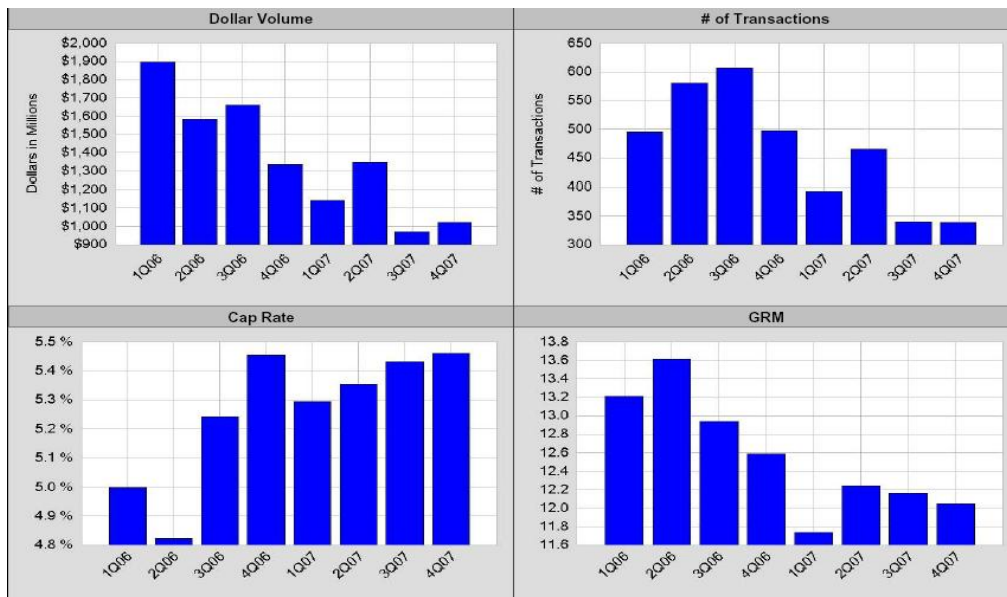


## An Exit Strategy That Defers Tax Liability Using the 1031 Exchange and TIC Investments

by Anne Baber, Investment Real Estate Broker

### Up is Up Until it Ain't ...

Well folks, now it ain't! This is an old commodity trader's saying, and it is certainly applicable to the Southern California real estate market. It is difficult to call the top of market except in hindsight. The following trend charts clearly illustrate the top of the multifamily market occurring during the first and second quarter of 2006 and the subsequent downward trend through the end of 2007. Note the significant decline in 2007 especially with respect to the number of transactions and the total dollar volume. Overall, the cap rates are trending up and, as expected, the gross rent multipliers are trending down.



This market downward turn has not been unexpected. The national real estate market is cyclical, and is typically a 16 – 18 year cycle, eight to nine years up and in turn eight to nine years down. The bottom of the last cycle was around 1997, so the market is doing what it is supposed to do. Of course, the sub prime implosion has certainly had a negative impact on the multifamily market. This will continue over the next several years as we have a lot more sub prime fall-out to work through and a record number of foreclosures to absorb.

Interestingly, while the overall real estate market has declined, unlike the single family market (one to four units), there have been relatively few foreclosures in the multi-family arena. As our property values increased over the last several years, the Buyer's down payments also increased per the lender's requirements. A down payment of 35% to 45% or more has been the norm. Therefore, since the property owners purchased their buildings in a cash flow position and have a vested interest (money) in the property, we see very few foreclosures.

It is interesting to note that in the midst of the daily barrage of economic bad news, in the 4<sup>th</sup> Quarter report of 2007, the UCLA Anderson Forecast holds steadfast to their previous tenet that the national economy is not technically in a recession nor is there one on the horizon. Though the economy is experiencing difficulties, the UCLA Anderson Forecast does not see the possibility of enough job losses to trigger an actual recession. Similarly, in California, they

foresee a slower and prolonged period of sluggishness for the state's economy, but no recession. As of this writing (January 21, 2008), this author fears that the UCLA Anderson Forecast could be wrong – short the copper!

### **The Good News**

The good news is that while the market has turned down, historically, sales prices are still relatively high and interest rates are relatively low. Sales prices are presently considerably higher than the previous market top (1989-1990) and we are probably still on the top portion of the down leg cycle. If you are looking towards retirement, it is still an excellent time to sell and take advantage of the 1031 Exchange and Tenant in Common Investments. While the real estate market is cyclical, we are not in lockstep nationally and market fluctuations give us opportunities in various geographical areas.

### **Geographical Diversification**

The beauty of TIC investments is that they allow an investor the ability to invest in different regions of the nation which are in upward trends in the real estate cycle. Tenant-in-Common investments (TICs) coupled with the 1031 Tax Deferred Exchange has exploded in popularity within the last few years. This is due, in part, to the IRS ruling in 2002 that TIC shares qualify as a 1031 Tax Deferred Exchange vehicle, providing that the sponsors meet certain guidelines. In addition, Baby Boomers entering retirement have increased demand for TIC investments in other regions of the nation that are poised for growth and are in an upward trend in the real estate cycle. These properties typically generate good cash flow and have attractive appreciation potential. By using the 1031 Exchange, sellers are deferring their capital gains liability by exchanging into TIC Investments in diversified geographical areas and thus are keeping Uncle Sam's dollars working for them.

### **Using the 1031 Exchange and TICs as a Retirement Vehicle**

TIC investments can benefit owners who are tired of the three "T's"; toilets, termites and tenants and would like to rid themselves of management headaches and retire. A straight sale would trigger a taxable event and the Seller would probably owe a hunk of change to the IRS in addition to the State.

A more favorable scenario would be to defer your capital gains taxes and maintain an attractive income stream, a portion of which will be sheltered. This can be realized by using a transaction structure that brings together the tax benefits of the 1031 Exchange and the ownership advantages of Tenancy in Common (TIC). The investors receive monthly distributions that now typically reflect annual yields of 6.5% to 7.5% of the cash invested in addition to the annual appreciation that is realized upon sale.

### **What is a Tax Deferred Exchange?**

A tax-deferred exchange is a method whereby a property owner trades one property (relinquished property) for another property (replacement property) and does not incur federal tax liability in the transaction. In an ordinary sales transaction, the seller is taxed on any gain realized by the sale of the property. In an exchange, the tax is deferred until some time in the future if and when the replacement property is sold. To be a fully tax-deferred exchange, the replacement property must be of equal or greater value in both equity and debt. The requirements and time frames of the IRS must be carefully met in order to qualify for an exchange and defer taxes.

### **What Are Tenant in Common (TIC) Investments?**

Very simply, "Tenant in Common" is a form of holding title that allows investors to own an undivided interest in a property. This enables small investors to own a percent interest of an institutional quality, multi-million dollar project that they otherwise could not afford. Investors receive a deed for their portion and receive a prorated share of the monthly rent (income), tax benefits and appreciation – without any management obligations for the day to day operations. The debt is already in place. The owner simply brings cash to the deal and assumes a portion of the non-recourse mortgage. The tax reporting is on one's Schedule E – the same as a direct

owner is doing now. However, a replacement property's larger basis permits new tax deductions – for more tax savings. The best part is that, unlike a partnership, this structure leaves control in the hands of the investor-owners.

### **Advantages of Tenant in Common Ownership**

- Flexible size to match your needs
- Pre-arranged financing
- No management hassles
- Potential increased after tax cash flow
- Economics of scale
- Can be identified and closed in a timely manner
- Investment can be diversified into more than one property

As a tenant in common, one can obviate management responsibility, defer capital gains taxes, increase both cash flow and tax deductions, increase appreciation potential, have more safeguards with triple net, high-credit tenants and maintain direct ownership. The option of partial ownership gives buyers the opportunity to diversify their real estate holdings by purchasing TIC interests in multiple properties. A TIC can get you more while you do less. Accordingly, this arrangement can solve several problems for owners looking to make their lives less complicated. *Anne Baber is a real estate broker with the Apartment Owners Association, Commercial Brokerage Division and has over 20 years experience in apartment house brokerage. She can be reached at (818) 235-1135 / anne@aoausa.com.*

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