

The 1031 Exchange Basics & Benefits for Retirement

In my advisory practice, I have been amazed at the number of people who are delighted to discover how incredibly flexible 1031 exchanges are. The following is an explanation of the basics and flexibilities of this wonderful tool. Once you understand how simple and beneficial exchanges can be, you may wonder why you haven't done one before now. Hopefully, the benefits are impressive enough to launch you toward your next deal.

What is a 1031 exchange? A 1031 exchange is the process of selling one investment real estate property and buying another in its place, tax deferred, using government guidelines as outlined in section 1031 of the Internal Revenue Code.

Just how flexible are 1031 guidelines? When the Internal Revenue Code 1031 states you may exchange like-kind property for like-kind property, it simply means investment real estate for investment real estate. If you own *any* of the following types of investment real estate, you can exchange it for *any of the same or different* following types of investment real estate: Land, farm, ranch, vacant lot, parking lot, warehouse, apartment building, duplex, townhouse, condominium, commercial building, office building, shopping center or mall. Of course, this is not a complete list, but you have the idea. For example, you can sell your vacant lot and within 180 days buy a shopping center or a condominium. Sell your apartment building or your farm and buy an office building or commercial warehouse. Sell your parking garage or a few of your houses and buy a strip-mall or an apartment building. You can sell several properties and combine the equities to buy a larger property. You can also do the reverse, sell a large property and diversify it among two or three smaller properties.

If you follow government guidelines, you will have no capital gains taxes to pay on the transaction. None! You can defer them perpetually into the future until it is time for your children or your favorite charity to inherit your property. Under current tax law, your heirs would receive a step-up in basis at the time of your passing, effectively eliminating capital gains taxes on the transfer.

What are the rules for doing exchanges? They are: List your property (down-leg property) with whomever you wish or sell it yourself. Before the close of escrow, you must have in place, an accommodator, also known as a qualified facilitator or intermediary. This is an absolute must if you want to defer capital gains on your transaction. The IRS is not flexible on this point. If you don't know where to find an accommodator, ask someone who is familiar with the business. Make sure the accommodator is licensed, bonded, and has a good reputation. Once your property sells and escrow closes, your accommodator will

hold the funds until you are ready to close on your next property (the up-leg property). You have 45 days to identify up to three potential up-leg properties. The IRS allows for this so if one of the properties you have identified sells to someone else, you still have one or two of the remaining properties you can buy. In addition to the 45 day identification period, you have 135 days to close on one or more of the properties you have chosen. In total, you have 180 days from the close of escrow on your down-leg property to close escrow on your up-leg property. That's it! Simple rules.

The challenge most real estate investors have in doing a 1031 exchange is to find a new up-leg property that has the same (or greater) debt-to-equity ratio than the down-leg property they are selling. As long as you can do this, you will have no worries about capital gains. But, if the ratio of debt-to-equity is less in the new property than it is in the old property, you have a tax problem. This can be a difficult challenge, but it doesn't have to be.

One solution many investors have used over the years is to buy into a **Tenant In Common (TIC)** arrangement. TICs have been around for decades. The approach described here has been around for about the last eight years. This TIC approach solves many problems. First and foremost, it allows for virtually any size equity to be plugged into the equation. So, you won't be hunting for weeks on end in a frantic search for just the right size property to fit your needs. This is turn-key. Secondly, the properties from which you may select are institutional grade or major league type properties. Many triple net TIC properties have national credit tenants, the kind who pay the rent even if they move out before their contract expires. These tenants pay their own taxes, insurance, and maintenance.

TIC shopping center properties may have tenants like Wal-Mart, Target, JC Penney, Safeway, Ralphs, Albertsons, Rite-Aid, Save-On Drug, Big 5 Sporting Goods, Pizza Hut, Jack in the Box, Subway Sandwiches, Baskin Robbins, Radio Shack, H&R Block, Bank of America, Mailboxes, Etc., Blockbuster Video, Kragen Auto Parts, Office Depot, JoAnn Fabrics or other national tenants. What is the next best thing to owning these franchises? It's having them pay you rent! TIC office buildings may house fortune 1000 companies or other growing corporations. Other properties may consist of light industrial, self-storage facilities and mixed-use properties.

TIC properties are professionally managed, and TIC owners enjoy receiving the monthly cash flow while the property stays profitable. This can be ideal for conservative investors. Take the time to calculate the *return on equity* of one or more of your properties. Now

factor in the number of hours you spend each week managing your properties. It may surprise you how hard you are working for the return you may be receiving. Compare those figures to TIC ownership returns and you may want to take a closer look. What kind of returns can you expect? For answers, ask someone in the business, an investment advisor who specializes in this particular market niche. Unlike the regular real estate brokerage community, TIC deals are only marketed by securities-licensed broker dealers. These professionals can prove to be an invaluable resource to you.

As a TIC owner, your name will appear on the deed as having an undivided percentage ownership in the property. As with any real estate ownership, there are risks and benefits. Combined to minimize your risks and enhance your benefits are the TIC sponsor's experience with property selection and professional management, as well as the use of non-recourse bank financing. Insurance coverage on the property is an added protection. Additional benefits are: (1) An upgrade in tenant quality, (2) Elimination of involvement in day-to-day tenant management problems, (3) Renewed deductions by way of interest and depreciation write-offs, (4) Upside potential of lease ups and equity growth, (5) Deferral of capital gains on the exchange, (6) Partially tax sheltered cash flow, and (7) Broader diversification of real estate holdings by type of real estate and by geographical location. Lastly, by combining your purchasing power with others, you are able to buy a property you might otherwise only dream of owning.

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