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# OLD McDONALD EXCHANGES A FARM

The farmer defers taxes and invests in a triple-net leased property.

DAVID H. FREEDMAN

**O**wners of raw land sometimes become excited at the possibility of selling the land to home builders, especially when the homebuilder offers to pay all the costs of the approval process. However, many of these land sellers have a low cost basis in their acreage, and they eventually realize that the federal and state governments impose a significant tax on the capital gain generated by the proposed sale. The liability typically ranges from 28% to 40%, depending on the laws of the state that is the taxpayer's residence for tax purposes. When sellers realize that about one-third of their gain will be taxed away, they begin to have second thoughts about executing an agreement of sale. There is a general tax phobia in American culture that appears to be particularly strong in the land-selling community, especially among frugal farmers.

## THE OPPORTUNITY FOR TAX DEFERRAL

Brokers who encounter this syndrome are wise to be proactive (as opposed to reactive) on this issue, and to attempt to show the land seller how to defer the tax and to do the necessary homework for them. It is inevitable that the land seller will go to his or her accountant and attorney and learn about the tax-deferred exchange option. Because the tax-deferred exchange is not widely employed, few local accountants or attorneys are knowledgeable about its details. The buyer or buyer's representative is in the best position to present the facts and lay out the benefits of an exchange.

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Initially, most one-time land sellers focus on how much money they will receive from the sale after they have paid all costs and taxes. Only subsequently do they realize that the amount they receive must be invested. The exchange transaction combines the receipt of funds with a reinvestment in another piece of real estate, but does not generate an immediate taxable consequence.

Another option that the buyer or the broker can present to the seller who wants a lump sum is an exchange transaction that involves a (tax-free) refinancing sometime after the closing. (A lapse of one year between exchange and refinancing appears to meet the code requirement.) This gives the seller the best of both worlds.

The farmer who sells long-held family land is unlikely to want to become a property manager. Thus, many "land selling" exchangers are attracted to triple-net leased properties in which the lessees are long-term investment-grade tenants. Acquisition of a triple-net lease of property is similar to buying a bond with the added benefits of the tax shelter and appreciation attributes of real estate assets. Also, because the financing is usually self-amortizing, these triple-net leases build equity each year, making them one of the most overlooked wealth-building tools in real estate today. The benefits of exchanging into triple-net leased property may be substantial.

To illustrate the opportunity, we follow the decision process of an elderly farmer, Tom McDonald, as he works his way to the closing table and maximizes his opportunity. Old McDonald is planning to sell his 72-acre farm in Virginia to a home builder for \$4 million. Old McDonald paid \$100,000 for the farm 21 years



ago, and he can't believe it is worth \$4 million, or even that housing development has reached his rural area of Virginia. His dream has come true. He may be able to stop working 14 hours a day, and he will have enough money to send his grandchildren to college and retire comfortably.

Being a wise old businessman (after all, he accumulated all those animals and other assets on the farm), Old McDonald knows that state and federal capital gains tax will be due if he sells the farm. So, he contacts his accountant to find out how much the tax bill will be and how to set up the transaction so that he gets the most money from the sale.

His accountant advises Old McDonald that he will have a \$3.9 million capital gain because his basis is only \$100,000 and that the federal capital gains tax is presently 28% and the State of Virginia personal income tax is 5.75%. Therefore, Old McDonald's overall tax will be 33.75% of \$3.9 million, or \$1,316,250, and his after-tax proceeds will be \$2,683,750. Old McDonald is quite excited with the prospect of receiving so much money upon sale of the farm. He calls his friend and financial advisor and asks how much tax-free income he could earn from \$2,683,750 of fairly conservative investments. The advisor tells him that he can earn approximately 5.5% tax-free, about \$147,606 per year. After doing a quick calculation, McDonald realizes that the \$147,606 means a return of only 3.69% on the \$4 million sale price, and he begins to wonder if there isn't a better solution to his problem.

Fortunately, Old McDonald encounters his favorite real estate broker, Bill Broker. In response to McDonald's inquiry, Bill introduces the concept of a tax-deferred exchange under Section 1031 of the IRS Code and tells McDonald that the way to maximize after-tax cash flow and to build the most wealth for his family is to exchange the farm for another property, one that will produce income. Bill tells McDonald that he can exchange for an apartment house, a shopping center, an office building, a triple-net leased retail building, or any other type of income-producing real estate. He also advises McDonald to use the \$4 million as equity, as a down payment on (say) an asset purchase of \$16 million (75% loan to value) with a \$12 million mortgage. McDonald is intimidated.

## AVAILABILITY OF TRIPLE-NET LEASED PROPERTIES

Triple-net leased properties are available from developers and through brokers. Typically, they are priced to yield 8.75% to 11%, depending on the quality of the tenant's credit. Investment-grade triple-net leases (BBB or better) currently trade in the range from 8.75% to 9.75%. Prices tend to remain at a consistent level above 10-year government Treasuries and move on a daily basis.

The market for triple-net leases moves quite quickly. Trading is thin, and properties usually sell within a few weeks of being offered for sale.

The network of brokers who specialize in this area is relatively small. The brokers' ads may be found in the Friday section of the *Wall Street Journal* called "Real Estate Corner." Typically, the advertising brokers do not have exclusive listing agreements, so the buyer who contemplates negotiations should be careful to include the actual seller in any negotiation. The best way to reach the selling principal is to submit a letter of intent.

Tax-deferred exchange buyers should begin looking for replacement property early and try to identify at least five real possibilities at least two months before they close the portion of the transaction in which they relinquish their property. If the triple-net purchase and exchange transaction is to be successful, the exchanger/purchaser must be proactive and do a considerable amount of preplanning.

He tells Bill that he doesn't know anything about operating real estate, and he doesn't want the liability of a \$12 million mortgage.

### LEVERAGING A TRIPLE-NET LEASED PROPERTY

Bill encourages McDonald to look at the after-tax returns that would be generated by exchange of his farm for a triple-net leased property, a property type that requires no management or real estate knowledge. He reassures Old McDonald that the

**EXHIBIT 1 Pro Forma for Triple-Net Leased Investment Grade Retail Property**

Market Value of Property	\$16,000,000
Equity/Invested Capital	\$4,000,000
Debt	\$12,000,000
Loan to Value Ratio	75%
Net Operating Income	\$1,520,000
Debt Service	\$1,183,887
Cash Flow Before Tax (8.4%)	\$336,113
Total Deductions	\$1,378,024
Cash Flow After Tax (7.44%)	\$297,703
Ten-Year Average Yield on Net Equity	6.77%
Substitute Basis	\$12,100,000
Ten-Year Equity Build Up (Loan Amortization)	\$2,128,834
Ten-Year Average Overall Yield Before Tax	13.72%
Management	Passive
Debt Liability	Nonrecourse
Capital Improvements	Minimal or None
25-Year Residual With No Appreciation	\$16,000,000
25-Year Residual With 3% Appreciation	\$28,000,000

mortgage loan on a triple-net leased property would be nonrecourse because it is secured by the assignment of a lease agreement executed by an investment grade tenant. He mentions tenants like Home Depot, Walmart, Toys R Us, Winn Dixie, Pep Boys, Kmart, Melville Corporation, Lowes, and Walgreens.

The broker goes back to his office and runs a proforma on his computer. He calls McDonald and informs him that the exchange transaction would generate an average income after tax of \$270,886 in the next 10 years, and that during that period equity would build up by \$2,128,834 because of principal amortization. Old McDonald is quite pleased. He does some quick calculations and realizes that Bill's proposed transaction is equal to an annual tax-free cash yield of 6.77%. This is 83% better than selling the property and reinvesting the proceeds and,

in addition, McDonald would be building significant equity each year.

Old McDonald becomes suspicious; this must be too good to be true. He can earn \$147,606 annually after taxes by selling and reinvesting the proceeds or he can earn \$270,886 annually after taxes by exchanging, and during the first ten years he would build \$2,128,834 of equity. But he's really excited and hops in his truck and goes to visit his attorney.

The attorney confirms that under Section 1031 of the Code, this is all possible. He tells Old McDonald that the most important element in the transaction is the identification and purchase of the replacement property. Ideally, he should find a \$16 million property with a \$12 million mortgage. The attorney also suggests that the agreement of sale with the home builder should include a flexible settlement date so that the actual closing on both the relinquished farm and the replacement triple-net leased property would occur on the same day.

**A PROFORMA FOR A HYPOTHETICAL PROPERTY**

Bill Broker presents McDonald with a proforma (Exhibit 1) based on a \$16 million property with a \$12 million mortgage and some fancy graphics of McDonald's position before and after the exchange. Old McDonald can now see the benefits of exchanging his equity into a leveraged triple-net lease and formally retains Bill to go out to the marketplace and find at least three properties that fit their search parameters.

Within a month, Bill presents Old McDonald with a large list of possible properties, and he recommends three that appear to be most desirable. After all of the details of the closing have been worked out and the exchange is completed, Old McDonald announces his retirement and leaves town for a well earned two-week vacation. The only question that remains after settlement is—where will Old McDonald keep all of his animals? ■