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COMMERCIAL REAL ESTATE

1031 EXCHANGES INVADE QUEENS

By John Maltz, SIOR

1031 Exchange transactions have been spotted with increasing frequency from Flushing to Middle Village; Ridgewood to Springfield Gardens and their take over of the typical real property sales transaction has altered the valuation of investment properties throughout the borough. But what is a 1031 Exchange, or have you already spotted one?

1031 Exchanges, permitted under a Federal Tax statute which has been on the books for over 60 years, has become the basis of a tidal wave of tax motivated real estate transactions which will soon dwarf the infamous tax shelter deals of the 60's and 70's.

The 1031 Exchange Rules were originally promulgated to avoid crippling the growth ability of investors and businesses when they sold a property to invest in a like kind one. While the tax is not avoided, except in extremely limited situations, it is deferred until the chain of exchanges is broken. Refer to Section 1031 of the IRS Code of 1986, as Amended and Section 1.1031 of the corresponding Treasury Regulations.

In effect, anyone selling investment real estate can reinvest all of the proceeds into the next transaction. Many experts agree that the increased leverage represented by approximately 25-30% in tax savings allows the exchanger to out bid competitive offers for the newly acquired property. However there are always strings attached.

There are procedural risks of some significance involved due to the rules requiring a

Qualified

Intermediary to hold cash and title to the exchange property while the transaction is being completed. Additionally, there are strict time constraints for the identification of a trade-up or trade-down property. Trading-up is when a property currently held is being sold and a new property must be selected. Trading-down is just the reverse. To receive complete tax benefits the simple rule of thumb is both equity and debt must be equal or greater than the property exchanged from. "Boot" from a transaction would be taxed at the full gains tax rate. An interesting note, leases having a term in excess of 30-years are considered real property under the exchange rules.

The 6-month time constraint to close on the property to be exchanged for has created several unintended consequences. Imagine a closing where the seller knows that the buyer must close within a prescribed time frame or lose significant dollars in tax relief. Of more dire concern is the oft-repeated circumstance of the "exchanger" purchasing the wrong property because of the 6-month deadline

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squeeze.

A new twist, substantially due to the availability of non-recourse, low interest rate financing, is the "finance out" option. So as to possibly avoid gains taxes, in some circumstances forever, upon the acquisition of the target property 90% financing leverage allows the exchanger to, in effect, take off

the table all of the capital gains achieved on the sale. It is quite easy to accomplish and lenders, of late have been easy to find. However, the non-recourse "finance-out" of many 1031 exchange transactions has, in effect, shifted property risk to the lenders. The quantity of these transactions over recent years has resulted in some lenders closing their books to new such business. Keeping in mind that the street believes "all retailers eventually go broke" and many 1031 exchange properties are net leased to retailers, banks may have the "opportunity" to repeat their playbook of the early 90's.

The tax shelter promoters of 40-years ago, like some of the 1031 Exchange promoters of today, used as their investment vehicle net leased commercial and retail properties. The

shelter promoters typically would flip the selected property to the investor at a new price boosted with secondary financing. While cash flow would be neutral, shelter would be created through depreciation of the inflated equity.

Some of the structured 1031 Exchanges are so similar in nature to these tax shelters that it has led some industry members to voice concerns regarding IRS review. The shared "red flag" characteristic of 1031 exchange transactions is the highly leveraged non-recourse financing often utilized solely for the purpose of sheltering income from Federal gains tax. Specifically, net-leased properties sold on an exchange basis are seeing their values inflated by unrealistically low capitalization rates in view of the risk, over the typical 20-year lease term, of the tenant becoming insolvent. With the simultaneous closing of title and the placement of highly-leveraged non-recourse financing on the property the investor is provided with immediate tax relief by receiving tax-free mortgage proceeds. An additional risk to the investor is the implementation of the "tracking rule," were the exchanger not to use the financing proceeds for investment purposes.

Combining sound real estate investing principles with tax savings strategies is the goal for many 1031 transactions, and with the counsel of a qualified real estate expert at your side, this goal can be attained.