

An Exit Strategy in a Down Market That Defers Tax Liability Using the 1031 Exchange and TIC Investments

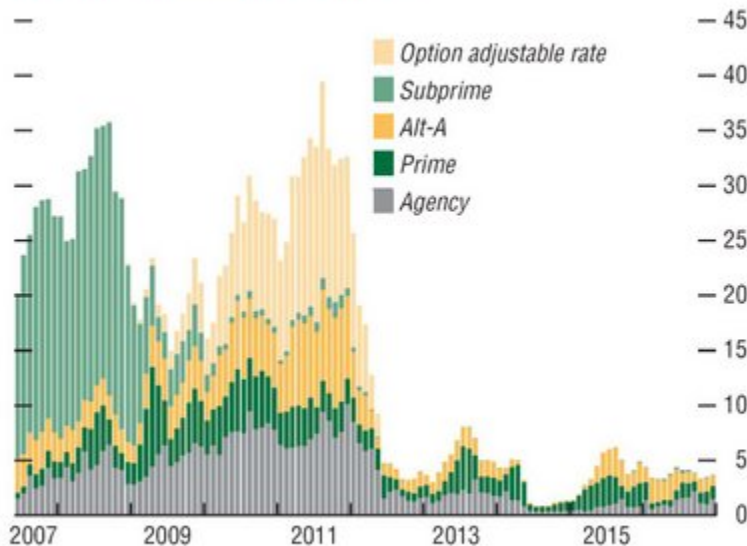
by Anne Baber, Investment Real Estate Broker

And now brace yourself for the Tsunami Wave of mortgage defaults....

The Southern California Market

There are some signs that the subprime implosion is finally beginning to stabilize. The rise in delinquency rates has started to flatten, but now we have another problem to muddle through - a larger wave of Alt-A ARMs and Option ARMs which will be resetting in the next few years (see chart below). Many of these mortgages will translate into foreclosures.

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

Although rising delinquencies have mostly been concentrated among subprime borrowers, recent data shows more creditworthy borrowers are increasingly falling behind with their payments. This underscores the point that the mortgage meltdown isn't confined to only those with weak credit.

Alt A loans (Alternative-documentation loans) are primarily credit score driven and their risk potential is greater than prime, but less than subprime. The candidates for these loans lacked adequate verification of income or assets. The lax paperwork paved the way for aggressive lending to the less creditworthy and emboldened borrowers to exaggerate their financial strength. These loans were very popular with buyers purchasing investment property rather than a home to live in. A number of these investors intended to ride the wave of home appreciation, sell before the interest rate resets and pocket their equity. As we all know, that did not happen.

We are probably going to have a “Muddle-Through Economy” for the next several years. The down economy has been fueled by the bursting of two bubbles: the housing bubble and the credit crisis. Also, it is going to take some time to work through the huge national inventory of foreclosed and overbuilt homes. We are probably talking 2011 before we finally work through this housing crisis and get back to a normal market where housing contributes significantly to GDP growth.

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.

The Good News (Multi-Family)

The good news is that while the market has turned downward, historically, sales prices are still relatively high, interest rates are relatively low 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.

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% to 7% of the cash invested in addition to the annual appreciation that is realized upon sale.

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 percentage 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.

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 increased 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.

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 reduce 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 or anne@aoausa.com.

Free Capital Gains Tax Planning Seminar & Deli Luncheon

Hosted by Anne Baber of AOA Commercial Brokerage
(Principals only please; no real estate agents.)

You Will Discover:

- How to use the 1031 as a retirement vehicle
- A proven safety net mechanism for 1031 exchanges
- The intricacies of how IRS Code Section 1031 works
- The advantages of Tenant-In-Common (TIC) investments
- An easy way to get more income while doing less management

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- **Torrance:** *Thursday, October 23th*
- **Valencia:** *Tuesday, October 28th*
- **Culver City:** *Thursday, October 30th*
- **Van Nuys:** *Thursday, November 6th*
- **Santa Ana:** *Tuesday, November 11th*
- **Ontario:** *Thursday, November 13th*
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Seminars will be held from 12:00 p.m.-2:00 p.m. Registration will begin at 11:30 a.m.
Seating is limited! For reservations and further information, please call Caelume Essence at AOA Commercial Brokerage (818) 235-1127 or email: caelume@aoausa.com.