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Industry Leaders: Good advice on your 1031 Exchange: "Don't Pay Boot"

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Around this time of the year most people are completing their taxes and looking to the year ahead for tax planning. For owners of real estate, their plan might include selling a property. What comes next is often a complex transaction to minimize tax exposure and maintain an acceptable investment portfolio. Owners of commercial real estate have a unique advantage when selling real estate in the form of a 1031 Exchange. This IRS tax code allows the seller of commercial real estate to defer capital gains taxes on the sale of property as long as the seller identifies a replacement property within 45 days of closing and then closes on a replacement property within 180 days of that sale. Along with this requirement, exchangers must also replace an equal amount of debt from the relinquished property and replace an equal amount of equity. More equity and more debt can be added to a deal, however, any equity that is not replaced is subject to capital gains tax. That portion left on the table is called "boot."

Most real estate investors have a particular investment mindset when it comes to the type or location of their investment in real estate, whether it is located within driving distance or in a particular sector like retail or residential. However, after selling a property, investors looking to complete a 1031 Exchange are constricted to identifying properties within 45 days. During this time constriction, an exchanger may not be able to find a particular property they desire, or may not be able to find enough properties to fully qualify their 1031 Exchange. For example, an investor selling a $15 million apartment building with $5 million in debt, must find properties in which she can place $10 million in equity and $5 million in debt. If the investor is only able to locate a $10 million property and place $5 million in debt, the additional $5 million in "boot" will become taxable. Many investors have decided to pay boot rather than invest in properties they are unsure about or are outside of a region they can actively manage. This decision could have harsh tax consequences, there are options to mitigate those tax liabilities and at the same time create value to one's portfolio. Not uncovering enough replacement properties could also wind up with the seller paying a substantial tax bill. But, they don't need to leave their taxable real estate gains on the table! Investors who need to identify an additional property to fulfill either debt or equity requirements can feel safe and confident by adding a net-lease property to their real estate portfolio.

A net-lease property is one where the lease requires the tenant to not only pay rent, but also take responsibility to pay all real estate taxes and all insurance expenses, as well as all property maintenance costs. This type of property usually has a single tenant in a free-standing building, most often retail, but also as tenants in industrial buildings, and corporate offices. The tenant is ideally a credit-worthy public company, with a long-term lease of 10 or more years. The lease structure creates a self-managing real estate investment, with rent guaranteed by the tenant or parent company for a long period. This structure allows investors to purchase property in distant areas of the country since there is no need for active management of the physical property, as would be needed in a multi-tenant commercial or residential property.

Investors who are unable to fully qualify their 1031 Exchange and face paying a substantial tax penalty in boot should consider adding a net-lease property to their list of identified properties. For an investor who really wants to focus on a particular type of real estate and perhaps has felt rushed in finding that perfect investment vehicle, a net-lease replacement property can serve as a placeholder for a year, and later be sold into another exchange for the desired property after a year of holding. A one-year holding period is usually a good minimum time frame to hold onto a replacement property so there is no question that the exchange was done for investment purposes - an important component for IRS scrutiny. Due to their long-term leases and credit-worthiness of their tenants, single-tenant net-leased properties can also garner high leverage, allowing for an exchanger to utilize a net-lease property to fulfil their requirement to replace debt.

It might seem complicated to locate a credit-tenanted property, but there are brokerage firms and specialists who assist in this search. It might only be a call away to discuss one's real estate preference and properly identify properties, registering them with a qualified intermediary that sets the whole structure of savings on real estate gains into positive motion.

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