



Understanding Deed in Lieu of Foreclosure

Utilizing 1031 Exchanges

1031 | DST

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1031 EXCHANGES

Before discussing Deed in Lieu transactions, it's important to first understand 1031 exchanges and Delaware Statutory Trusts (DSTs). A 1031 exchange can serve as an effective tax deferral strategy for investors as part of succession and estate planning. Internal Revenue Code Section 1031 states:

"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 which is to be held either for productive use in a trade or business or for investment." This provision allows investors to defer capital gains taxes when exchanging qualifying investment real estate properties. The 1031 exchange can be a powerful tool for preserving and growing wealth through real estate investments.

Did You Know...

A 1031 Exchange may afford you the opportunity to defer capital gains taxes and build wealth.

Section 1031 of the Internal Revenue Code provides an effective strategy for deferring the capital gains tax that may arise from the sale of your business/investment property.

By exchanging the property for like-kind real estate, property owners may defer their tax and use all of the sale proceeds for the purchase of replacement property.

Like-kind real estate includes business/investment property, but excludes any personal use property.

DELAWARE STATUTORY TRUSTS

A Delaware Statutory Trust (DST) is a distinct legal entity created under Delaware law that permits fractional ownership of real estate assets that may be used in a 1031 Exchange.

However, to use a DST in a 1031 Exchange syndication program, it must comply with the requirements of IRS Revenue Ruling 2004-86, so that a beneficial interest in the trust is treated as an undivided fractional interest in real estate for federal income tax purposes (as opposed to a security or other prohibited interest that would not be treated as real property under Section 1031). An Exchanger can defer taxes by investing in a DST rather than in a whole property.



DEED IN LIEU

Most people don't realize that they're allowed to 1031 Exchange a Deed in Lieu of Foreclosure and defer the tax consequences. This is commonly referred to as handing the keys back to the bank.

Depending on the adjusted cost basis of the property being surrendered, we have solutions that would allow the real estate owner to invest pennies on the dollar. Imagine making an investment smaller than the tax consequences!



Many borrowers going through a foreclosure (or a deed in lieu of foreclosure) will have a taxable loss because the tax basis of the property exceeds the amount of debt. However, a taxpayer who loses a property through a foreclosure sale can recognize taxable gain although the taxpayer receives no cash from the sale. This can occur when the taxpayer has previously refinanced the property for more than the original loan and pulled equity out. A Deed in Lieu of Foreclosure can benefit an investor facing financial difficulties in several ways.

BENEFITS

1. Avoiding Foreclosure: By voluntarily transferring the property deed to the lender, the investor can avoid the lengthy and stressful foreclosure process.

2. Less Damage to Credit: While a deed in lieu still negatively impacts credit, it's generally less damaging than a foreclosure.

3. Possible Deficiency Waiver: Lenders may agree to forgive any remaining loan balance (deficiency) after the property is sold, relieving the investor of further financial obligation.

4. Reduced Costs and Fees: Foreclosure involves legal fees and other costs that a deed in lieu can help avoid.

5. Faster Resolution: This process can be quicker, allowing investors to move on and start rebuilding their financial stability sooner.

6. Substantial out of pocket cash savings.

7. Ownership of a long term, net leased property.

Overall, a deed in lieu of foreclosure can be a more dignified and less financially burdensome alternative to foreclosure for struggling investors.

IN THE NEWS

Late Mortgage Payments Pile Up for
Giant Apartment Lender

-The Wall Street Journal, February
'24

Risk of default is rising for \$1.2 trillion
of commercial real estate debt

-LA Times, August '23

'The office market has an existential
crisis right now': Billionaire Barry
Sternlicht joins chorus warning of \$1
trillion correction

-FORTUNE.COM, January '24





RECOURSE

If the debt secured by the property is nonrecourse, the taxpayer will realize taxable gain from the foreclosure equal to the difference between the outstanding principal amount of the debt being satisfied by the foreclosure and the taxpayer's adjusted tax basis in the property. For example, if the taxpayer's nonrecourse debt is \$1,000,000, and the adjusted tax basis in the property is \$200,000, the taxpayer will realize \$800,000 of taxable gain from the foreclosure in the year in which the foreclosure occurs. The amount recognized will equal the principal amount of the debt even if the fair market value of the property is lower than the principal amount.

Recourse debt has different rules. The recognized gain is limited to the fair market value of the property at the time of the foreclosure. Any income from debt relief in excess of the fair market value is cancellation of indebtedness income (COD), and not gain from the disposition of the property. Thus, if the taxpayer's recourse debt is \$1,000,000, the fair market value of the property is \$700,000, and the adjusted tax basis in the property is \$200,000, the taxpayer will recognize \$500,000 of taxable gain from the foreclosure, and \$300,000 of COD.

The taxpayer will owe tax on this gain for the year in which the foreclosure occurs. In many jurisdictions, however, the taxpayer will have a right of redemption once the foreclosure occurs. According to the IRS reporting requirements for a lender who acquires property in a foreclosure, an interest in property is acquired on the date title is transferred to the lender (unless possession and the burdens and benefits of ownership have already been transferred to the lender).

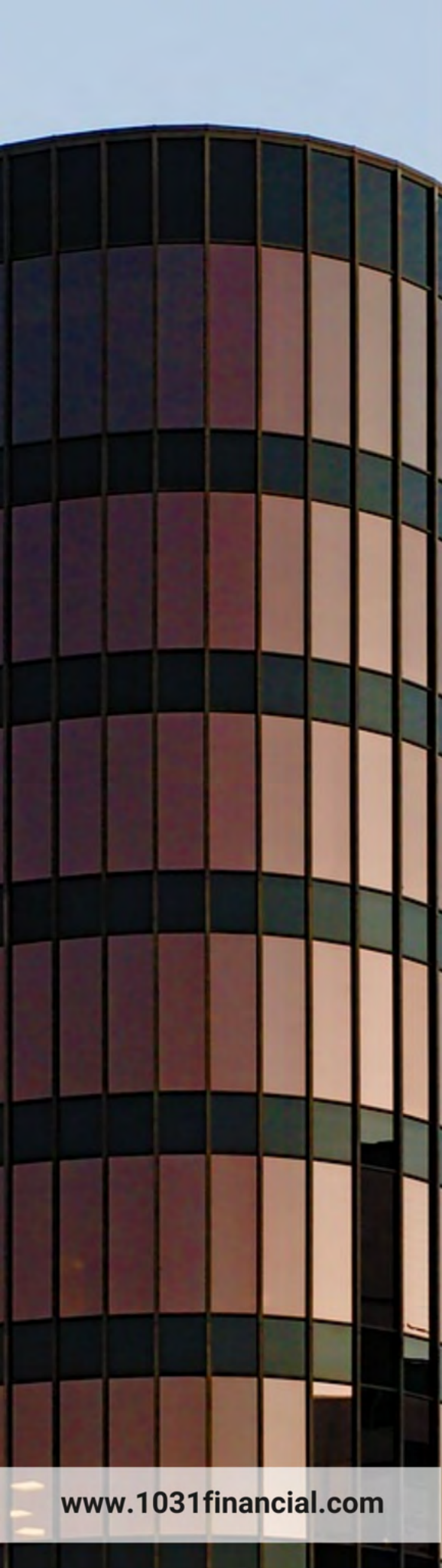
In the event of a foreclosure where the borrower retains a right of redemption, IRS reporting regulations stipulate that if the lender acquires the property at a sale conducted to satisfy the debt (such as a foreclosure or execution sale), the lender is considered to have obtained an interest in the property on the later of either the sale date or the expiration date of the borrower's right of redemption, if applicable.



FRIENDLY LENDERS

A friendly lender can provide invaluable support and flexibility to an investor facing financial difficulties with their property. Such a lender is characterized by open communication and transparency, offering clear explanations of available options and timelines. They are willing to negotiate alternative solutions to foreclosure, taking into account the investor's financial situation and goals. Potential actions by a friendly lender include loan modifications to adjust terms and make payments more manageable, forbearance agreements to temporarily reduce or suspend payments, and accepting a deed in lieu of foreclosure to help the investor avoid foreclosure and potential credit damage. They might also agree to a short sale, allowing the investor to sell the property for less than the outstanding mortgage balance, possibly forgiving the remaining debt or negotiating terms for repayment. Additionally, they may provide guidance and support to help the investor complete a 1031 exchange, ensuring a smooth transition to a replacement property.

The benefits to the investor of engaging with a friendly lender are significant. Avoiding foreclosure can prevent the lengthy, stressful, and credit-damaging process that typically ensues. By negotiating alternatives such as a deed in lieu or a short sale, the investor can protect their credit score and gain financial relief through loan modifications or forbearance agreements, allowing them to stabilize their situation. In cases where a deficiency waiver is possible, the investor can be relieved of further financial obligations. Ultimately, with the support of a friendly lender, the investor has a better chance to recover financially and reinvest in future opportunities, including utilizing a 1031 exchange to defer capital gains taxes. This cooperative approach benefits both the lender and the investor, fostering a positive resolution to a challenging situation.



NEUTRAL LENDERS

A neutral lender maintains a balanced approach, neither overly accommodating nor excessively stringent. They adhere strictly to standard procedures and policies, ensuring that all communications and negotiations are clear and straightforward. This type of lender will provide the investor with a comprehensive overview of available options, such as loan modifications, forbearance agreements, or the possibility of a short sale, but will do so without extending additional favors or leniencies. They may agree to loan modifications or forbearance agreements if the investor meets specific criteria, adjusting terms to make payments more manageable. They might also allow a deed in lieu of foreclosure or a short sale if it aligns with the lender's interests and policies, ensuring the investor understands the implications and requirements of each option. Guidance for a 1031 exchange could be provided, but the lender's involvement would be limited to ensuring compliance with necessary procedures.

The benefits of working with a neutral lender include a clear and predictable process. The investor can expect fair treatment based on the lender's established policies, without the risk of unexpected changes in terms or conditions. This approach provides the investor with a structured path to address their financial difficulties, whether through modified loan terms, temporary payment relief, or property disposition methods like a deed in lieu or short sale. While a neutral lender may not offer the same level of personalized support as a friendly lender, the investor can still achieve financial stability and potentially reinvest in future opportunities. By adhering to standard procedures and providing necessary options for relief, a neutral lender helps ensure that the investor can navigate their challenges with clarity and a sense of predictable outcomes.

UNFRIENDLY LENDERS

Many lenders will not cooperate with the taxpayer and there will be no transfer agreement to assign to the QI, and the relinquished property will be transferred to the lender through the foreclosure. In such a situation, the QI can also acquire and transfer legal title to the relinquished property to meet the safe harbor. This method will work in a foreclosure sale if the relinquished property is deeded to the QI prior to the foreclosure. This transfer can increase the cost of an exchange because of the additional deed recording fees or real property transfer taxes. If the real property is owned in an LLC that is also a disregarded entity for federal tax purposes, the taxpayer can transfer the LLC as the relinquished property to possibly avoid transfer taxes.

The taxpayer would assign the membership interest in the LLC to the QI, effective immediately prior to the foreclosure, and this assignment will be treated as the transfer of the relinquished property to the QI for the QI safe harbor. Further, the lender is not required to receive written notice of the assignment of membership interests in the LLC in order to meet the QI safe harbor because there has been an actual transfer of the relinquished property to the QI. Thus, the lender might not find out about the transfer of the membership interests in the LLC to the QI, which might help the taxpayer avoid difficulties with an uncooperative lender. The lender then forecloses on the property while the QI owns the LLC, and the QI has met the requirement that it transfer the relinquished property to the transferee.

PROBLEM #1

Underwater Investment Property in a 1031 Exchange: John, an investor, owns a commercial property he purchased for \$1.5 million. The property has a mortgage balance of \$1.2 million. John decides to use a 1031 exchange to defer capital gains taxes by exchanging his current property for a new one.

Market Decline: Due to an economic downturn, the value of John's property drops to \$1 million. This situation puts John underwater because the property's market value is now less than the mortgage balance.

Challenges:

1. **Negative Equity:** The property is worth less than the outstanding mortgage, making it difficult to sell or exchange without incurring a loss.
2. **Financing Issues:** Securing financing for a new property in a 1031 exchange becomes challenging since the lender will consider the negative equity situation.
3. **Tax Implications:** If John proceeds with a sale without a 1031 exchange, he may face significant capital gains taxes on any prior depreciation taken, even though he has no actual equity left.

OPTIONS

Potential Solution - Deed in Lieu of Foreclosure:

John negotiates a deed in lieu of foreclosure with his lender. By voluntarily transferring the deed to the lender, John can:

1. **Avoid Foreclosure:** Preventing the negative credit impact and stress of foreclosure.
2. **Debt Forgiveness:** Possibly negotiate the waiver of any deficiency, meaning the lender forgives the remaining mortgage balance after taking the property.
3. **Financial Reset:** John can reset his financial situation, eliminating the underwater property and any associated debt, allowing him to start fresh.

In this scenario, a deed in lieu of foreclosure provides John with a way to avoid the complications of an underwater property in a 1031 exchange and move forward with better financial stability.



PROBLEM #2

Best Candidates: Commercial property owners with a low tax basis facing foreclosure.

The Problem: The property owner may owe a substantial capital gains tax upon foreclosure. In fact, the worst problem about foreclosure may not be the loss of property, but the tax owed. Taxable gain is recognized from a foreclosure since the event is deemed a sale by the IRS. The gain (recapture) equals the amount of the deemed sale, less the adjusted tax basis, assuming non recourse debt. Combined, federal state and local taxes may exceed 30% of the gain. The lower the tax basis in the property, the greater the gain, and the greater the tax. A low tax basis in the foreclosed property typically results from long-term ownership or from carrying in a low tax basis from a previous 1031 exchange.

SOLUTION

The Solution: Complete a 1031 exchange where the equity for the replacement property is substantially less than the tax that would be due.

How It Works: Defer the tax by giving the property back to the lender through a qualified intermediary, initiating a 1031 exchange. Use a deed in lieu of foreclosure to transfer the property. Acquire a long term, investment grade credit, net lease replacement property with credit tenant financing for around 10% equity. This transaction cannot work using a 1031 exchange with property other than a long term, investment grade, net lease property with credit based financing, since too much equity would otherwise be required. The Advisory Group at Net Lease Capital provides appropriate properties, financing and transaction structures to optimize owner outcomes.

EXAMPLE

- **Background:** Eight years ago, Marty traded into a \$24mm property, using nonrecourse debt at 75% LTV. Today, the property is only worth \$20mm. Marty refinanced to pull out equity so his debt, today, is \$20mm. His current basis is \$2mm.
- **The Problem:** He would give the property back to the bank, but it would cost him at least \$4.8mm of capital gains tax, or about 30% of the gain, where the gain is calculated as the difference between the amount of nonrecourse debt and the adjusted basis.
- **The Solution:** \$2.2mm million saved of cash out of pocket, plus residual value of the replacement property.

Option 1: Foreclosure and Recapture Tax

- \$20mm existing debt (giving property back to lender)
- \$0mm cash
- \$20mm deemed sale price
- -\$2mm basis
- \$18mm capital gain
- x 30% (Blended rate; Actual rate may be higher)
- \$5.4mm capital gains tax

-\$5.4mm cash

Option 2: 1031 Exchange

- \$20mm existing debt (giving property back to lender through a qualified intermediary to initiate an exchange)
- \$20mm deemed sale price
- \$2.8mm equity to purchase replacement property

\$2.8mm Cash

\$2.6MM AHEAD BY INVESTING

Handing the Keys Back to the Bank

Scenario 1	Sample Client	Debt Forgiveness
Not doing a 1031 Exchange	Office Landlord	\$20,000,000.00

Tax Bracket of Tax Payer: 30%

Taxes from Debt Forgiveness -2mm Basis: \$5,400,000

Deed in Lieu using a 1031 Exchange	Tenant Type	LTV	fr	1031 Investment	Estimated Debt	Estimated Total RE
Zero Coupon High LTV DST	Credit NNN 20-Year Lease	86.00%	0.14	\$2,800,000	\$17,200,000.00	\$20,000,000.00

Investment 20 Year Hold: \$2,800,000

GLOSSARY OF COMMON TERMS

Accredited Investor: Defined in Rule 501 of Regulation D to refer to investors who are financially sophisticated and have a reduced need for the protection provided by certain government filings. While each state may have additional accreditation requirements, individuals are generally considered to be accredited if they (i) have a minimum net worth exceeding \$1,000,000 for individuals, including spouse or spousal equivalent (excluding the value of your primary residence), (ii) a minimum annual income requirement for the past two years of \$200,000 per year for an individual; or \$300,000 per year, including spouse or spousal equivalent and a reasonable expectation of the same income level in the current year, (iii) an individual who is licensed and in good standing as a (a) General Securities Representative (Series 7), (b) Licensed Investment Adviser Representative (Series 65), or (c) Licensed Private Securities Offerings Representative (Series 82), or (iv) a “knowledgeable employee” as defined under the Investment Company Act of 1940, of the Trust or the Trustee or an affiliated management person of the Trust, such as the Sponsor.

Boot: Any consideration other than “like-kind” property received by the investor. Boot is subject to taxation to the extent there is capital gain. Boot can accumulate over each exchange and is retroactive back to the original relinquished property. Boot can refer to cash boot, mortgage boot and personal property.

Cash Boot: Any funds received by the Exchanger—either actually or constructively—from the sale of the relinquished property.

Constructive Receipt: Exercising control over your exchange funds or other property including having money or property from the exchange credited to your bank account or property or funds reserved for you. Being in constructive receipt of exchange funds or property may result in the disallowance of the tax-deferred, like-kind exchange transaction thereby creating a taxable sale. An example of constructive receipt would be the investor selling his relinquished property and having a closing officer hold the proceeds in an escrow or trust account on his behalf.

Direct Deeding: Either the relinquished property or the replacement property can be deeded directly from seller to buyer without deeding the property to the Qualified Intermediary. Direct deeding may eliminate paying transfer taxes twice on the sale of the relinquished property and purchase of the replacement property.

Exchange Agreement: The written agreement defining the transfer of the relinquished property, the subsequent receipt of the replacement property and the restrictions on the exchange proceeds during the exchange period. The exchange agreement specifies all the terms of the relationship between the investor and the qualified intermediary.

Exchange Period: The period of time during which an investor must complete the acquisition of the replacement property in a like-kind exchange transaction. The exchange period is 180 calendar days from the transfer of the investor's relinquished property, or the due date (including extensions) of the investor's income tax return for the year in which the tax-deferred, like-kind exchange transaction took place (whichever is earlier), and is not extended due to holidays or weekends.

Exchanger: An individual, married couple or any other entity such as a corporation, limited liability company, partnership or trust. An investor has property and would like to exchange it for new property.

Identification Period: The period of time during which an investor must identify potential replacement properties for a tax-deferred, like-kind exchange. The period is 45 calendar days from the transfer of the investor's relinquished property and is not extended due to holidays or weekends.

Like-Kind Property: Any two assets or properties that are considered to be the same type under federal income tax law, making an exchange between them tax deferred. Like-kind real estate property is basically any real estate that is not held for personal use, including a second home which is held for investment purposes. Following the Tax Cut and Jobs Act of 2017, like-kind property is limited to real property.

Mortgage Boot: Mortgage Boot occurs when the Exchanger does not acquire debt that is equal to or greater than the debt that was paid off, and is therefore ‘relieved’ of debt, which is perceived as taking a monetary benefit out of the exchange. Therefore, the debt relief portion is taxable, unless offset by adding equivalent cash to the transaction.

Private Placement Memorandum (“PPM”): A legal document stating the objectives, risks and terms of investment involved with a private placement. This may include items such as the financial statements, management biographies, detailed description of the business, etc. A PPM serves to provide buyers with information on the offering and to protect the sponsor from the liability associated with selling unregistered securities.

Qualified Intermediary: Also called: intermediary, QI, accommodator, facilitator, or qualified escrow holder. The QI is a third party that holds exchange funds and helps to facilitate the exchange.

Regulation D Offering: An exemption from registration of securities offerings under U.S. Securities laws often used for TIC and DST ownership investments where, among other factors, investors generally must be qualified as accredited investors.

Relinquished Property: The original property given up by the investor which is sold by the qualified intermediary. This property is sometimes also referred to as the sale, “downleg” or “Phase I” property.

Replacement Property: The like-kind property to be acquired or received by the investor from qualified intermediary's purchase from the seller in a tax-deferred exchange transaction. This property is sometimes also referred to as the purchase, “upleg” or “Phase II” property.

Reverse Exchange: A reverse 1031 Exchange represents a tax deferral strategy when for a variety of reasons, the replacement property must be purchased before the relinquished or old property is sold. It is more complex than a forward 1031 Exchange and requires careful planning.

Sponsor: The party offering a commercial property asset available for sale to investors. The sponsor purchases the property, arranges the financing (if any), sells the fractionalized interests to individual investors, and typically handles accounting and property management after closing.





1031 Financial works with accredited investors and professional advisors including but not limited to attorneys, accountants and qualified intermediaries to help their clients with Delaware Statutory Trust (DST) real estate transactions. Our firm represents some of the largest DST sponsors by offering professionally managed, institutional grade properties, with the added benefit of being able to replace debt on a non-recourse basis. Interests in these properties may qualify as a "Like Kind" exchange.

For more information, please contact 1031 Financial at: [347.293.0084](tel:347.293.0084)

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Securities offered through 1031 Securities Inc., member FINRA/SIPC.

General Real Estate Risk

All forms of real estate investing are speculative and involve a high degree of risk. Investors should be able to bear the complete loss of an investment. All real estate is generally subject to the risks of increased and ongoing vacancy, problematic tenants, economic downturns, physical damage or loss, unexpected repairs and maintenance, eminent domain, negative rezoning, blight, environmental damage and liability, and overall valuation fluctuations that may be outside of the owner's control.

Specific 1031 Exchange Risks

1031 Exchanges are highly complex and failure to comply with the stringent requirements may result in a complete loss of the desired tax deferral. Investors should carefully consult with independent tax and legal counsel prior to initiating, and while performing, a tax deferred exchange.

There are numerous section 1031 rules and requirements including, but not limited to: seller cannot receive or control the net sales proceeds, replacement property must be like-kind to the relinquished property, the original replacement property must be identified within 45 days from the sale of the property, the replacement property must be acquired within 180 days from the sale of the original property, and the debt placed or assumed on the replacement property must be equal or greater than the debt encumbering the relinquished property.

Illiquidity

There is no significantly established secondary market for syndicated, fractionalized TIC and DST ownership interests. The transfer of these interests may also be legally restricted. Investors should carefully consider both their ongoing liquidity needs and estate planning goals prior to investing in such an interest.

Limited Diversification

Most offerings are for ownership interests in a single property, and any desired diversification must be achieved with other real estate investments.

No Guarantee of Performance

Bluerock Real Estate does not guarantee ongoing distributions or overall investment performance.

Sponsor-Related Fees

Bluerock Real Estate and its affiliates will collect significant fees related to the acquisition, syndication, ongoing management, and eventual disposition of any real estate offerings. These fees could materially impact the performance of an investment and should be carefully considered prior to any such investment.

Leverage-Related Volatility

The use of leverage in real estate investments may increase volatility and the overall risk of loss.

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Do not construe the contents and discussion herein as legal, tax or accounting advice. The information contained herein is believed to be accurate, however, no such warranties, representations, or guarantees are provided to that effect, either expressly or implicitly. Further, the information contained herein is intended only to provide a high level overview and not an exhaustive explanation of the rules, regulations, exceptions, etc. generally applicable to a like-kind exchange pursuant to Internal Revenue Code Section 1031. The discussions and examples contained herein are based on law presently in effect and certain proposed Treasury Regulations. Nonetheless, readers should be aware that new administrative, legislative or judicial action could significantly change the information contained herein. Transactions involving Internal Revenue Code Section 1031 are highly complex, and it is strongly recommended that investors seek competent, independent tax and legal counsel prior to initiating, and while performing, such a tax deferred exchange.

Securities, such as the DSTs mentioned herein, have not been and will not be registered under the Securities Act of 1933 or applicable state securities laws, nor has the Securities and Exchange Commission or any state regulatory authority passed upon or endorsed the merits of the disclosure herein. In making a decision investors must rely on their own examination of the transaction and its terms, including the merits and risks involved. There can be no guarantee that the methods described herein will suit your individual needs or that the rules governing such methods will not change over time.