

CAPITALIZING ON LIKE-KIND EXCHANGES

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Internal Revenue Code Section 1031 allows a seller to defer capital gains taxes if the person reinvests in a like-kind property of equal value. If an investor sells his six-unit residential rental property, for example, he can reinvest in various types of real estate, including multifamily, office, retail, industrial or undeveloped land.

"The 1031 tax deferred exchange is one of the last free passes allowed on our tax codes," says Barry Silver, principal with San Rafael, California-based The Silver Group. "Anyone who is selling an income property should consider an exchange, as you are able to defer your tax liability and roll all of the equity from the relinquished property into the up leg. This means the investor can use money that would otherwise be paid in taxes to continue to increase their cash flow."

As Silver notes, however, "The investor cannot take receipt of any proceeds from a sale or it will be subject to taxes."

William Winn, president of Irvine, California-based Passco Companies LLC, stresses that the 1031 exchanger must use all proceeds from the sale of the first property and assume as much debt on the purchase of the replacement property or pay taxes on the difference.

LIMITATIONS OF 1031 EXCHANGES

While experts agree that 1031 exchanges are an excellent wealth preservation strategy, Anthony Thompson of Thompson National Properties, advises that investors considering a 1031 realize the inherent risks and limitations:

- Real estate is an illiquid investment. The investor may be better served paying the taxes and investing the proceeds in stocks, bonds or other

alternative investments.

- The capital gains taxes might increase or the investor might be in a higher tax bracket in the future. It might be better to sell property A and pay taxes now, rather than sell property B in 10 years and pay taxes at a higher rate.

- There are costs involved in purchasing real estate, including title insurance and closing costs.

- It is also important to understand the tax implications of the depreciation schedule for the replacement property.

TIC, DST, AND NNN

For investors that have consulted with a financial planner and decided a 1031 exchange is in their best interest, there are many options. Here, we look briefly at the Tenant-in-Common (TIC) structure, the Delaware Statutory Trust (DST), and net-lease properties (NNN).

In a TIC deal, multiple investors purchase a fractional interest in a property. TIC sponsors are able to sell interests of 1 to 20 percent to multiple investors, not to exceed 35. The sponsor generally assumes management responsibility for the property.

With a DST transaction, a trust owns the property and the 1031 exchanger is a beneficiary. Thompson, chairman and CEO, and Jack Maurer, vice chairman and partner with Irvine, California-based Thompson National Properties, believe the DST will become more popular than the TIC structure for several reasons. The DST is a simpler vehicle for lenders and insurance companies because they are only dealing with one entity. (With a TIC, there can be up to 35 entities purchasing a property.) There is less upfront cost in terms of title insurance, closing costs and attorney's fees. The exchanger is not listed as a borrower on the loan.

TICs and DSTs are popular 1031 strategies because it is often easier to find a fractional interest that matches the amount of the property an investor has sold than to find a whole building. Thompson notes that it is also easier to diversify, buying fractional interests through several TIC or DST transactions rather than investing in one property.

"With a TIC or DST, the properties tend to be larger, institutional quality investments," adds Thompson. "And the sponsor negotiates with the lender, handles the legal costs, and signs the loan guarantees."

Maurer also notes that DSTs offer a more flexible exit strategy, allowing the investor to contribute his interest to a real estate investment trust (REIT) rather than an outright sale, which is a tax-planning consideration for many investors.

Sean O'Shea of Los Angeles-based BRC Advisors is skeptical of the TIC structure. His concerns relate to the integrity of the sponsor, the illiquidity of the asset (you may have to wait until the sponsor sells the property to convert your investment); and disputes among TIC investors or between TIC investors and the TIC sponsor. "Ask good questions and make sure the sponsor can answer all of the questions satisfactorily," he says.

O'Shea recommends net-lease assets with investment-grade credit-tenant leases. "With a net-lease asset, the tenant is responsible for operational expenses, so this is a good passive investment with a predictable income stream," he says.

It is crucial to choose an asset with a strong tenant in place. "Don't buy an asset with a tenant whose stock you wouldn't buy," O'Shea says. "You're banking on the success of that tenant."

The probability of a default on a corporate bond backed by an investment-

grade tenant over a 20-year rolling average is about 4.12 percent, says O'Shea, citing Moody's Investor Services as his source. Default by a non-investment grade tenant is 42 percent or greater. O'Shea explains, "Moody's evaluates bond default probability, not lease default probability. It is a customary reference used to reflect the 'risk premium' that investors may unwittingly assume by investing in properties occupied by less-than-investment-grade tenants without a corporate

guarantee of lease obligations."

He adds, "It is reasonable to suggest that they would default on a bond before they would ever default on a corporately guaranteed lease. This provides more security for a high net worth investor."

According to O'Shea, "The biggest challenge today is matching an acceptable debt component in the post-credit crunch environment. A client cannot know with certainty if he can secure acceptable debt in terms of interest rate,

loan-to-value, or term of loan available. Also, most new transactions will require the taxpayer/investor to have full recourse rather than non-recourse or partial recourse of the past. This is why the investment-grade credit-tenant transactions in which we specialize are a risk-averse option for investors since the mortgage loan is based on a corporate guarantee and corporate lease rather than the net worth of an individual investor."

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THE FUTURE OF 1031 EXCHANGES

“Over the years, we have heard that the government will try to eliminate the 1031 tax deferred exchange,” Silver says. “I certainly hope this does not happen as there will be a tremendous ripple effect. The 1031 exchange that allows investors to defer taxes is the main mechanism that drives new retail development. Retailers depend on new store development to grow their business. Much of this new development is acquired by investors involved with 1031 exchanges. Without this pool of motivated buyers, development would be greatly reduced and real estate values would decline.”

Winn does not expect changes in governmental regulations pertaining to TIC or 1031 transactions. However,

he says, “After the presidential election, [federal] capital gains taxes might be pushed higher than the current 15 percent — they were 30 percent a few years ago. This would negatively affect real estate and increase the demand for 1031s.”

O’Shea believes capital gains taxes will increase next year: 15 to 20 percent under McCain and up to 25 percent under Obama. He predicts a flood of 1031 exchanges at the end of this year, even in a down market.

Thompson and Maurer predict that 1031 exchange activity will be driven by demographics over the next 20 years. As more baby-boomers transition into semi-retirement they may want more passive investments or diversification of their investments.

On the other hand, investors are watching the results of past TIC activ-

ity. As Silver says, “We are currently experiencing a correction in the market due to the contraction of the debt markets. After 2 to 3 years of record velocity and returns, the market is returning to the norm. Over-aggressive lending practices led to buyers paying record prices during this period. Many investors plan to hold property for the long-term, but those who plan to sell in the next few years may find there is no one who will match the prices paid in 2006 through 2008. Some of the most aggressive buyers during the past few years were the TICs. Each deal they bought was immediately resold to investors at a 10- to 15-percent premium. Many acquisitions were done with short-term, interest-only debt. With [currently] declining values, only time will tell if these deals were good.”

HOW TO FIND A COMPANY TO FACILITATE YOUR 1031 EXCHANGE

The 1031 structure is tricky. The IRS requires that investors completing a 1031 exchange meet very specific criteria in a very short time period. If your exchange falls through or if you don’t meet all of the requirements, you may be responsible for capital gains taxes you’d planned to defer or you could be on the line for tax fraud.

You should always consult your financial advisor or an accounting professional to understand the benefits and limitations of a 1031 exchange and the various types of properties in which you can invest. William Winn of Passco Companies LLC suggests that your financial planner can also refer you to a securities broker, who handles TIC transactions and DST transactions and who understands net-lease properties in order to help you evaluate which type of investment best suits your needs. (A real estate broker would generally be more knowledgeable about net-lease properties than about TIC or DST options.)

Here are the questions you need to ask before choosing a company to assist with your 1031 exchange:

- What is your company’s track record with 1031 exchanges/TICs/DSTs/ net-lease investments?
- What types of investments are available? Jack Maurer of Thompson National Properties explains that you should be comfortable that the company will have product available at the time you will need to close on your replacement property.

- What return can I expect?
- What is the certainty of close? You cannot choose a different property after the 45-day identification period. If you are unable to close, you’ll have to pay taxes.
- What is the due diligence process? (A TIC or DST sponsor should have completed due diligence on the property and have a lender ready to close. Make sure you are comfortable with the company’s due diligence.)
- Anthony Thompson of Thompson National Properties suggests you ask TIC or DST sponsors about the company’s financial strength. If another investor backs out, will the company have the money to close on the property you’ve identified at the time you need to close?
- Barry Silver of The Silver Group recommends that investors ask a company about TIC deals that failed to close.
- For an NNN investment, Sean O’Shea of BRC Advisors suggests that you look for a company that can advise you on the potential future value of the real estate as well as the current value of the lease. “You need to look at the location, the demographics, the traffic patterns and the terms of the lease,” he says.
- You should always request references — from recent clients and from clients of several years ago. TIC or DST sponsors should also provide bank references as well as their accountant’s name. You want to make sure the company has an audited financial statement to verify the company’s financial strength.

1031 SCENARIOS

Example 1: Sean O'Shea of BRC Advisors is helping a client who is selling a \$20 million shopping center and wants to defer the \$3.6 million tax liability. The client has roughly \$10 million in equity in the property. If he were to pay his capital gain tax liability from the sale, he would have approximately \$6.4 million in net proceeds without a 1031 trade.

"This is an enviable position on the face of it," O'Shea says, "but there is a more effective, risk-averse replacement solution."

"Because all sectors of the national real estate market are overpriced in our judgment, we are recommending a small portfolio of credit-tenant net-leased properties as a solution," O'Shea says. The client will purchase several investment-grade, credit-tenant properties worth a total of \$19.95 million. The properties have 87 percent loan-to-value debt in place — which is very rare for this market — and they are non-recourse loans, which are not readily available in this market.

In this first phase of the transaction, the equity component is \$10 million and the debt component is roughly \$9.95 million. The client completes his 1031 exchange by acquiring these assets matching his existing equity and debt per 1031 Trade Exchange Code compliance.

In this particular case, the client has

the option to refinance, as part of the loan provisions, and receive net loan proceeds (\$7.25 million), which is not a taxable event since the trade has already been completed.

Bottom line: The down payment for the portfolio is roughly 13 percent (or \$2.75 million, which is less than his tax obligation) and the client will assume roughly \$17.2 million in fixed-rate mortgages (mitigating future interest rate risk). The rents, which carry a corporate guarantee, will pay off the mortgages in approximately 22 years. After the refinance, the investor is free to re-invest his tax-free \$7.25 million elsewhere, without having to meet the 1031 45-day rule. An investment at 10 percent interest will result in \$725,000 annual cash flow.

Example 2: A developer in New York left a 100,000-square-foot B/C grade property to his five children. The property languished for 15 years, producing no income because a tenant would fail or the building would need repair. As the local real estate market improved several years ago, the value of the building increased. The brothers and sisters, who were in their 50s and 60s, sold the property for \$26 million and would have paid \$13 million or more in taxes had they not reinvested the money in TIC interests through a 1031 exchange. Anthony Thompson and Jack Maurer, then with Triple Net Properties

(which has since merged with Grubb & Ellis), helped the family to reinvest the money in two office buildings, an apartment building, a multifamily/retail building and an industrial building in five different states. The new properties generate more than \$1.6 million in cash flow each year (more than \$300,000 per person) — much of that tax-sheltered because of depreciation or because the properties are located in states with no income tax.

Example 3: William Winn of Passco Companies LLC is currently helping a client who sold a four-plex apartment building (which had provided \$10,000 annual cash flow) for \$900,000 to purchase a TIC interest in a 300-unit Class A multifamily property. The client paid off a \$400,000 loan on the previous property. The client is investing the remaining \$500,000 and assuming a \$500,000 loan in order to purchase the 3 percent undivided interest in the property. Passco Companies will continue to handle the asset and property management for the multifamily property, which will generate approximately \$30,000 in annual cash flow to this client. Because the deal will be completed as a 1031 transaction, the investor is deferring payment of approximately \$225,000 in federal and state taxes.