

JULY 17, 2002

Maltz: 1031 exchanges have hidden risks

By JOHN MALTZ, SIOR
GREINER-MALTZ

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 60s and 70s.

The non-recourse "financing-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 90s.

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.

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.

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 squeeze.

Let's look at the math for an "idealized" 1031 Exchange transaction:

Seller A, with a low basis, sells an apartment complex for \$5 million, incurring an approximate potential of \$1 million in capital gains tax liability. Were Seller A to pay such tax and invest the balance at an 8% annual return, the resulting cash flow would be \$320,000.

Alternatively, utilizing the 1031 Exchange rules, the seller exchanges for a \$6 million single tenant retail building hav-

ing a bonded net lease providing a 9% per annum return. A nano-second after closing, a 90%, 25-year, self-liquidating, 8% fixed non-recourse mortgage is placed on the property.

The debt service on the mortgage of \$5.4 million is \$500,137.00 per annum. The property's net income of \$540,000 provides excess annual cash flow of approximately \$39,000, a 6.5% return on the buyer's cash left in the deal of \$600,000. Assuming the refinancing proceeds of \$5.4 million is invested at 8%, the total annual return would be approximately \$470,000, as opposed to the \$320,000 were the seller not to have utilized the 1031 Exchange option. 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.