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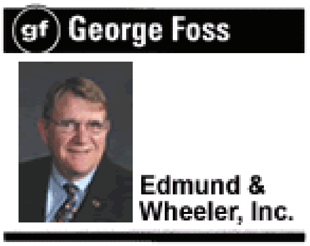
THE LARGEST WEEKLY COMMERCIAL/INVESTMENT NEWSPAPER COVERING THE STATE

What Every Real Estate Investor Wants to Know: How Can I Make Section 1031 Work For Me?



What every real estate investor wants to know is "How can I make Section 1031 work for me? Isn't that just for investors who have multimillion dollar properties?" And, the best question of all; "I want to sell my property and I don't want to manage real estate again, how can I have my cake and eat it too?" The power of 1031 is that it is for every investor, regardless of size, as long as the current property has been used for business, productive use or investment purposes. So, no matter whether investors are selling a two family dwelling that they acquired five years ago, undeveloped land, a strip mall or shopping plaza or hotel property, 1031 is a powerful tool to defer capital gains and unrecaptured depreciation.

Investors that were previously chasing market appreciation have begun to realize that their investments must make financial sense and produce sufficient cash flow to justify their portfolio space. Section 1031 provides an avenue to redirect those investment dollars without incurring capital gains tax. Realigning their real estate portfolio may be the biggest favor investors can do for themselves in this tenuous market. There will be bargains in the marketplace as investors reinvent their strategies for long-term results and strong balance sheets will attract the financing to make the right acquisitions. The biggest development in Section 1031 is the variety of replacement property choices that now exist. Previously, investors were confined to locating new property that would carry the same headaches of their old property. Revenue Procedure 2002-22 codified tenant-in-common (TIC) ownership and the birth of a new real estate industry.

Investors can become fed up with hands on management, endless capital improvements and ever-rising operating expenses, Section 1031 can be the solution to a perfect real estate exit strategy. Further, as the population matures, older investors are seeking income streams without the hassles of hands-on management. Now they can sell their property using a Section 1031 Exchange and acquire a TIC interest, handing over the management and profit and loss statement to a team of experts and receive a steady income stream. Another powerful aspect of Section 1031 is that eventually, investors can exchange into their dream house as their primary residence, having avoided capital gains altogether!

A wide range of properties are available and in a variety of markets (geographic) and market segments (tenant mix). There are strong markets throughout the country, as an example, medical facilities are expected to provide attractive returns for the future. Whether investors are concentrating on cash flow or market appreciation, there are choices that will meet virtually every appetite. TIC's can be sold as either real estate or as securities and the TIC companies are committed to performing thorough due diligence on each prospective offering before it is presented for investor consideration. This due diligence, or the thorough analysis of property facts and risks, should be performed on every TIC offering before the decision is made to invest. TIC's offer different risk and reward profiles, varying maturities, professional management and easy transitioning for every investor. TIC interest can be exchanged again upon sale (aka "swap till you drop"). TIC's are NOT the only choice for passive real estate. An Umbrella Partnership Real Estate Investment Trust (UP-REIT) provides a mechanism to invest real estate exchange proceeds into real property that is later converted to marketable securities through the mechanism of Section 721. These products are sold by securities dealers and carry the scrutiny of the Securities and Exchange Commission. Sale will trigger tax but REIT shares are far more liquid than TIC interests. The challenge for utilizing Section 1031 has always been finding the right replacement property in the allotted 45-day time frame. Institutionalizing the process can result in a large list of potential properties.

Even in today's challenging market, the best TIC properties don't stay in the marketplace for very long, so timing will still be critical. Having a due diligence package delivered to the investor with an offering certainly makes the process more palatable.

Its time for investors to take a hard look at their real estate portfolio and visualize realigning their holdings to produce long-term results; they will most probably recognize the power of Section 1031. As Mark Twain once said "history never repeats itself; but sometimes it rhymes."

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Five section 1031 replacement property options for investment and business real estate owners

gf George Foss

Edmund & Wheeler, Inc.

cl Christine Latulip

Edmund & Wheeler, Inc.

Owners of investment and business property considering the sale and reinvestment of their real property have choices that are far greater than their own neighborhood. Section 1031 exchanges require that the new or replacement property be "like-kind" but that definition has expanded to include diverse investments; here are five examples of replacement property opportunities.

Personal Residence Option

Yes, you can convert your investment property to personal use. Clients looking to make a life-style change are often intrigued by this option. Simply, acquire the property that you want using a section 1031 exchange and rent it for two years. This satisfies the investment intent and later you can abandon your investment intent and use the property 100% personally. If you own this property at least five years and have used it for two of the five as your personal residence, at the time of sale, you will be eligible for the section 121 personal residence exclusion ($250,000/$500,000). Section 121 can be utilized every two years and there is no maximum limitation on its use.

Estate Planning

Gifting of real property is a popular way to transfer assets from one generation to the other. This can be accomplished by exchanging a piece of investment property to a single-family residence that can be rented to your family member at fair market rent. Since you need to continue your real estate investment, rent it for two years and then begin a gifting process. Currently you can make a gift of $12,000 per year per person. This option allows you to assist your family member with one of the most important choices they'll ever make, buying a home, while you're still here to provide the advice and counsel necessary.

Passive (TIC) Option

Tenant-in-common (TIC) ownership provides an opportunity to own institutional property without the hassles of managing tenants. Total annualized returns range from 6% to more than 15% with the right property. Now you can collect your earnings from the management company and never again talk to a tenant!

By regulation (revenue procedure 2002-22) a qualifying TIC is limited to 35 or fewer investors, has outside management, and the owners retain approval rights over the most important issues affecting the property. Extensive due diligence is performed by the sponsor and full disclosure of the performance assumptions is provided to prospective investors.

TIC investments will provide an opportunity to own institutional type properties, eliminate the management burdens, and provide for diversification, lower risk and increase cash flow. TIC interests can be exchanged again and again. While there isn't a ready market if you want to get out before sale, the returns and lack of direct intervention provide a stable investment alternative. TIC's are typically sold with 50% non-recourse debt.

UP-REIT Option

An UP-REIT is an umbrella partnership real estate investment trust. Once again, exchange your current investment property and purchase an interest in an UP-REIT. REIT's regularly carve off one or more buildings from their diverse holdings for investment clients to acquire using 1031 funds. After a period of seasoning, the UP-REIT is folded back into the REIT.

The disadvantage is that once you have moved your investment into this model, it cannot be exchanged again without paying the capital gains tax, however, REIT shares are typically publicly traded.

Gas & Oil Royalty Option

This should give you an idea of how broad the definition of "like-kind" is when it comes to real estate. Investors receive legal title to the percentage of royalties purchased. Generally these will be mineral rights for oil, gas, or timber properties. These have existing cash flow and documented stability and growth. Properties incur no monthly expense or liabilities related to additional development, making it easier to track their performance and yield. Thanks to an active auction market, liquidity is available. Also, these interests may be exchanged again later. Debt is not involved.

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THE LARGEST BUSINESS PUBLICATION OF ITS KIND IN THE NATION

The benefits of utilizing a reverse exchange: Buy a new property now, sell the old one later

gf George Foss

Edmund & Wheeler, Inc.

cl Christine Latulip

Edmund & Wheeler, Inc.

Section 1031 of the Internal Revenue Code provides for the ability to exchange your existing property for new property without triggering capital gains tax, a provision that has been in the code since 1921. While it has been enhanced and tested by case law since that time, it was revenue procedure 2000-37, approved in September of 2000, which codified the safe harbors for exchanges done in reverse. A reverse exchange is simply where the new property is acquired before the old property is sold, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange. Reverse exchanges are an exceptionally powerful tool for the client who must act on the purchase of the new property immediately since the rule prohibits the client from owning both the new property and the old property at the same time and still get tax-deferred treatment. Reverse exchanges are not for the faint of heart, but they work to preserve the tax deferral. This is good news for prospective clients that have identified the property that they want to acquire (replacement property) before they have found a buyer for their existing property (relinquished property). With the current real estate market, it may take longer to sell your current property, yet you don't want to miss the opportunity to acquire the new property while the price is right.

A Qualified Exchange Accommodation Arrangement (QEAA) is created by a Qualified Intermediary (QI) who acts as the Exchange Accommodation Titleholder (EAT). The following example will assist in understanding the principles at work:

Our client, Blue Moon, LLC, identified a target property that was only available if Blue Moon could acquire it before the end of the month. Blue Moon wanted to sell three of its existing properties to fund the transaction. We described the mechanism that could accomplish the transaction noting that the code requires that the ownership cannot be by the taxpayer or a disqualified person and that the taxpayer must have a bona fide intent to treat the transaction as an exchange. We went to work creating an agreement that called for Edmund & Wheeler, Inc., QI, to create a single purpose entity, Acorn, Inc. to hold title to the desired property. Once the corporation (the EAT) was created and the agreement signed by the client, Acorn, Inc. was positioned to acquire the new property. The purchase was funded by means of an equity loan that Blue Moon arranged for with its lending institution using the existing property equity positions loaned to Blue Moon and a first mortgage on the new property, with Acorn, Inc. as borrower and the principal of Blue Moon as guarantor.

Acorn, Inc. acquired title to the target property and leased it to Blue Moon for its immediate use. In the meantime, Blue Moon listed its three existing properties for sale and within 45 days of Acorn, Inc. acquiring the target property it identified these three properties to Edmund & Wheeler, Inc., the QI. Blue Moon went to work to sell as many of the properties that it could within 180 days so that the target property could be deeded from Acorn, Inc. to Blue Moon.

Blue Moon was diligent in its sale of the existing properties but was only able to sell two of the three it identified for sale. The sales proceeds of the two that did sell were passed through to the QI and just prior to the 180th day, the equity loan was paid down and the target property was deeded from Acorn, Inc. to Blue Moon, LLC.

Reverse exchanges are described and diagramed on our website at www.section1031.com. In the menu, look for "Case Studies;" case 2 describes the above situation and case 5 is a variation that would provide for the EAT to acquire the old property. Revenue procedure 2000-37 is available under "Tools for Professionals."

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Qualify your investment (second home) property as an IRC Section 1031 exchange

gf George Foss

Edmund & Wheeler, Inc.

cl Christine Latulip

Edmund & Wheeler, Inc.

On a gain of $300,000, (sale $450,000 less original cost of $120,000 and selling expenses of $30,000) the tax bill will be $69,000.00, ouch! The best way to avoid this situation is to convert the property from personal use to a commercial rental for at least two tax years, the longer the better, and later sell it using a Section 1031 Exchange.

We are consulted daily about how to make a vacation property qualify as an Internal Revenue Code (IRC) Section 1031 Exchange. This is a troublesome area, however, with careful planning and patience, the capital gain tax can be deferred, indefinitely.

A recent case will help illustrate how this can be accomplished. Our client owns a slope side townhouse at a New England ski resort that he and his family have used for weekends and vacations for the past ten years. During that time, the property has experienced significant market appreciation and the client is facing a 15% federal capital gain tax as well as a state capital gain tax of 8%. On a gain of $300,000, (sale $450,000 less original cost of $120,000 and selling expenses of $30,000) the tax bill will be $69,000.00, ouch! The best way to avoid this situation is to convert the property from personal use to a commercial rental for at least two tax years, the longer the better, and later sell it using a Section 1031 Exchange. He immediately signs a rental agreement with a local agent and informs his accountant that he is making a change in use of the property.

Now, roll the calendar ahead by two years, he is ready to sell the ski property and enter into an exchange agreement with a QI. He is anticipating acquiring replacement property that will further benefit the family. In order for him to get a good exchange (one where no tax is due) he will need to purchase new property of an equal or greater value of the property he sells. His two high school aged children have decided to attend an out of state college and he is contemplating acquiring a four-family residence in the college community at a cost of $560,000. His plan is for the children to reside in one unit while they attend college and rent the remaining three units to other students. Three-quarters of the new property ($420,000) will be used for investment purposes and he will lower his tuition bill by providing off campus housing. Note that since his children will not be paying market rent, he needs to provide $140,000 of the purchase price personally (cash or bank loan). He plans to own this new property for the next four to six years and will exchange again for property in a sunshine state.

He engages us as his qualified intermediary once he has a purchase and sale agreement on the ski property. An exchange agreement is created and signed by the QI and the client. Instructions are then sent to the settlement agent representing the buyer of the ski property. At closing, the funds are made payable to the QI and held in escrow pending the election of the replacement property in the designated college town. By regulation, a list of potential replacement properties must be identified in writing within 45 days of the sale of the ski property and the acquisitions must be completed within 180 days. Once again, the family gets a great benefit without the loss of equity that has been accumulated in the investment property to capital gains tax. It is clear that careful planning produces great results!

More detailed information and case studies about Section 1031 like-kind exchanges is available on our website at www.section1031.com, or contact Chris Latulip or George Foss III at Edmund & Wheeler, Inc., 567 Cottage St., Littleton, N.H. 03561, (603) 823-8888.

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