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THE PRACTITIONER'S CORNER *David H. Freedman*

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The Practitioner's Corner

DAVID H. FREEDMAN*

The Growing Popularity of the Tax-Deferred Exchange

The tax-deferred exchange is one of the last wealth accumulation/tax sheltering vehicles available to the real estate investor. Because of a lack of awareness regarding the effectiveness of the transaction structure and its wealth-building power, this vehicle is one of the least utilized opportunities in the investment property marketplace. The purpose of this article is to explain the substantial benefits available to the investment property owner from a tax-deferred exchange, and how these benefits can be achieved.

Basically, a tax-deferred exchange defers the payment of capital gains taxes, which can amount to 31 percent (state and federal) of the taxable gain. The deferred taxes are, in essence, an interest-free loan from Uncle Sam, which can be invested in a replacement asset and leveraged, thereby generating much greater investment power for acquisition of a replacement property. As a result, the investor should be able to improve his investment portfolio and achieve greater returns.

Who Can Best Use a Tax-Deferred Exchange?

The tax-deferred exchange is primarily for property owners who would otherwise realize and have to pay taxes on gain on the conventional sale or disposition of the property in question. The exchange mechanism makes good business sense in the following situations:

1. Investors and operators who own apartment, office, shopping center, or other management-intensive properties, want to make a lifestyle change by acquiring investments that do not require management or heavy administrative responsibilities, and want to be relieved of personal guarantees of mortgage obligations.
2. Owners who are presented with "once in a lifetime" opportunities to sell property substantially above market.
3. Owners of appreciated undeveloped land who do not want to develop it themselves. The appreciation can be converted into spendable monthly income by exchanging for income-producing property.

* Principal of the Freedman Company, a Philadelphia-based real estate investment counseling firm that specializes in tax deferred exchange, and triple net lease purchases.

4. Tax-deferred exchanges have been used innovatively among creditors and debtors (instead of foreclosure or deed in lieu of foreclosure), so that the debtors are not subject to cancellation of debt income and the corresponding ordinary income tax liability.
5. Owners of property generating phantom income because cash flow is applied to heavy debt amortization.

Investor's Goal: Maximize Return and Accumulate Wealth

Typically, the investor wants to maximize after-tax yield on equity, maximize the ongoing equity build-up through principal reduction, maximize cash flow through rental increases, and maximize the residual value of the property by choosing a well-located asset. The investor's overall goal is maximum wealth accumulation over the projected holding period of the asset.

In a majority of cases, the most productive exchange transactions are structured by leveraging the available equity as greatly as the marketplace will allow. This basic principal (leverage) of investment real estate applies especially in the exchange situation, because the income tax shelter of the interest expense deduction and the depreciation deduction increases the after-tax return on equity. Both deductions will be greater because of the larger asset being acquired, with the same amount of equity. *The simple question is, can a tax-deferred exchange support the investors wealth accumulation goal?* The following illustration provides a few answers.

Example: Albert Apartment and Sam Smart are partners in a 150-unit garden apartment complex in Cheltenham, Pennsylvania. They are tired of the day-to-day management and physical plant responsibilities. Albert and Sam have personally guaranteed the debt on the complex and want to relieve themselves of the liability. They have owned the complex for many years and are planning to retire and move to Vermont. They want to sell their investment. However, Albert and Sam realize that if they sell the complex they will be liable for a capital gains tax of $665,415 which would leave them with net proceeds after debt repayment, brokerage commission, closing costs and transfer tax of approximately $530,000. They are presently receiving $99,331 in cash flow after-tax. They are painfully aware that they will not be able to invest their $530,000 in cash proceeds after sale and earn $99,331 after-tax (or 18.7 percent tax free). They have a significant problem. In addition, they are beginning to review their estate planning and do not want to leave a management-intensive asset to their children. Albert and Sam approached their commercial real estate counselor with the problem, and he advised them to begin planning for a tax-deferred exchange. He recommended that they roll over their $1,350,000 of equity into a 25-year triple-net-

leased investment grade property for $7,975,000 by assuming a $6,875,000 nonrecourse mortgage.

After the exchange, Albert and Sam will earn a greater after-tax return on their investment. They will be building up equity each year as their debt service amortizes principal ($110,000 year on average). Upon the expiration of the twenty-five year lease term, Albert and Sam will own the property free and clear. Assuming the property holds its value, they will have a $7,975,000 residual free and clear. Assuming a 3 percent appreciation rate, they will have a $16,700,000 residual free and clear.

The critical ingredient for Albert and Sam is that they are relieved of the management responsibility and debt liability. In addition, two other benefits result from the transaction:

- Upon Albert and Sam's demise, the property will pass to their heirs with a stepped-up basis, thereby eliminating the capital gains liability forever.
- As equity builds and when interest rates decrease, Albert and Sam may have the ability to refinance the property and pull out cash on a tax-free basis.

Financial Analysis Criteria

There is no point in doing a tax-deferred exchange unless the investors' position is improved. Because each investor sees value from a different perspective, there are many avenues to take to meet specific needs.

Essentially, the investor compares what he has to what he will be receiving in exchange. It is that simple. Typically, six elements of financial feasibility apply to tax deferred exchange transactions.

1. A comparison of the equity performance after tax.
2. A comparison of the physical quality of the assets (curb appeal), the quality of the credit, the quality of the location, and the perceived ability to refinance or liquidate the assets in the future.
3. A comparison of the projected residual value of the assets.
4. A review of the management effort required to produce the return.
5. A review of the personal financial liability of the investor (recourse or non-recourse debt).
6. Comparison to other investments, with emphasis on relative risk.

Triple Net Leases

A leveraged triple net lease property is one of the prudent vehicles being employed in the tax-deferred exchange marketplace. This type of property minimizes risk, maximizes after-tax return, and allows the investor to minimize personal liability and management responsibility. Of course, investors with greater appetite for risk may consider exchanging into raw land, development transactions, all types of income-producing real estate, negative cash flow

property with upside potential, and other variations of investment/ business real estate.

Pre-Planning—The Businessman's Job

Pre-planning is a necessary key to a successful tax deferred exchange. The businessman's job is to identify and obtain control (by way of an agreement) of the replacement property within the time required by the Internal Revenue Code. The technicalities can be handled by knowledgeable professionals. A proactive approach to finding suitable replacement property should begin as soon as the investor decides to put the existing property on the market. The prudent investor should attempt to arrange the exchange so that replacement property is acquired simultaneously, or shortly after transfer of the relinquished property. Obviously, as much flexibility as is possible should be built into the closing date. Simple economics dictate that funds available from the transfer of the existing property be put to work as quickly as possible. In addition, closing the purchase of the replacement property eliminates risk of failure to comply with the tax regulations. If there is a glitch in closing on the replacement property, then the time available can be used to fix the glitch or otherwise accommodate to the delay.

Common Misconceptions

Myth: Exchanges require two parties who want each other's properties.

Fact: Two-party exchanges are possible, but in reality, such two-party swaps rarely occur. Today, an exchange is accomplished with the help of a qualified intermediary and usually involves four principal parties: the exchangor (the taxpayer), a buyer for the relinquished property, a seller of the replacement property, and the intermediary. The parties often do not know each other, and their properties may even be located in different states.

Myth: The like-kind requirement limits an exchangor's options.

Fact: Property must be exchanged for "like-kind" property. But "like-kind" simply means that real property must be exchanged for real property. All real property is like-kind, so a fee simple interest may be exchanged for a tenancy-in-common interest; one property may be exchanged for more than one property. Vacant land may be exchanged for an office building, for example. However, real property may not be exchanged for personal property.

Myth: In an exchange, title on the exchanged properties must pass simultaneously.

Fact: The properties do not have to close at the same time. However, the replacement property must close within 180 days after closing on the relinquished property. When the two transactions do not close at the same time, the exchange is called a deferred exchange.

Conclusion

The tax-deferred exchange can be extremely attractive and is be-

coming quite popular with real estate owners who cannot afford the capital gains tax liability and who want to maximize their wealth. In the past, investors had been hesitant to enter into an exchange transaction because of perceived complexity. They failed to focus on the substantial benefits available. In 1991, the IRS published regulations that took the guesswork out of exchanges, and as a result, the marketplace is experiencing a steady growth of exchange transactions as more practitioners and investors experience the benefits.