The Next Generation of 1031 Exchanges

by David Fisher

I have always wanted to come to the rescue like John Wayne did in almost all his movies. It didn't matter if he was saving settlers from the bad guys in the Wild West, saving Shinbone from Liberty Valance, fighting at the Alamo, the Civil War or World War II; he always gave it his best shot. With a few exceptions, he always came through in the clutch and I always wished that I could do the same.

Well, I believe that finally it's my time to come to the rescue of property owners who are staring at a large tax liability when selling a great investment property or even a high-end luxury residence.

The 1031 Exchange

Section 1031 is a great opportunity to accumulate wealth through buying and selling real estate. If you can transact a 1031 exchange do so. But sometimes a 1031 exchange can't be completed or isn't appropriate and that is what we are going to discuss in our conversation.

Using a Section 453 tax deferral strategies, you can sell today, defer those taxes today, turn an illiquid asset into a liquid retirement cash flow and receive a much higher retirement income than if you paid those taxes first.

There is a little known but highly effective proprietary trust based on Section 453 with a 22-year track record of successfully deferring taxes over 2000 times that in some cases may be a better option than Section 1031. Consider these situations and opportunities.

For example, a property owner has been using 1031 exchanges successfully to accumulate wealth through real estate but after doing so for 30+ years, he is ready to retire and enjoy retirement. He no longer wants to be involved

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in real estate but would like a low risk retirement cash flow. The first concern he is going to have is his tax liability. Since a 1031 is not an option, what are his taxes going to be. Let's assume for our conversation that he bought his original property for $100k and bought his last property for $4 million. He can sell the property for $5 million. Many property owners may not realize that their basis for the sale is not $4 million but $100k. That's correct. The basis is the first property bought not the last so in this case, our property owner has a capital gain (profit) of $4.9 million. In California, he will have to pay the 20% federal capital gains tax, 13% state tax, depreciation recapture of 25% of all the properties (ouch) and finally the 3.8% Obamacare tax and there may be other taxes in California that apply as well. That's a lot of taxes.

What if there was a 1031 exit strategy where the property owner could sell his property for $5 million and still defer taxes without a 1031 and have a larger retirement income than if you paid taxes first? Well, you can. Today. That's right. Using a Section 453 tax deferral strategies, you can sell today, defer taxes today and have a greater retirement income than if you paid taxes first. And, even better, you can pass the deferral and the retirement cash flow on to your heirs. Being able to defer taxes and generate an income from that deferral is great leverage.

As I mentioned earlier, if you can transact a 1031 exchange with no problems, do so. Having said that, consider this situation. You want to transact a 1031 but it's a sellers' market. On one hand, that's great for your sale but on the other hand, you now must buy a replacement property in a sellers' market and have only 45 days to identify one. So, in this case, you buy low, sell high and buy high and if you need to put more debt on the replace-

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ment property, it could be at a higher interest rate. What if you had the following option?

The 453 Exchange

Again, using Section 453, you can sell today, defer taxes today and have an unlimited amount of time to wait until market conditions becomes more favorable to buying. What if it takes four years for the market conditions to become more favorable to buy? No problem. While waiting, we can generate about a 5% cap rate to the client until it's the right time to buy. For example, we work with one of the top commercial brokers in California who has transacted over $2 billion in real estate transactions. He loves this idea because he has many clients that have large capital gains in their property and want to transact 1031 exchanges. He refuses because if they sell in a sellers' market, they must buy in a sellers' market and there is little advantage. So instead, he sells today using tax deferral strategies in a seller's market, defers taxes today and waits for better market conditions and his clients receive roughly a 5% cap rate while waiting.

For example, he sells his client's property for $10 million in a sellers' market but then must identify and ultimately buy another $10 million property in what is still a sellers' market. If he sold his client's property with debt, he must replace that debt with new debt at possibly at a higher interest rate. So, to complete the 1031, he must buy at the top of the cycle. Say four years later, the property has come back as happens on a down business cycle and is now worth $8 million. What if instead, the broker could buy low, sell high and by better? When he sells, he can wait an unlimited amount of time to buy another property when conditions are more favorable to buying and while he waits, his client can receive approximately a 5% cap rate on the sales proceeds. So, he waits and buys the replacement property for $8 million instead of $10 million and he receives $500,000 a year before taxes

($10 million x 5%) for four years from the trust. Sounds good to me.

You have worked hard over the last 30 years to bring value to your apartment building with the great information you received from the AOA. You are ready to sell and retire and move closer to the grandkids, so you don't want any more real estate. So, because a 1031 isn't appropriate, you will have to pay taxes on the sale. Again, those taxes will include the 20% capital gains tax, 13% state tax, depreciation recapture at 25% and the Obamacare tax at 3.8%. That could be about 40% of your profits and will dramatically reduce your retirement income. Because of the large tax liability, your CPA tells you not to sell and instead use the stepped-up basis at death to avoid some of the taxes. Not necessarily a bad strategy but what about this instead. John Wayne can't help you in this situation but Section 453 can.

Using Section 453 tax deferral strategies, working together with your broker, you can sell today, defer those taxes today, turn an illiquid asset into a liquid retirement cash flow and receive a much higher retirement income than if you paid those taxes first. Even better, the tax deferral and the retirement income can be passed on to your heirs and they can continue receiving the larger income because of the leverage by deferring taxes for as long as they like. Sounds good to me.

Consider some other reasons why the next generation of 1031 exchanges can offer more flexibility than Section 1031. If, for whatever reason, a 1031 can't be completed, the sales proceeds will not become taxable to you, taxes will still be deferred, and you still have unlimited time to find another property. What if you didn't have to worry about "like kind property"? Sell your apartment and buy a beach house in Mal-

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ibu. You can if you promise to invite me to visit. Also, there are no loan-to-value problems and even better, if the numbers work out, you can loan yourself the proceeds to buy another property and instead of borrowing from a financial institution, you can not only borrow from yourself and pay yourself interest. How great is that!

You can defer taxes on any kind of property. Say you have a vacation home or a high-end luxury residential property that you would like to sell but there will be a large tax liability. A 1031 may not work but a 453 will. Say you bought your home 30 years ago and now if you sell, it will create a large tax liability. Again, a 1031 isn't appropriate but you can defer taxes even on a residential property.

One Final Thought

Although each situation is different, there have been situations where it was possible to defer taxes on the sale of a property that is owned by foreign citizens. For example, I was contacted earlier this year by a broker that I work with. His deal to buy a $3 million property for his client just died. The owners were Mexican citizens and if they sold, there would be large tax consequences and therefore the sale made no sense. We looked at the situation, came up with some solutions and ultimately the brokers made the sale. We can't promise that this will be the result in all situations, but we can certainly investigate almost any situations to find out if we can assist in helping you make the best decisions for your situation.

We have discussed real life situations and how we can defer the capital gains tax, state tax, depreciation recapture if it's not a residential property and the Obamacare tax when we use the Section 453 tax deferral strategies. Here are some additional benefits. For

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purposes of our conversation, we will focus on your wanting to retire but they can apply to all situations.

This program can provide a dependable retirement income managed by a team of investment professionals with over 80 years of investment experience. You can diversify your retirement assets into numerous retirement investment programs that can provide a dependable retirement income and at the same time potentially reduce investment risk.

The tax deferral strategies can eliminate the risks of ownership. Say that you want to retire but won't because of the large tax liability that you thought you had to pay before reading this article. (Shameless plug.) By keeping your property, you still maintain the risks of owning real estate. Now you can sell, defer taxes, generate a lifetime retirement income and not lose sleep over tenants, toilets and taxes.

Because you can defer the taxes mentioned above, which could be hundreds of thousands if not millions of dollars, you can help you maintain and even increase your family wealth. You keep the tax deferral in your pocket and can receive income from the tax deferral which will increase family wealth.

You can increase and diversify estate liquidity and turn illiquid real estate into a diversified group of liquid assets that can provide a lifetime income stream for you and that income stream can be passed on to your heirs.

And finally, as mentioned above, it can be a 1031 exit strategy. Let's talk about this for a moment. Now, apartment owners know that they have a 1031 exit strategy that they previously didn't have so there is no real need to transact a 1031 using Delaware Statutory Trusts as replacement properties. In the interest of full disclosure, I have worked with Delaware Statutory Trusts and they fill a need in a 1031 when you can't identify a property in a 1031. However, I would think twice about using them as a retirement vehicle.

A Delaware Statutory Trust is not real estate but rather is classified as a security. Because of this classification, in order to get involved in one, you must follow security requirements, and, in some cases, you may not be able to get involved in one. In addition, they are illiquid and almost impossible to get out of except due to death or disability. Usually, the property in the Delaware Statutory Trust goes through rigorous due diligence but sometimes a change in market conditions may cause situations where there could be problems with the property and ultimately the benefits that you, the trust beneficiary is concerned.

The bottom line is that a Delaware Statutory Trust could be a retirement benefit, but I believe that the Section 453 program may be a better option.

So, the next time you are walking down Rodeo Drive and you see a John Wayne looking character complete with cowboy hat, belt bucket, cowboy boots carrying a briefcase, stop and say hello to me and thank me for rescuing you after reading this discussion on the next generation of 1031 exchanges. **By the way, please come by and visit us at Booth 216 in September at the AOA Trade Show. I will be the one not wearing a cowboy hat.** Take care and I appreciate your interest and courtesy in spending time with me for a few moments. Best wishes. AOA

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