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1031 Exchanges: *Deferring Gains on the Sale of Real Property*

For investors who seek to defer capital gains on the sale of investment property, one complex yet effective option is a 1031 exchange (also known as a Starker exchange).

Named after Section 1031 of the Internal Revenue Code, 1031 exchanges became more popular and accessible after a key ruling in 2002 by the Internal Revenue Service, which for the first time allowed property owners to exchange qualified real estate for fractional-ownership interest in larger investment properties.

By joining with other investors in a so-called "tenant-in-common" ownership, an investor can exchange investment real estate (such as vacant land) for fractional ownership in property such as an office building or shopping mall. Fractional ownership potentially makes it easier for an owner to find replacement property within the 45-day identification period required by the IRS.

> One appealing aspect of a 1031 strategy is that deferring capital gains taxes can free up money for other types of investments. This strategy may also help an investor reallocate an investment portfolio without having to pay current federal taxes on any gains.

POSTPONING TAX ON GAINS

Unlike the typical sale of investment property wherein the owner is taxed on any gains he or she realizes, a 1031 exchange potentially enables the property owner to postpone the tax on gains until some point in the future, and perhaps indefinitely if the transactions are documented and conducted properly. The process involves selling qualified investment property — generally non–owner-occupied real property such as a rental home (not a vacation home) — and purchasing "like-kind" property of equal or greater value within a set time period. All qualifying real property in the United States is considered "like kind." For a 1031 exchange, both the property being sold and the property being acquired generally must be held for productive use in a trade or business or for investment purposes.

Successfully completing a 1031 exchange requires extraordinary attention to detail, as well as professional help. IRS rules mandate that the proceeds from the sale of the original property must be held by a third party (such as a Qualified Intermediary) and meet specific conditions. Otherwise, the IRS will disqualify the transaction as an exchange.

ADDITIONAL REQUIREMENTS

• In order for the capital gain and depreciation recapture to be fully deferred, the fair market value of the acquired property must be equal to or greater than the net sales price of the property being sold. Mortgages and other debt must be included in the calculations. If the owner's debt goes down as a result of the exchange and it is considered a personal benefit, the IRS will consider it income, which is taxable.

• Each property must be held as an investment or for use in a business or trade. Generally, the property being sold should have been held for more than 12 months before being marketed, and the acquired property should be held for at least 12 months after the transaction.

• Various forms of ownership are allowed for the exchanged properties, including title by individuals, joint tenancy, community property, corporation, LLC, and trust. However, the ownership structure selling the relinquished property must be the same as the ownership structure acquiring the replacement property.

• Transaction timelines are extremely rigid. The owner has only 45 days after relinquishing the original property to identify potential replacement properties. The exchange must be completed within 180 days of the transfer of the relinquished property. No extensions are available.

As long as all milestones, definitions, and deadlines are met, there is no limit to the number of exchanges an investor may do. Some investors may prefer to avoid capital gains taxes for a lifetime, swapping properties until the investment ultimately becomes part of his or her estate.

One appealing aspect of a 1031 strategy is the fact that deferring capital gains taxes can free up money for other types of investments. This strategy may also help an investor reallocate an investment portfolio without having to pay current federal taxes on any gains. It would be wise to consult with a qualified tax professional before proceeding with a 1031 exchange.

There are risks associated with investing in partnerships. Key among them is that they are long-term investments with an indefinite holding period and no, or very limited, liquidity. Furthermore, there is typically no current market for the units/shares; if one becomes available, it may result in a deep discount from the original price, in which case the investor may receive back less than the original amount invested. This type of investment is considered to be speculative. There are no assurances that the stated investment objectives will be reached. An investor will need to meet specific income and net-worth suitability standards, which vary by state.

The standards, along with the risks and other information concerning a partnership, are set forth in the prospectus, which can be obtained from your financial professional. Please consider the investment objectives, risks, charges, and expenses before investing. Be sure to read the prospectus carefully before deciding whether to invest.

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