

1031 Carve Out: The Retirement Route

By Rob Naylor

Consider the following scenarios:

- ❑ A real estate investor sells the duplex he has been living in and pays the IRS the capital gains tax. He later buys a four-plex.
- ❑ A farmer sells his 200-acre farm and farmhouse and pays the capital gains tax on the sale. His objective was to raise cash for retirement. He is disappointed with the dismal returns of bank CD's on the one hand and nervous about the roller coaster nature of the stock market on the other hand. So, he plans to buy some rental income property.
- ❑ The owner of an eight-plex sells the building she has been living in and pays the taxes. She was motivated to sell so she could move closer to her children and grandchildren. She would like to re-invest the money in real estate but isn't sure she wants to continue on with the burden of landlording during her retirement years. She wants to have a life without the daily grind of dealing with tenant problems.
- ❑ A business owner sells his business and the property of its operations as a "packaged deal", pays the capital gains tax, and looks for ways to diversify his profits for retirement.

What do these investors have in common? All of them made a substantial but unnecessary gift to the IRS! They paid an irrevocable capital gains tax that could have funded their retirement instead of padding the bank account of the IRS.

What you don't know about government loopholes can cost you a fortune. On the other hand, read on and discover an under-utilized tax break that can help you build or fund your retirement fortune, large or small. The IRS loves a cheerful giver and even if you are not so cheerful, they love it when you are not aware of your options. Now here is some news to be cheerful about: Rainbows of fortune do exist, even in the IRS code! By following a few simple rules, you can make sure the reward is at your end of the rainbow and not the IRS's end.

Many of you are familiar with the popularity of 1031 exchanges. In the old days, real estate exchanges

were rigid and had to be simultaneous in order to reap the tax benefits. Nowadays, they have the flexibility of taking up to 180 days to complete. Do you think you could transact a real estate deal in six months time? Now you see why this is becoming so popular. From the close of escrow on your first property, you have 45 days to identify your ideal replacement property. The IRS rules allow you to identify three candidates (if you are using the three-property ID rule). Then you have an additional 135 days to close escrow on the property of your choice. You may even split your exchange to purchase two or three of the identified properties. So from the close of your first escrow, you have a total of 180 days to close escrow on your next property in order to defer all capital gains taxes.

The sale of your personal residence or business operations does not qualify for favored tax deferral under Internal Revenue Code 1031 and is taxed at the close of escrow. Remember though, it is only the residence *portion* or the business operations *portion* that does not qualify for tax deferral. The remaining portion can qualify with a little help from a qualified intermediary, required by the IRS, and your escrow company. There is a way in each of the previous four scenarios to legally implement a carve-out solution and execute a 1031 exchange. Let's revisit them and see how the carve-out solution could have helped:

- ❑ The duplex owner can 1031 exchange the renter-occupied half of the duplex into his next deal, defer capital gains, and buy more real estate with the tax savings. If the duplex units are disproportionate in size, he should deduct the square footage of his living space from the 1031 transaction.
- ❑ The farmer could decide to keep or sell one acre as his personal residence, then carve-out and exchange the other 199 acres into his next real estate purchase and defer capital gains. If the farmer wanted to keep more acreage and sell the rest to buy some income property, that could also be a viable option for his retirement plans.
- ❑ The eight-plex owner can exchange seven of her eight units into her next income producing property to fund her retirement. Here again, she can defer the capital gains.

- Business owners can separate the value of their business from the value of the real estate beneath it and surrounding it. The real estate investment portion is eligible for 1031 exchange treatment and deferral of capital gains. This could save the business owner hundreds of thousands and, in some cases, millions of dollars in taxes that can then fund retirement benefits for his or her family.

In each transaction, the above solutions could save a substantial tax savings that otherwise would have needlessly gone into the cheerful and eager hands of the IRS as capital gains taxes. Without implementing such solutions, real estate owners can only lament, “It is gone and it is too late to ever get it back!”

According to real estate attorneys, the separation of the investment portion of your “investment property” (the carve-out) from your business or the personal residence portion of your property can be accomplished two ways- the hard way, or the easy way. The hard way is to redo the legal description of the property. The easy way is done by supplying an honest but accurate letter of instruction to the escrow company of how the property is to be divided and what portion will be exchanged. These carve-out solutions are commonplace.

Finding a Suitable Replacement Property

Now that we have solved the tax issue, what about the issue of finding a suitable replacement property? For the seasoned apartment owner who is tired of toilets, tenants and trash, or the investor who would really rather not get involved in the trials and tribulations of active landlording but would love to participate in the tax benefits and potential financial rewards of real estate ownership, there *is* a solution. The Tenants-In- Common (TIC) approach to real estate ownership can be a lifesaver. TIC sponsor companies have a variety of property types to choose from: Commercial office buildings, grocery anchored shopping centers, light industrial, self-storage and mixed-use properties. These properties are professionally managed, and in many cases the tenants leasing these spaces are triple net tenants, those who pay the three major property expenses of taxes, insurance and maintenance. More recently, some property options have included large apartment complexes.

Many of these properties are institutional grade, major league properties that were not accessible to smaller investors before TICs became available. There is a minimum investment (equity ownership commitment) required to participate in these properties. This typically ranges from \$100,000 to \$400,000, though some of the larger projects may have minimums in the seven-figure range. Investors can get into these properties by direct investments of cash or by rolling their 1031 equity proceeds into one of these transactions. The sponsors who put these deals together generally have decades of experience combined in real estate syndications, property management, and TIC sponsorships. TIC owners can enjoy freedom from hands-on management, opportunities for monthly cash-flow that is partially tax-sheltered via depreciation write offs, increased cash flow as expiring leases are leased up to higher rents, potential equity appreciation, deferral of capital gains taxes, and the elimination of capital gains in the ultimate transfer to your heirs. Property portfolio diversification is also a plus. As with any real estate investment, there are various risks involving but not limited to: possible loss of principal, variations in occupancy which may negatively impact cash flow, the illiquidity of real estate, and limits on management control.

An LLC Surprise for Smaller Investment Amounts

For investors who want in on these multi-million dollar properties and the many benefits they offer, yet have a smaller amount to invest, some property sponsors have created multiple limited liability company (LLC) units. This allows for a \$25,000 minimum investment, with \$5,000 incremental bump-ups for investors who want more than the minimum. One cannot 1031 exchange *into these particular types* of LLC units, but one can exchange *out of* them, provided all other LLC members are agreed and the lender and sponsor on the up-leg property are agreed. Remember, these LLC units may represent only a small portion of a property while TIC owners would own the majority of it. If you are looking for a place to park some dollars and don't like what the banks are paying or how the stock market is behaving, this might be a viable option for you.

Consult with a TIC specialist about your options. These consultations are generally free of charge.

You may find your options and safeguards so appealing that you may soon be on your way to your first 1031 exchange carve-out to retirement.

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