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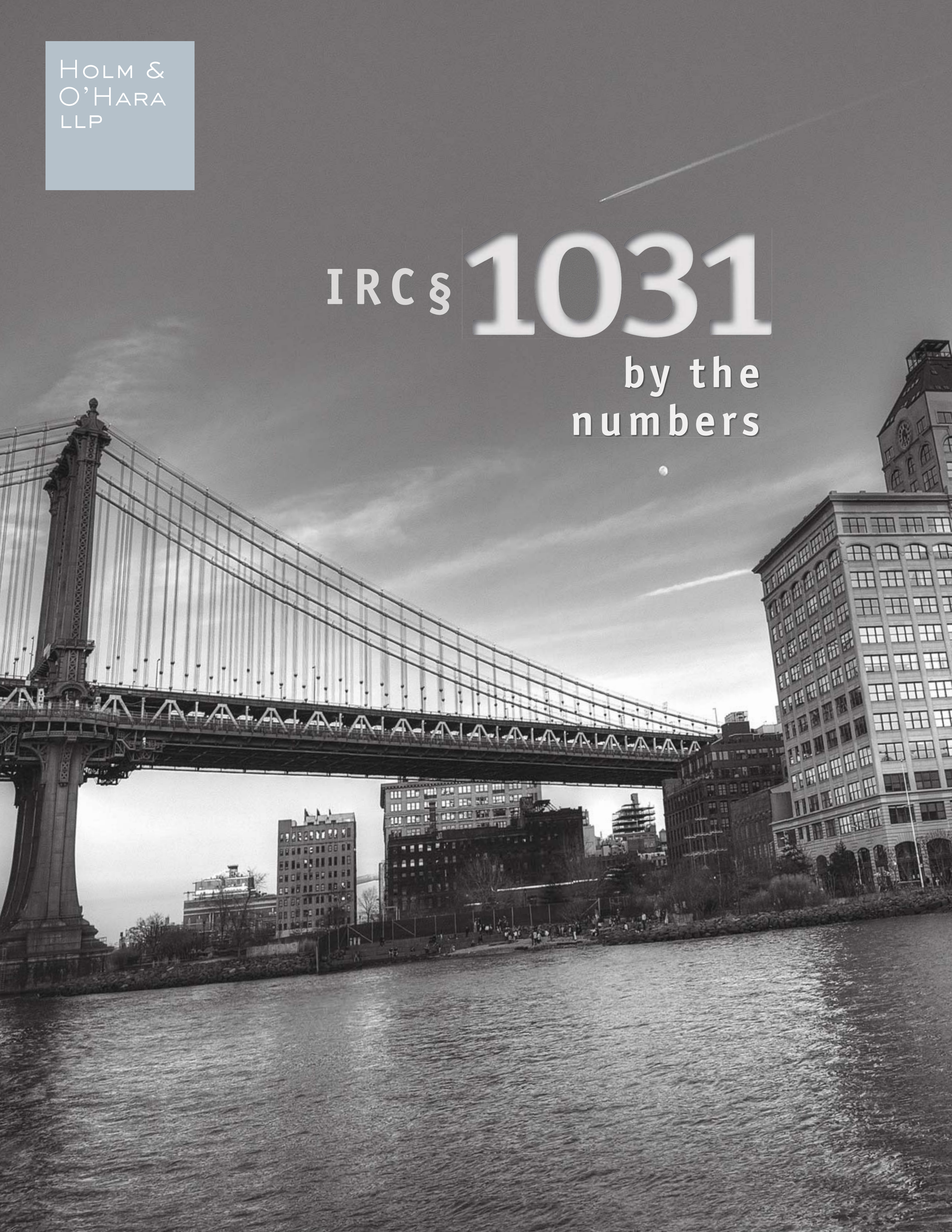

IRC § 1031 by the numbers

Real estate is the vehicle of choice for many investors.

It is a tangible asset that typically provides a regular, reliable income and can appreciate significantly in value over time. Like other investments, real estate holdings should be periodically reviewed to ensure that they are both meeting the investor's current needs and supporting future objectives.

In considering whether a real estate investment — even one of long standing — remains the right vehicle for a particular investor, several factors should be reviewed:

- Income
- Operating costs
- Time owned
- Management effort
- Depreciation
- Market trends

It may make sense to consider disposing of a specific property and reinvesting all or part of the proceeds in a different property if:

- Cost and effort required to manage the property exceed owner's current tolerance level
- Income from property is restricted by regulations or unfavorable lease terms
- Dramatic increase in market value has occurred since property was acquired
- Considerable depreciation has been claimed over the years
- Owner requires additional income and/or increased liquidity
- Owner wishes to engage in estate and long-term financial planning

An IRC §1031 Like-Kind Exchange allows for an investment property to be sold and the proceeds reinvested in other investment property within a certain time frame. Restrictions apply and documents need to be filed on a timely basis.

In many IRC §1031 Like-Kind Exchanges:

- **Operating Expenses** may decrease because the lease terms for commercial properties shift operating expenses to the tenant. Additionally, replacement properties are often located in geographic regions with lower operating costs.
- **Operating Income** may increase because of the significant reduction in expenses and the transformation of a residential tenant base to a commercial tenant base.
- **Cap Rate** *(net operating income/original capital cost)* may increase if the replacement property produces more operating income in ratio to its original capital cost.

Three case studies based on hypothetical circumstances derived from composite client experiences show how a §1031 Like-Kind Exchange might be beneficial, depending on the situation.

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HOW IRC §1031 WORKS: CASE STUDIES

Mr. and Mrs. "Smith" owned a multi family building for several decades. The asset was underperforming and they grew weary of the work involved in managing it.

Sale of the building would trigger payment of approximately 40% of the profits in capital gains taxes.

Working with their advisors, the Smiths crafted a plan that involved a complete §1031 Like-Kind Exchange.

CASE STUDY 1:	STARTING/RELINQUISHED PROPERTY	REPLACEMENT PROPERTY(IES)
PROPERTY DESCRIPTION	Multi family Apartment Building	5 Triple Net Lease Properties
SALE/PURCHASE PRICE	$17,000,000	$17,000,000
CLOSING COSTS	$1,250,000	$150,000
CAPITAL GAINS DEFERRED	$6,300,000	N/A
CAPITAL GAINS PAID	$0	N/A
TOTAL OPERATING EXPENSES	$354,000	$100,000
NET OPERATING INCOME	$486,000	$1,005,000
CAP RATE/AVG. CAP RATE	2.9%	5.9%

BENEFITS:

- Doubled net operating income
- Increased cap rate by nearly 2x, and reduced operating expenses by 70%
- Deferred over $6M in capital gains taxes
- Diversified investment into 5 triple net lease properties, in 5 geographic regions, in 4 different industries

Mr. "Lee" purchased his mixed-use building when real estate prices were low. Although the value of the property increased substantially, the income derived from it was stagnant.

He wanted to unlock some of the capital tied up in the building in order to pay off a mortgage on his primary residence, help his children acquire houses, and purchase a retirement home.

He achieved these goals through a partial §1031 Like-Kind Exchange.

CASE STUDY 2:	STARTING/RELINQUISHED PROPERTY	REPLACEMENT PROPERTY(IES)
PROPERTY DESCRIPTION	Mixed Use Commercial–Residential Building	3 Triple Net Lease Properties $9,000,000 Cash ($5.3M Net)
SALE/PURCHASE PRICE	$20,000,000	$11,000,000
CLOSING COSTS	$1,400,000	$100,000
CAPITAL GAINS DEFERRED	$2,200,000	N/A
CAPITAL GAINS PAID	$3,720,000	N/A
TOTAL OPERATING EXPENSES	$460,000	$104,000
NET OPERATING INCOME	$400,000	$611,000
CAP RATE/AVG. CAP RATE	2%	5.5%

BENEFITS:

- Increased net operating income by more than 50%
- Increased cap rate 2.75x
- Reduced operating expenses by nearly 80%
- Unlocked $9M in capital ($5.3M net after taxes)
- Deferred over $2M in capital gains taxes ($3.7M paid on cash-out portion)
- Diversified into 3 triple net lease properties in 3 different states and industries

Mrs. "Brown" was exhausted by difficult tenants and rent regulations made it very difficult to increase her income.

In addition to wanting to simplify her life and increase income, she wanted to relocate to be near family.

She opted for a complete §1031 Like-Kind Exchange.

CASE STUDY 3:	STARTING/RELINQUISHED PROPERTY	REPLACEMENT PROPERTY(IES)
PROPERTY DESCRIPTION	Multi family Apartment Building	2 Triple Net Lease Properties
SALE/PURCHASE PRICE	$9,000,000	$9,000,000
CLOSING COSTS	$730,000	$70,000
CAPITAL GAINS DEFERRED	$3,308,000	N/A
CAPITAL GAINS PAID	$0	N/A
TOTAL OPERATING EXPENSES	$135,000	$55,000
NET OPERATING INCOME	$105,000	$485,000
CAP RATE/AVG. CAP RATE	1.1%	5.4%

BENEFITS:

- Increased net operating income by almost 5x
- Increased cap rate by nearly 5x
- Reduced operating expenses by nearly 60%
- Deferred over $3M in capital gains taxes
- Diversified into 2 triple net lease properties in 2 different states and industries

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Explanations:

Closing Costs:

Typical closing costs include a number of elements. Some tend to be a straightforward percentage, while others vary:

- Real estate broker commission
- NYC real property transfer tax
- NYS transfer tax
- Outstanding violations and fines
- Legal fees and disbursements

Operating Expenses:

- Loan payments
- Property taxes
- Utilities
- Insurance
- Management expenses

Disclosures:

- All examples are estimates based on hypothetical case studies derived from composites of client experiences.
- Closing costs include real estate broker commissions, state and local transfer taxes, attorneys' fees, and any fees associated with liens and violations. This example number assumes no debt on the property.
- The hypothetical cost basis includes the purchase price, together with the closing costs and capital improvements.
- This estimate is based on the current top capital gains and Net Investment Income Tax (NIIT) rates and is subject to change.
- The closing costs may include environmental and structural engineering reports, fees associated with obtaining financing, attorneys' fees, accounting or other fees, and qualified intermediary fees.

Holm & O'Hara LLP offers strategic legal support for complex real estate transactions and trusts and estates (and matters that include aspects of both), as well as comprehensive legal services for corporations, closely held businesses and their owners. Our labor law practice also represents the labor side in ERISA and related matters for government- and union-based pension and welfare funds. We work efficiently, using teams to provide the personal attention our clients require. In every instance, we strive to secure the most favorable results for our clients; to apply our knowledge and experience to create solutions that endure beyond the immediate need; and to provide sound counsel to protect our clients' interests.

HOLM & O'HARA LLP

Main Office:
3 West 35th Street
9th Floor
New York, NY 10001

p. 212.682.2280
f. 212.682.2153
www.hohlaw.com
Offices in NY, NJ and CT