

Creating Multiple Streams of Income
Using 1031 Exchanges,
Tenant in Common Interests, and
Zero Cash Flow Properties

1031 Training LLC
www.1031Training.com
1-781-729-2957

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Introduction

Within the last five years we have seen the Internet change the way businesses, both service- and product-driven alike, operate and compete.

Any business that has a low barrier to entry or enjoys large profit margins has witnessed new competitors enter and challenge what was considered the norm. And some industries such as travel agencies have nearly become extinct.

The Internet hasn't been the only cause of these changes; new competition has forced old-line retailers and service companies to totally rethink who and what they are and to enter new areas to increase profits. Some companies are treading on areas that are completely outside their norm. Costco, for example, has entered both the real estate and banking industry. H&R Block, having conquered the tax return industry, is now using its muscle to cross-sell new financial products to their current group of customers. Wal-Mart has decided that banking will be a new and exciting area for them to conquer.

Consolidation and mergers are another factor. The trends that we have been seeing in corporate America are pointing to the next decade as being even more competitive, particularly within the real estate and financial services industries.. As this plays out it will become increasingly necessary for professionals in these industries to seek additional opportunities and sources of income to combat the reduced profit margins and cannibalization of customers that the competition will bring. The trends for the smaller professionals within the real estate and financial services industry point to (a) becoming specialists who works within a specific market niche or (b) adding new profit centers that complement what they already have in a bundled services approach. Whichever approach *you* choose (if you do choose any), the opportunities presented here will allow you to position yourself for **three new income streams – 1031 Exchanges, Tenant in Common, and Zero Cash Flow** –that can seamlessly blend into any type of real estate or financial services that you currently offer. These opportunities can be used either as new tools for your marketing or as stand alone profit centers that can easily net you hundreds of thousands (and in some cases millions of dollars) in professional service fees and commissions.

Included in the second part of this booklet are free and inexpensive proven marketing strategies that you can either apply to your current business or as a technique to integrate these new profit centers into your current business or finally to be used with these new profit centers to create an entirely new business model around. Either way that you choose to use them, these strategies will work for both immediate and long-term results.

1031 Exchanges

100% Tax-Free!

1031 exchanges allow for the sale of any business or investment property, including raw land, without incurring any tax liability regardless of the size of the gain made on the sale.

That's correct! **You can show your clients how to sell their commercial property without paying any taxes!** And since almost every state in America allows for a 1031 exchange, your clients can now avoid paying taxes to both the federal government and state as well.

Tax free or tax deferral?

By right, we should say "tax deferral" because an exchange doesn't really let you escape taxes but just postpones the taxes due until you sell the property and take the cash from the sale.

But there are a number of techniques available which can provide a 1031 exchange to eliminate most or all of the taxes due from the sale forever. When we hear someone say an exchange is only a deferral and you eventually have to pay the taxes, we know that person has only a rudimentary knowledge about exchanges. This is an opportunity to win a new convert by explaining to them all the advantages –including the advanced ones that hardly anyone understands – that offer clients the opportunity to make the sale 100% tax free.

How 1031 exchanges have surged in popularity

According to a recent *Wall Street Journal* report dated August 15, 2006, 1031 exchanges are surging in popularity *even* in a declining real estate market. As a matter of fact, 1031 exchanges have been the only bright spot in the real estate industry as of late.

Why are 1031 exchanges so popular, and why in a declining market are they surging in popularity? The answer is very simple. Although today's tax rates are at their lowest in years, when both federal and state taxes are combined, it is very common to pay a full third of the selling price as taxes. Not only do you have to consider oth state and federal capital gain taxes, but don't forget to add in other items like recapture and alternative minimum tax. With today's high real estate prices and rapid appreciation that we have seen over the last decade, we are talking very large amounts of money in taxes that everyday people can avoid by using a 1031 exchange.

In any declining market, such as the one we have right now, more people will be trying to sell their property, thereby increasing the properties available for sale and putting additional pressure on prices. A soft real estate market may require some sellers to lower their prices an additional 15% to generate any interest. And any opportunity to save

money by reducing expenses from the sale, especially income taxes, becomes more attractive and helps take the sting out of the lower prices.

There are many other factors contributing to the surge in 1031 exchanges. As you read through this report, you will see that the market has not even begun to be tapped. Demographic trends – aging baby boomers and growing number of immigrants owning real estate – will increase the popularity of 1031 exchanges, and when the real estate market finally recovers even more niches will exist for you to exploit.

Overview and history of the exchange industry

The US Treasury Department introduced the idea of exchanges (although not as we do them today) in 1921 when they created IRS code section 202(c), which was later renamed to section 1031.

Many of today's rules, including the introduction of the 45- and 180-day time requirements, were first introduced in 1984 when Congress adopted the Deficit Reduction Act. Eventually this paved the way for the final rulings and clarification of open exchange issues, which the Treasury Department completed and issued effective July 2, 1990. It was here that we had final clarification of the 45-calendar-day identification period and the 180-calendar-day exchange period. It also addressed some settled issues such as constructive receipt of proceeds from an exchange, creating what we now call the "safe harbor provisions" and made modifications to the exchange rules which disallowed partnership percentage of ownership interests from qualifying for a 1031 exchange.

It was the Tax Reform Act of 1986, though, that changed the real estate world forever and began what has been nothing less than an explosion in 1031 exchange transactions. The Tax Reform Act of 1986 eliminated what was considered by some to be preferential treatment of capital gains. In short, the Act removed the tax advantages of owning real estate, which generated losses by introducing the rules of passive loss limitations. Soon all the advantages of gains being taxed at a lower rate began to disappear, exposing sellers of real estate to tax rates and depreciation recapture at the highest rates, the same as ordinary income. 1031 exchanges remained the only tool still available at the time to escape these new higher rates.

The Department of the Treasury is still constantly reviewing and making slight modifications to section 1031. But it is now well entrenched and as it grows in both acceptance and understanding, it will continue to grow as a strategy to increase cash flows, shelter income, and become a tool for retirement planning. As new products that complement exchanges, such as tenant in common interests and zero cash flow properties, are introduced and coupled with advanced tax strategies such as cost segregation analysis, we will see the use of exchanges move from what is considered a specialty to become part of an everyday sale of investment real estate.

Exchanges are exploding!

Exchanges are hotter than ever and continue to grow in popularity. According to the latest numbers released, 400,000 exchanges took place in the 2004 tax year, including individuals, partnerships, trusts and corporations who as taxpayers are all allowed to execute a 1031 exchange. Conservatively, the industry is projected to continue to grow at a rate of 5% per year over the next 10 years even in years of a down real estate market.

All this is a result of more sellers of real estate learning about 1031 exchanges and those that do know about them discovering the even richer advantages that exchanging can offer them. Three of the largest trends expected to fuel the growth of exchanges are:

- Baby boomers starting to enter their retirement years
- The increase of real estate ownership within the first generation immigrant market, and
- The migration of middle-income America from the northern states to the southern and western states.

At first glance, these statistics look very good . Exchanges seem to be well known and used commonly *within the real estate industry*. However, a recent study of the New England area between 2003-2004 produced startlingly different results than what early evidence lead us to believe.

A sampling of 182 owners of smaller investment real estate in Massachusetts and parts of southern New Hampshire and Northern Rhode Island revealed the following:

- 24% had performed an 1031 exchange
- 22% had heard of an exchange but didn't fully understand them
- 54% had never heard of a 1031 exchange
- 22% percent of those who do an exchange, do another one within three years

How can it be that 54% of a market that is supposedly growing had not heard about an exchange? Who is it then that is causing the market to grow? The answer to these questions became obvious as the study revealed even more:

- The average age for an owner of investment property is 56 years old.
- The average number of investment properties owned was three.
- 19% of the respondents were not born in the United States and had a primary language other than English

The most startling discovery of all though was that 48% of the owners sampled had no professional financial team. They had no regular accountant, attorney, or financial planner to assist them or explain to them what an exchange was and the advantages that it offered them.

Most of them used a franchise tax return preparer or did their own taxes. Many didn't feel that their returns were complicated enough or their financial position warranted any expert advice.

The growth in exchanges at that time was being driven by the larger property owners and more sophisticated clients who had access to a team of professionals to help guide them and explain to them the benefits of exchanging.

When this report was revealed it became very clear that proper education of the public about the advantages that exchanging offers real estate investors, **the market could probably grow by an *additional* 1 to 2% every year over the next decade.**

Opportunity knocks!

The lack of knowledge that people have about exchanges should not be seen as a disadvantage. As a matter of fact, it is proof positive that the 1031 exchange market is ready to explode with growth, assuming that we educate people at a grass roots level. An aggressive marketer should consider this market share up for grabs and ready for the taking.

What about Tenant in Common and Zero Cash Flow Properties?

The growth rate of 1031 exchanges is very good and is projected to continue at what most people would consider an extremely healthy growth rate, allowing many opportunities for companies to expand and grow even with additional competition.

But above and beyond that, two types of replacement properties – Tenant in Common and Zero Cash Flow – offer even greater opportunities in conjunction with 1031s.

Tenant in Common Properties

In 2002, the Internal Revenue Service issued a revenue ruling setting forth a set of requirements that allow certain types of properties to be co-owned with others and qualify as a like-kind replacement property within a 1031 exchange.

These properties, known as Tenant in Common properties or TICs, allow many smaller individual investors to purchase institutional quality real estate such as grocery-store-anchored shopping centers, large multi-family apartment complexes, and office parks and warehouses.

The market for Tenant in Common properties however is nothing short of phenomenal. Since the IRS has allowed Tenant in Common TIC properties to participate in an exchange, they have grown from 0 to over a \$4,000,000,000 – that’s a four billion dollar industry in 4 short years. TICs are expected to continue this rocketing growth for the next 10 years and reach over \$20,000,000,000 (twenty billion dollars) a year.

Because TICs are real property, they also qualify for an exchange when it comes time to liquidate and sell them. The TIC resale industry can even double their current total dollar amount in the future because they are still not known by many exchangers and are unheard of by almost all real estate agents, accountants, financial planners, and attorneys. The market growth of TICs as replacement properties in exchanges is mind boggling. Think how easy it would be to sell someone on this new form of real estate ownership by telling them, “Let me show you how to double or triple your real estate rental cash flow from what you now have and maybe even make it tax free”.

TICs usually offer cash-on-cash returns that are considerable higher – *sometimes three times higher* – than investors receive from smaller investment properties because of the way commercial properties are purchased with the concept of cash flow when large appreciation or speculation is not a top priority.

Another advantage of TIC properties is that they can come with debt. Not any debt, but *non-recourse* debt, which means your client doesn’t even have to personally guarantee the loan. Your clients can now control possibly millions of dollars of top commercial real estate with minimum down payments and in some cases with nothing more than a credit

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