

**Recent IRS Relief for Property Owners!
(A Very Good Thing...If Handled Correctly)
by William Truax**

A new technique has come into being in the worlds of real estate and taxation. Previously, property owners who wished to "trade up" without incurring income tax at the moment of sale could only do so with some difficulty and uncertainty. Not long ago, a new Revenue Procedure (a Rev. Proc. is simply a new way of dealing with an already-existing law) issued by the Internal Revenue Service cleared a path to achieving this tax advantage in a way that ordinary folks can actually live with.

Let me introduce you to Section 1031 of the Internal Revenue Code first, and then to the new Revenue Procedure enabling you to take advantage of it. Section 1031 has long allowed tax-deferred exchanges of like-kind properties, sometimes known as "tax-free swaps." By far, it's most common use has been in real estate, where an investor can swap a business- or investment-related piece of real property for other real property without paying any immediate tax, even if the gain on the sale of the first property is colossal. But many taxpayers were effectively barred by its restrictions from taking advantage of 1031 exchanges. This new development provides a remedy.

Here's a scenario now common in Southern California, and first we'll look at it when Section 1031 can't be applied. Let's say the Johnsons bought a rental property (Property A) 10 years ago for \$500,000. It has appreciated to \$5 million. Now they've come upon a new development deal (Property B) which they'd love to get into because they could make a mint on it, and that \$5 million would make it theirs. But once they pay income tax on the sale of Property A and pay off what's probably a substantial mortgage, they'd be woefully short of what's needed. On the other hand, if they refinance and pull out the equity in Property A to get the cash, the additional loan payments and interest will eat up all the available cash flow they've been enjoying, leaving them with no income. Neither of their choices makes good sense...so they're stuck where they are. Unless we put Section 1031 to work.

Instead of just selling Property A outright, we arrange for a tax-deferred exchange. Property A gets sold, the proceeds go to an escrow agent (or facilitator), and the Johnsons never touch the money. They direct the agent to purchase Property B. Done correctly and within the proper time frames, the sale of A and purchase of B qualifies as a tax-deferred exchange, meaning *they'd pay no tax on the deal at this time*. Suddenly, that tax of more than a million dollars is out of the picture, and all the Property A equity goes to work in Property B, making for much happier — and richer — Johnsons.

But implementing Section 1031 exchanges is a thorny business. Firstly, tight time frames apply. You must *irrevocably* identify your replacement property or properties within 45 days of the sale of Property A. You must close escrow on Property B within 180 days of the sale of Property A. Wow. Sometimes, it's hard enough just to get Property A sold, much less coordinate that sale with a related purchase. What if one of the deals falls out of escrow? What if something negative suddenly comes to light about the replacement property? What if...?

Second, you'll still be in the landlord business with your new property, and often people want out. You need income, though.

Next, where do you find that suitable replacement property? Do you put an ad in the paper? How's this? "Perfect property wanted. Must be in excellent repair, have good cash flow, and be priced well under market." Furthermore, perhaps you'll be uncertain that what looks like a great deal really is. Other issues can apply, too. But do these forever bar you from the tax benefits of Section 1031? Not anymore.

Not long ago, the IRS released Revenue Procedure 2002-22, opening the door for "tenant-in-common" interests to partake of the benefits of Section 1031. Individuals can become part of a group, a syndication of interests, and together purchase a much larger property than they'd be able to buy individually. The new provision makes it possible for the whole group to qualify for the Section 1031 tax-deferred exchange benefit. Once qualification occurred, the way was cleared for a technique that virtually bypasses the difficulties of pulling off a proper 1031 exchange.

Rendered simply, a promoter puts together a real estate deal, usually with a mature commercial rental property. He's brought together property and management while himself addressing legalities and the financial side of matters. It's his job to pick a worthy property which provides a good cash flow to the

owners, will keep on doing so, and stands a good chance of appreciating over time. Due to securities laws, there are usually no more than 30 to 35 investors in one property, all with a separate partial interest in a very large deal. Your piece is yours only. And this isn't joint tenancy, where all parties can have a claim to the entire property. As a tenant-in-common, your interest, completely separate, can be sold, traded, gifted, deeded to trust, and so on.

The advantages to the investor can be quite substantial. Here are a few.

1) The investor can "cash out" of his old property and trade up without loss of equity. He gets a nice, stable income return on his investment, and that investment is of *all* his equity from the property he formerly owned. Consequently, his return will be considerably higher than if he'd had to leave behind gobs of money as tax to the government, which would have happened had he not used 1031.

2) Section 1031 allows only 180 days between the sale of Property A and close of escrow on Property B. However, since tenant-in-common arrangements are now being put together quite frequently, chances are that an attractive deal will be available regardless of when one's sale actually closes. In light of that, there's no need to try to control the timing of multiple deals simultaneously.

3) Given the right promoter, you have a real estate expert on your side who has selected this deal from all the choices out there.

4) The promoter will provide maintenance to actively look after the property during the entire period of ownership, making it maintenance-free for you.

5) Because of the large market for 1031 tenant-in-common properties, one is able to hook up with savvy real estate professionals whose properties are in all parts of the country. No longer are you limited to the small geographic area you or your broker are familiar with. Southern California's real estate boom has now matured, suggesting that looking to other locales for the best possible deals makes sense.

So, a Section 1031 tenant-in-common interest can be the cure for what ails you, right? You get to put all, not just part, of your money to work at a nice rate of return, you get a stable and continuing income, you're freed of management headaches, and you can invest in currently hot areas. But beware, buyer.

The whole area of tenant-in-common properties has expanded so quickly that there are still some shady operators in the woodwork. You could get into a deal which looks fine on paper but turns out to be a money pit. The tenants could be driven away by incompetent management. The local market where the property is located could experience a downturn. The deal could be rigged so that your profits are limited, while the promoter gets the lion's share. The promoter could do a rotten job of addressing the tax issues in the deal, causing you to lose, if you're ever audited by the IRS, the tax benefit you were counting on. Lots of things might go wrong; exercise caution, choose wisely.

These deals, like any real estate deal, can be evaluated, if you know how. A promoter's track record can be checked. The legal, tax, and securities issues can and should be reviewed. The financial assumptions and projections should be examined closely for over-optimism or omissions. All these things and more should be studied thoroughly before you invest, ideally by someone experienced in the market *and* who knows the nooks and crannies of this sort of deal *and* who understands the tax, real estate, financial, and securities issues involved.

Utilizing Section 1031 with a tenant-in-common arrangement can be a life saver for investors, given the right deal. If you don't feel up to the entire task, simply bring in an advisor. An experienced advisor can help you find the right deal, and probably much faster than you could acting alone.

William Truax is a Tax Court practitioner in Los Angeles. He is the President of Verité Advisors, a full-range financial services group and Chairman of the Investment Committee for Professional Business Bank in Pasadena, where he is responsible for management of a portfolio exceeding \$100 million in assets. Please forward correspondence to William Truax, WILLIAM TRUAX, E.A., INC., 249 N. Brand Blvd., #316, Glendale, CA 91203 or call (323) 257-5762.