The Next Generation of 1031 Exchanges

BY DAVID FISHER

A pretty smart fellow named Darwin once summarized that it's not the biggest, the brightest or the best that will survive, but those who adapt the fastest. He was talking about evolution of species, but that can also include evolution in the business world. Every day, there are new, cutting-edge ideas that challenge us to rethink and evolve how we operate day-to-day.

Take, for example, the 1031 exchange: on its face, it is a great way to accumulate wealth through the buying and selling of real estate. Dig deeper and you expose some of its flaws, including the IRS hoops through which one must jump to complete a 1031 exchange. As a result, in many cases it's not an appropriate financial decision.

What if you could defer capital gains taxes, state taxes (where appropriate), depreciation recapture and the Obamacare tax when selling either commercial, investment or residential property?

What if you didn't have to adhere to time constraints, such as the 45-day and 180-day clocks?

What if you weren't bound by like-kind requirement or loan-to-value ratio?
What if you could downsize and not trigger a taxable event?

What if you could generate a new depreciation schedule, regardless of the buying price of the new property?

What if you could sell, retire and still defer taxes? Or — even better — what if you could diversify the sales proceeds by investing in stocks, bonds, annuities, REITs and other investment opportunities without having to buy only more real estate?

You can. The evolutionary process has created the next generation of 1031 exchanges, which boasts a 22-year track record of successfully deferring taxes more than 2,000 times. It's also been successfully defended in the 13 instances in which the IRS audited the process.

This program is a proprietary trust based on Section 453 of the tax code. The nuts and bolts of how our proprietary trust works may be the topic of a forthcoming column, but let's focus on the opportunities afforded by using Creative Real Estate Strategies' tax-deferral method.

A TOOL FOR RETIREMENT ...

As I mentioned earlier, transacting a 1031 exchange can be a challenging feat. Sometimes, a 1031 just isn't appropriate or can't be completed. For instance, say you owned one or more properties over the years, successfully deferring taxes using a 1031, and now you are ready to sell and retire. You don't want any more real estate. Your basis when selling is the original basis of the first 1031 property and not the last one, which may create a large tax liability.

In that same scenario, our trust can act as a 1031 exit plan. By using our tried-and-true Section 453 strategies, you could sell your property, defer taxes and receive a larger lifetime retirement income than if you paid taxes first.

(As an aside, it's worth noting that you may consider a Delaware Statutory Trust in this situation as well. However, that isn't the most beneficial option when a property owner wants to retire. Our strategies allow you to diversify your retirement income through any of the investment opportunities mentioned above.)

A TOOL TO GET MORE BANG FOR YOUR BUCK ...

There are several other instances in which our strategies are a better fit for investors, including a "hot" seller's market. While that's an ideal time to sell and lock in your gains, a potential problem arises when you attempt to defer taxes via a 1031. Its rules dictate that you have just 45 days to identify a new property, which means that while you're selling in a hot market, you're also forced to buy in one. Unless you can launch a nationwide search for a replacement property, you stand to gain very little — selling high, but buying high. On top of all that, if you need new debt on the replacement property, it may cost you more in interest and, depending on the price of the new property, there may be little or even no new depreciation.

As an alternative, working with CRES in that scenario, you can sell high, defer taxes and have an unlimited time to buy more real estate. If you felt inclined to wait a couple of years for the market cycle to become more favorable for buying, you could do so. While you waited, you could receive about a 5 percent cap rate on the sales proceeds. That means once you got back into the market, you could buy any type of property you like and even downsize without tax consequences.

A TOOL TO CONSOLIDATE ...

In another example, a client owns several properties, but would like to consolidate them into one or two properties. If the timing isn't just right, a 1031 can be a real challenge to execute.

However, by using our next-generation 1031 exchanges, timing is less of an issue. The trust is created when the first sale is made and may be able to be used for multiple sales. That way, the client can sell all properties, defer taxes without a 1031 and proceed to buy the property/properties that the client would like, all without the burden of time constraints for buying a new property.

A TOOL TO AVOID CAPITAL GAINS TAXES ...

Consider this scenario. A property owner wants to sell and retire, but his CPA argues against it. The CPA's reasoning? The property has belonged to the family for such a long period of time, the entirety of the sales proceeds would be subject to taxes. The CPA recommends that the property owner use the stepped-up basis at death to avoid the capital gains tax. The risk in this plan is the wait for that stepped-up basis. Should the market experience a downturn, the property owner loses the income generated from the trust. (Let's be honest: there may not even be a stepped-up basis at some point in the future.)

While that may be a good strategy, there is an even better one. At CRES, we could help the property owner sell today and defer taxes today, turning an illiquid asset into a liquid one. That would generate a larger lifetime retirement income than if the property owner paid taxes first. It would also put an "estate freeze" on that property.

A TOOL TO DIVERSIFY ...

A successful investment plan involves a diverse portfolio. That doesn't mean diverse strictly within a specific asset classification, but rather across several asset classifications to reduce investment risk. A 1031 exchange requires investors to stay within a real estate asset classification. Even in cases in which you have different real estate assets, market conditions may affect those assets, regardless of the type of property or the geographic location of the properties. Using the next generation of 1031 exchanges, you're not limited to buying real estate. You can also diversify into stocks, fixed income, guaranteed insurance contracts, REITs and any other asset classification that you would like within your risk tolerance.

A TOOL TO EVOLVE ...

The benefits of the next generation of 1031 exchanges are plentiful. The strategy offers opportunities in which there is no holding period on a property and no need to sever a partnership agreement. It allows a client unlimited time to buy another property, while offering estate planning opportunities to lower the federal state tax. There is no need to obtain additional debt, allowing a client to sell an investment property and buy a personal residence. Our tax-deferral strategies can even defer taxes when the sale of a luxury residential property creates a large tax liability (in the millions of dollars) for the seller. Perhaps best of all, the IRS is very familiar with our strategies and every IRS audit has been transacted with no changes necessary.

Wow! Evolution can be tiring, but now there are no excuses to pay capital gains tax (or state tax where applicable), depreciation recapture and the Obamacare tax. So go sell something and defer your taxes now! ■

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