

What you should know about . . .

§1031 tax-deferred (Starker) exchanges

By Elizabeth Erhardt

SECTION 1031 OF THE INTERNAL REVENUE CODE ("§1031") offers you a powerful tool to defer capital gains taxes while allowing you to maximize your real estate investments. Section 1031 allows a real estate investor to "exchange" properties by selling one property (the "Relinquished Property") and buying another (the "Replacement Property"), while deferring payment of capital gains taxes on the sale of the Relinquished Property.

Generally speaking, capital gains taxes are paid on the difference between the amount for which you originally purchased the property, as reduced for accumulated straight line depreciation ("Basis") and the sales price for which you ultimately sell the property, less closing costs and commissions. If a depreciation in excess of straight-line has been taken, the tax on that excess is taxed as ordinary income. Section 1031 allows you to roll what you would otherwise owe to the government in taxes into a Replacement Property.

Many property owners will make a series of §1031 exchanges over the course of their lifetime in order to build equity on the money ultimately earmarked for the federal government. By deferring payment of taxes, the property owner essentially leverages the government's money.

Several rules must be followed in order to successfully complete a §1031 tax-deferred exchange:


- Both the Relinquished Property and the Replacement Property must be either held for business or held for investment in order to qualify for an exchange. Residential Apartment Buildings housing tenants qualify as real estate "held for business." Real estate "held for investment" includes raw land and other passive forms of real estate investment. Properties held for personal use, including vacation homes, will not qualify for an exchange.
- The Relinquished Property and the Replacement Property must be of like-kind. For practical purposes, any rental property within the 50 states or U.S. Virgin

The "like-kind" rule. Any rental property will qualify as like-kind property regardless of whether or not it is similar to the Relinquished Property. Therefore, for all practical purposes, if you own a rental duplex like the one at left, you could exchange it for the commercial office building at right and still satisfy the §1031 like-kind requirement.



Islands will qualify as like-kind property regardless of whether or not it is similar to the Relinquished Property. Therefore, you may exchange a residential rental duplex for a 40-unit residential, commercial or mixed-use rental building and still satisfy the like-kind requirement.

- Proceeds from the sale of your Relinquished Property must be placed in a special escrow account with a Qualified Intermediary. The Qualified Intermediary creates a safe harbor to place the sale proceeds from the Relinquished Property prior to funding the closing of the Replacement Property. If you fail to use a Qualified Intermediary, the IRS may conclude that you had "constructive receipt" of the revenues generated from the sale of the Relinquished Property and subject you to capital gains taxes even though you rolled the sales proceeds into the purchase of the Replacement Property.
- The purchase price of the Replacement Property(ies) must be equal to or greater than the net sales price of the Relinquished Property.
- All cash or other proceeds received from the sale of the Relinquished Property must be used to acquire the Replacement Property.
- The Replacement Property(ies) must be identified within 45 days of escrow closing on the sale of the Relinquished Property.
- The Replacement Property(ies) must close within 180 days of escrow closing on the Relinquished Property.

Some of these rules may be difficult to follow. As a result, a variety of Replacement Property solutions have evolved. The first step in initiating a §1031 exchange is to consult with a financial advisor specializing in §1031 exchanges or a real estate or tax attorney knowledgeable in §1031 exchanges. 

While you were sleeping . . .

By Kim Stryker

While you were going about your day, other Californians were trying to find ways to make it difficult for you to screen prospective tenants, force you to do more paperwork or be sued.

Summertime is when Sacramento bills move through committees where they can be amended or killed, then move to the Senate and Assembly floor for a final “aye” or “nay.” You’ve read about some of them this spring. Some bills have passed primary hurdles and are now moving to final votes.

Sen. John Burton’s SB 1145 was sponsored by the non-profit group Western Center on Law and Poverty. It attempted to make permanent an expiring law that requires owners to give tenants a 60 day notice if rents were increased by more than 10 per cent; prohibit discrimination by an owner of a prospective tenant’s income to account for the aggregate income of co-renters or government rent subsidy. It also attempted to permanently require an owner to give a tenant 60 days notice (rather than 30) on evictions for owner move-ins. SPOSF members met with Burton’s staff in April to discuss our problems with the bill, particularly the 60-day eviction provision. In early June that segment was deleted. It will be heard for a final vote and is expected to pass.

Assembly member Sally Lieber’s AB 2582 attempted to force owners to reveal information about known hazardous substances on a property to a prospective tenant. While good in intentions, the measure’s language was so poorly written it created extreme potential for lawsuits. Her AB 2583 would have made it difficult for owners to obtain personal information from tenants and included civil damages of up to \$5000, attorney’s fees, and a civil penalty. SPOSF members met with Lieber and her staff to point out problems with the bills, including poorly written language in both bills that set owners up for unnecessary lawsuits. Both bills died in late May.

Assembly member John Dutra’s AB 2088 clarifies language in the Costa-Hawkins law to insure that when the last tenant on a lease leaves, the owner can raise the rent to market. SPOSF met with Dutra’s staff and worked to support the bill. It has passed committee and is waiting for a full hearing.

Assembly member Joseph Canciamilla’s AB 2175

SPOSF members: Consider joining our Sacramento Team. Keeping close tabs on state legislative activity is one of the most effective ways of protecting our property rights.

would have allowed owners to sell their buildings to their tenants and make them eligible for condo conversions. It died in committee in late April.

Sen. Richard Alarcon’s SB 1634, sponsored by the expanding national non-profit ACORN, encouraged local cities to create a database of owners who have been accused of building code violations. The bill would not allow state funds to pay for these databases, so cities (taxpayers!) would be required to fund them. It would allow a major intrusion into owners’ privacy, allowing easy access to information about the owner, the building and alleged violations. It would create serious problems for owners seeking insurance, particularly owner-occupied buildings seeking homeowners’ insurance. It would allow renters to use alleged code violations to avoid paying rent until the “violation” is cleared, and puts the onus on the owner to clear up mistakes or updates on the database. This bill was heard in Committee on June 23. The SPOSF Sacramento team lobbied hard on this, followed by a broadcast to the members for follow-up faxes. Thankfully it died in committee. However, the author states he will try to resurrect the bill later this summer.

In addition to the annual Sacramento feeding frenzy against rental property owners, other anti-housing measures were enacted in the state. In spring, the San Diego City Council passed a “just cause eviction” ordinance. Rent control and “Just Cause” ordinances are being discussed in Glendale and San Jose.

Locally, our very own Tenderloin Housing Clinic and the Tenants Union are promoting another anti-Ellis Act PR campaign, full of staged protests and media articles. They claim Ellis Act evictions are up three-fold and thus new state legislation is needed to curb the use of the Ellis Act. Ironically, the use of the Ellis Act has only increased in San Francisco after the very same tenant activists forced legislation to prevent owner move-in evictions.

California will soon experience more problems housing low-income renters due to Federal cut-backs in the H.U.D. Section 8 voucher problem. Years ago H.U.D.

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abandoned the idea of rent control because it resulted in actually increased rental costs overall while it suppressed new housing construction. H.U.D. developed the voucher program to encourage owners to rent to low-income tenants and give renters flexibility where they lived, appropriately relating the subsidy to the renter, not the building. New cut-backs will increase difficulty for low-income tenants to find affordable housing in California.

SPOSF’s “Sacramento Team” has done a fine job of representing us in Sacramento this spring and summer, and will continue to keep a close eye there. If you would like to join these active citizen lobbyists, please contact me at kim_sposf@sbcglobal.net or Ilse at ilsec@mind-spring.com. By keeping our eyes and ears open, we are in a better position to get our perspective known and help shape or defeat statewide measures that affect our homes. 🏠

The case for professional property management

By Ilse Cordoni

It seems that many SPOSF members bought their properties during a simpler time when, as Ava mentioned in the last newsletter, Mrs. Madrigal could make a humane and kindly offer of assistance to her tenant without having it become an entitlement.

Those days are long gone and not likely to return.

Due to a statewide housing shortage, a very liberal congress and well-established tenant lobbying organizations, consumer-protection regulations favoring tenants are proliferating on both the local and state level. Each year the business that we used to do so gracefully becomes more fraught with bureaucracy and legal landmines.

Fearful of the consequences of making a misstep in this litigious climate, when our units become vacant many of us hold them off of the market hoping for a change in the rules. Some of us give up and sell the buildings that for years we loved and which we considered our hedge against retirement.

There is another way and I believe that it is a viable answer to the predicament. We can have our buildings professionally managed.

At the time we purchased our buildings we consid-

ered ourselves different from the ‘big’ landlords who use professional property managers. We prided ourselves in our ability to manage our own buildings—to be small business owners. Now that times have changed and our lot has

been cast in with those big building owners, we need to consider alternative ways of doing business.

Professional property management has many benefits. It relieves us of the burden of staying current with the laws. It ensures that our records will be well maintained. It saves our time. Best of all, it puts distance between the owner and the renter—even if we occupy the same building.

Using a professional property manager is a lot like using a real estate agent to buy or sell property. The agent should know the market, know the rules, know how to solve the problems that commonly surface in the market place and, most of all, know how to negotiate. A professional property manager will know the rules and have systems in place to ensure compliance. They will be experts in obtaining and screening for qualified tenants. They will take the calls in the middle of the night from the tenant with a plugged toilet or a leaky roof and arrange for the repair. They have repairpeople on staff or have arrangements for best pricing with service providers. Best of all, they will send you a check each month.

Fees vary but should be in the range of 6-7% of the monthly gross. For those of us who are holding our units off of the market, this will provide a nice opportunity to see our buildings become a source of income again. For those of us who have been renting and self-managing our buildings, it will provide a welcome respite.

When we bought our buildings many of us participated in hands-on renovations—we painted, tiled, sanded floors, installed cabinets and supervised the workers who did the plumbing and wiring that we might not be able to do. Over the years we have become more hands-off, hiring painters and contractors to do the repairs and renovations. The next step is for us to hire a professional to handle our asset, so that we can enjoy the benefits of our investment with less stress and perhaps even more profitability.

Consider it! 🏠