

Wealth Planning Update

Tips for Managing Real Estate Capital Gains

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In this Wealth Planning Update:

- » *Capital gains taxes may be deferred with proper planning and the use of like-kind exchanges.*
- » *Identifying the right replacement property and determining how best to manage it going forward is crucial to the success of a like-kind exchange.*
- » *There is much complexity involved in properly implementing a like-kind exchange. It is important to consult with a knowledgeable advisor.*

Deferring taxes through a like-kind exchange

Have you ever hesitated to sell a real estate investment due to concerns about capital gain taxes, recapture of depreciation, and the state income taxes that would result? In many cases if you are planning to sell real estate and purchase new real estate, the tax gain can be deferred by following certain procedures spelled out in the Internal Revenue Code (IRC). An investor can exchange one real estate investment for another (or several) and can postpone paying taxes on the unrealized gain in the relinquished property if the proceeds are reinvested in 'like-kind' property. This type of like-kind exchange, or 1031 exchange named after the IRC Section that allows the deferral, can be very powerful by allowing real estate investors to reinvest the proceeds from a sale on a pre-tax basis.

Basic requirements

There are several basic requirements for completing a like-kind exchange.

- The property must be held for investment or used in a trade or business. Inventory and personal use property are not eligible.
- The relinquished and acquired properties must be of like kind. Like-kind property is property of the same nature, character, or class. Prior to 2018, a wide range of property from real estate to tangible personal property qualified for tax deferral through a like-kind exchange. However, the Tax Cuts and Jobs Act of 2017 eliminated this treatment for all property except real estate. Fortunately, most types of real estate qualify as like-kind property, so farmland can be exchanged for an apartment building or a vacant lot can be exchanged for a strip mall.

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- Unless you are literally exchanging one piece of real estate for another without a price differential, a Qualified Intermediary is used to hold the proceeds received from the sold property and apply to acquire the new property.
- The replacement properties must be identified within 45 days of the sale of the relinquished property. Up to three replacement properties or 200 percent of the fair market value, whichever is greater, may be identified. A taxpayer can identify more than three properties with a value greater than 200% of the value of the relinquished properties, the taxpayer must acquire at least 95% of the value of the identified properties.
- The new property must be acquired within 180 days of the sale of the relinquished property.
- To qualify for full tax deferral, the value of the acquired property must equal or exceed the value of the relinquished property, including debt. If the acquired property is worth less than the relinquished property, then only a partial deferral may be available.

Reverse 1031 exchanges, where the new property is acquired before the existing property is sold, are also allowed. While the basics of completing a reverse exchange are relatively straightforward, it is important to consult with your professional and tax advisors and identify an experienced qualified intermediary to make sure that the tax deferral will hold up.

Planning with like-kind exchanges

To the extent that a like-kind exchange allows for the deferral of gain recognition, the basis (cost for tax purposes) of the relinquished property carries over to the acquired property. Depreciation begins in the year of acquisition, but based on the existing basis of the original property.

Through a series of like-kind exchanges, you can potentially change properties many times while deferring taxes. In fact, the gain can be eliminated by holding exchanged real estate until you pass away under current tax law. This way your estate receives a basis step up to fair market value and the property can then be sold by your heirs for no gain.

Like-kind exchanges can be done with family members or other related parties. However, there are rules in place intended to prevent related parties from swapping low-basis assets for high-basis assets in order to reduce income taxes. Generally, both parties must hold the exchanged properties for two-years for the deferral to work, but there are exceptions to these rules that are worth discussing with an advisor.

The 1031 exchange rules also provide flexibility for investors that want to make a smaller investment in a multiple-owner scenario. Tenancy-in-common (TIC) interests are undivided, fractional interests in real estate, which still qualify for the deferral of capital gains taxes. A Delaware Statutory Trust (DST) is a legal entity constructed under Delaware law to comply with the 1031 exchange requirements. The DST owns real estate and investors can purchase ownership interests in the DST. Both of these types of real estate ownership take the management out of the investors' hands while potentially providing access to professionally managed, institutional-grade real estate. These types of ownership also have drawbacks and

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therefore may not be good options for many investors. For instance, investors do not have control over how the property is managed or when it is sold and the interests typically are not very liquid.

So, just complete a 1031 exchange and all is well, right? Not so fast...

Selling assets at what may be the top of the market is great. Everyone likes to 'time the market' to maximize returns. However, completing a 1031 exchange means that you will probably be buying something near the top of the market as well. When factoring in the costs of selling the original property and the costs of acquiring the replacement property, an investor may need to buy an asset with significantly higher yield than the one they sold just to replace the cash flow they received from the sold property. Fortunately, there are strategies to accomplish this, including:

- Acquiring a different asset class with higher yields (e.g. retail vs. multi-family).
- Acquiring assets in a location or market where higher yields are normal (tertiary markets vs. core markets).
- Acquiring assets of a different 'class' (e.g. Class A Office vs Class B Office).
- Finding an asset or assets to buy at below market price (off-market or distressed).

Each of these strategies comes with their own challenges. Successfully identifying and managing real estate assets to maximize their cash flow (higher yields) and creating appreciation requires both general and specific real estate expertise, such as local market knowledge and contacts, property management capabilities, transactional capabilities, and asset management and assessment expertise across different asset types and classes. Managing real estate from a distance can lead to challenges, complications, and/or missed opportunities that can make the difference between a successful investment and problematic one.

Tenant management

Some individuals who aren't real estate professionals may want the approach of finding a 'coupon clipper' type investment to complete the 1031 exchange and just pick up the check in the mailbox every month. Oftentimes these exchanged properties consist of a single building with a single tenant who has a lease that requires minimal involvement from the landlord and 'Single-Tenant, Net Leased' (STNL) investments. Unfortunately, these types of properties can be problematic for several reasons. High demand drives prices up (and yields down), and quality properties may be hard to find and far away. Furthermore, with a single tenant any interruption in the rent leaves a property generating no income, and there is risk of tenant default or bankruptcy.

Alternatives to STNL investments include multi-tenant properties, either commercial or residential, which may diversify risk by offering an owner multiple income streams. Of course, the perceived stability of multi-family assets are reflected in the pricing. Other downsides include the fact that multi-tenant properties can be management intensive. Commercial properties typically provide higher yields, but replacing a tenant may require significant cash reserves to facilitate.

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Your advisor can discuss options with you; as part of Wells Fargo, they have access to asset management services to assist you in the full life cycle of owning investment real estate and can help at any stage. Comprehensive analysis, planning, and execution is available to help you achieve your short, medium, and long term investment goals if you are considering a 1031 exchange.

Disclosures

Real estate investments have special risks including the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. Risk factors are outlined in an offering's private placement memorandum.

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