

How Understanding 1031 Exchanges Can Help Your Real Estate Investment Plans

The flipping phenomenon in real estate has turned many novice investors into mini-Trumps – or so they hope. But for individuals who plan to buy and sell real estate as a long-term asset or retirement strategy, it's worth understanding the 1031 Exchange.

Also known as “like-kind” exchanges, 1031 exchanges allow an investor to defer capital gains taxes if he or she sells a big asset, such as a rental vacation home, and invest the proceeds immediately in a similar asset. Although 1031 exchanges can apply to many types of exchanges, they are most often used for real estate. The advantage? The investor can delay tax consequences when upgrading the investment property he or she owns.

How 1031s got started: Named for their place in the U.S. tax code, 1031 exchanges were created in the 1920s for businesses and big-league investors who owned many assets and wanted a way to defer taxes over the long term. Until a few years ago, those groups were still the main customers for 1031 transactions – but skyrocketing real-estate values and the rising number of Baby Boomers headed for retirement have made 1031 exchanges popular for smaller investors, too. However, these are complex transactions and almost always require assistance from tax advisors and intermediaries required to facilitate each deal.

Understanding how 1031 Exchanges Work: 1031 exchanges have strict time frames for buying and selling real estate if the exchange is not simultaneous, so it's important to find a broker and tax adviser who understands exactly how these complex transactions work. The simplest form of a “forward” 1031 exchange works like this: A person with available property identifies a property of “like-kind” value for an exchange. Because of the IRS's broad definition of “like-kind”, the property doesn't have to be identical or for the exact same purpose – in other words, a six-unit apartment property could be exchanged for a warehouse, strip mall, or even undeveloped land. Under the basic rules of 1031 exchanges, investors have 45 days to identify up to three properties of equal or greater value that they plan to exchange for the old one and a total of 180 days to close the deal. 1031 exchange transactions require the involvement of a third-party intermediary – often a tax or real estate professional – to hold the money while the exchange is done so the tax advantage doesn't evaporate.

What's a reverse exchange? It allows the replacement property to be purchased and closed on before the relinquished property is sold. Usually the Intermediary takes title to the replacement property and holds title until the taxpayer can find a buyer for his relinquished property and close on the sale under an Exchange Agreement with the Intermediary. Subsequent to the closing of the relinquished property (or simultaneous with this closing), the Intermediary conveys title to the replacement property to the taxpayer.

What kind of property doesn't qualify under 1031? A personal residence; land under development; construction or fix/flips for resale; property purchased for resale; inventory property; corporation common stock, bonds, notes and partnership interests.

Are there other restrictions? A person may be disqualified if they don't handle their 1031 strategy properly. An investor who buys and sells frequently may be declared a "dealer" of real estate and be subject to ordinary income taxes instead of capital gains. Consult an adviser.

Is there an easier way to buy? Qualified commercial real estate agents are often good at continually spotting properties that would qualify for a 1031 exchange. But keep in mind other alternatives that may save money in brokerage costs. Major retailers that do a good job of scouting locations may also have an outreach function for attracting individual investors for syndicates formed to own their real estate. This type of ownership can also be done as a 1031 strategy, but again, with the right advice. Even the most established real estate opportunities have risks.

Keep abreast of the tax code: Even if an investor doesn't have as much expertise in tax issues as the average CPA or real estate attorney, it's important to have a basic understanding of the tax issues that affect real estate transactions. The IRS website (www.IRS.gov) is a good bookmark to help investors start that education.

Preparing for the Change in Federal Bankruptcy Law

In a little more than two months, the difficult decision to file bankruptcy will become even more stressful for individuals. The Bankruptcy Abuse Prevention and Consumer Protection Act will go into effect Oct. 17 with significantly tougher reporting and qualification requirements.

The most highly publicized aspect of the new law involves tough new restrictions on who may qualify for Chapter 7 bankruptcy, the most common form of individual filing that allows consumers to erase their debts.

Yet advisers say it's important to understand one important fact -- *your own state laws might override certain parts of the new federal restrictions*, making the payment and asset-retention outlook for debtors better or worse than they would be strictly under the letter of the federal law. That's why it's critical that potential filers get the advice of a qualified local bankruptcy attorney, a CERTIFIED FINANCIAL PLANNER™ or a tax professional – sometimes all three.

Here are some basic questions to ask about filing for bankruptcy and how the new law may affect the assets you have under your control:

What are the most important changes involving Chapter 7? New federal requirements for the most popular category of individual bankruptcy – Chapter 7 – now impose an income test (also known as a “means test”) that allows exclusion for certain living expenses, including the following provisions:

- If the debtor's average monthly net income for 60 months is greater than \$10,000, they won't be able to file under Chapter 7;
- If the debtor's average monthly net income for 60 months is less than \$6,000, then filing will likely be permitted;
- Between \$6,000 and \$10,000, the debtor can file under Chapter 7 only if net monthly income is less than 25 percent of all non-priority unsecured debts.

Also, after Oct. 17, filers will also have to supply proof that they've completed consumer credit counseling, preferably with a payment plan, within six months of filing. These detailed reporting requirements will show if you were running up your credit cards before filing or acting irresponsibly in other ways.

Will documentation change? Tremendously. Under current Chapter 7 requirements, filers need to file a relatively basic list of current assets and debts, a list of current income and expenses and an overall statement of financial affairs. Now, it gets more complicated. The courts want to see tax returns and detailed projections of earnings.

They'll want to see assets in retirement accounts and even educational accounts such as 529 college savings plans (see below).

What about home-ownership issues? If you want to use a new state as your domicile, you have to live there for 730 days. However, regardless of what state laws apply, the new bankruptcy act states that you must live in a home for 1215 days (40 months) to receive your state's homestead exemption. Otherwise, protection for the home is capped at \$125,000. Also, there's a ten-year review period to determine if the debtor attempted to transfer money or equity into a homestead with the intent to hinder, delay or defraud a creditor.

What about retirement assets? For filings on or after Oct. 17, retirement funds that are exempt from taxation (including qualified plans, qualified annuities, IRAs, Roth IRAs or deferred compensation plans) will likely stay exempt in bankruptcy. However, funds in a traditional or Roth IRA (but not SEP plans or SIMPLE IRAs) are exempt only up to \$1 million. Again, check state law.

What about education savings? All money held in a Coverdell education savings account or a Section 529 college savings plan for *more than two years* is protected from payment of bankruptcy debts as long as the account beneficiary is a child, a stepchild, grandchild or step-grandchild.

Where can a consumer find advisers? One resource for bankruptcy attorneys is the American Board of Certification, (www.abworld.org), which provides a state-by-state listing of certified attorneys in bankruptcy law. The National Foundation for Credit Counseling (www.nfcc.org) lists nonprofit consumer credit counseling agencies nationwide. Advisers can also be located through the Financial Planning Association® (www.plannersearch.org). All references should be checked locally.

Debtors can avoid all of this hassle just by filing before Oct. 17, right? Maybe. The right advisers who know both state and federal law can advise clients whether it will be best to file now or after the new law takes effect. Remember – there is no one-size-fits all bankruptcy solution.

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Charitable Trusts: Creating Gifts that Keep on Giving

For people who are looking for an income stream from a valuable asset and a chance to help a worthy cause, creating a charitable trust may be a good solution.

There are various options for the creation of charitable trusts. At most university and charity Web sites, you'll see reference to them. They've become a popular way for organizations to build their endowment.

What is a Charitable Remainder Trust? With a charitable remainder trust, an individual places assets in the trust – stock, real estate, bonds, etc., – and names a charitable organization as the final recipient. The trust pays an income to the donor for his or her life or for the joint lives of the donor and his or her spouse. CRT assets that meet annuity trust or unitrust requirements won't be included in the donor's estate.

A charitable remainder trust provides a fixed dollar amount with each payment to the beneficiary. This amount corresponds to a percentage of the original investment paid out annually. For example, a \$100,000 charitable remainder trust that pays 7.5 percent would pay \$7,500 each year for the lifetime of the beneficiary or a fixed period of years.

After the donor's death, the trust's assets go to the charitable recipient. Because there are no capital gains taxes due on appreciated assets placed in the trust, this strategy helps preserve the full value of the gift for the charity and also helps increase the income generated by the principal. Typically, contributions to this type of trust are partially deductible for income tax purposes.

What is a Charitable Lead Trust? When an individual transfers assets, or principal, to a charitable lead trust, any income generated by the principal goes to a designated charitable organization for the duration of the trust. Upon termination of the trust (typically upon the death of the donor), the assets pass to the donor's beneficiaries.

Is there a way to leave something for heirs? Both of the above strategies keep paying income as long as the donor is alive, but the full income stream reverts to the charity after the donor dies.

The following may be one way to give heirs at least a small amount related to those assets when the donor reverts to the organization -- if the funds are in a charitable remainder trust.

A wealth replacement trust may be created at the same time as a charitable remainder trust. It works this way. The wealth replacement trust is funded with a life insurance

policy on the life of the donor, and the premiums are paid with part of the income from the charitable remainder trust. When the donor dies, the death benefit paid to the wealth replacement trust is distributed to the beneficiaries.

How big does the asset have to be? There's a consensus that it's not worth the attorney fees to create a trust with an asset value of less than \$100,000. Some recipients suggest that income beneficiaries may be at least 50 years old when payments begin.

How much income can be earned? At most colleges and universities, the trust's average payout is in the neighborhood of 5 percent. The payment is based on whatever is stipulated in the trust document within the limits set by the Internal Revenue Code and the account balance. CRTs are not meant to be high income investments – donors need to diversify.

What's involved? Creating a charitable trust isn't a speedy or inexpensive process. Setup fees may vary, but most attorneys will charge a flat fee – check with several attorneys with good references to compare. Donors will need a qualified estate attorney -- one who works well with their tax professional. Both will have to examine the donor's tax situation and income goals to make sure this idea achieves both goals --- what's right for the charity and what's right for the donor.

How do I check out the recipient? Most established colleges and universities as well as other charities with a respected track record offer detailed explanations of charitable trusts and how donors can participate. Most organizations feature these explanations on their Web sites. But don't stop there. Ask for information that you can show your tax adviser and ask questions and gather information before you make a move.

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