

# A guide to investing in 1031 exchange programs

What you should know before you invest

Before you make an investment decision, it is important to review your financial situation, investment objectives, risk tolerance, time horizon, diversification and liquidity needs with your financial advisor. This guide will help you better understand the typical features and costs associated with investments in 1031 exchange programs, as well as how your financial advisor and Wells Fargo Advisors are compensated when you invest in these products. For detailed information about a particular 1031 exchange program, you should read the private placement memorandum (PPM) or offering documents for that fund. A PPM is a securities disclosure document that contains a complete description of the security and the terms of sale in addition to information about the issuer's financial situation, risks of investment, and other important information.

## What is a 1031 exchange program?

Title 26, Section 1031 of the Internal Revenue Code (IRC) allows investors to exchange investment properties for “like-kind” assets to be held for productive use in a trade or business or for investment purposes. A 1031 Exchange Program is a strategy utilizing private funds that is designed to allow an investor to structure their property investments in such a way as to adhere to section 1031 of the Internal Revenue Code and potentially benefit from a number of its provisions. These funds may be structured as Delaware Statutory Trusts (DSTs), Limited Liability Companies (LLCs) or Limited Partnerships (LPs) that allow investors to defer capital gains taxes on the sale of the original property. This guide will focus on those funds (Funds) structured as DSTs. A 1031 exchange does not eliminate the need to pay taxes; it simply defers payment until the investor decides to realize all gains, rather than reinvesting them. In sum, such funds are created to allow for investors to realize the tax advantages of Section 1031 by contributing the proceeds of a sale of real estate to the fund and gaining exposure to multiple properties held by the fund. To qualify for a 1031 exchange, you must comply with the requirements of IRC Section 1031, which are complex. For instance, a typical 1031 exchange process involving a DST may include the following steps:

- A 1031 exchange involves the sale of an investment property, the proceeds of which must be placed with a Qualified Intermediary.
- Within 45 days of this sale, the seller must identify a replacement property, which, in the case of a participant in a Program, involves the identification of the applicable Fund as a potential “like-kind” property/properties for the 1031 exchange. NOTE: The rules regarding replacement property identification are complex and failure to complete the applicable tax forms correctly may impact your ability to take advantage of the Section 1031 tax benefits.

**Investment and Insurance Products are:**

- Not Insured by the FDIC or Any Federal Government Agency
- Not a Deposit or Other Obligation of, or Guaranteed by, the Bank or Any Bank Affiliate
- Subject to Investment Risks, Including Possible Loss of the Principal Amount Invested

- Upon being accepted into a Fund, the proceeds of the original sale must be reinvested within 180 days of the original sale. There, however, is no guarantee you will be accepted into a Fund and need to consider carefully other potential replacement property/properties to identify on the applicable tax forms.
- After two years, a potential subsequent exchange of the DST into a real estate investment trust (REIT) via Section 721 of the IRC (also known as an UPREIT transaction), which an investor may contribute property, in this case the DST, to a REIT operating partnership without triggering a taxable event, and pursuant to which the investor receives Operating Partnership (OP) units can occur.
- Upon holding the OP units for one year, investors may elect to continue to hold the units or redeem all or part of the units for stock in the REIT or cash, allowing for ultimate liquidity, if desired, at which time taxes would be due on any recognized gain.

Prospective investors should carefully read and consider the offering documents and consult with their tax advisor before investing in or considering a 1031 exchange. Each prospective purchaser is advised to also consult with their own tax advisor regarding the specific tax consequences of a contribution of property to a partnership, including the federal, state, local, foreign and other tax consequences of such transactions, ownership or sale and of potential changes in applicable tax laws. Further, prospective investors should independently obtain advice from their tax counsel and/or tax accountant about the Program and any Section 1031 exchange and applicable state laws, including without limitation, whether the acquisition of an interest in a Program may qualify for IRC Section 1031 treatment, completing any tax forms related to the Section 1031 exchange, identifying replacement properties with the intention of complying with the identification rules under IRC Section 1031, contributing property to a partnership with the intention of qualifying for IRC Section 721 treatment, and/or making an investment with the Program, relying exclusively on such advice with respect to tax risks and issues, while making no assertion inconsistent with the foregoing.

While 1031 exchanges from one property to another specific property are available to the general public, an exchange from relinquished property into a 1031 exchange fund is only accessible to institutional investors and qualified high net worth individuals through private qualified exchange funds, usually organized as limited partnerships or Delaware Statutory Trusts. These investment vehicles seek investors and pool investor capital to create private investment funds for the general partner(s) or sponsor(s) to manage.

**Capital distributions.** Over the long term, the investments that the managers make in the portfolio may become a realized profit to the fund if those managers sell, merge, recapitalize, or bring the investments to the public market at a higher value. If the fund makes such a profit, the 1031 exchange fund will typically disperse those proceeds to its partners on a pro-rata basis through a capital distribution. This is how the fund pays investors. Capital distribution issuance is at the discretion of the fund manager. Not all 1031 exchange funds will hold investments for the full tax realization period, which would require investors to owe taxes on any fund gains and potentially risk capital gain tax advantages.

# Investment characteristics

## **1031 exchange funds have the following characteristics:**

**“Absolute” returns.** Most 1031 exchange funds seek to achieve positive or “absolute” returns regardless of the market environment (rather than merely striving to “beat” or outperform a market index). It is important to note that, in seeking to achieve an absolute performance, funds may use sophisticated and high-risk investment strategies. 1031 exchange funds may also use incentive-based compensation, such as “carried interest” (a share of any profits that the general partners receive as compensation), as encouragement for managers to achieve annual net cash returns.

**Use of leverage.** 1031 exchange funds may employ leverage as a means to enhance returns, but leverage is typically not the exclusive investment strategy. The potential benefit of leverage is that it can increase buying power while amplifying investment returns. Leverage also increases risk, because it magnifies negative returns if investments are poorly underwritten or executed and/or market conditions deteriorate.

# Investor characteristics

**Suitability.** 1031 exchange funds are not appropriate for all investors. Prospective investors are required to meet minimum financial eligibility guidelines to invest in such funds. These investments are appropriate for investors with large eligible capital gains they are seeking to defer. Each investor will have a unique tax situation and should work with their own tax advisor. You should evaluate your individual financial condition and your ability to tolerate risk before you invest in these funds.

Because 1031 exchange funds are typically not registered with the Securities and Exchange Commission (SEC), they can offer or sell securities to only certain types of individuals known as “accredited investors.” Accredited investors are defined as an individual with at least \$1 million (exclusive of the value of the primary residence) in individual or joint net worth or an accredited U.S. institutional investor, which is defined as an entity having at least \$5 million in investable assets.

Prior to investing in 1031 exchange funds, it is important to remember that regardless of your ability to qualify financially to invest in these products, you must fully understand the products’ risks and characteristics, including tax implications, and be capable of tolerating the risk involved with the investment — including the potential loss of the entire investment.

**Diversification.** Wells Fargo Advisors believes that investors should diversify their investments. It is recommended that investors observe an asset allocation strategy and not overweight their overall portfolio in any one class of securities, particularly in private equity, and private real estate funds that include 1031 exchange funds. It is important to note asset allocation and diversification are investment methods used to help manage risk. They do not guarantee investment returns or protect against loss.

## Certain risks

Understand that this list only highlights some of the key risks associated with 1031 exchange funds and is not an exhaustive list of risks. For a comprehensive discussion on risks, please refer to the fund offering documents.

**Long-term investment.** Unlike mutual funds, which generally invest in publicly traded securities and offer daily liquidity, 1031 exchange funds have illiquid underlying investments that may not be easy to sell and the return of capital and realization of gains, if any, from an investment will generally occur only upon the partial or complete disposition or refinancing of such investments. 1031 exchange funds have limited provisions for redemptions and you should therefore expect that they would not receive a return of capital for an extended period, with expected holding periods of 7 or more years. As a result, investments into 1031 exchange funds are not appropriate for all investors and realization of gains, if any, from an investment will generally occur only upon the partial or complete disposition or refinancing of such investments. 1031 Exchange funds have limited provisions for redemptions and you should therefore expect that they would not receive a return of capital for an extended period, with expected holding periods of 7 or more years. As a result, investments into 1031 exchange funds are not appropriate for all investors, especially those who need liquidity. In an effort to maximize profits, an 1031 exchange fund manager may choose to hold onto an investment beyond 7 years. Before investing, it is important to read and consider carefully the detailed information found in the fund's offering documents, including details about the investment's objectives, risk/return profile, and fees and to understand the fund's potential holding periods.

**Illiquidity and limited transferability.** 1031 exchange funds are not "liquid" (they cannot be sold or exchanged for cash quickly or easily), and the interests are typically non-transferable without the consent of a fund's managing member. As private funds, there are no established secondary markets for 1031 exchange fund interests and none are expected to develop. Given this lack of an active trading market for fund interests, any sale to a replacement investor performed in accordance with the fund transfer restrictions may result in a discounted sale price relative to current valuations. Wells Fargo Advisors does not participate in, or receive compensation for, such secondary sales. As a result of this illiquidity and restrictions on transferability, 1031 exchange funds are generally only appropriate for sophisticated investors who have carefully considered their financial capability to bear large fluctuations in value and hold these investments for the long term.

**Lack of portability.** Most private equity and real estate offerings, which include 1031 exchange funds, are unique to the selling firm. In most cases, if you or your financial advisor leave Wells Fargo Advisors, your investments will be unable to transfer to another firm.

**Difficult valuation assessment.** The portfolio holdings in 1031 exchange funds may be difficult to value because financial markets or exchanges do not usually quote or trade the holdings. As such, market prices for most of a fund's holdings will not be readily available. Additionally, it may be hard to quantify the impact a manager has had on underlying investments until the manager sells the investments.

**Leverage.** 1031 exchange funds may use leverage in connection with certain investments or participate in investments with highly leveraged capital structures. Although the use of leverage may potentially enhance returns and increase the number of investments that can be made, leverage also involves a high degree of financial risk and may increase the exposure of such investments to factors such as rising interest rates, downturns in the economy or deterioration in the condition of the assets underlying such investments.

**Unregistered investment.** As with other unregistered pooled vehicles, the regulatory protections of the Investment Company Act of 1940 are not available with 1031 exchange funds, and as such, offer fewer legal protections than you would have if you invested in a more traditional investment, such as a mutual fund. For instance, 1031 exchange funds are not required to provide you with information about their underlying holdings or provide periodic pricing and valuation information. Therefore, you are often putting your complete trust in the managers' abilities to meet their funds' objectives, without the benefit of knowing their investment selections. This lack of information may make it more difficult for you to evaluate the risks associated with the funds.

**No assurance of achieving tax benefits.** It is possible, due to tax, regulatory, or investment decisions, that a fund, or its investors, are unable to realize any tax benefits. Accordingly, 1031 exchange funds generally provide no assurances that an investor will realize any tax benefit or that the fund itself will satisfy all the requirements of the opportunity zone regulations for an investor to be able to realize the associated tax benefits. You should evaluate the merits of the underlying investment and not solely invest in a 1031 exchange fund for any potential tax advantage.

**Tax treatment.** Generally, investors in 1031 exchange funds are subject to income taxes on the income and/or capital gains distributed to them from those funds. In some years, investors' tax liabilities may exceed any distributions received from the funds. Additionally, investors may be subject to various limitations on their ability to use their allowable share of deductions and losses from the funds (for example, passive loss limitations, investment interest limitations, capital loss limitations and limitations on the deductibility of miscellaneous itemized deductions).

1031 exchange funds and contributions thereto have very specific guidelines that must be followed in order to participate in beneficial tax treatment. These funds are not appropriate for retirement accounts such as IRAs. Investors considering using retirement accounts or tax-exempt entities, such as endowments or foundations, should consult with their financial advisor and tax professional. Additionally, prior to considering any investment, these funds should be scrutinized for tax consequences with your tax adviser before an investment is made. There are a number of adverse tax consequences that should be taken into account when considering an investment in 1031 exchange funds.

Most are organized as limited partnerships (LPs), limited liability companies (LLCs) or Delaware Statutory Trusts (DSTs). These structures pursue a "pass-through taxation" strategy where taxes are "passed through" to the owners, who then report loss or income on their personal income tax returns. 1031 exchange funds will send their investors Schedule K-1 tax statements, which are typically issued later than 1099s. For this reason, investors may need to file a tax extension for every year of involvement with the fund.

In an effort to maximize profits, a 1031 exchange program manager may choose to liquidate an investment prior to realization of any tax benefit. As noted above, prior to investing, a program's offering document should be consulted to understand potential holding periods, tax implications and risks, among other important considerations.

## Consult with your tax advisor

Wells Fargo Advisors, its affiliates, and your financial advisor are not tax or legal advisors. The IRC regulations and associated compliance obligations regarding 1031 exchanges are complex. The use of a 1031 exchange fund to comply with these obligations poses unique tax issues and risks that you should discuss with your tax and legal advisor prior to initiating any 1031 exchange or participating in a 1031 exchange program. You should discuss with your tax or legal advisor whether any tax benefits of a 1031 exchange program benefit your unique tax situation and outweigh the potential risks involved in this investment. A 1031 exchange fund involves unique tax reporting requirements that may be more complex, including state tax rules that may be different than federal tax treatment.

## Costs of investing in 1031 exchange funds, including compensation to your financial advisor and Wells Fargo Advisors

Expenses associated with 1031 exchange funds are significantly higher than many other traditional investment vehicles. There are no limits on the fees such funds can charge investors, and several types of fees and charges are associated with these funds. You need to understand these expenses before investing. Costs will reduce the value of your total investment and your return. Investors should analyze the added cost against the benefits obtained by investing in 1031 exchange funds.

Wells Fargo Advisors and your financial advisor receive payments depending on the fund, amount invested, and class you select. For helping you invest in these funds, Wells Fargo Advisors and your financial advisor are compensated in ways that vary depending on the selected investment. Funds pay Wells Fargo Advisors from the fees paid by you. Part of that payment then goes to your financial advisor, and the remainder is retained by Wells Fargo Advisors.

For brokerage accounts, a financial advisor's compensation is based on the sales fees mainly set by the funds and described in the offering documents. For advisory accounts, a financial advisor's compensation is based on a percentage of the assets in the account rather than on the sales fees associated with a given fund.

The compensation formula that determines the amount of payment to your financial advisor is the same across many funds. Some funds, however, may carry higher sales charges than others, which may create an incentive for the financial advisor to recommend those funds. Typically, registered funds have higher upfront sales charges and lower investment minimums than unregistered funds due to the costs associated with filing the registration statement.

All fees and expenses are disclosed in the fund “offering documents” (documents provided by a fund that explain its objectives, risks, terms of investment and other policies), and you should carefully review these charges and expenses and understand their implication regarding your potential investment. Typical expenses include, but are not limited to, the following: Performance or incentive fee. In addition to the annual management fee, a 1031 exchange fund may charge a performance-based fee referred to as “carried interest.” This fee is usually a fixed percentage of the performance and typically accrues only after the fund’s net returns clear a predefined hurdle rate of return.

As an example, assume that a 1031 exchange fund has a carried interest charge of 20% and a pre-established 8% hurdle rate. A total return of 10% (net of management fee) by the fund in any given year would entitle the manager to collect 20% (performance incentive fee) on 2% of the profits or, in other words, those returns that were in excess of its 8% hurdle rate. This would result in a total net return to investors of 9.6%. A performance fee, such as the one described, could motivate a fund manager to take greater risks in the hope of generating a larger return and, in turn, receiving a higher fee.

Placement fee (generally applied only to brokerage share classes). The placement fee is a front-end sales charge (a sales charge that must be paid upon purchase) paid to the placement agent. In turn, the agent may pay a portion of those fees to affiliated or unaffiliated registered broker-dealers or other entities involved in the offer and sale of the 1031 exchange program interests.

For brokerage accounts, you may pay Wells Fargo Advisors directly prior to investing into a 1031 exchange program, or Wells Fargo Advisors may receive all or a portion of the placement fee that you otherwise pay to the program or program manager. Wells Fargo Advisors uses this fee to compensate its financial advisors.

Management fee. Investors are charged an annual management fee on the value of their investment. This fee is the cost of a fund manager making the investment decisions for you and for managing the fund. The fund manager typically receives a fee of 1% to 2% of net assets, although this amount depends on various factors, including the type of fund.

For brokerage accounts, all or a portion of the management fee may be paid to Wells Fargo Advisors to compensate it and your financial advisor for distribution and marketing, as well as for other continued services provided to the fund and your account. This fee is often called a “trail fee,” which alternatively (or a portion of which) may be treated as a separate fund fee or expense. See the “trail fee” section below.

Transaction and administrative expenses. As limited partners, investors are charged a pro-rated percentage (based on their investment) of all transactional, administrative and other expenses incurred by the fund. These expenses are not paid directly as a fee, but rather are deducted from the fund’s assets, resulting in the reduction of investment returns.

Trail fees (generally applied only to brokerage share classes). As noted above, in lieu of paying trail fees from (or exclusively from) the management fee, some funds may charge trail fees. All or a portion of the trail fees are generally paid to fund placement agents for the on-going services provided to the fund and investor accounts.

For brokerage accounts, Wells Fargo Advisors generally receives all or a portion of the trail fee, which is used, in part, to compensate your financial advisor.

# Intra-Company compensation arrangements

Wells Fargo Advisors may also receive compensation from other Wells Fargo & Company subsidiaries, including for the referral of certain business among such subsidiaries. Additionally, within the division that operates in Wells Fargo Bank financial centers and some Wells Fargo branches, both financial advisors and Licensed Bankers can assist you with your investment needs. A Licensed Banker is a Wells Fargo Bank associate who is registered with Wells Fargo Advisors.

Licensed Bankers may also refer you to a financial advisor. In these instances, both the financial advisor and the Licensed Banker may be compensated for the sale of a 1031 exchange fund, but the Licensed Banker may receive less through this referral arrangement than from a direct sale. Referrals and recommendations are made independent of compensation arrangements and based solely on the client's needs and objectives.

## Additional compensation received by Wells Fargo from fund sponsors and other fund relationships

In addition to transaction-based commissions received by Wells Fargo Advisors and your financial advisor described above, Wells Fargo Advisors may receive compensation paid by the fund companies, not related to individual transactions, a specific share class or account type. This "non-commission" compensation received by Wells Fargo Advisors from fund companies and/or their managers, may include payments for training, educational conferences, meetings for financial advisors and clients, and overall marketing support, as well as for other general services provided to fund companies and/or their managers. This compensation may be paid directly by the fund manager or charged as a fund expense.

As a large financial holding company, Wells Fargo & Company provides a wide range of financial services to various fund companies through its subsidiaries and affiliates. A Wells Fargo Advisors affiliate may have lending, trading, investment banking or other relationships with funds offered by Wells Fargo Advisors and their fund managers. A Wells Fargo Advisors affiliate may also have an equity interest in such fund managers. These other relationships with funds and fund managers across Wells Fargo & Company provide financial and other benefits to Wells Fargo & Company, as well as Wells Fargo Advisors.

## 1031 exchange funds

1031 exchange funds are not appropriate for all investors and are only open to "qualified" investors within the meaning of the U.S. securities laws. They are speculative, highly illiquid, and are designed for long-term investment, and not as trading vehicles. There is no assurance that any investment strategy pursued by the fund will be successful or that the fund will achieve its intended objective.



Investments in these funds entail significant risks, volatility, and capital loss including the loss of the entire amount invested. The increased risk of investment loss is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund for which the fund does not represent a complete investment program.

While investors may potentially benefit from the ability of 1031 exchange funds to potentially defer capital gains, the investments themselves can carry significant risks. 1031 exchange funds are subject to market, funding, liquidity, capital, regulatory, and other material risks. There is no guarantee any investment strategy will be successful under all market conditions. The value of any property may decline as a result of a downturn in the property market, and economic and market conditions. There is no guarantee value appreciation will be achieved and the operating company may be forced to sell properties at a lower price than anticipated. There is often limited (or even non-existent) liquidity and a lack of transparency regarding the underlying assets. They do not represent a complete investment program. 1031 exchange fund investments often demand long holding periods to allow for disposition and exit strategy. There is generally no secondary market for interests, and there may be restrictions on transferring such interests. 1031 exchange funds involve other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Understand that this list only highlights some of the key risks associated with private capital and real estate funds and is not an exhaustive list of risks. For a comprehensive discussion on risks, please refer to the fund offering documents.

## Additional risk factors

### **Risks Related to Holding Interests in the DST (“DST Interests”)**

- There are limitations on the actions that the manager and trustee of the DST can take relative to the real estate. IRS Revenue Ruling 2004-86, which sets forth the IRS standards for DST Interests acquired in an IRC Section 1031 exchange, provides, in part, that in order for investors in the DST to be treated as acquiring a direct interest in the DST's real estate for tax purposes, the DST must impose significant prohibitions on the powers of the DST's manager and trustee. These prohibitions are explained in more detail in the Offering Documents.
- If the manager and trustee are required to take action to conserve and protect the property held by the DST but are unable to do so due to the prohibitions imposed on their powers, they may determine to terminate (or be required to terminate) the DST and transfer the property to a limited partnership (a “Transfer Distribution”). An interest in a limited partnership, unlike a DST Interest, is not treated as a direct interest in the underlying real estate for tax purposes.
- In addition to the U.S. federal income tax consequences described above, you should consider the state and local tax consequences of acquiring, owning, holding and disposing of a DST interest, and seek the advice of your own independent tax advisor.

### **Risks Related to Debt Financing**

- The effect of a financing (where a Transfer Distribution has occurred) or sale of the property owned by the DST could affect the rate of return to the investors in the DST with respect to that property and the projected time of disposition of the property. In an environment of increasing mortgage rates, if we place mortgage debt on properties (if a Transfer Distribution has occurred), we run the risk of being unable to refinance such debt if mortgage rates are higher at the time a balloon payment is due.

### **Risks Related to the Master Lease Structure**

- If the Master Lease is terminated or expires, the economic success of an investment in the property will depend upon the results of operations of the property, which will be subject to those risks typically associated with investments in real estate. Fluctuations in vacancy rates, rent schedules and operating expenses can adversely affect operating results or render the sale (or financing, where a Transfer Distribution has occurred) of the property difficult or unattractive. In such case, the poor performance of such property may adversely affect the overall returns to the investors in the DST.
- There is a potential risk that the Master Tenant could default on its obligations under the Master Lease and that the product sponsor could default on its obligations under the Guaranty.

### **Risks Related to Adverse Changes in General Economic Conditions**

- An economic downturn could adversely affect rental income generated from end tenants. From time to time, an economic downturn could occur that would result in slowed economic activity.

### **Risks Related to Investments in Real Property**

- Real properties are illiquid investments, and we may be unable to sell, refinance or reposition a property or properties in response to changes in economic or other conditions.

This material is for informational purposes only and does not constitute an offer to sell, or the solicitation of an offer to buy or sell any securities. The program description referenced herein shall not be offered or sold to any person in any jurisdiction in which the offer, solicitation, purchase or sale would be unlawful under the securities law of such jurisdiction. The securities are only offered to accredited investors and qualified clients by Offering Documents. The Offering Documents contain more complete information about the securities including investment objectives, risks and charges and expenses of the security.

Prospective investors should carefully read and consider the Offering Documents and consult with his/her tax advisor before investing or sending any money. Each prospective purchaser should be advised to consult with his/her own tax advisor regarding the specific tax consequences to him/her of a contribution of property to a partnership, including the federal, state, local, foreign and other tax consequences of such transactions, ownership or sale and of potential changes in applicable tax laws.