Exit Strategies for High-End Real Estate

Learn the basics and the benefits of like-kind active and passive exchange options that help sellers defer capital gains. **by Les Sweetow**

Texas property owners have witnessed extraordinary property appreciation since 2011, driven in part by buyers migrating from states like California to avoid high taxes. According to a May 2019 Legg Mason commercial real estate report on the rise of the Sunbelt, Texas led the nation in domestic migration measured over a 10-year period from 2008 thru 2018. Industry forecasts for projected growth continue to name Texas as the percentage leader in population growth through 2030, well outpacing second-place Florida.

How Increased Migration Is Affecting Texas Property Values

The growth in domestic migration has benefited Texas property owners, with demand outpacing supply, resulting in higher prices.

In the luxury-home market, Austin, Dallas, Houston, and San Antonio rank in the top 40 of U.S. cities with the highest percentage of million-dollar homes, according to a July 2018 LendingTree report. Luxury home sales in Texas were a strong driver of the Texas housing market during the first 10 months of 2018, according to the Texas REALTORS® *2018 Texas Luxury Home Sales Report*. The median price for Texas luxury homes was $1.35 million, with the average price per square foot at $358.

The April 2019 Home Price Index report from the Real Estate Center at Texas A&M University reported data which support that Texas realty demand and home-price appreciation have grown well beyond the four largest metro areas. Of course, no one has recognized these trends better than REALTORS®, who continue to play a pivotal role in facilitating these transactions throughout the state.

When High Property Values Hurt Owners' Bottom Line

While homeowners welcome the benefits associated with higher property values and increasing equity, price appreciation also comes with the sobering reality for some property owners that the tax implications of a sale may be unacceptably high.

Even with the Internal Revenue Code (IRC) 121 exclusion of gain from sale of principal residence up to $250,000 for single tax payers and $500,000 for married couples on principal residences owned for at least two years, the consequence of a sale may still lead to significant capital gains if the realized gain is well in excess of the property's adjusted basis—and well beyond the IRS exclusion limits. Many owners of expensive properties with a low adjusted basis have chosen instead to lease the property for years to avoid realizing a capital gain at closing.

How a 1031 Exchange Can Benefit Sellers

You may be familiar with IRC 1031 exchange rules as they apply to residen-


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tial and commercial investment real estate, but few are aware of the opportunity to convert a primary residence into a rental property and then qualify for a section 1031 exchange by combining IRC 121 with IRC 1031.

If the primary residence has been leased for two out of the last five years preceding the sale of the property, owners may be able to exchange their property into another property and defer the capital gains if the replacement property is held for investment.

Under IRC section 1031, the owner of an investment property can exchange into a like-kind property of equal or greater value held for productive use in trade or business, or for investment.

Like-kind properties don't have to be the same type as the property being sold to qualify. They can include raw land, single-family houses, apartments, commercial properties, and so forth. Under certain conditions, oil, gas, and mineral rights qualified as real property may also be able to benefit from an exchange.

Vacation and second homes may also qualify under a safe harbor if the unit has been leased at fair market value for a qualified period during the year. Given the complexity and the risks of failing to adhere to strict IRS guidelines, agents should advise their clients to seek tax and legal advice prior to contemplating any such transaction.

The Result When a 1031 Exchange Is Done Properly

In a qualified 1031 exchange, property owners can defer paying federal and state capital gains taxes to include depreciation recapture. The exchange process must prevent actual or constructive receipt of funds and, as such, is often managed through the services of a professional qualified intermediary to navigate the complexity of the process. Many attorneys and tax professionals as well as large national property exchange companies engage in this service.

While a new opportunity to list a property for sale that otherwise would have remained a rental is apparent, some property owners may not want to take on the active management of a new and yet unknown exchanged property, electing instead to keep their current residence as a rental. However, passive exchange alternatives exist which don't involve active property management, yet these alternatives still offer many of the same risks and rewards associated with active property ownership and management.

Types of Passive Exchange Options

Two types of passive exchange options include an exchange into a Qualified Opportunity Zone Fund or a Delaware Statutory Trust (DST).

QUALIFIED OPPORTUNITY ZONE

Qualified opportunity zones are nominated by the state and certified by the Treasury Department as areas designated as economically distressed and in need of improvements for economic development. The fund invests in zone development, and investors are given the opportunity to benefit from the potential growth in the community through higher asset values and returns associated with the fund's investment.

DELAWARE STATUTORY TRUST (DST)

DST property exchange offerings are limited to accredited investors as defined by the U.S. Securities and Exchange Commission (SEC). They offer investors a fractional beneficial interest in large, institutional quality and professionally managed commercial properties. The advantage of this type of interest is that small investors may be able to exchange both debt and equity into the types of properties usually limited to institutional investors without the burden of active management or participation. Investors in DST offerings will not have any management or operational control.

As property values continue to climb and baby boomers seek to downsize, many owners will seek your advice on how to achieve their desired real estate objectives.

Both DSTs and qualified opportunity zone funds can provide excellent returns to an investor's portfolio but are highly speculative and offer substantial risks. Your clients should be advised to seek legal, tax, and investment advice prior to investing.

As property values continue to climb and baby boomers seek to downsize, many owners will seek your advice on how to achieve their desired real estate objectives. Owners who face the potential for considerable capital gains may not be aware of the potential to exchange into an actively managed or passive fractional beneficial property interest. Owners of properties subject to condemnation under eminent domain may also be able to initiate a like-kind exchange under IRC 1033 Involuntary Conversions, and will additionally benefit from sound advice. The ability to provide clients with valuable insights and options will further demonstrate a commitment to serving their best interest.

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