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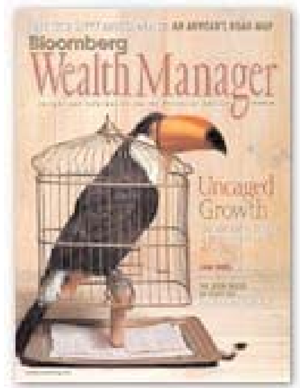
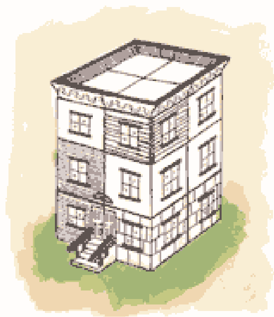


Exchange Place

By Gayle Ronan

For clients with property that no longer fits their needs, 1031 exchanges help them to keep a real estate interest while deferring taxes.

Peter McCrea had a client who wanted to sell a piece of undeveloped land in order to invest in a new hedge fund. It was obvious to both McCrea and his client that selling a $5million chunk of property with virtually no cost basis would result in a hefty tax bill. So McCrea—an advisor with 1031place.com, a subsidiary of LHO Group in New Canaan, Conn.—suggested instead that his client exchange the property for an income-earning interest in it that could be mortgaged after closing. McCrea's strategy allowed the client to liquidate and reinvest 100 percent of his equity without incurring taxes, retain a real estate allocation with the potential for appreciation, and invest in the hedge fund—thus achieving his main objective.



Key to the success of McCrea's approach was the switch of old property for new using a 1031 exchange, named for the section of the tax code that sanctions them. These exchanges have been around for decades but are still often overlooked by advisors, perhaps in part because 1031 exchanges must be brokered by "accommodators" intermediaries qualified according to the Internal Revenue Service—and involve other tax and legal experts, as well. Yet for property that has significantly appreciated but that your client no longer particularly needs, a 1031 exchange can be a tax-efficient exit strategy, say Phil Storms, an advisor with Westmont Cos. in Denver. The aim, he stresses, "is to find something that works better than what the client currently owns."

In a typical 1031 transaction, a property that's used in a trade or business—such as the building a doctor owns and practices in—or that is held for investment, like a rental home, is sold and replaced with a property or properties of like kind. From the point of view of the IRS, "like kind" just means the new property must be either raw land or used for business purposes. When this sale occurs, any gain rolls into the purchase of the new property or properties, assuming the new holdings are at least of

TIT FOR TAT

"WHAT ADVISORS TEND to overlook is that 1031 exchanges can be applied to persona property as well as real estate," says Julianna A. Clementi, vice president of Cole Taylor Deferred Exchange Corp. a subsidiary of Chicago's Cole Taylor Bank. Clementi has facilitated exchanges of aircraft, railcars, racehorses, artwork, and even violins. The tax code states that as long as the property is being used in a trade or business or held or investment, it may be exchanged to property of like kind.

But whereas "like kind" has a very broad definition when applied to real estate, the term takes a literal interpretation when it's applied to personal property. So, although you can exchange a duplex for a strip mall, or raw land for a collection of small rental homes, "if you are selling a heavy-duty truck and buying a light-duty truck, that's not considered like-kind," says Clementi.

To further illustrate the strictness of "like kind" she cites a private-letter ruling (PR8127089) in which the Internal Revenue Service disallowed the replacement of a lithograph for a watercolor because the artistic medium was different.

Clementi urges the use of common sense in this area. Al lack of test cases has prompted one tax payer to get aggressive, taking their chances with the probability of facing an audit-by exchanging a marble sculpture for a bronze, for example.

But she thinks there are ample opportunities to make qualified exchanges without trying to push the like-kind envelope."There are a lot of nuances to personal-property exchanges, which advisers need to be aware of before advising clients to consider them," says Clementi. But she urges advisors not be to dissuaded and to simply spend a little time with the Treasure regulations pertaining to SECTION 1031." "The goal of a financial advisor is to flag those opportunities for clients," says Clementi. "That will help them keep the most money possible in their pockets."

To make the bust use of 1031s, you need to remember to look beyond stocks and bonds and even real estate holdings when reviewing a client's portfolio. You need to look at the artwork on the walls, think to ask about stamp or coin collections, or the antique cars in the garage. Let the client know that if the time comes when their assets needed to be sold, you have a plan for doing so with minimal to no taxation-whether this means helping them accumulate bigger collections or exchanging something into smaller pieces to facilitate a conversion to cash over the course of several tax years.

Knowing how to minimize or control the realization of gains makes an advisor's services all the more valuable, observes Clementi. Which is, after all, the whole point.

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equal or greater value, the difference—known as boot—is taxed as gain. Between the closings on the two properties, an accommodator—you find a professionally qualified on through the Federation of Exchange Accommodators (FEA) or through real estate agents or attorneys with 1031 experience—holds the proceeds in escrow. For instance, Judith Lau, president of Lau & Associates, a financial-planning firm in Wilmington, DE, has a client who owned a piece of farmland that was incurring costs when she needed more income. Lau helped arrange for the property to be exchanged for a small shopping mall occupied b rent-paying tenants through a third-party accommodator.

Storms find exchanges especially useful for clients nearing retirement. One of his clients had been renting out an inherited home in Delmar, CA, for years. As she planned for retirement, the $18,000 in annual rental income the house generated just wasn't adequate. Again, using an accommodator, Storms helped her exchange the $500,000 home for a building that leases space to a day-care center. Her $500,000 investment not generates $60,000 in annual income. "Had we sold and bought bonds," says Storms, "we would have earned only 8 percent on a principal greatly reduced by capital-gains taxes, which at the time [about 10 years ago] were 28 percent."

Storms also points out that 1031 exchanges can actually accelerate wealth accumulation for those willing to remain invested in real estate. Unlike sales involving other assets, which are held outside tax-advantaged retirement account and typically result in a principal-reducing taxable even, the tax deferral of 1031s keeps all invested moneys working And although the more property an investor holds and the more valuable it is, the more beneficial exchanging is, 1031 exchanges are effective for more than just your wealthiest clients.

Indeed, the IRS mad the exchanges even more user friendly when it acknowledged the acceptability of so-called reverse exchanges in a 1998 private-letter ruling to a utility company. Reverse exchanges allow property owners to buy a replacement property—which a qualified intermediary takes title to—before selling the old property. (The exchanges can apply to things other than real estate, too; see "Tit for Tat")

Gary Gorman, manager of Professional Exchange Accommodators in Englewood, CO, emphasizes the wealth-transfer and estate-planning opportunities afforded by 1031 exchanges. He offers this scenario: a family ranch or farm is exchanged by retiring parents for smaller real estate parcels, which are used by the offspring for business purposes. These can then be gifted to the children over time. Even if the parent retain ownership, the can still sell these smaller parcels over a period of tax years, giving the retired couple the ability to control when and how much gain they're realizing while at the same time reallocating their assets. Yet another alternative is converting rental properties into a personal residence. (see "Rent to Own")

RENT TO OWN: *CONVERT INGRENTAL PROPERTY INTO A PERSONAL RESIDENCE*

GARY GORMAN, MANAGER OF Professional Exchange Accommodators of Denver, provides an example of how a home owning client with a few stray rental properties can—in four easy steps—convert those investment properties into a personal residence and access the $500,00 gain excluding ($250,000 for singles) available to all home-owning taxpayers.

Step 1 The Smiths own four small rental houses, with a $100,000 gain in each, as well as a personal residence. They expect to retire in a few years and want to redeploy the funds they have invested in rental property to other assets more appropriate to retirees, like stocks and bonds. Using a qualified intermediary for the exchanges, they arrange to sell the four small homes and roll their proceeds and gains into one large house, which they buy for $400,000.

Step 2 The Smiths rent out the large house and live in their personal residence.

Step 3 At least a year after buying and renting out the large house, the Smiths well their persona residence, which they have live in for many years, excluding the $500,000 in gains realized on the sale. They the move into the new house and invest the proceeds of the home sale to produce retirement income.

Step 4 Two years after moving into the new house they sell it for $500,000, realizing a $100,000 gain. This gain also qualifies for exclusion. (Remember that the exclusion on personal residences essentially renews every two years—the days of the once-in-a-lifetime exclusion are gone.)

The bottom line? As the Smiths enter retirement, they do so having realized $1million in gains tax-free, conceivably in as little as 36 months. (The shortest time period during which a 1031 exchange can be completed is 24 ½ months.) They are free to take any portion of that money and buy a retirement home or invest it all and rent a home—it's entirely up to them and entirely untaxed.

In 2000 Congress attempted, if not to shut down this sort of tax alchemy, then at least to make it less attractive by lengthening the holding periods. The attempt was thwarted. Although moves to limit 1031 exchanges could be resurrected at some point, it's seen as unlikely during the next few years despite the recent power shift in the Senate, especially because congressional representatives of both parties face elections every two years.

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It's the 1031 exchange's flexibility that draws advisers to them, despite the fact that planners themselves aren't part of the 1031 fee chain—only the accountants, attorneys, real estate agents, and accommodators realize an immediate income benefit from the transactions. "For us, [1031] exchanging is obviously not a primary part of our business or our investment strategy," says McCrea. But, he adds, "it serves our portfolios and our clients well" And this is the bottom line for McCrea.

It's the flexibility that draws advisors to 1031 exchanges

Also, like Lau and Storms, McCrea favors having real estate in client accounts for the diversification it offers. But they all stress that there needs to be a solid reason that a given piece of property appropriate for a particular client.

"When an adviser looks at a client's holdings, he needs to stop and ask, Oh are you doing this? What do you expect to gain from it?'" says Lau. "When a property is held for investment like an apartment complex, there is an opportunity to upgrade or diversify by accessing a 1031 exchange. But when the property serves a family purpose—like a beach house—exchanging isn't viable."

Once Lau establishes who property is being held, she asks herself whether the performance of the investment cam be improved. It can, the client makes a good candidate for a 1031 exchange, and it's time to find a good property. At this point, it helps to have a stable of referrals at hand, including a good real estate management team to refer the client to—someone who can find good properties for exchanges. "Coming up with the idea to exchange is simple," says Lay. Finding good replacement property—which allows the client to upgrade or diversify his holding or improve income—is not, she stresses.

She also recommends that clients engage attorneys who have 1031 expertise. "Familiarity with the issues and technicalities is not a common skill," says Lau. Qualified intermediaries even those with years of experience are not authorized to make tax determinations and their documents often relieve them of any responsibility if an exchange is disallowed. Their job is simply to accommodate the exchange: to hold the proceeds of sale—or title to the replacement property, if a reverse exchange is involved—in escrow until all the closing are completed. Although a good accommodator will have a strong grasp of the procedures and IRS rules that allow for these exchanges, the involvement of legal and tax experts to review documents and shepherd the exchange through its closings is seen as essential (For more on choosing an accommodator, see "The Buck Stops Here,")

The emphasis on expertise is universally shared by advisors who recommend 1031 exchanges to their clients. Why? The IRS will disallow improperly executed exchanges, meaning capital-gains taxes become due on the sold property. Most, often, the improper execution is a matter of poor timing says Keith Raker, a lawyer who handles 1031 exchanges at Arter & Hadden, a Cleveland law firm. Timing, as it relates to exchanges, is apparently almost everything.

First, the simple mistake of not getting organized early enough to have an opportunity to exchange is fairly common say Raker. Before a piece of property is put on the market—before the client even signs a sales agreement with a real estate agent—an accommodator needs to be engaged.

Problems can also crop up concerning the time taken between closing

THE BUCK STOPS HERE

YOUR CLIENT NEEDS A good—and trustworthy—accommodator for a successful 1031 exchange. The best source is The Federation of Exchange Accommodators, (FEA). You can also ask for referrals from attorneys and real estate agents with knowledge of 1031 exchanges. Once you have some names, use answers to the following questions to make a final pick. Is the accommodator a member in good standing with the FEA and bonded by an independent insurance company?

- **What is the accommodator's background and experience? The person should be a certified public accountant or an attorney with real estate and 1031 experience.**

- **Who will pay any resulting penalties should the accommodator make a mistake?**

- **Is the client being asked to sign a waiver should the transaction be disallowed by the Internal Revenue Service? It's best if the accommodator's firm takes full responsibility.**

- **Who receives interest on the funds held in escrow? Many qualified intermediaries quote low service fees yet keep the interest earned on funds held in escrow.**

- **How accessible is the accommodator? Will he meet with your client in person? If so, will a face-to-face meeting do more than a phone consultation?**

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on the old property and identifying the new one. Most 1031 exchanges are delayed ones—the buyer and seller are not exchanging property directly with one another—and for the transaction to be considered valid, the person exchanging properties has to arrange for a qualified intermediary to handle the closing both on the old property and on the new. A 45-day window is allowed between closing on the old property or properties in a delayed exchange. The exchange of properties must be completed within 180 days to be valid, Take 46 days to shop around, or 181 days to close, and forget about deferring the tax on the gain. It is considered realized and due. Yet another mistiming that can undermine and exchange, according to Raker, has to do with when the tax returns are filed. If a client's tax return is due before the 180-day window closes, the client needs to extend his filing date or risk losing the deferral benefit.

Beyond bad timing, what else can go wrong? Unfortunately, as with any other large chunk of money, there's the risk that the funds could disappear—either through fraud or default. "Many accommodators offer fidelity bonds to insure against embezzlement,' says Tim Egan, executive director of the FEA in Sacramento. And most, he says, hold funds in bank CDs insured by the Federal Deposit Insurance Corporation.

Still this is not a federally regulated industry, adds David Kuns, an officer with Starker Services, a Los Gatos, CA, exchange accommodator, and a vice president with FEA. "Our industry is like any other where other people's money is involved. You need to know with whom you are dealing," Kuns says.

Yet for advisors, the biggest potential problem with 1031 exchanges isn't unscrupulous dealing but rather the threat of involving a client in a transaction unnecessarily. Raker stresses that swapping property merely to avoid taxes accomplishes nothing. "You need to be gaining some value—a fully depreciated property for one with development potential—or to trade up to a more expensive parcel," he says.

Lau agrees, "You need the right clients, sitting with the right property in the right portfolio. This is not something to do just because it sounds good—you need good reason as well," she says.

Indeed, sometime a portfolio is best served by simply paying the taxes, urges Kent Noard, an adviser with Sterling Wood Financial in San Jose, CA. Noard wards against becoming so enamored with tax avoidance that you lose sight of the investment potential—or lack thereof—of the new property. "Don't let [the] tax tail wag the dog," Noard says.

"The goal should be to find the best investment once a property is earmarked to sale, be it real estate or some other asset." Whether it's a one-bedroom condo in Chicago rented out due to a job transfer to Los Angeles or vacant land in Arizona bought during a middle-aged fantasy about building a dream vacation home—the opportunity exists to exchange leftover property into something more appropriate to a client's current investment need and market conditions. For the right person, exchanging versus outright selling can have very tangible results. Although knowing when to suggest them may garner only intangible results for an adviser, it's another means of adding value to your services.

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Advisor and journalist Gayle Ronan writes
frequently on financial-planning topics