

**Episode 25– March 26, 2008**  
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Peter: On today's show we're going to discuss Internal Revenue Code number 1031 more commonly known in the real estate investing world as tax-deferred exchanges and while we will start with the basics, our focus will be on additional opportunities to exchange into a diverse range of like kind property. Today's guest, Scott R. Saunders, senior vice president with Asset Preservation Inc. has an extensive 1031 background structuring and overseeing over 50,000 transactions during his 16 years in the exchange industry. His company, Asset Preservation, a subsidiary of Stewart Title is a leading national Internal Revenue Code 1031 qualified intermediary or Q. I. and has successfully completed over 130,000 1031 exchanges throughout the nation. Scott dedicates a significant portion of his time speaking to accountants, attorneys, real estate brokers, and principles nationwide. He has spoken at the annual National Bar Association, Colorado Association of Realtors, GMC's Real Estate Annual Convention, and the list goes on and on and on. In fact, if you want to know a complete bio on our guest today, Scott Saunders, please go to our website at Income Property Investment Talk. Scott, thank you for being on our show today.

Scott: Hey, it's great to be with you today.

Peter: Scott, today's economy at best is challenging. It's challenging for consumers who are rethinking purchases whether their big tickets, small items, businesses to refocus strategies. With the media doing its best to scare investors away from real estate of course a big mistake for some investors and we'll touch on that a whole lot more later on when our special guest joins us at 11:15, but how has this negativity, how has this overall view impacted the number of exchanges that you are doing at Asset Preservation?

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Scott: At our company we're certainly seeing a slowdown in exchange activity in response to investors either pulling out of the marketplace and not purchasing properties or maybe just sitting on their current investment properties concerned about the media reports. There's just been a slew of reports whether it's from CNN or other sources talking about the housing market, what's going on in the residential side of things so there have been investors that have been affected by that. The concern is that when you look historically real estate is still an excellent performing investment as an asset class and most financial advisors would say every investor should have some of their investments in a real estate of some sort whether it's direct ownership or through a REIT, known as a real estate investment trust, or some other vehicle. There has certainly been a slowdown and in response particularly with a lot of the investors who have maybe jumped in kind of at the end of 2004 or '05, maybe looking for a quick purchase to get in to some of these boom marketplaces. That certainly has been an impact there.

Peter: There is no denying that, and if I can I'm just going to throw out something here with the media. One of the things that I think is the biggest problem is a lack of resources on their end as well so they can't really get out and cover what we say is a local business. There is a reason why for years and years and years the mantra location, location, location has made a lot of sense in real estate because it's all about local markets and sub markets.

Scott: Absolutely. In fact, even in today's marketplace you can go to a lot of areas, there are resources out there that can help people out but there are markets last year, I can give you an example, Charlotte, North Carolina, just on the residential side appreciated approximately 2% last year. There are a number of other markets that have been fairly

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strong as well. Pockets up in Oregon, Washington, where there is a lot of tech, Texas and a lot of other pockets around the country have performed well on the residential side and that's not even touching the fact that commercial real estate, which really isn't linked to the residential market, has been performing extremely well. The fundamentals are very strong in a lot of areas on the commercial side as well.

Dean: Yes, in fact I do a lot of commercial real estate myself and probably four out of every five transactions I'm doing right now are on the commercial side and there is some absolutely incredible opportunities out there. We've always felt Scott, the principle of live where you want to live but invest only where it makes economic sense, and I love how you touched on the fact that there are sub markets and micro markets that you can invest in. Someone will say well this area is not a good area to invest in but I can promise you that right across town we can find you phenomenal investments. So it really is localized down to the sub markets, down to the neighborhoods. That's why it behooves everybody out there to have a real estate professional or a team of professionals that can help you make sure that they cut through those things that can increase risk and we love to mitigate, and not eliminate risk.

Scott: You bet. I'll give you an example; our company is based outside of Sacramento, California. Years ago an exchanger that was doing investments in California, often times they'd stay in the local market. They might stay in that general county or somewhere they could drive by and visit a property. What we've seen change over the past 10 years is exchangers are much more willing to invest out-of-state and take advantage of markets that maybe have a different geographic base, job creation and job growth, and just more comfortable investing in some of these other areas to either 1) diversify their investment

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portfolio, so they don't have all their eggs in one basket and 2) to take advantage of different economic conditions so that they've got the growth potential in some of the other marketplaces out there whether it's as you mentioned a sub marketplace locally or maybe it's a larger marketplace that has really good fundamentals going on.

Dean: Yes, that's absolutely true. We have been investing all over the country and the institutions have been doing this for many, many years. It's not something new. The large insurance companies, the real estate investment trusts, they've known this principle. The reason why the entrepreneurial investor is hesitant to jump in is mostly because of management because they feel uncomfortable living in one state and investing in another because they don't have a team in place. It's important to be able to, and I don't blame them, if they don't have a team in place in one of these other markets they shouldn't be investing there. But that's the beauty of understanding the concept of putting a team of professionals in the market of everyone from an exchange company like yourself, to attorneys, to general contractors, to brokers, to lenders and all who understand that market before you go jumping in. Once you have that team in place it's phenomenal.

Peter: Scott, let me just jump in here real quickly because our guest after the 11:15 break is going to be talking about location investing and how important that is, so let me jump back to your earlier statement where you talked about real estate should be a part of everyone's portfolio. You mentioned individual ownership, you mentioned REITs, but there's also something in and around and something that has grown tremendously because of the 1031 is the tenant in common investment or the TIC. I wanted you to talk little bit about that, how it has grown, why it's important, so can you expand a little bit

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about the tenant in common ownership, exactly what that is and what are some of the benefits of investing in a tenant in common?

Scott: Absolutely. I'd be happy to do that. Tenant in common, which often times is referred to now as the TIC really refers to investment among up to 35 co-investors and it's generally going to be in some sort of commercial property. It's not, Peter, you and I necessarily owning a property together even though we could do that as tenants in common, that's happened for years and years. Tenant in common ownership or TICs as we refer to them today referred to these programs that are set up. What happened was there was a revenue ruling that came out back in 2002, its known in the industry as Rev Proc 2002 -- 22, and really what that did is it took something that had been happening for a long time and many markets people have gone together whether their developers or commercial investors and they've co-invested and owned some sort of a fractional slice of a larger commercial property. What this revenue ruling did though is it really put out some parameters out there if entities wanted to qualify for what was known as a private letter ruling from the service, get some indicators as to what needs to be in place for something to qualify to be considered tenant in common ownership not a partnership interest. That's kind of the heart of that. A partnership interest does not qualify for deferral under section 1031 however TIC ownership does.

Peter: Scott, let me just stop you there because I think that's a big point you just made and maybe you want to expand on that a little bit and just differentiate very quickly what you mean by the partnership versus the TIC ownership again.

Scott: Sure. I'd be happy to do that. When I say a partnership interest, we're referring to a partnership or let's say an LLC as a common vehicle that people own property today. In

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an LLC you have members, let's say three members, you can have three partners in a partnership. The partnership or the LLC can do a 1031 exchange at the entity level, so that whole partnership or LLC can exchange for any other property. However, a change in the tax code back in 1986 prohibited a partnership interest. If somebody owns let's say one-third interest in a partnership, that's considered personal property even though the partnership or the LLC owns real property. So that is excluded from 1031 treatment.

What these tenant in common programs are is they're really kind of a hybrid. It's a bunch of co-owners but it doesn't cross over the line where they take on the attributes of being considered a partnership. That's kind of the foundation. You asked me to describe some of the benefits and I'll give you some of those. One of the big benefits is it takes somebody that owns several small single-family rentals maybe that are fairly management intensive. They can exchange out of those and go into fractional ownership of a large commercial building with good-quality tenants and long-term leases. So instead of having that management responsibility, the tenant turnover and fixing the carpets and all of that, you hear it talked in the industry as toilets, trash and tenants, the Ts. They can now go into commercial real estate that an institution would buy or a pension fund. They now have an office building with tenants that have long-term leases, rent escalators and now they have much more passive ownership. Somebody else is managing the property and they've got these long-term tenants in place and so a big appeal of the TIC is having a cash flow coming in without the active management responsibilities.

Dean: I like also how they can't get the economies of scale. There's a lot of times when you buy say a fourplex that you can get the economies of scale regarding large bulk purchases of materials, of paint and of carpet, and of management fees and so many

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different things you go across the board that really help a small entrepreneurial investor to be able to take advantage of what the institutions have been taking advantage of for years.

Scott: Exactly. It gives them a chance because a lot of investors don't necessarily have the resources to purchase the building for 50 or \$80 million but they may have enough equity where they can go in for a 2.5% slice of the building with some other co-owners. They've built up some equity and now they're in that game and got a much better performing investment, more cash flow and like you said the economies of scale as well when it comes from the management side of it. So there's a huge demand for that sort of product out there now and there are a lot of companies that have actually stepped up and now offer the product and its offered in office buildings, apartments, industrial, and believe it or not there are even certain oil and gas programs that qualify. There is really kind of anything that you can think of in terms of commercial real estate is now available for purchase through these TIC programs that are out there.

Peter: Scott, let me just cut you off right there real quickly because were coming up on a break. We're talking with Scott Saunders, senior vice president with Asset Preservation. When we get back we'll talk more about 1031 tenant in common investment opportunities and location investments.

**BREAK**

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Peter: At the beginning of today's program we talked about the tremendous amount of volatility in the US economy. We talked about the media constantly reporting about the negative attributes of real estate investing but we also did mention that there are opportunities available, that real estate is local. Location, location, location it's a mantra that we're going to discuss with our next guest, a special guest for this segment, Britton Ebert, RealSource economist who oversees quantitative factors to market entry and analytics of exit markets and works to ensure the compatibility of theoretical models with actual data findings. Britton holds a BS in Economics in Business from the University of Utah, Britton, welcome to Income Property Investment Talk.

Britton: Good morning Peter.

Peter: Britton, as I said, real estate is local, I'm going to repeat it, you know me repetition's powerful, I believe in repeating things three times so the message seeps in. But what I want you to do, I was hoping maybe you could talk to us about how as RealSource's economist you look at the markets, you find the markets, and you find the opportunities for RealSource investors across the country. Maybe you could talk about that process, maybe some of the resources that you use and also touch on this media bombardment that we've dubbed it here at Income Property Investment Talk.

Britton: As I listened to you guys discuss that a little bit earlier in the show I got thinking that what investors and what most of us are hearing out in the national news right now and in the national media is an aggregation of what's going on in the economy. It's accumulation of all the news that's happening in the majority of markets but what's important for investors to understand is that there are always exceptions and we're finding those exceptions. Even within those exceptions, there are markets that are

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exceptional in terms of their potential growth opportunities. So even though there is a lot of negative media attention talking about a lot of areas within the country, there are still areas that fall outside of that, that haven't slowed down and that are still growing at extremely strong and beneficial levels. That can be difficult because it's hard to find those areas and what's important is that you need to have a very comprehensive model that can look at a number of factors going on right now because our times have changed, as many investors have been able to tell. There are new risks out there but if you can locate yourself within the right market with the right fundamentals the rewards are definitely still there. That's something that we want to iterate as economists out there observing what's been happening right now.

Peter: Britton, before you get into the economic model and how you go about pinpointing these markets, what bit of advice, a due diligence nugget if you will can you tell the listeners right now in terms of when they hear or when they read or when they see this negative coverage, what can you tell them to maybe look around that, what piece of advice do you have?

Britton: It's interesting, I actually see there being some value in some of the negativity that's been happening right now. The last few years there were some irrational behaviors that we allowed to happen but with some of the negativity I think it tends to unsettle investors and maybe even scare them into being a little bit more careful which is valuable because that will inspire or hopefully inspire savvy investors to perform a more thorough and solid due diligence. As they perform that due diligence, they'll be more likely to find value opportunities in their properties.

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Dean: Now on that note, I don't know if I have these figures straight, but I understand that your company through the economists in the markets they've picked have picked about 18 or so markets and have never been wrong in a market yet regarding predicting that they had cash flow in upside growth. Is really your track record that good?

Britton: Sure. What's important to understand is we're looking at markets. Markets have different types of traits and attributes. Some markets are stronger appreciation markets and we'll direct investors looking for specifically that in that direction. Other markets are more cash flow centric and we can direct investors to those types of areas. What RealSource has done with the economic model is we're able to identify markets that have the best investment potential but we're also able to separate that into which markets have the best cash flow opportunities in which markets have the best appreciation opportunities. Ideally investors should look for both but RealSource is specialized in finding those markets that provide that type of opportunities to investors.

Peter: Britton Ebert, RealSource economist is here with us for the next couple minutes if you want to give him a call, now's the time 1-866-472-5790. So Britton, basically what you're saying is there are opportunities out there as long as you do some due diligence.

Britton: Absolutely. In fact there are markets right now that are growing exceptionally well and to back off and to ignore these opportunities I think would be a mistake.

Peter: Can you get into talking a little bit more about that economic model you were discussing earlier?

Britton: What I had mentioned earlier is that in order to evaluate the entire country, it needs to be a comprehensive model. Now, technically there are over 360 metropolitan statistical areas in the country right now or MSAs, so our model has economic variables

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for each of those MSAs and we broke it down into a three-phase process. During phase 1 of our model what we're looking at is an individual MSA's sensitivity to the national economy, things like interest rates, exchange rates, how sensitive a particular economy is to what's going on nationally. Then, in phase 2 of the model what we're looking at is the actual real estate values of that MSA, how sensitive they are to certain individual variables within that metro area, things like job growth, population growth, affordability, supply and demand variables. We look at over 30 variables in terms of how real estate values are going to behave over the next three to five years. Then phase 3 of the model, what we're looking at is qualitative attributes, things like are there good cultural amenities, is the area a safe place to live, and we're also looking at the future impact of job announcements and job expansions. Through that we can gain a pretty good idea of which areas in the country provide less than average opportunity and which areas provide average opportunity and which areas provide above-average opportunity. So the model is really kind of a filtering process for us to isolate which areas in the country will contain the best investment potential.

Peter: Scott, that's some impressive work that Britton's doing over there. I want to bring you into the conversation. I felt like I haven't spoken to you in a bit. Do you have any questions for Britton at all?

Scott: I have one maybe on a practical level. Britton, if you were just to toss out of the listeners an area or maybe what variables to consider and maybe a pocket that you see has potential, I know you don't want to tip your hand fully but can you give a little indication there because I know a lot of the listeners are looking for opportunities and would be looking for your perspectives on that. Can you throw a little nugget out to everybody?

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Britton: Sure, absolutely. One of the things that we have been noticing in terms of economic shift in trends is a shift away from some of the Midwest markets in terms of the auto industry decline that's happened up there to an extent. A lot of that shifted down in towards the southeast portion of the United States. A lot of the Japanese car manufacturers, Toyota, Honda, Hyundai, and Nissan all have plants in the southeast. All of the same kind of crescent shape in some of the markets down there and so there's some excellent opportunities where many of these newer auto plants are being built within the southeast and so I say that's an area to begin looking. Now having said that, that doesn't include all Southeast markets. It's markets specific to where those plants are and where the growth opportunities lie relative to those plants. That's a great question.

Dean: I like some of things you said. I'm listening for the little subtleties when you were describing your model. You just threw out something like qualitative analysis, what about the amenities of the city. A lot of people don't realize how important it is on that level because whenever there's a government that's trying to entice business to come to that area because really jobs are one of the number one criteria and as you know that fuels the economy. When they're trying to entice the company to relocate, they send their CEOs down and their CEOs come down there and if they don't see something there that they can see them moving their wife and not having their wife be upset then a lot of times they haven't relocated because the CEOs didn't like the place they went. Even things as small as qualitative analysis on a market are extremely important. That's just one of hundreds of variables that you look at.

Britton: Absolutely. One of the important things on top of that is there are so many variables that can make or break a major job announcement whether it's a tax incentive

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that the local authorities are providing or whether it's the infrastructure in terms of transportation opportunities that may make it attractive to shadow boomers who may be moving into that market but you're definitely right in terms of there being many qualitative attributes.

Peter: Britton, I'm going to throw a hardball here I'm not sure that you want to discuss at this time but you're mentioning auto plants and we had a guest on, Dr. Jim Gillespie, last month or a couple months ago talking about the energy crisis. Do you have any comment about that particular situation and what it means to real estate investors across the globe?

Britton: Two things, there has been a surge in many markets also in the South that have benefited from energy. Areas that have had oil and natural gas in those areas have seen a significant boom here through the energy crisis but also, kind of a different portion of energy is investors need to start finding ways to manage that whether it's billing their tenants for energy or coming up with new energy efficient buildings, I think that's an excellent way to add value to properties here over the next few years. If I were an investor I would keep it on the back of my mind.

Dean: Those who are listening ought to listen to some of our archives regarding our lead certified green buildings. Those are some fascinating things and I think that's one of the directions that this country is heading for in the future.

Britton: Absolutely, we don't see oil prices and the energy price situation changing here in the next few years. There may be some minor cyclical patterns but I don't see a major decrease in energy prices happening anytime soon.

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Peter: Britton, we're about a minute and 30 seconds from the break. We thank you for coming on the program. A last nugget to leave our listeners with and a way to contact you at RealSource should they have any additional questions.

Britton: My e-mail is Britton@RealSource.net. My last nugget of wisdom or piece of advice is to keep moving. I think it is important to pay closer attention to the values and opportunities that lie within a property. You need to make sure you have a clear strategy going in but if you do that and you're in the right market there is still excellent opportunities out there.

Dean: And if they call you, maybe perhaps you can tell them what they need to do in order to get their hands on that hundreds of thousands of dollars of research that your company has put into these markets, you can tell them how they can tap into that.

Britton: I'd be more than willing to do that.

Dean: Excellent.

Peter: Britton Ebert, we thank you for coming on the program and we look forward to having you on at a future date.

Britton: Thank you.

Peter: OK. We're about one minute till the break Scott, so when we get back maybe we'll talk more with Scott Saunders, senior vice president of Asset Preservation about vacation properties, vacation homes held for investments. We'll cover that; we'll cover some issues in and around converting residences to rental properties, what a split treatment transaction is, so stay tuned. We'll be right back.

**BREAK**

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Peter: Welcome back to Income Property Investment Talk. We're here with Scott Saunders, Sr. VP, Asset Preservation. Scott, let's talk vacation homes held for investment. There is many tax and legal advisers believe it is possible to perform an exchange on a vacation home provided the personal use is incidental and the investor can substantiate the primary purpose was holding the property for investment not personal use. There is something called Moore versus Commissioner, a significant tax court decision that I'm not going to take any more time trying to explain away but I know it's important. Can you talk about that and other issues in and around vacation homes and the 1031 exchange process?

Scott: Absolutely, I would love to. Let me tell you, vacation ownership whether it's a vacation home, a second home has skyrocketed in recent times. We've seen a lot of people purchasing homes whether it's near the seashore or the mountains and they've got really a couple objectives. It's probably for long-term investment. In fact, there are studies by the National Association of Realtors that project these marketplaces because of demographics to be appreciating over the next 10 years. There is just, if you look at the boomers, a lot of demand for that sort of product. So, from an investment standpoint on the appreciation front it's an attractive investment in a lot of areas. There are lots of those that are going on. Our company as you mentioned has done 130,000 exchanges, a fair number of those have been for vacation properties that have been held for investment purposes. Over the years there's been a, there's kind of a gray area in the tax code and

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fortunately in the past 12 months we've had a lot of guidance come out. A real significant thing that happened back in February, and that was just last month, was the release of a revenue procedure and is since known as Rev Proc 2000 -- 16, but what this did is it really came out and was a response to an IRS treasury report last fall and it gave some guidance to investors to be able to show that a property that was being held for investment in a vacation area was held for investment purposes. As you can imagine this is a little tricky when there is some personal use. What this did is it created what's known as a safe harbor and that just means that if an investor stays above these parameters or guidelines their transaction will be safe in this regard, it will be considered held for investment. This is really important and finally gave some much-needed guidance to investors. Let me give you the essence of it. What it said is if an investor owns a property for at least 24 months before they do an exchange, so they look at this as a qualifying use period, and in that 24 month period they rented out for at least 14 days at a fair market rent, so at least two weeks of rental before the exchange and then after they exchange into let's say another vacation home held for investment they rented also for at least 14 days a year for a 24 month period. If they do that that's considered held for investment. The other piece of this is that the investor's personal use of this property cannot exceed the greater of 14 days or 10% of the days that it's rented during this period. So they can use it as two weeks a year or 10% of the time it's rented if they happen to rent it for longer periods of time.

Peter: That's interesting. So, if you are able to, if you have the success marketing your vacation home, vacation rental property and you do very well and you market it and you

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rent it for five months, five months is about 150 days, 10% of that is what you can use it for then?

Scott: Correct. Really what you're looking at is your use can't be greater than the 10% of the time or that 14 days.

Dean: Because our listeners will probably forget those numbers is there a place online or is it okay that they call you to ask that question just for confirmation?

Scott: Absolutely. I'll make a shameless plug for a qualified intermediary but one of the things we do is we facilitate 1031 exchanges. We also help guide taxpayers through the exchange process so absolutely. Let me give you a toll-free number to our national headquarters in California is 800-282-1031. We also have a website that actually has this information online and that is [www.APIexchange.com](http://www.APIexchange.com), so that's available online for reference. I do want to mention something that's really important. Because this area is kind of evolving and we're starting to get some clarification on any exchange transaction, but especially one dealing with the exchange of a vacation home held for investment, it's absolutely critical that the investor speak with their CPA or their legal advisor about their specific situation. That's just an important principle with any 1031 exchange transaction. They've got to get their individual advisers involved and get their input before proceeding. A lot of times their CPA or attorney might know some unique specifics about their situation that a qualified intermediary who's talking to them about general concepts doesn't know and a qualified intermediary is prohibited from giving tax or legal advice. We can talk about the broad picture of what's possible, what was maybe an aggressive strategy or a conservative approach. An intermediary can't give specific tax or legal advice to an individual investor.

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Dean: We're on the air with Scott Saunders, senior vice president of Asset Preservation, a subsidiary of Stewart Title here on Income Property Investment Talk. What about, you mentioned reverse exchanges earlier. I think that this may be a market where this could have a lot of value. You said you did a large reverse exchange on a large apartment portfolio. Where we've used the reverse exchange that has been very, very helpful to our clients is they come across a deal, I'm sure there are many reasons to use a reverse exchange but this is the one that we found in practicality, that we have a client that comes across a deal that they know if they don't make a move on that property that they're going to lose it just because it's so undervalued or such a hot product or maybe it's an auction property but they haven't sold their relinquished property yet. So we've used the reverse exchange very, very successfully during that. Is that what you found or have you found other uses for it?

Scott: There are other uses for it but let me just tell the listeners just to establish what a reverse exchange is. A reverse exchange is simply reversing the order. It's purchasing that replacement property before you sell the relinquished property, the current one that you own. The IRS has provided some safe harbor guidance on that back in year 2000 of 180-day window. To answer your question though it is a great strategy in today's market because right now the inventory levels are going up, you've got people wanting to sell and it's really a great buyer's market in a lot of areas. Britton mentioned different pockets to look for. If you've got some great property that either you want to take advantage of a really good purchase opportunity today because sellers are getting desperate and need to unload property or you see a market that's got great appreciation potential and it's just a spectacular investment, you can go ahead and lock that property up, actually close on it

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today with the purchase of it in a reverse exchange and take up to 180 days under the safe harbor to sell your current property. It's a great strategy. I think in the market with the inventory that's out there you're going to see more investors making aggressive offers and taking advantage of the market conditions out there. It's a great strategy for that.

Peter: So with the reverse exchange, you brought up my next question but again I believe in repetition, you'd still have to abide by those rules and regulations of the delayed exchange or the most popular 1031 exchange as well, that 180 day time period to get rid of the relinquished property?

Scott: Correct. Realize every 1031 exchange falls under section 1031 of the Internal Revenue Code. They're going to be time requirements. In a reverse exchange that is not going to be subject to scrutiny by the IRS, that's called a safe harbor reverse exchange, you do have 180 calendar days from when you close on the purchase to sell the relinquished property. There are also other exchange requirements that apply in exchange. For example, if somebody wants full tax deferral, they want to defer all of the capital gain taxes, they need to reinvest all of their net equity and have the same or a greater amount of debt on the purchase.

Dean: We call it over and up.

Scott: Over and up, exactly. Basically you look at going to the same purchase price or greater and reinvesting all of your net equity in that. If you do that you have full tax deferral. Those same principles apply in a reverse exchange as well. I'll use some rough numbers for you. Let's say I'm selling a property for \$1 million and let's say in a reverse I find a purchase opportunity for 800,000. And just rough numbers there's going to be \$200,000 of boot unless somebody makes improvements to that property through a

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reverse improvement exchange or they purchase a second replacement property within the 180 day window there.

Dean: Can you explain boot in case someone doesn't understand what that is?

Scott: Sure. I apologize, there's a lot of vernacular in the 1031 exchange industry. Boot simply defined is non-like kind property. A like kind property is anything that can be acquired in exchange. There are two types of boot. Cash boot is when you receive cash proceeds, so it's simply putting money into your pocket after you sell. The other type of boot is known as mortgage boot, sometimes you hear that referred to as debt relief, and this one is a little trickier so it's a good one to bring up. If I've got a mortgage of \$100,000 on my relinquished property and only 70,000 on the replacement property then there's \$30,000 of mortgage boot and that's taxed by the IRS just as if I put the cash in my pocket. So you really need to look at both of those items to make sure that you've got full tax deferral in a 1031 exchange.

Peter: It's interesting that you bring up mortgages and financing because after the 45 minute break, when we get back at 47 1/2, 48 minutes on the hour we are going to have Stan Hanks talk to us about what's available in terms of commercial financing. Scott, we have about two minutes to that next break and I just want to make sure, did you have enough time to get into everything in and around the vacation home and explaining what is needed to qualify for the 1031?

Scott: Thanks for the opportunity there. I wanted to bring up this revenue procedure, which creates a safe harbor. You have alluded to something known as the tax court decision. It was last summer, known as the Moore decision. Without going into details of that, what I want to expose to the listeners is that this safe harbor says if you want sleep

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well at night, if you want to be above having the property challenged as being held for investment, you stay above the parameters of the safe harbor. However, this Moore tax court decision basically said that if you can substantiate that the primary purpose for holding the property is for investment and that the personal use is incidental, there is the opportunity to still be able to do 1031 exchanges that maybe are outside of the safe harbor treatment. There are a number of things to look at, certainly rental income and treating the property on the tax return as being held for investment, treating any interested deductions as investment interest not home mortgage interest, a whole host of factors are critical. I just want to say that there are opportunities for people that maybe want to look at that tax court decision with their CPA as well as this revenue procedure. There is a lot of potential in the area of vacation home exchanges. To take away to remember is that having some rental income is a critical component. You can't just make an argument for appreciation alone is why it was held for investment.

Peter: Excellent, Scott. Thank you for taking us so wonderfully into our next break.

When we get back we'll talk with Scott Saunders more about the 1031 exchange process.

**BREAK**

Thanks for tuning in today to Income Property Investment Talk. If you have a question for Peter or Dean call now, listener lines are open. The toll free number is 1-866-472-5790. That number again is 1-866-472-5790. Now back to Peter and Dean.

Peter: We're fortunate to have and we welcome back to our program Stan Hanks from RealSource commercial. Stan does our Mortgage Minute for us on a regular basis. Stan, what's happening with commercial financing right now?

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Stan: Well, some would say there's nothing happening unfortunately and some would say there's a lot happening. I tend to be on the latter, I think that there are a lot of good things that are happening but it is somewhat of a maze that you have to carefully wind yourself through. We are seeing the Fed taking, as we know aggressive stance on trying to make money available and it is resulting in some really favorable rates, even in the commercial industry right now. Anyone that's buying a, for example, multifamily property which is going to get the best rate, you should be seeing rates in the mid-5%. You can fix a 10-year rate right now in the low fives. That's really phenomenal. But then you're also going to have rates that are going to be in the mid to low sixes based on your projects. Just know there is money out there, you can get it but it's going to be a little more difficult than it has been.

Peter: Stan, we only have you for a short period of time today and I just want the listeners to know if they do want to reach you on Income Property Investment Talk they can click a button that says ask the mortgage minute professionals and that will help them reach out to you and help them maybe untangle that web that you referred to with financing as it is today.

Stan: Through that method also, if you go to RealSource.net you can have access to our rates. We update rates regularly obviously because we're in a fluctuating market. There are nuances on sizes of loans, product types; whether you want recourse or nonrecourse, and those are the things we can help walk your listeners through.

Peter: That's fantastic Stan. I really appreciate you coming on the line with us. I promise you next week we'll give you a few more minutes to discuss commercial financing with our audience.

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Stan: No problem, please give me a call if you ever have any questions, 800-929-2150.

Peter: Stan Hanks, RealSource commercial, thank you so much. Scott Saunders, let's get back, we only have a few more minutes, let's talk about, we've been talking about excuse me like kind property and the exchange process as it relates to real property, real estate. You deal with a number of other areas when it comes to like kind property do you not?

Scott: Absolutely. Like kind property when you come to real estate is extremely broad. Anything that is held for investment really qualifies for 1031 exchange but within that there are a whole bunch of planning opportunities. I mentioned earlier some of these oil and gas programs can qualify for 1031-tax deferral. In certain states, I am here in Colorado, that happens to be where I office out of, water rights that are considered real property under state law can be exchanged for other like kind real property. Development rights, we just got a ruling back in New York a few weeks ago on development rights, air rights, the list goes on and on when you're dealing with real property. One thing I just want to briefly toss out is even the potential to convert a primary residence into a property that's rented out. So let's just say you've got somebody that's down, I'll pick on La Jolla, California they bought their house 30 years ago for a couple hundred thousand dollars and today it's worth several million dollars because the market's appreciated. They can move out of that house because they're only going to have so much tax deferral under the primary residence rules, a maximum of half a million tax exclusion if they're married, make it a rental property. They rent it out for a period of time, let's say somewhere between a year to two but long enough to substantiate that it's now being held for investment. When they go to sell that property they take advantage of the tax exclusion available under section 121, the half a million, but then they do an exchange

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let's say into three properties each worth \$500,000. So they sell for 2 million, half a million goes into their pocket and they acquire three properties in a 1031 exchange. Now, what do they do, they've got these properties producing retirement cash flow from them all out of the equity that was tied up in their primary residence. That's just an opportunity on real property. Personal property is a whole universe there but any personal property whether it's maybe property used in a business, manufactured equipment or it could be art that's held for investment. We just did an exchange on a multimillion-dollar gold coin collection a few months ago. A lot of things when you're dealing with personal property can also qualify for tax deferral.

Peter: And I would think that process would more than likely be a little bit more complicated.

Scott: The process isn't that much more complicated however the definition of what's considered qualifying property is more narrow. It's got to be, when you're dealing with tangible personal property, property that's considered like class or fits within codes that are classified under something known as the North American Standard Industrial Classification Manual. To speak English on that, to kind of give it a practical flair, if you're going to exchange aircraft lets say a turboprop jet that you use for your business...

Peter: Like the one in my backyard?

Scott: I'm glad you got one in your backyard; I don't have one in mind. You're going to exchange your turboprop and you're going to go into a Lear jet for business. Those are going to fall within the same asset class. You couldn't exchange a turboprop for let's say leased automobiles because even though they're both related to transportation they are going to fall under different asset classes. Exchanging aircraft is a fairly common

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transaction particularly for corporations and businesses that use it, that's a real common one under 1031.

Peter: Earlier when you were talking about the conversion of the residence to a rental property, of the vacation home, all those numbers that you mentioned earlier that you have to prove 14 day and the 10%, that all applies in and around that as well?

Scott: Correct. Yes it does.

Peter: Scott, we've talked about a whole gamut of different ideas, different processes in and around this exchange. We have about two minutes left in the program. Is there something that we didn't hit on today that you wanted to talk about that you know is very important for our listeners to know?

Scott: Well, let me just give you one piece that's important. Whenever you do a 1031 exchange you're going to use a company that's known as a qualified intermediary, we are referred to as Q. I.s, or facilitators, or accommodators. Something to be aware of, at the federal level qualified intermediaries are not regulated. There are a few states progressing with various levels of state registration or regulation. It's really important that you look at that company and look at what security mechanisms do they provide. They hold your money during that up to 180-day exchange period and it can be fairly substantial if a company does a volume of transactions. I would say what's important to look at is what sort of security mechanisms do they provide to you and there are a lot of things to look for, certainly fidelity bond is they good one, but some sort of backing by a significant parent company. You mentioned ours happens to be Stewart Title. It's beneficial. There are other companies out there that have excellent security mechanisms. That's critical. Look at their experience and what sort of expertise they can help you with. A qualified

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intermediary is a valuable part of your team. I heard that concept mentioned earlier. You need some resources. Use an intermediary to kind of pick their brains and really learn what might be some significant challenges in the transaction, whether it's vesting or title issues but use an intermediary that's going to typically ask a series of questions to set up your exchange in a way that would be favorable and then be sure again to review it with a CPA or a qualified attorney that's providing tax advice.

Peter: Scott Saunders, senior vice president, Asset Preservation, we thank you for joining us on Income Property Investment Talk. Next week, we'll be talking foreign real estate so join us here every Wednesday at Income Property Investment Talk.

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