



Question of the Month: Buying up for basis: What to do when opportunity knocks?

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This time of year, real estate owners are beginning to draft end-of-year statements for their properties and will consider their expected tax liability. For many owners, real estate is a long-term asset and may have been held far beyond its depreciable advantages. For these owners, rental income becomes another form of taxable income. For owners looking to maintain the substantial tax advantages real estate can provide, completing a 1031 Exchange and trading up to a higher priced property will allow them to increase their basis pool and generate higher after-tax returns.

We recently worked with a client who had a property that had been held for over 40 years and had been completely depreciated. While they had been holding the property for several years without the benefit of depreciation, a buyer offered a purchase price they couldn't refuse. With a \$10 million sale price, the return on the initial \$80,000 investment certainly compelled them to sell!! However, due to their complete lack of basis, the combination of long-term capital gains, and depreciation recapture tax, the sellers would have been looking at a near 40% tax liability against the sale price! After we presented all their options, they decided to start the process of a 1031 Exchange, rather than paying the rather hefty tax liability. With no debt in place, a standard 1031 would have been rather easy, simply needing to find an equivalent piece of property worth \$10 million and completing the transactions per the 1031 timeline. However, when they were to complete that transaction, their \$0 basis would have carried over, and once again, they would be investing in an asset class without taking full advantage of some of its most attractive qualities. So rather than simply purchasing an equivalent property, they wisely decided to buy up.

After scouring the market for multi-tenant properties, the exchangers still didn't feel confident in any larger properties. They had identified a \$7 million property that was close by and offered a considerable return, but still needed to place at least \$3 million in equity. It was at this point that the exchanger, upon our recommendation, turned to the concept of a purchase of a net-lease property to complete their exchange and buy up for basis.

Net-lease properties are a niche area of real estate, normally free-standing single-tenant properties, wherein the tenant, in addition to rent, agrees to pay for all taxes, insurance, and even all maintenance. This leaves the landlord (in this case, the exchanger) with no financial obligations and creates a secure stream of cash flows without variability. These tenants are often publicly-traded investment-grade corporations, which include corporate guarantees for the rent on the lease. This structure creates a bond-like return which is highly desirable to lend on from a variety of financial institutions, including most large banks, insurance companies, and community banks. Leverage on these properties is generally consistent up to 70% and is usually non-recourse to the borrower except for "bad boy" carve-outs. This type of financing, combined with the nature of net-leases, enables buyers to own a piece of real estate that requires minimal management and no on-site

responsibility. This allows for buyers to purchase properties anywhere in the country since they have no worries about personally doing or hiring management.

Our exchanger, utilized this type of NNN real estate and was able to source financing at 70%, combined with the \$3 of equity, the exchanger purchased 2 properties: one all-cash for \$7 million and one with \$3 million in equity and \$7 million in non-recourse debt, for a total of \$17 million. This purchase kept the buyer within the 200% rule of 1031 Exchanges and allowed them to diversify from 1 to 2 properties. More importantly, the increase of the real estate value owned increased by \$7 million, and so did the exchanger's basis. Now with a replenished basis pool of \$7 million, the exchanger will be able to not only enjoy a more diversified real estate portfolio, but will also be able to take advantage of tax benefits available to real estate.

By buying up and increasing the dollar value of real estate ownership through a type of property that requires little to no management, the exchanger increased cash flow, lowered ongoing tax liability, and were able to defer both capital gains and depreciation recapture to a later date....a beautiful utilization of smart real estate strategy.

Marilyn Kane is the president and Sean Shanahan is the senior financial analyst at Iridium Capital Group, New York, N.Y.

New York Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540