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Are 1031 Exchanges Misused?

New York City—Last year the volume of 1031 exchanges dipped as a result of the decline in sales transactions. However, their popularity as a tax-savings mechanism continues to grow. Therein lies a danger, according to John Maltz, managing director of Greiner-Maltz. "1031 exchanges have become the basis of a tidal wave of tax-motivated real estate transactions, which will soon dwarf the infamous tax shelter deals of the '60s and '70s," he claimed. He added that the number of businesses offering 1031 exchange services has grown exponentially in the last few years.

While Maltz supports the use of 1031 exchanges as a means to legitimately defer taxes, he is concerned that some investors are overlooking sound real estate fundamentals in pursuit of tax savings. An example, he said, is net-leased retail property sold on an exchange basis. Often the value of the property is based on a bonded lease with a retail tenant. "You're buying a property purely for the income, with no relationship to the value of the real estate when it's empty," Maltz said. Net-leased properties sold on an exchange basis are seeing their values inflated by unrealistically low capitalization rates in view of the risk of the tenant becoming insolvent.

Although it is difficult to determine when tax interests alone are driving a 1031 exchange, many accountants caution that investors should not be moved by tax considerations to buy poor real estate. Michael Sanders, partner with Powell Goldstein Frazier & Murphy L.L.P., offers an additional caution. "The IRS, as well as the states, audits these deals very closely. ... There are very precise rules and the IRS will hold you to them," he said.

That scrutiny, coupled with the fact that 1031 exchanges are tax deferments not tax-saving shelters, may stave off Maltz's greatest concern about the rise in 1031 exchanges. "We're concerned that the real benefits will be ruined by excess," he said.

—Jessica Roe