1031 Exchanges & Delaware Statutory Trusts

WHAT TO KNOW BEFORE YOU INVEST

Temecula, CA

NEXPOINT

www.nexpoint.com

1031 Exchange Basics

What is a 1031 exchange? This IRS-recognized tax deferral strategy allows an investor to sell an investment property and acquire a similar property with the intent to defer capital gains and depreciation recapture taxes. The Internal Revenue Code §1031 summarizes it clearly:

> *No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment, if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.*

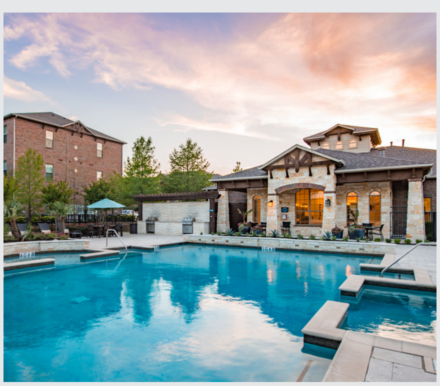
Note: 1031 DST programs are not suitable for all investors.

Like-Kind Properties May Include:

- Multifamily Apartment Buildings
- Single-Family Rental Homes
- Condominiums and Duplexes
- Office Buildings
- Retail Centers
- Warehouses and Storage Units

But Can Also Include:

- Vacant Lots
- Water, Air and Mineral Rights
- Development Rights
- Easements
- Tenancy-in-Common (TIC) Interests
- Delaware Statutory Trust (DST) Interests



The Retreat, McKinney, TX

Elysian at Flamingo, Las Vegas, NV

Cape Coral, FL

Photos shown in this brochure are properties held by NexPoint.

4 STEPS

DST 1031 Exchange Process

DAY 0
Close of Property

1 The investor sells the relinquished property to a third-party buyer.

DAY 45
Identification Period
See Glossary on pg. 6

2 Sale proceeds are transferred to a qualified intermediary (QI).

3 The QI uses the proceeds to purchase the replacement property on behalf of the investor within the time limits defined in the Internal Revenue Code.

MAXIMUM OF 180 DAYS
to complete the exchange

4 Upon closing, the investor owns a fractional interest in a trust that owns the replacement property

Failure to satisfy these requirements can create a tax liability

Identification Rules

The ability to defer taxes through a 1031 exchange may be a valuable benefit to taxpayers. In order to benefit, the exchange rule for identification and receipt of replacement property must be strictly followed, including those used for identification:

Three Property Rule	The rule used most often by taxpayers allows up to three replacement properties to be identified without regard to the fair market values of the properties. Any or all of the three properties identified may be purchased.
200% Rule	The rule states that the taxpayer may identify any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer.
95% Rule	The taxpayer may identify as many properties as they wish, without regard to price, but must then close on 95% of those identified properties.

Main Objectives of the DST 1031 Exchange*

Tax Deferral

Access to Higher Quality Real Estate through Fractional Ownership

Potential Capital Appreciation

Potentially Tax-Efficient, Non-Correlating Income

DSTs: A Potentially Efficient Way to Complete a 1031 Exchange

Through IRS Rev Proc 2004-86, DSTs now provide a structure to facilitate a fractional ownership strategy for the purpose of a 1031 exchange. A DST is a legal entity created under Delaware law as a trust that holds title to 100% of the interest in the real property and investors acquire a beneficial interest in the trust, with limited personal liability for the underlying assets.

As illustrated here, you can think of a DST as owning a small piece of a property. Although many 1031 exchanges are completed directly by the property owner acquiring his or her own property, DSTs are an alternative solution providing a passive ownership that may be a viable solution for some investors. The investment is passive because it does not require active management by the investor and the sponsor of the DST provides all property management duties.

Adair, Sandy Springs, GA

Advantages of Fractional Ownership

Whole-property purchase responsibilities:

Locate a suitable replacement property and perform adequate due diligence on the asset.

Secure funding of the entire purchase price, including financing to replace any debt on the original property within the required time frame.

Manage the property on a day-to-day basis.

Meritage, Houston, TX

Fractionally-Owned purchase potential advantages:

Access to suitable replacement properties sponsored and pre-packaged with financing, due diligence, and title commitments.

Pooled funds with other investors allow for possibility to purchase higher quality assets.

Experienced property management teams who handle the day-to-day operation of the assets.

Considerations

Potential Benefits

Ability to own higher-quality real estate with lower investment minimums

Ability to diversify a portfolio with various locations and property types

Professional asset and property management creates passive ownership, which eliminates property management responsibilities for the investor, but retains monthly income in most cases

Quick closing process helps meet timing requirements

Potential Risks

The trustee may be unable to close a deal within the required time frame

There may be limited transferability, lack of liquidity and less control over operating decisions for individual investors. There is a potential of loss of principal value invested

If the trustee violates one of the mandatory tax restrictions, the investment could become immediately taxable

The tax code could change and negatively impact the investor

DST 1031 Case Study

Example 1: Calculation of Capital Gain

In the scenario we're about to see, the original property cost $300,000 and was sold for $450,000 with $10,000 in cost of sales. While holding the property, the owner claimed $150,000 of depreciation expenses, and $50,000 in capital improvements resulting in an adjusted cost basis of $200,000. The Federal Capital Gain Tax Rate is booked at 20% for this individual's income bracket, the Net Investment Income Tax is 3.8% for this income bracket, and state income tax ranges from 0-13.3%.

$64,620 - $96,540
Total savings to the client through deferred taxes in a DST 1031 exchange

Step One: Calculate **Adjust Basis**	
Original Purchase Price	$300,000
Add Capital Improvements	50,000
Minus Depreciation	(150,000)
Equals Adjusted Basis	$200,000
Step Two: Calculate **Capital Gain**	
FMV or Sales Price	$450,000
Minus Adjusted Basis	(200,000)
Minus Cost of Sale	(10,000)
Equals Capital Gain	$240,000
Step Two: Calculate Tax	
Assumed Capital Gain Tax Rate	20.00%
Assumed Depreciation Recapture Rate	25.00%
Assumed State Tax Rate	0 to 13.3%
Net Investment Income Tax	3.8%
Total Tax	**$64,620 to $96,540**

Example 2: A Comparison Scenario

In a properly executed 1031 exchange with the taxes deferred, more investment dollars are available for the new investment property. Using the same terms as the above example, let's now compare how our seller in the highest tax bracket would profit in the follow scenarios:

	Scenario A Paying Taxes on Property Sale	**Scenario B** Completing a 1031 Exchange
Purchase Price	$300,000	$300,000
Capital Improvements	$50,000	$50,000
Depreciation	($150,000)	($150,000)
Adjusted Cost Basis	$200,000	$200,000
Sale Price - Cost of Sales	$440,000	$440,000
Total Taxable Gain	$240,000	$240,000
Long-Term Capital Gain Liability (20%)	$18,000[1]	$0
State Tax (0-13.3%)	$0 - $31,920	$0
Net Investment Income Tax (3.8%	$9,120	$0
Depreciation Recapture Tax (25%)	$37,500[2]	$0
Total Taxes Due	$64,620 - $96,540	$0
Net Proceeds for Investment	$375,380 - $343,460	$440,000

1. Long-Term Capital Gain Liability computed only on gains not subject to the 25% Depreciation Recapture Tax [(240,000-150,000)*20%]
2. Depreciation Recapture tax computed to the extend of accumulated depreciation prior to sales ($150,000*25%)

Glossary of Terms

Accredited Investor - Defined in Rule 501 of Regulation D. While each state may have additional accreditation requirements, individuals are generally considered to be accredited if they have a net worth exceeding $1,000,000 (not including value of primary residence), or if their income exceeds $200,000 in each of the last two years. A joint income with a spouse exceeding $300,000 for those years with an expectation of the same income level in the current year.

Basis - The value of a property for tax purposes. Takes into consideration added value for capital improvements and decreased by the amount of depreciation taken.

Boot - The money or the fair market value of “other property” received by the taxpayer in an exchange. Subject to taxation to the extent there is a capital gain. Examples of boots can include: cash boot, mortgage boot, and personal property.

Exchange Period - The time frame in which the exchanger must acquire the replacement property in the exchange. Starts on the date the exchanger transfers the first relinquished property and ends when the exchange is completed or on the 180th day.

Exchanger - The property owner aiming to defer capital gain by utilizing a 1031 exchange.

Forward Exchange - Most common form of a 1031 exchange. Begins with the sale of the relinquished property and completes with the purchase of a replacement property.

Identification Period - The 45th period in which the investor must identify up to three potential replacement properties for a like-kind exchange. The 45 day window begins with the transfer of the investor’s relinquished property.

Like-Kind Property - Any real property hold for productive use in a trade or business or for investment can be considered “like-kind” property. Any real estate that is not help for personal use.

Private Placement Memorandum (PPM) - A legal, offering document that contains relevant objectives, disclosures, risks, and terms to aid investors in making informed investment decisions. May include financial statements, details of the company or entity issuing the securities offered, and the procedures for investing. Sometimes referred to as offering memorandum or offering document.

Qualified Intermediary - Third party entity that holds the exchanged funds and helps facilitate the exchange. Also referred to as QI, exchange facilitator, or exchange accomodator.

Realized Gain - Amount of the realized gain that is subject to tax. In a fully tax-deferred 1031 exchange, no gain is recognized.

Relinquished Property - The property the exchanger is selling.

Replacement Property - The property the exchanger is acquiring (purchasing).

Reverse Exchange - A 1031 exchange in which the replacement property must be purchased before the relinquished property is sold. Can also take place when improvements must be made to the replacement property before is can be acquired by the exchanger. Generally more complex than a forward 1031 exchange.

Sponsor - The company/party offering a property asset is available for sale to investors. The sponsor handles everything from purchasing the property, to building the financials, to handling of the property management. The sponsor will sell fractionalized interests to individual investors.

Important Risks and Disclosures

The Private Placement Memorandum contains more complete information regarding the investment including the following risk factors:

- 1031 exchange programs are not suitable for all investors. Please contact your tax professional or financial advisor.
- There will be no public market for the interests. Limited transferability and lack of liquidity.
- There is no specified time that the investment will be liquidated.
- Delaware Statutory Trusts are a relatively new vehicle for real estate investment and are inflexible vehicles to own real property.
- Investors will have no voting rights and will have no control over management of the trust or the property.
- There is no guarantee that investor will receive any return.
- Distributions may be derived from sources other than earnings. No assurance of when distributions will be made or that any particular rate of distribution will be maintained.
- The property will be subject to a master lease agreement.
- The property will be subject to the risks generally associated with the acquisition, ownership and operation of real estate including, without limitation, environmental concerns, competition, occupancy, easements and restrictions and other real estate related risks.
- The manager and its affiliates are subject to conflicts of interest between their activities, roles and duties for other entities and the activities, roles and duties they have assumed on behalf of the Trust. Conflicts exist in allocating management time, services and functions between their current and future activities and the Trust.
- Accredited investor use only.
- No assurance that the disposition of property will allow for the repayment of outstanding indebtedness.
- Reliance on an advisor
- Payment of significant fees to the advisor and its affiliates
- Limited powers of the advisor with respect to the properties.
- Risk that a prospective purchase may not be consummated.

*There can be no assurance that the investment objectives described herein will be achieved. Investment in securities sponsored by NexPoint is subject to substantial risks and may result in the loss of principal invested.

Polo Glen, Melbourne, FL

Please contact your financial advisor for more information

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