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The Riddle Report

Some Benefits Of A Tax Free Exchange

The main benefit of a tax-free exchange is just that–freedom from a tax. The gain that could be realized by one or both of the principals in the exchange transaction does not need to be recognized at the time of the closing. The gains tax is deferred until the property owner makes a taxable disposition of the new property at some later time.

It takes more patience and hard work to set up an exchange than it does to arrange a straight purchase and sale of real estate. Some property owners and their agents simply do not understand the benefits of an exchange or are worried about the strict requirements imposed by the Internal Revenue Code.

Owners need to know that the 1031 Exchange is just another tool like a purchase, sale, option or lease.

The real estate exchange has become a normal business tool used by investors, corporations and business owners throughout the country. If you have not used this tool, you may have already paid too much in taxes.

The benefit from the tax postponement is apparent. The owner can reinvest the full equity in other property, including gains, without any decrease in value due to tax payments. In effect, the government extends an interest-free loan to the investor, who then is able to obtain leverage over and above that obtained from regular mortgage financing.

An example is a trade up to a larger income property.

An investor owns a 10-unit apartment building that is too small for an on-site manager. The income is desirable and a sale would be costly because of a large gain. The equity could be exchanged up into a larger apartment property that would adapt to professional management. The larger property would have increased income to cover the bigger loans and management fees. After the transaction the owner can have the same or higher income, hire a professional property management company and be relieved of management problems.

"Like-Kind" Property

To qualify as a 1031 exchange, the property being sold and the property being acquired must be "like-kind."

The Like-Kind Property Definition is a very broad term which

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means that both the original and replacement properties must be of "the same nature or character, even if they differ in grade or quality." In other words, you can't exchange farming equipment for an apartment building, because they're not the same asset. In terms of real estate, you can exchange almost any type of property, as long as it's not personal property, it must be an investment property.

Some examples of types of exchanges that would be allowed

- Exchanging a duplex for an apartment building.
- Exchanging a single family rental property for a commercial office building.
- Exchanging a rental property or vacation rental for a warehouse.
- Exchanging a single-family rental property in Nevada, you could exchange it for a commercial rental property in Texas.

There are strict rules that must be followed to make a real estate exchange, and the original replacement property must be within the U.S. to qualify under section 1031.

Let's get together to evaluate your present portfolio of properties and review your plans for future acquisitions. A real estate exchange might be something that you may want to consider in the future. ❑

Management Of Your Investment Portfolio

When you make your investment in real estate, it is implied that you want to make money. The cash can come from direct income from the property or from capital gains from a sale after an increase in value. Either way, the investment must be managed, considered, and watched at all times. If the owner and manager are taking care of business, there may be ways to increase the income, and the value. There is always the possibility to make a sale for the right price and terms. Keeping aware of the market might bring an opportunity to make a tax-deferred exchange into a property with more benefits for the owner.

Real estate investors often own various kinds of properties. They may have a mix of commercial, residential income, land and groups of houses. These owners have an extensive portfolio of investment real estate.

Owners of portfolios of stocks and bonds meet with or call their broker often. Like seeing a doctor or dentist at regular intervals, it makes sense for real estate investors also to meet with their real estate investment representative or counselor at least a couple of times a year. Exchanging ideas with the professional who has the daily pulse of the real estate market can be profitable. At each meeting, the investor can plan on finding out the current market conditions that will have an effect on equities that are now owned or that could be acquired.

In many cases, the owner's investment representative is also the property manager. If not, perhaps the property manager should also be present at these meetings at least once a year.

Make Notes Before And During Meeting

Planning any professional meeting in advance will make it more productive. To keep any business meeting on track and save everyone time, notes should be made in advance by the property portfolio owner or the real estate investment specialist. The following are some examples of questions or subjects that might be discussed at each meeting; or some at least once a year:

1. In what ways can the management of my properties be improved? Can any current expenses be decreased?

2. How do our rent levels compare with the others in the immediate area?

3. Have there been collection problems–are all rents current at this time?

4. Is the current maintenance of the properties up to the best standards?

5. Has the planning department approved any zoning variances in the areas of my properties? Would it enhance the value of any property of mine to apply for a change in zoning?

6. Have any new construction projects been started nearby? What are they and what effect might they

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have on my properties or rents in the area?

7. Is the present use of my properties the highest and best use?

8. What improvements could be made that would increase the income?

9. Are we attracting the kind of tenants that should be in this type of property? Would anyone else be more desirable?

10. Are any properties of the type we own on the market at this time in this immediate area? What is the price and how is that price justified? Has there been any buyer interest in it at that price? Should we consider adding it to my portfolio of properties? If so, how can we acquire it, either by cash purchase or exchange?

11. Is my leverage position in all properties at its maximum potential? Would there be any benefit in a refinance of any of my properties at this time?

12. Are any properties in this portfolio suitable for a condo or co-op conversion? If so, should we do the conversion or sell the property to an expert in that field?

13. Can we offer any property for syndication? How would we handle it?

14. Which of my properties has the best set of benefits for me? Which has the least benefits?

15. Which of the properties in the portfolio would be the most desirable to dispose of at this time?

When each of the points in the meeting have been covered, both the property owner and his/her representatives should have a much better picture of the property portfolio and what should be accomplished. At this time, maybe each property owned should be graded in order of the most desirable to the least desirable to continue holding. Then the answer to item #15 will be apparent.

This can be the "bottom line" and the reason for the meeting. The goal should be set for the sale or exchange of the least productive property (to this owner) in the list of real estate owned. This might be the property of the highest potential to someone else, but of less interest to this owner because of the increase in value already shown by current estimates of worth or appraisal. This result is very satisfying since the "weak" property is identified and the goal is set to use its equity to acquire a certain type of real estate that will fit better into this owner's portfolio.

This gives a result for the owner that is seldom achieved by most investment real estate owners. At all times, there is a definite effort being made by a top real estate professional to improve the owner's position.

The problem of a taxable gain from that property need not be a consideration to this owner. The broker, working with the property owner's attorney and accountant can arrange to defer that tax by setting up a tax-deferred exchange into a more productive property. ❑

Suburban Office Buildings

With commercial real estate investing, suburban office buildings remain many investors primary acquisition target.

These investors reason that a suburban office building that can be purchased at a price below replacement cost must be a good buy. Careful choices must be made, as there must be a demand for office space in the area and a gradual increase in rents. Since rents have increased in most areas, the long-term demand for office space looks good.

Suburban vs. Downtown

Recovery in suburban office markets has outpaced downtown markets because the suburban markets began from a more disadvantaged position.

Overbuilding during the 1980s was much greater in the suburbs due to the lower cost of land, availability of land and the economic feasibility of constructing smaller buildings. Consequently, the national suburban office vacancy rate at the end of the decade was approximately five percentage points higher than the national downtown rate.

Construction and Absorption

Recent years have brought many positive changes in the U.S. office market. The biggest reason was the almost complete absence of new construction for several years. Just 5 million feet of new space was delivered annually during this period, while absorption averaged 42 million feet annually. ❑

Office Building Comparisons

Newer office buildings may fill up at the expense of older office buildings. Since new buildings cost more to build than the older ones, rents may be higher. The actual dollars-per-square-foot costs must be compared, along with other benefits that the tenant may receive, before a final decision is made by the tenant on staying or moving.

In many areas, there are still a number of vacancies reported in office buildings. Most of this available space is in the newer properties. One of the most important jobs of a leasing agent for a building with this available space is to analyze other buildings to see if any tenant could be induced to move.

Here are some of the items for comparison:

1. What is the time factor for employees at the old location? In a business' expansion at the old location, they may have expanded to different floors or to different buildings, as more space was needed. There may be a big loss in employee time due to the inconvenient layout.

2. Maybe the tenant is planning an expansion in the next few years, which will make it necessary to rent space in the old location at then-current rentals, raising the average rental per square foot for the tenant's entire space, in a less than adequate location.

3. Don't assume that the new space rentals are not competitive. Cost-of-living clauses in the tenant's existing lease may have escalated the rent level up to the costs in the newer, more modern building.

4. The newer building represents more efficient design, better and newer lighting, modern in every way. The intangible improvements in employee morale and efficiency might overcome any slight difference in dollar-costs per month.

5. Finally, a change in location to a more, prestigious building in a better part of the community can contribute to the reputation of the tenant–and ultimately to the profitability of the business.

The tenants who could be good new tenants at the new location will usually not be aware of all of the benefits of a move until they are contacted and are given the opportunity to make the comparison. ❏

Your Real Estate Investment

Knowing what you can do in some investment situations can be the difference between an annual profit or loss in your currently owned commercial property or the one you intend to acquire. How you acquire it can be important.

The professional commercial real estate broker is in the position to represent a client in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. This real estate practitioner stays aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax advice (unless he/she is also an attorney or a certified public accountant). In any complex transaction that might result in changes in any owner's legal or tax situation, the other members of the "consulting team" should be the owner's attorney and/or tax advisor. We always recommend consulting with these professionals during the planning and closing of major real estate transactions. All can affect taxes and estate planning.

We are the heart of your professional team, creating the real estate transactions that will be needed to expand your estate. Let's get together to evaluate your present portfolio of properties, or review your plans for future acquisition.

Starting with your present position and your goals for the future, we can set out moving directly toward achieving those goals. ❏

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