



Avoid Deadline Traps in 1031 Exchanges

Income property owners have wonderful opportunities to legally defer all gains taxes upon sale of their properties by using 1031 exchanges. By simply following the 1031 exchange rules every time you sell one or more properties and buy replacement properties, you can legally defer all gains taxes on the sales for the rest of your life (when you die your estate escapes all the capital gains taxes forever!). But the downside of 1031 exchanges is that there are strict tax rules to be followed and short deadlines to be met. Here's how to avoid the deadline traps in "exchanging".

How it works

Section 1031 of the IRS code lets you sell your property and buy a new property without paying any taxes as long as you follow some specific tax rules:

- Your mortgage on the successor property must have a mortgage at least as large as the one you paid off.
- You must identify your successor property within 45 days of selling your property.
- You must complete the purchase of your successor property within 180 days of selling your property.
- The successor property must be of a "like kind".
- A "qualified intermediary" must handle the exchange funds.

Sophisticated owners use 1031 exchanges all the time. What makes them especially attractive is that any depreciation you have taken on the sold property becomes part of the taxable gain, but it is recaptured at ordinary income rates. Deferring that can be a major benefit. The tax savings are very substantial and can be reinvested, rather than handed over to the IRS. When the gain is large, this tax deferral could double the cash you can reinvest in your next property.

The Traps

Trap 1 – Inability to identify/purchase successor property before sale

In real life, exchanging exposes the seller to a lot of time pressures and the risk of having the either the sell or buy side transactions fail to close. Unless you have the cash to buy the successor property without first selling – which can be a lot – you have to wait until your first property sells to commit to the purchase. In practice this usually means that you are at a big disadvantage in trying to buy a successor property: the owners don't want to gamble their sale on whether your sale closes. They may be doing a tax deferred exchange too. They'd rather have a sure sale.

Trap 2 – Not meeting deadline to identify successor property

Unfortunately, it's very common to see an exchanging seller racing through every income property in town, desperate to find a property to buy because they have just 45 days to identify it. Result: poor bargaining power and the likelihood of buying a building you would not normally want, just to avoid all those taxes.

Trap 3 – Not meeting deadline to purchase successor property

The rule is that you must complete the purchase of your successor property in 180 days after your property is sold. It's not unusual for commercial property escrows to last 4 months or more,

putting your deadline at risk. There's a temptation to be less diligent about problems you uncover during inspections of the property and books, just so your purchase date won't slip.

Beat the traps

As you can see, the disadvantage of the 1031 exchanges rules is that you, the seller, are under a very short deadline to identify and purchase your successor property. **But some types of successor properties can be identified and purchased well within these deadlines:**

Triple Net Leases

One standard solution has been to buy a triple net lease. In a 'triple net' the tenant is usually one corporation, sometimes very large, which assumes all the work of maintaining and operating the property. A lease to one fast food chain is a classic case. What could be better? A blue chip tenant with no work - it sounds too good to be true. Often it is, and these certainly are a fast solution to 1031 exchange deadlines. However, there are some serious risks to be aware of:

- The tenant is often a franchisee, not the 'blue chip' corporation itself. Their business may fail either at the location being leased or from unrelated problems in their personal lives or business.
- Even if the corporation is the actual tenant, they may decide to close the facility that the investor owns. A strong triple net tenant usually requires some walk-away provisions that let them abandon the lease. Or the tenant may be acquired or just go bankrupt. The division that is leasing the location you own can be closed down, leaving you no recourse to the parent.
- If the tenant business closes or fails, chances are the investor is left with a single or limited purpose property that is difficult or impossible to re-lease. The 'reliable' income may vanish. The value of the property may drop substantially, even to 'bare land' value.
- Rents are often held down by lease terms that favor the tenant, so that over time they trail the market. The stronger the tenant the better terms they will take. And the lower the return to you, the investor.
- Value and salability: the closer a triple net lease comes to its expiration, the lower the property's value becomes. The tenant may be about to leave and potential buyers don't want an un-rented property

Tenant-in-Common Ownership

A better solution may be to trade your original property, tax deferred, into a 'tenants-in-common' (TIC) ownership position in a property co-owned with other investors. Their interests are identical to yours, not opposite: to maximize return for a given level of risk. Investors can opt for a property with a safely diversified tenant roster, a building that stands to increase in value over time and be useful for decades. This can be the type of property you would like to have purchased if you had the time and cash to go in as a solo owner. You will be on title as an owner and the group ownership can add financial strength to the deal.

As a direct owner, you can 'exchange' out of the property fully tax-deferred, just as you could have as a solo owner/operator. You can even exchange back into a solo property if you or your heirs choose to.

All the evaluation of a TIC opportunity can be done even before you list your property for sale. When it comes time to close, you have an exchange property waiting.

How to evaluate a private Tenants-in-Common property

- ✓ Choose a private TIC with quality, central deal management that has a stake in the investment's success (unlike a property management company), one that relieves the investor of all the normal headaches of solo ownership while the owner has the security (and tax deferral benefits) of being an *owner with direct title to the property*, not just a partner.
- ✓ As in any other fully managed investment the key is top quality. Make sure you have principled, committed management, just as with the stocks you buy.
- ✓ Do your homework: there are lots of ways to check a private TIC management team's character, ability and performance, many not possible when buying securities, and it's far easier than doing due diligence on a building you might buy.
 - Verify actual past results
 - Check professional references
 - Speak with current investors
 - Review the investment analysis and plan
 - Visit the property
 - Meet the management personally and make a personal judgment

About Drake Property Group

Drake is a privately held real estate investment firm, offering TIC as well as other private investments. It is composed of several companies that specialize in the acquisition, development, repositioning, and management of California real property investments. The Drake/Aegis family of companies has completed over 50 development projects. Since the founding of Aegis Investments in 1974 by Peter F. Supino, Principal, the Drake/Aegis family of companies has distinguished itself as developers and investment advisors of both historic and contemporary properties.

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