First American Exchange

A QUALIFIED 1031 EXCHANGE INTERMEDIARY

# *"Real Estate Exit Strategies"*

When interest rates rise and the real estate market starts turning "softer," you may ask yourself the question "Do I want to continue owning real estate, or should I sell and consider other investment alternatives?" There are many wise investment alternatives, but the problem with selling real estate to get into them is that the capital gain tax will be triggered, and you will have less equity to reinvest.

There are, however, a few options that offer the ability to exit the real estate market while reducing or avoiding the capital gain tax. Many of these strategies are complex and their suitability is totally reliant on your particular facts and circumstances, so be sure to talk with your tax or legal advisor before pursuing any one of these alternatives.

## *Option 1: The 1031 Exchange*

Internal Revenue Code Section 1031 applies to "property held for productive use in a trade or business or for investment," and it allows for the deferral of capital gain tax if such property is exchanged solely for property of "like-kind." The broad definition of like kind can help investors in many ways. For example, owners tired of the property management headaches of several properties can leverage their equity into one larger one. IRC Section 1031 also has broad geographic application, applying to real estate throughout the United States. For example, if properly structured a couple owning rental houses in California who have kids attending college out of state can exchange their California rentals for investment properties that their children can rent from them while attending college. Many investors exchange real estate all of their lives and leverage their unused tax dollars to purchase real estate that generates greater and greater returns. Once investors retire, they can then sell real estate and take the cash, paying the lowest capital gain tax possible due to their income tax retirement bracket. Even better yet, investors can leave their real estate holdings to their children, who will inherit the property at a stepped up basis, thereby eliminating any gain that had accumulated throughout the years!

## *Option 2: The Tenancy In Common Investment*

The "Tenancy in Common" concept allows individuals to own a fractional interest in high grade commercial properties, such as a shopping center or office building, and thereby opens the door to higher-valued and better-located properties than an individual could afford independently. For example, if an investor has $500,000 in exchange equity, it might be difficult to find a 1031 replacement property with this value which would generate a good return. With the "TIC" program, the investor can take the same $500,000 and purchase a 5% tenancy-in-common interest in an up and coming retail center with a value of $10 million, co-owned with 19 other investors. The investor can then enjoy a triple net leased, professionally managed property and a monthly cash flow without any of the hassles of property management.

## *Option 3: An Installment Sale*

An installment sale, aka seller carryback note or seller financing, works best for real estate investors who want to sell their real estate but don't need a lump sum

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payment. Instead of receiving a lump sum of money at the time of sale, buyers pay the seller monthly income at a rate and term to be decided by the seller. Taxes are not actually avoided nor totally deferred with a note; they are due yearly based upon the amount of payments the seller receives. The Charitable Remainder Trust is also based upon this "money over time" concept. The tax benefit of installment reporting is that because taxes are not due on a lump sum at the time of sale, interest is earned on the deferred dollars over the years. However, always discuss the transaction with your tax advisor as installment sale reporting may be disallowed or restricted if not structured properly.

### *Option 4: The Charitable Remainder Trust (CRT)*

A CRT allows an investor to receive lifetime monthly payments after transferring the asset to a trust. With this option, the asset is transferred to a trust and the charity is the entity who will inherit any funds once the investor dies. The main advantage of a CRT is that in addition to monthly cash flow and the satisfaction of one's philanthropic objectives, the donor qualifies for a charitable income tax deduction, which is usually the present market value of the remaining interest to the charity. Additionally, if the deduction is not all used during the first year of contribution, it may be carried forward and utilized over five years.

### *Option 5: Joint Use of IRC Sections 121/1031*

When a personal residence is sold, IRC section 121 allows for capital gain tax exclusion of up to $250,000 if a taxpayer is single, and $500,000 if a taxpayer is married, as long as the residence has been owned and personally used by the taxpayer for an aggregate of two of the preceding five years before the sale. With the enactment of Rev. Proc. 2005-14, there is now a way to exclude gain in excess of the $250,000/$500,000 limits. For example, if a house was bought for $100,000 20 years ago, and it is now being sold for $1 million, the taxable gain is $900,000. Under the old law, taxes would be owed on $400,000 of gain. Under the new law, if a married couple first converts the house to a rental, they can exclude $500,000 tax free at closing under IRC Section 121, and then perform a 1031 exchange and buy another rental house for $500,000, to exclude the remaining $400,000 of gain! Another popular strategy involves exchanging a rental house for a rental house, holding the rental house for awhile (this is a gray area; 2 years is common) and then moving in and making it a new personal residence. The house can then later be sold and taxes excluded under IRC Section 121 (with the exception of deprecation recapture) as long as the house is held for at least five years from the date of purchase through the exchange (HR 4520).

### *Option 6: Gifting Real Estate Interests*

If you wish for your children to own a portion of your real estate while you are still alive, you can gift portions of the real estate to them each year in the amount of the annual gift tax exclusion ($12,000), or if a Family Limited Partnership (FLP) is set up, you can gift limited partnership interests to the children using the annual gift tax exclusions (plus the FLP can be discounted). One caveat: Unlike inheriting real estate in which the heir's basis is the fair market value of the property as of the date of inheritance ("stepped-up" basis), a donee's basis from a gift is the same as the basis of the donor, so your children may wish to consider a 1031 exchange or other options in this newsletter when they sell their real estate to avoid a big capital gain consequence.

There are many other strategies that can be used in lieu of these options, and often the best results come from a combination of techniques. There are also many risks and disadvantages associated with all of the options; for example, Charitable Remainder Trusts can be costly to structure, and it may be difficult to find a buyer when you want to sell or exchange a TIC investment. In addition to consulting with a tax advisor, investors should seek the advice of a real estate attorney with experience in tax and business, and also consider the advice of a financial planner who can offer even more options for one's investment portfolio.



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