

By Charles "Duke" Runnels, CEO FORT Properties

Challenges for 1031 Exchanges: Best replacement properties

It would be a gross understatement to say that 1031 exchanges are a popular and driving force in the commercial real estate arena. It would also be no exaggeration to say that the volume of tenant-in-common (TIC) investments is at an all-time high right now. TIC investments continue to grow in popularity as a strategy to complete a 1031 exchange and more and more investors are reviewing their opportunities and taking advantage of the tax benefits associated with this approach. What properties are currently of interest to investors and what challenges are investors facing? Has the reduction in capital gains tax affected activity?



Charles "Duke" Runnels cash flow and are often seen as a secure investment option. Investors with more conservative goals are also attracted to industrial/flex or office properties with few tenants for the same reasons – a steady cash flow to supplement retirement or other income.

If, however, the investors are younger and more aggressive in their investment approach and willing to take on additional risk, the successful management of that risk may yield them greater growth. Because these investors have a longer investment horizon to create and build wealth, they are more likely to consider properties with higher vacancy rates, or below market leases. They may also be willing to personally take on more of the management of the properties, and might consider apartment buildings or self-storage properties, all focused on wealth creation.

The Challenges for 1031 Exchanges

Every investment poses challenges. The challenges faced by 1031 investors, companies, and sellers, are the same challenges faced by any owner or buyer of real estate. The biggest hurdle is finding acceptable properties to fit the investment objective, regardless of whether it is a new purchase or a 1031 exchange. In today's market there is an excessive amount of capital in comparison to quality properties - spurred in part by the availability of low cost debt.

Also, in many instances, individual investors are competing against pension funds or real estate investment trusts (REITs) to purchase a property. Because real estate continues to be an outstanding hedge against inflation, institutional investors (such as retirement funds) are increasing their real estate holdings. Real estate tends to be a very diverse investment - offering not only regional diversity but diversity in product type – increasing its reputation as a safer investment option. Institutional investors are very interested in safety due to the uncertain interest rate environment and world political instability.

The expectations of the seller can also lead to significant challenges. If investors are selling into

an escalating hot market, many assume that they will be able to find replacement properties of the same quality for a cheaper price than the properties they are selling. Most investors are challenged to find such a property and when coupled with the time constraints of the 1031 exchange often make questionable decisions on replacement properties. However, it's imperative that aside from the tax benefits, investors ensure the replacement property is a solid investment.

Capital Gains Reduction

In 2004, the federal government lowered the capital gains tax from a property sale from 20 percent to 15 percent. However, when investors really take a look at the other taxes assessed when selling – such as recapture tax and state income tax – the total tax most pay may be closer to 25-30 percent. The 5 percent reduction on the capital gains tax is not significant enough to cause people to want to sell now and pay the taxes. Plus, the expanding 1031 exchange market has more than offset any drop-off from those investors who cash out of the market as a result of the lower federal capital gains rate. Additionally, if investors opt to sell and pay the capital gains, they could be facing the Alternative Minimum Tax, and no one can pre-

dict the ramifications that will have on the bottom line from a personal tax perspective. Therefore, 1031 exchanges, and specifically, TIC investments as a means to fulfill the 1031 exchange will continue to grow in popularity. In fact, industry sources have predicted that the total amount of TIC investments for 2005 should top \$12 billion.

About FORT Properties

Charles "Duke" Runnels is President and CEO of FORT Properties, Inc., the premier provider of Tenant-in-Common (TIC) fractional ownership offerings. The fully-licensed FORT model provides maximum benefits to investors and sellers. As one of the only pre-capitalized TIC companies, FORT reduces the financial and timing risks associated with 1031 exchanges. Buyers of FORT real estate portfolio assets obtain the most secure, predictable and passive tax-deferred real estate investment in the marketplace. Comprised of a team of seasoned real estate experts, FORT Properties is committed to building a bridge between private investment capital and institutional-quality real estate. For detailed information on FORT Properties' services, offerings, and team of professionals please visit www.FORTproperties.com. ■