



1031 Exchanges for Tax & Accounting Professionals (Why Should Brokers Have All of the Fun?)

The more time that we spend dealing with IRC Section 1031, the more we realize that the focus of 1031 Exchanges is somewhat misplaced on real estate and securities brokers. Don't get us wrong; as both real estate and securities brokers, we certainly appreciate the business activity that is generated through 1031 Exchanges, but we understand that, by thoughtful and expert application of the options available through a 1031 Exchange, the benefits to the investor can extend far beyond simple tax deferral. Let's explore some of these options!

First, let's separate the 1031 Exchange investor market into two parts; Active-Investors, who want to maximize their real estate investment(s) through hands-on active management and Passive-Investors, who want to enjoy the benefits of their real estate investment(s) without the need for active, hands-on management. In regard to their real estate investments, Active-Investors are frequently focused on the singular aspect of maximizing value or cash flow from that specific property, not on realizing the other, non-tax deferral, benefits that may be obtained through a 1031 Exchange. Passive-Investors, on the other hand, frequently are in a position to look at how a 1031 Exchange may help to realize other, alternative financial and non-financial goals. For this discussion we will focus on Passive-Investors.

Passive-Investors typically used to be Active-Investors, they just moved to a different stage of their lives. As we get older, most of us reach a stage where we want to enjoy the fruits of our labor. Frequently, this transition from active to passive investing coincides with several other events.

Passive-Investors are frequently at or nearing retirement age, where they will have an enhanced need for cash flow (as opposed to appreciation). While they could use their primary income to subsidize their real estate investments while they were in the work force, they often need stable, predictable cash flow to supplement their pensions once they leave the work force. Since they are typically unable to earn and save substantial amounts of new capital, they typically seek capital preservation (as opposed to wealth creation) for their investments. The use of a 1031 Exchange can often help to achieve these goals.

Passive-Investors (like many real estate investors) frequently have a very high concentration of their assets and net worth in real estate investments (here in Southern California, it is not unusual to see investors with 60%-80% of their net worth in real estate, sometimes consisting of just their primary residence and one investment property!) Clearly, this level of concentration is beyond the norm for a balanced portfolio, but the recent rapid appreciation of real estate, combined with the after tax benefits make it painful or difficult to 'pay the tax piper' and then invest the remaining proceeds in non-real estate investments. Expert use of a 1031 Exchange can provide ways to help re-balance a portfolio.

Passive-Investors often have multiple prospective heirs and they need to develop ways to maximize the real benefits that these heirs will eventually receive. How many of our clients have more than two children, who never see eye-to-eye? (Answer: most of them). What may happen if that investor has one real estate investment property to divide among three heirs? Experience tells us that this often results in disagreements, arguments, litigation and fracturing of the family relationship. No loving parent would ever wish that result upon their children. Skillful use of a 1031 Exchange can help to alleviate this concern.

Passive-Investors commonly want to create a mechanism for increased liquidity down the road to take care of either planned or un-planned liquidity needs, but how do you do that without selling the real estate asset and paying taxes? Again, smart use of a 1031 Exchange can help to provide a solution.

1031 Exchanges for Tax & Accounting Professionals (Why Should Brokers Have All of the Fun?) [Continued]

Finally, many investors who want to be Passive-Investors hold their real estate investments in partnership (of one form or another) with other investors. How do they extricate themselves from a partnership into an individually exchangeable estate? Once again, our old friend, proactive forethought and expert advice comes to the rescue.

The best news for tax and accounting professionals is that, other than the actual selling of the relinquished property and/or buying of the replacement property, none of these objectives can typically be achieved by a client's real estate or securities broker(s). Realistically, only the client's tax or accounting professional is in a position to identify and address these additional objectives. The only bad news is that you must typically be proactive in order to determine if the client has additional objectives and the resources necessary to achieve them.

OK, enough of the preliminaries, let's discuss some of the specifics.

Passive-Investors typically need steady, predictable cash flow. The most common property investment for individual investors is residential income properties, ranging from individual condos or single family residences to mid-sized apartment complexes. A common characteristic of residential income properties is that they tend to be among the fastest appreciating properties, especially on a risk-adjusted basis. However, a common corollary is that residential income properties tend to provide little (or zero) cash flow on imputed value. In fact, nation wide, residential income properties of fewer than four units typically produce between 2% to 3% of cash flow on imputed value. Properties of greater than four units typically produce between 4% to 6% of cash flow on imputed value (here in Southern California, those returns are between -2% to 2% for fewer than four units and 2% to 4% for properties larger than four units). So, while they are great wealth creators, they are often lousy cash flow generators.

However, the other side of this coin are single tenant or otherwise net leased properties, which tend to provide greater (and perhaps more predictable) cash flow, at the expense of upside potential or appreciation. If a client is at the Passive-Investor stage, moving from low cash flow properties to higher cash flow properties may make sense. Given that the Passive-Investor typically needs the cash flow to be steady and predictable, perhaps splitting the proceeds into multiple single tenant or otherwise net leased properties can diversify the risk and increase the predictability of the cash flow. Perhaps adding a tenant in common (TIC) interest or two can further diversify the investment (be aware, however, that most TIC deals include debt of between 50% to 70%, which may increase your client's leverage just when they are trying to de-lever their lives).

Passive-Investors often have a high concentration of their wealth in a few real estate assets. As mentioned above, it is not unusual for an investor to have 60% or more of their total net worth in a few, relatively illiquid real estate investments. While, this may be reasonable during the wealth creation stage of an investor's life, it is typically imprudent once an investor has reached the Passive-Investor stage of their life. In addition, it is not uncommon for that concentration to exist in only one or two investment properties, which tend to be similar in type and geographic location...hardly the model for diversification. One solution may be to exchange from an actively-managed property into an easily financed passively-managed property type, such as a single tenant property, leased on a long term basis to a credit tenant. If, after completing the exchange, the investor finances the new property at a 50% leverage ratio and then reinvests the loan proceeds into non-real estate financial assets, they may reduce their reliance on real estate from 60% (for example) down to 30%, while increasing the portion of their non-real estate financial assets to at least 30% of their total net worth. In addition, this strategy can be combined with buying several properties, of different type (retail, office, warehouse-distribution, for example) and different geographic locations in order to achieve diversification of property type, tenant profile and geography.

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Passive-Investors are often also thinking of estate planning. While leaving real estate assets can be a very important aspect of an estate plan (especially with the heirs enjoying a stepped-up tax basis), we have seen many examples of good intentions gone awry because the heirs were not able to agree about the operation of the real estate asset that they collectively inherited. Given how frequently siblings disagree on so many levels, it is no surprise that they frequently disagree about the real estate assets. Unfortunately, these disagreements often flare into anger, estrangement and litigation to partition the property among the heirs. What a nightmare! However, if the Passive-Investor sells their actively-managed property and exchanges into several passively-managed properties (single tenant, or otherwise net leased properties and, maybe, a TIC or two), they can create a scenario where they obtain all of the benefits of cash flow generation, portfolio balancing, diversification, while also solving the problem of dividing a single real estate asset among multiple heirs.

Finally, combining all of these ingredients also provides for the opportunity to achieve personal liquidity without upsetting the entire portfolio. For example, an investor has three heirs and buys four properties of different type and location. They lever three of the properties at 50% and use the proceeds to balance their portfolio. Should they need personal liquidity, they either finance or sell the fourth property to achieve that goal. They now have (1) Passively managed properties with (2) significantly greater cash flow with (3) diversification of their real estate portfolio while (4) rebalancing their investment portfolio while (5) solving an estate planning challenge and (6) providing for personal liquidity.

And you thought that IRC Section 1031 was for tax deferral! As we have pointed out, while there is great value to be achieved through the 'normal' use of a 1031 Exchange, it is through the careful, proactive analysis of a clients full financial and personal picture that the true power of a 1031 Exchange unfolds. Clearly, there is no reason that Brokers should have all of the fun!

CapHarbor is a real estate brokerage company serving the needs of 1031 investors who are seeking passively managed replacement properties (Single-Tenant, NNN-Leased properties by the whole through our real estate licenses and tenant in Common (TIC) interests on a fractional basis for accredited investors through our securities licenses). Visit us at www.capharbor.com or call 877-886-1031 to learn more about our services.

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