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Good time to revisit financial friends

Real estate investors may find that it's favorable to seek 1031 exchange or Delaware statutory trust

FINANCIAL FOCUS

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As the housing market slowly climbs out of its deepest abyss since the Great Depression, I think it's a good idea to revisit some old, pre-recession financial friends. After all, even the best of friends can be fickle at times. Therefore, it's best that investors know what to expect before re-upping the relationship.

For real estate investors, their best friend has been and continues to be the 1031 exchange. In its simplest form, a 1031 exchange allows real estate investors to defer capital gains tax. And in the age of Obama, deferring any tax is a good thing. Government is a monster: Why give it more food?

Section 1031 of the Internal Revenue Code provides a strategy for deferring capital gains tax that may arise from a business/investment property sale. By exchanging the property for other like-kind real estate, property owners may defer their tax and use all of the proceeds for the purchase of replacement property. So, unlike picking a winner on the stock market, it isn't two steps forward, one step back.

Like-kind real estate includes business/investment property, but not the property owner's primary residence. As mentioned previously, Section 1031 does not apply to the exchange of stocks, bonds and indirect investments in real estate like real estate investment trusts. With a REIT, one owns shares of a company that owns real estate and not the real estate directly.

After making a decision to exchange, the real estate investor must decide whether to continue along the path of active management or unload the burden of tenants, toilets and turnover.

More and more investors are choosing the latter because of simple demographics. Our population is aging … fast. Unlike stocks and bonds, real estate is an actively managed asset, and this requires energy. Like it or not, energy is something we have less of as we grow older.

Therefore, many owners will choose to relieve themselves of the burden of active real estate management by exchanging into a Delaware statutory trust property (or properties). This allows accredited investors to "trade up" to ownership of a larger commercial property like Target, Kohl's or Disney. In so doing, the investor will go from owning 100 percent of a smaller, labor-intensive, self-managed asset to owning part of a much larger, remotely managed property (or properties).

The key here for a successful investment experience is management. Real estate is a tangible asset. Therefore, it must be actively managed by someone, somewhere. If property managers do not put investor capitalism in front of management capitalism, trouble will arise and investment success can become problematic.

When people exchange into a DST, they are investing in management as well as property. The importance of this cannot be overstated. Good management is critical to the profitability of any real estate investment.

Because management is critical to this equation, it should be done as close to home as possible. Investors should look for a property provider of sufficient size and financial strength to serve as manager too.

Outsourcing this function is not a good idea. Too often, this results in management placing its own interests in front of investors/owners. If the manager has no "skin in the game" in terms of investor affection and loyalty, it will not end well.

To avoid this pitfall when exchanging in the next market up cycle, investors should stick with "heritage" players in the industry. These are companies that were in at the industry's inception and have been through multiple ups and downs in the market cycle.

Avoid new and opportunistic property providers like the plague. They will disappear like autumn leaves with the market's next downturn. Protect principal and cash flow with the best possible credit tenant and the best possible property management.

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