find a replacement property that meets all of their investment objectives, not just "any" property.
3. **Market Risk**: 1031 Exchanges are not immune from the market risk that applies to any real estate investment. Changes in rental rates, market demand, or macroeconomic factors like unemployment can have a material impact on the value of the replacement property, which could wipe out the equity injected into it.

# BENEFITS AND RISKS OF A 1031 EXCHANGE

4. **Qualified Intermediary:** Finally, the Qualified Intermediary is a key player in the transaction. Their job is to facilitate the exchange of the two properties within the boundaries of the 1031 Exchange rules. There are two risks associated with this role. First, they handle the exchange of funds in the deal. If they were to unexpectedly go out of business, funds could be lost. Second, if they make a mistake, the transaction could become taxable.

For all of the reasons above, investors should complete a significant amount of Due Diligence prior to initiating one. To mitigate some of these risks, it can be beneficial to work with a Private Equity Firm.

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# 1031 EXCHANGES WITH A PRIVATE EQUITY SPONSOR

A 1031 Exchange is a complex transaction that must be executed flawlessly to achieve the desired tax benefits. In addition, the competition for the best replacement properties can be fierce. For both of these reasons, there is a strong argument to be made that individual investors should not go it alone. Fortunately, there is a specific process that can be used to allow individual investors to partner with a private equity firm to complete a 1031 Exchange.

## How it Works

The key to completing a 1031 Exchange with a private equity firm is the way that the property is titled. Most private equity firms - including ours - use the "Tenants In Common" ownership structure.

## What are Tenants in Common?

"Tenants in Common" (TIC) is a specialized type of commercial real estate ownership structure that allows multiple owners of the same property.

The property can be commercial or residential and when one of the owners passes away, their interest is passed to an heir. Each "tenant" has a fractional ownership interest in the property so the total ownership interest must add up to 100%. For example, Sam can own 50%, Bill can own 25% and Frank can own 25%. Or, there could be 10 "tenants" that own 10% each.

The legal agreement governing a Tenants In Common arrangement can be created or modified at any time, meaning that an owner can further split his or her interest if additional individuals wish to join the ownership group. This is particularly helpful when it comes to a 1031 Exchange. This way, when a new investor needs to place their 1031 funds, the agreement can be amended to admit them.

## How is the Tenancy Agreement Used to Facilitate a 1031 Exchange?

IRS Revenue Procedure 2002-22 provides guidance for the use of a fractional ownership agreement as a replacement property in a 1031 Exchange. The text of the procedure outlines 15 conditions under which this arrangement can be used:

1. **Tenancy In Common Ownership:** Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law.
2. **Number of Co-Owners:** The number of co-owners must be limited to no more than 35 persons.
3. **No Treatment of Co-Ownership as an Entity:** The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other business entity.
4. **Co-Ownership Agreement:** The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of the revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the property (see section 6.05 of the revenue procedure for conditions relating to voting).

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# 1031 EXCHANGES WITH A PRIVATE EQUITY SPONSOR

5. **Voting:** The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases of a portion or all of the property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the property must be by unanimous approval of the co-owners.
6. **Restrictions on Alienation:** In general, each co-owner must have the rights to transfer, partition, and encumber the co-owners undivided interest in the real property without the agreement or approval of any person.
7. **Sharing Proceeds and Liabilities Upon Sale of Property:** If the property is sold, any debt secured by a blanket lien must be satisfied, and the remaining sales proceeds must be distributed to the co-owners.
8. **Proportionate Sharing of Profits and Losses:** Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owners' undivided interest.
9. **Proportionate Sharing of Debt:** The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.
10. **Options:** A co-owner may issue an option to purchase another co-owner's undivided interest, provided that the exercise price for the call option reflects the fair market value of the property, determined as of the time the option is exercised.
11. **No Business Activities:** The co-owner's activities must be limited to those customarily performed in connection with the maintenance and repair of the rental property.
12. **Management and Brokerage Agreements:** The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than 13 times annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee.
13. **Leasing Agreements:** All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the property.
14. **Loan Agreements:** The lender, with respect to any debt that encumbers the property or with respect to any debt incurred to acquire an undivided interest in the property, may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the property.
15. **Payments to Sponsor:** Except as otherwise provided in the revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest.

If the above conditions are met, a replacement property owner under a TIC structure qualifies for tax deferral under the 1031 Exchange program. Working with a private equity firm ensures that they are.

# RISKS AND BENEFITS OF WORKING WITH A PRIVATE EQUITY FIRM TO COMPLETE A 1031 EXCHANGE

In addition to the general risks and benefits of a 1031 Exchange described above, there are several others that are unique to using a private equity firm to facilitate it.

## Benefits

The most consequential benefits of working with a private equity firm to facilitate a 1031 Exchange include:

- **Access**: Working with a private equity firm provides investors with access to institutional quality assets that they would be otherwise unable to afford on their own.
- **Leverage**: Individual investors can leverage the experience, connections, and expertise of the private equity firm to find the most suitable replacement properties and to ensure that the transaction is completed according to IRS rules.
- **Time**: With the fractional ownership of the Tenants in Common structure and the private equity firm managing the assets, individual investors can achieve all of the benefits of real estate ownership without the hassle of actually maintaining the property.
- **Liquidity**: Because the Tenants in Common ownership structure allow an owner to sell or transfer their share to another party, this type of 1031 investment tends to offer more liquidity than others. However, it should be noted that a sale could be taxable if funds are not immediately placed in another 1031 Exchange.

While these benefits are substantial, they aren't without risk.

## Risks

The most significant risk of working with private equity to facilitate a 1031 Exchange is the choice of the firm itself. Choosing the wrong partner or one that does not have the requisite experience can result in a rules violation that causes the transaction to become taxable. Such a situation could turn out to be very expensive and negate the benefits of the 1031 Exchange.

When choosing a firm, investors should perform a significant amount of due diligence to ensure they have the experience and expertise needed to execute the transaction properly. If there is any doubt, investors should further consult a real estate/tax attorney for outside counsel.

If a suitable private equity partner is discovered and it is determined that the benefits of the transaction outweigh the risks, investors can proceed with the transaction to realize both the general benefits of a 1031 Exchange and the specific benefits of working with a private equity firm to execute one.

# WHAT'S NEXT?

As you consider replacement property options, think of how your 1031 investment will align with your goals besides just deferring taxes. By exchanging into what we believe to be inflation resistant, grocery-anchored CRE properties, you not only continue building your wealth but further insulate your portfolio from the effects of inflation and market volatility. Our team wants to help you realize this through our streamlined process dedicated to efficiently completing your exchange in just three steps.

### Step 01 - Discover

First National Realty Partners can only work with qualified accredited investors. **Schedule a call** with our Investor Relations Team to get access to our exclusive private investment offerings.

### Step 02 - Engage

After approval, you will have full access to our commercial real estate investment opportunities. You will receive an account on our Investment Lobby, where you can view drone footage of properties, download due diligence documents, and attend live investment presentations. You will also have a dedicated account manager for a fully personalized investment experience.

### Step 03 - Invest

After you identify an investment property that meets your goals, you can easily request to invest online or through your account manager. You'll review & e-sign the subscription documents, fund your investment, and start receiving cashflow based on the property's performance and your percentage of ownership.

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