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REAL ESTATE ADVISOR

FIVE MISCONCEPTIONS SURROUNDING SECTION 1031 EXCHANGES

Whether you know them as like-kind, tax-deferred or Section 1031 exchanges, they've become an important tax strategy for real estate investors. These transactions allow investors to exchange properties of a "like kind" and defer any gains on the relinquished properties until they sell the replacement properties. But, despite their popularity, a number of misconceptions remain regarding how they can be structured. Let's look at five.

1. Sec. 1031 exchanges must be simultaneous transactions

Years ago, Sec. 1031 exchanges required a simultaneous swapping of deeds between parties. There are no such requirements today, however. Now taxpayers can complete an exchange on a delayed basis, so long as they purchase replacement property within 180 days of selling the property they had relinquished — or, if earlier, the due date of their return for the year of the exchange.

Investors may also choose to structure their Sec. 1031 transactions as a *reverse exchange*, in which replacement property is acquired before the relinquished property is sold, or as an *improvement exchange* in which one party is required to make improvements to the property before the exchange takes place.

2. You must purchase the same class of property that you sell

Although the term "like-kind" seems to imply that similar properties must be exchanged, the true definition is more expansive than that. As long as both the property to be sold and the property to be purchased are held for productive use in a trade or business or for investment purposes, you're free to purchase whatever type of property you want. For example, you can exchange a shopping mall for an apartment building or a vacant plot of land for a fully developed parcel.

Depending on the state law governing the transaction, nontraditional interests in real property, such as development rights, air rights and timber rights, may also be traded in a Sec. 1031 exchange.

3. Only two properties can be involved in a Sec. 1031 exchange

There are no provisions within either the Internal Revenue Code or the Treasury Regulations that restrict the number of properties involved in a Sec. 1031 exchange. Investors can, and often do, exchange several properties for one (or vice versa).

4. Your attorney or accountant can facilitate the exchange

Sec. 1031 transactions can be facilitated only by a qualified intermediary (who, by IRS definition, is not the taxpayer or an agent of the taxpayer). Anyone who has had an existing business relationship with you in the past two years (such as your attorney, accountant, realtor or broker) is prohibited from facilitating your exchange. They may recommend a facilitator to you, but they can't act as the facilitator.

If you or any disqualified person comes into receipt of the exchange funds during the transaction, the exchange will be void. Using a well-established qualified intermediary enables you to avoid situations that might void an otherwise valid exchange.

5. The entire proceeds must be used to purchase replacement property

To complete a Sec. 1031 exchange, you must:

- Buy replacement property whose value is equal to or greater than the value of the property you're relinquishing,
- Use all of your equity in the property you're relinquishing to purchase the replacement property, and

- Obtain financing on the replacement property that's equal to or greater than the mortgage being paid off on the property you're relinquishing at the time of the exchange.

Applying any of the above scenarios, however, won't negate the validity of a Sec. 1031 exchange. It simply means you'll pay tax on the portion of gain that isn't deferred. For example, if you purchase replacement property of a lesser value or with less financing, you'll be liable for capital gains tax on the amount not reinvested. In other words, you can purchase replacement property for a lesser amount and put cash received in your pocket, as long as you don't mind paying some taxes.

Is there a Sec. 1031 exchange in your future?

Some investors have never checked into Sec. 1031 exchanges because they think they're only for "big" investors. But any investor contemplating the sale of investment property should consider a Sec. 1031 exchange — regardless of pocketbook depth or portfolio size. Why? Because deferring capital gains tax on appreciated property generally is beneficial.

One important caveat, however: this strategy can be costly if tax rates are higher when you sell the replacement property. So be sure to discuss Sec. 1031 exchanges with your tax advisor before executing one to see if it makes sense for your particular situation.

Section 1031 exchanges and homeowners exclusion suffer under 2008 tax law

The tax code allows you to exclude up to \$250,000 of capital gain (\$500,000 if you're married filing jointly) on the sale of your principal residence, provided you meet certain tests. But excluding gain on a principal residence acquired through a Section 1031 exchange is a bit trickier now, thanks to the Housing Assistance Tax Act of 2008.

Although principal residences aren't eligible for Sec. 1031 exchanges, a home that's a rental property is eligible and can later be converted to a principal residence. As of Jan. 1, 2009, the amount of gain that can be excluded on the sale of a principal residence may be reduced if the home was used for something other than a principal residence during the period of ownership. The reduction is prorated based on the number of years the property wasn't used as a principal residence and the total number of ownership years. (Use of the home as a rental property before Jan. 1, 2009, isn't part of the equation.)

For example, Steve and Sally use a Sec. 1031 exchange to acquire a home for \$1 million on Jan. 1, 2009. The home serves as a rental for five years and then the couple moves in and makes it their principal residence for the next five years. On Jan. 1, 2019, the couple sells the home for \$1.5 million, netting them a \$500,000 gain. Under the new rules, they can exclude only the portion of gain related to their use of the home as their principal residence. Since that portion is 50%, they would have a \$250,000 taxable gain representing 50% of the gain attributable to the Sec. 1031 exchange.

ADVERSARIES NO LONGER

Win-win agreements between developers and environmentalists increasing

Have you heard the latest? In many locales, developers and environmentalists seem to be bridging their philosophical divide. Frustrated by legal costs and government inaction, they're turning to creative compromise as the best strategy for achieving their individual goals.

Changing mindsets

More and more developers have been seeing that greener buildings can translate into healthier bottom lines. A study by California's Sustainable Building Task Force found for example, an upfront investment of only 2% in green building design would result in an average future savings of 10 times the initial

investment. (While the 2% cost figure is a rule of thumb, some buildings have qualified for green certification at no additional cost.)

Reduced energy costs are only the beginning of green building-related savings. Sustainable building tenants benefit from increased worker productivity and healthier employees, while developers reap the reward of higher rents and premium resale prices.

At the same time that developers are adopting a more eco-conscious mentality, environmentalists are moving toward more compromise and less confrontation. Forest sit-ins and legal battles are out; win-win agreements are in.

Cutting deals

As a result, environmental groups and developers of late have cut some unprecedented deals that allow development in exchange for conservation initiatives. Some agreements allow residential developments, oil drilling or new power plants in exchange for preserving some undeveloped land, imposing stricter environmental practices than required by law or investing in alternative energy. Here are three examples of win-win conservation developments:

1. Tejon Ranch, which owns the largest private tract of property in California (422-square-miles of hills, valleys and canyons that are home to the endangered California condor) recently agreed to preserve 90% of the land in exchange for an agreement by environmental groups not to oppose the building of up to 26,000 homes on the remaining 10%.
2. The Columbia Land Trust, a regional nonprofit focused on protecting key lands, struck a deal to purchase development rights for 85% of the 24,000-acre tree farm owned by Pope Resources (a timber company). Under the agreement struck earlier this year, the land, which is highly prized for its scenic, recreational, wildlife and timber value, will remain as a working forest. Pope Resources will retain rights to 15% of the land for other uses, including possible development. The agreement put the property on a different track than it was on while satisfying both conservationists and developers.
3. Kansas City Power & Light, in a negotiated compromise, agreed to build one new power plant instead of two, clean up two others and invest in wind power. In exchange, environmentalists dropped litigation aimed at blocking the power plants.

Making complex trade-offs

Although they're becoming more common, negotiated agreements are made more complex simply by the number of stakeholders involved. Developers and environmentalists aren't the only ones at the table ... Native Americans, business leaders, motorized recreation groups, local government officials and others are clamoring to be heard.

Viable solutions are reached when interested parties recognize the need for mutual cooperation, and then negotiate an acceptable win-win solution for citizens, businesses, landscapes and wildlife.

SPOTLIGHT ON MP&S

Marks Paneth & Shron Revenue Maximization Checklist

The Real Estate Group at Marks Paneth & Shron LLP (MP&S) has developed a Revenue Maximization Checklist to help property owners ask the right questions and gain maximum benefit from existing lease provisions. A well designed audit of procedures surrounding property accounting such as billing, collections, lease abstracts and lease audits conducted by accountants deeply versed in commercial real estate can turn up unanticipated revenue opportunities and help ensure that property portfolios are yielding maximum returns.

Best Practices for 2010

Marks Paneth & Shron has issued the firm's annual "smart business moves" statement for 2010. In this year's statement, MP&S emphasizes the importance of businesses maintaining their sense of vigilance and accountability in the coming year.

Economy Creates Changes in Wealth Management Services

As the financial crisis took hold, many high-net-worth individuals withdrew assets or left their wealth management firms. But as the economy improves, wealth management firms are seeking ways to alter their business models and provide a better service to risk-averse clients, who are demanding more transparency. Daniel Kesner, a partner in our Family Office and Business Management Group, has commented on recent changes in wealth management services.

ASK THE ADVISOR

Given the current economy, is it wise to accept Section 8 tenants?

With the economic recovery still in slow motion, an increasing number of landlords may be tempted to accept Section 8 tenants. Under Sec. 8 rules, low-income individuals or families receive a voucher from the Department of Housing and Urban Development (HUD) to subsidize their rent.

Dependable cash flow

Sec. 8 tenants provide a dependable cash flow source, because the government always pays its part of the rent —though not always on a timely basis. Uncle Sam also provides for cost-of-living based rent increases, though such increases are left up to the government's discretion and the government also determines what the increase will be.

Despite landlord fears that low-income individuals won't maintain the property, Sec. 8 renters can be better than average low-income tenants. That's because Sec. 8 renters have something to lose: if a landlord files a justified claim against a renter, the renter could lose Sec. 8 eligibility for up to five years. Landlords who accept HUD vouchers will always have a pool of potential tenants, because there are generally more people approved for Sec. 8 than there is housing available.

But there are drawbacks

In terms of disadvantages, offering a property as Sec. 8 housing could preclude it from more upscale development options. A wrong move in this direction could be especially costly in urban areas undergoing revitalization.

Other drawbacks? Landlords aren't allowed to raise rent on Sec. 8 tenants. Moreover, the properties must meet certain federal requirements. For example, a Sec. 8 property must have electricity, heat and water, and provide a kitchen, bathroom and at least one bedroom per two people. To ensure these requirements are met, the government regularly inspects Sec. 8 properties. While these inspections shouldn't be a burden, some landlords fear that government enforcement of petty requirements may become an issue. In contrast, landlords using a property manager may view inspections as a way to ensure the property management company is doing its job.

Legal issues may also crop up. By providing renters with free legal representation in the event of a tenant-landlord dispute, Uncle Sam makes it easier for them to sue. In addition, landlords who wish to evict a Sec. 8 tenant must provide detailed documentation to substantiate their complaints.

Is Sec. 8 right for you?

Getting started as a Sec. 8 landlord is easy. The hard part — and one which deserves the most thought — is deciding whether Sec. 8 is right for you. Working with a CPA who has expertise in real estate and government housing can help ensure you make the right decision.

SEASON'S GREETINGS

On behalf of Marks Paneth & Shron, best wishes for the holiday season and the New Year.

FOR FURTHER INFORMATION

If you have any questions, please contact **Harry Moehringer**, Partner-in-Charge of the **Real Estate Services Group** at 212.503.8904 or hmoehringer@markspaneth.com or any of the other partners in the MP&S Real Estate Services Group:

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