

Capital Gains Tax - Real Estate Capital Gains Tax

By Mike Fickes

At its core, a [1031 exchange](#) is designed to accomplish one simple goal: to avoid taxes. But owners turn to 1031 exchanges to carry out a variety of business strategies. A retail owner might use an exchange to trade an old mall for a newer, trendier shopping center. In a more complex deal, an exchange can be part of an exit strategy for a partnership.

In a 1031 exchange, owners defer the *capital gains tax* they typically pay in a property sale. For instance, an investor that purchases a building for \$20 million and then sells it for \$50 million will avoid paying taxes on the \$30 million gain.

To complete an exchange, an investor uses property instead of money as the medium for the transaction, essentially paying for the new property with the title of the relinquished property. The equity held by the investor in the new property must equal or exceed the equity held in the previously owned property. The key benefit of an exchange is that the investor is permitted to defer the 20% to 30% capital gains tax payments that would accompany a conventional sale.

Inland Group Inc. of Oak Brook, Ill., for example, acquired 85 properties valued at just under \$1 billion last year and used 1031 exchanges to fund a dozen of those acquisitions. As a holding company that owns several private REITs, Inland has used the 1031 market to supplement its acquisition strategy since 1980, according to Joe Cosenza, vice chairman. Exchanges not only funnel capital into acquisitions, they form exit strategies for properties that have peaked in value.

Earlier this year, Inland exchanged the Shorecrest Shopping Center, a grocery-anchored property in Racine, Wis., for \$6.2 million and rolled the proceeds into a regional big box center called Deer Trace in Kohler, Wis.

To pay for the \$13.5 million Deer Trace center, Inland used the entire \$6.2 million garnered from Shorecrest, including the taxes deferred on the capital gains by virtue of the 1031 exchange, plus an equity contribution of \$7.3 million. A larger, more expensive property, Deer Trace will likely bring a greater cash flow from its high-profile retail tenants, including Home Depot, T.J. Maxx, Michaels Arts & Crafts and Famous Footwear.

For Cosenza, the choice between using an exchange or paying for a new property depends upon the company's current need for cash. If cash is not a priority, an exchange is the better strategy. "You can exchange into a larger property with more cash flow," Cosenza explains.

Protecting Business Strategies

All 1031 exchanges revolve around two absolute deadlines. Within 45 days of closing on the relinquished property, a 1031 trader must file a list of possible replacement properties with an intermediary — a firm certified to act as the [closing agent for 1031 exchanges](#). The second deadline occurs 180 days after the initial transaction. At that time, the exchanger must close on a replacement property, using equity equal to or more than the equity in the original property. Miss either deadline, and the IRS will send a *capital gains tax* bill.

In light of the deadlines and other issues that can complicate exchanges, a cottage industry of 1031 exchange advisors has emerged over the years. These advisors include qualified intermediaries, which provide technical advice and closing services. Numerous real estate brokers and net-leasing firms help exchangers locate replacement properties, and accountants and attorneys provide specialized tax advice related to 1031 transactions.

The larger and more complex the 1031 transaction, the more important comprehensive expertise becomes.

"Negotiating a 1031 exchange can cause brain damage, because you can never be sure any particular deal will close," notes Bruce MacDonald, president of Nashua, N.H.-based Net Lease Capital Advisors, one of a handful of firms that blends knowledge of the 1031 property market with financial and tax expertise.

Sometimes, a seller tries to use the 180-day deadline as leverage to raise the price of the property. For that reason, warns MacDonald, "You never want to be in a situation where you must close on a particular property to protect your tax position."

McDonald gives an example of how to avoid that trap. Early in 2001, for example, a client of Net Lease Capital sold an apartment complex in California. The initial transaction brought in \$70 million, an excellent price in what was then a red-hot California market, according to MacDonald. A completed 1031 exchange would save the owner approximately \$10 million in *Real estate capital gains taxes*, while facilitating an exit from a property market that had likely peaked.

To that end, Net Lease Capital helped the apartment owner identify four properties worth a total of \$120 million to complete the exchange. Of the four properties, the client's first choice was a multifamily property near Denver, a market the owner judged to be positioned for growth. In the event the multifamily exchange failed, the remaining three options were the client's "safety net" choices: credit-tenant properties that were certain to close quickly at the listed prices. In fact, the exchanger closed quickly on one of those properties, a \$20 million distribution center, leaving \$50 million on the table.

The apartment complex near Denver, the strategic goal of the transaction, carried an asking price of \$50 million. As a multifamily investor, the exchanger wanted the Denver apartment complex. The seller in Denver understood the desirability of the complex, and he also knew the potential buyer faced an impending 180-day closing deadline.

The seller in Denver assumed the exchanger would sweeten the offer by a few million dollars as the deadline approached in order to avoid the alternative: no deal and a million dollar tax bill.

As negotiations proceeded, the exchanger realized that the seller was using the impending deadline to raise the price. With about a month left until the deadline, the exchanger decided the preferred deal was not satisfactory and moved on to complete two more transactions on its safety-net properties that totaled \$50 million.

While the exchanger did not acquire its first-choice property, having back-up properties assured eventual success. The deal ended with the trader holding \$70 million in triple-net leased properties occupied by credit tenants. "Later, they refinanced and pulled out the cash," MacDonald says. "At some point, they will re-deploy their equity back into the apartment market."

The Swap-and-Drop Strategy

The 1031 exchange strategy gets more complicated when business strategies involve partnerships. Investors cannot exchange partnership interests in the 1031 market, according to MacDonald. But the partnership itself can make an exchange. If a two-person partnership owned a single property worth \$10 million, the partnership could enter the exchange market and trade it for two properties worth \$10 million. Those properties could match the partners' interests and allow for an easy dissolution of the partnership in the future. This is a partnership exit strategy called "swap and drop."

Take the case of one private developer with a \$200 million portfolio of shopping centers owned by 26 partnerships. Early in 2002, the company's accountants retained Net Lease Capital to design an exit strategy for the partnerships — an exchange that presented enormous challenges given the number of parties involved.

The partnerships averaged four partners each, and Net Lease Capital was required to identify appropriate replacement properties for more than 100 partnership interests within a 45-day time period.

In addition, the company was looking for properties leased on a triple-net basis to single tenants with investment-grade credit of BBB- or higher, otherwise known as credit-tenant-lease or CTL properties. MacDonald says nearly \$1.5 billion enters the market via sale-leasebacks every year, and an equivalent amount through 1031 exchanges.

Because investors can identify and close on CTL properties so quickly, these properties are important tools for commercial 1031 exchangers. The properties' wide availability ensures that an exchanger can execute a strategy without leaving taxable capital gains on the table. Leftover proceeds can move swiftly into one or several CTL properties, which can then be refinanced, sold, exchanged again or kept. In short, CTL properties have become a kind of 1031-exchange lubricant by greasing the transactional wheels of the 1031 vehicle.

Louis Weller, a principal in the San Francisco office of Deloitte & Touche, LLP, notes that real estate owners began flocking to the 1031 exchange market in the late 1990s as real estate in general experienced radical appreciation. And the 1031 exchange continues to entice owners looking for tax breaks. "As more dollars flow through real estate transactions," he explains, "there are more capital gains for people to defer."