

Strategies for a Real Estate Bubble

By Robert R. Tweed

Is there still money to be made in real estate? Yes, but investors need to be smarter going forward.

For the last quarter century, one of the best investments has been California real estate. But we are starting to see prices level off and returns fall in the residential market. If you are a real estate investor depending on the value of your real estate to meet your financial goals, some strategic thinking is in order.

As a real estate investor, you need to ask yourself the following questions:

- What will be the impact on my lifestyle and future plans if the value of my property declines 10-20%?
- How long can I afford to carry the property if it is not providing cash flow?
- Are my assets overly concentrated, where a single disaster could destroy my net worth?
- Am I managing my property adequately to optimize cash flow?
- Are there other investments that offer better return opportunities for my equity?
- When will I need to start pulling equity out of my investments for retirement or other financial requirements?
- Are there better ownership structures for my real estate investments?
- Do I want to position my real estate assets to pass them on to my heirs with minimal tax implications?

Often when investors stop and look at their answers to these questions they find they're not as comfortable with their real estate investments as they might want to be. But, instead of managing the risk of real estate investing, many individuals mentally 'lock' themselves into a property because they can't bear the thought of how much they will have to pay in taxes if they were to sell. What they don't realize is that there are options that defer taxes and enable them to manage the risk of their investments.

Managing risk starts with understanding what your vulnerabilities are as a real estate investor. In addition to the potential of an overall market decline, investors face the risks that (1) the location becomes a negative due to changes in the surrounding area, (2) the use for which the property is designed becomes unsuitable, such as an aging retail center, (3) improvements on the property are damaged or destroyed, and (4) a natural disaster adversely impacts values.

To limit the impact of these risks, ideally, you should diversify your real estate portfolio, just as you would stock investments. You also need to actively manage those investments by keeping up not only with the maintenance of your property, but also understanding how property values are changing around the site. If your property isn't appreciating at a competitive rate, you should be looking at options.

Investment properties may be sold and the proceeds reinvested in one or more alternative properties without incurring capital gains or depreciation recovery taxes through an IRS Section 1031 exchange. "Like kind" or 1031 exchanges allow the complete and indefinite deferral of capital gains taxes and recapture of depreciation taxes. This permits taxpayers - without losing equity to taxes - to position their real estate investments to match perceived opportunities.

A TIC 1031 exchange may be used to trade up to larger investment properties, increase tax-sheltered cash flow, relocate real estate investments, change the type or character of real estate investments, diversify to multiple properties or consolidate from multiple properties, and more, as long as the exchange meets IRS rules. This gives real estate investors the potential to continually build equity through reinvesting gains that would have been lost to taxes. Using a 1031 exchange, capital gains and depreciation recapture taxes are deferred until the proceeds are finally paid to the investor.

1031 Exchanges may be:

- simultaneous closings of the exchange property and replacement property(ies);
- a delayed exchange, where the exchange property is sold prior to the purchase of the replacement property(ies);
- a reverse exchange where the replacement property is purchased before the exchange property sells.
- an improvement (construction) exchange, which allows improvements to be made on a property so that it will qualify as an exchange property. This might happen when a new building is constructed on the replacement property to accommodate a business and increase the value of the property to meet the exchange requirements.

Investors may also use Tenants in Common (TIC) 1031 exchanges to diversify their real estate holding and to own a partial share in larger, multi-owner real estate properties.

TIC 1031 exchanges have really come into their own since October of 2002, when the IRS released Revenue Procedure 2002-22, which established standards under which 1031 exchanges could be used with tenants in common interests. We are seeing these exchanges used by investors to potentially gain geographic and use diversification, increase cash flow, reduce or eliminate their personal involvement in managing the properties, benefit from the economies of scale of a larger project and much more.

The first step in putting together a 1031 exchange is to sit down with an investment professional who specializes in real estate exchanges and review your options. This individual can help you understand the IRS' requirements for a valid 1031 exchange, the tax implications of selling or exchanging properties and tools you can use to cash out of real estate investments while still minimizing the tax impact.

It's been relatively easy for California investors to make money in real estate over the past few decades, but there is no guarantee that will continue. You don't want to make the mistake of confusing a rising market with brilliant investment decisions, particularly when the bulk of your net worth is in investment real estate.

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