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Special Â§1031 exchange options for real estate investment trusts and portfolio owners

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Given the state of the real estate market, owners buying and selling property must be creative to achieve their goals and maximize investment returns. Essential to these activities is an understanding of the many structuring options available to owners under the "safe harbor" provisions of Â§1031. Many real estate investment trusts (REITs) and other large commercial property owners have the greatest ability to take advantage of these options given that they tend to have some cash on hand and own multiple properties. Set forth below are a number of ways in which the safe harbor provisions of the Internal Revenue Code may be used to benefit these owners.

1. Seize the moment to buy distressed or undervalued property in a reverse exchange. Many property owners are aware that Revenue Procedure 2000-37 permits safe harbor treatment for a reverse exchange where a replacement property is purchased before selling the relinquished property. However, many may not realize that if a reverse exchange is performed, the property owner may have up to 360 calendar days to complete all aspects of the exchange transaction. For example, suppose a REIT purchases the first replacement property for $100 million in a reverse exchange and within 180 calendar days thereafter sells a $150 million relinquished property. This completes the reverse exchange as to $100 million of value presuming the reverse exchange is properly structured. When the relinquished property is sold, $100 million of the exchange proceeds are deferred on the reverse portion of the exchange. A new forward delayed exchange is initiated however as to the $50 million balance of exchange proceeds. Thus, the property owner will have up to another 180 calendar days after the sale of the $150 million relinquished property to purchase replacement property worth roughly $50 million or more and achieve 100% deferral on all gain from the sale of the $150 million relinquished property. All together, this provides the property owner a total of up to 360 calendar days to complete all portions of the reverse and subsequent delayed exchange.

2. Take advantage of the fact that many sales are being delayed. Many large property owners are unable to close on the sale of property either due to the buyer's inability to obtain financing or the difficulties of finding a buyer for property in today's market. However, as set forth above, such owners may improve investment returns by taking advantage of the fact that it is a buyer's market and an excellent time to expand their portfolio. In such case, the owner may elect to establish a parking arrangement with a qualified intermediary prior to acquiring the new replacement property in order to be able to defer gain on the subsequent sale of a relinquished property. The owner may not know whether any particular property may or may not sell but, by establishing a reverse exchange before acquiring the replacement property, the owner gives themselves the opportunity to defer gain by such purchase if a subsequent sale is consummated. Attention to detail is required however.

Specifically, the owner must identify all of the properties they intend to relinquish in the exchange within 45 calendar days from the purchase of the replacement property, which means the owner must have some idea of what property or properties are most likely to sell and close within the required time parameters. In addition, the owner must ensure that the same "taxowner" owns both the relinquished and replacement property. This can be problematic as many REITs and large property owners hold title to properties in the name of entities which, while affiliated, may not be considered the same taxowner by the IRS.

3. Solve the buyer's financing problem to effect the sale. Given the problem today of procuring financing for the purchase of property, owners may find that that they have a far greater ability to move a property if they offer seller financing. While this may be true, if the seller intends to perform a tax deferred exchange in connection with such sale, the seller needs to be aware of special requirements which the seller must follow to achieve 100% deferral. First, if the seller simply sells property and takes back a note, the note will be taxed on the installment basis unless included in the exchange transaction. For example, if a seller sells a building for $50 million and takes back a note for $45 million, such $45 million will be taxed to the seller when the payments are made under the terms of the note. The only amount available for deferral is $5 million presuming an exchange is established prior to the sale. However, if the seller has the means of supplying the financing for the note, the seller has the opportunity to defer 100% of the capital gain taxes arising from the sale. This requires that the note and any mortgage be made payable to the qualified intermediary at closing. To obtain full deferral, the exchanger or a third party must purchase the note from the qualified intermediary during the 180-day exchange period. In the above example, this would mean that the seller would pay $45 million to the qualified intermediary in exchange for an assignment of the note. As a result, the qualified intermediary would thereafter hold roughly $50 million of exchange proceeds and the full $50 million would be used by the exchanger to buy replacement property within the exchange period, thereby fully deferring all capital gain. The seller ends up owning the note but does not owe tax on the principal payments when paid as the seller has effectively deferred such tax.

4. Use seller financing to finance the acquisition of replacement property rather than conventional financing. Seller financing can also be used to assist the seller in an exchange buy its replacement property if financing is needed to do so. In every exchange, to achieve full deferral, the exchanger must trade up or equally in value and spend the net equity derived from the sale of the relinquished property. If there is a mortgage on the relinquished property, such mortgage debt can be replaced when the replacement property is acquired either through conventional third party financing or through financing offered by the seller. Either source will allow the exchanger to treat that portion of the purchase prices as deferred.

5. Use Â§1031 to reallocate resources and maximize returns. Many REITs and large property owners today are in the process of streamlining the location and/or types of properties owned in an effort to decrease costs and increase efficiencies. This may mean that the owner wants to sell properties that are not within a certain property class or a certain geographic region and buy properties that all fall into one property class (industrial, retail, multifamily etc.) or that are located in one or more concentrated areas. Obviously, this decision might be based on one property class obtaining better returns than others or being perceived as better buys. Regardless, Â§1031 is ideally suited to achieve such goals as it permits owners to sell and buy multiple properties which can be in the same or different geographic regions and of the same or different asset classes. Thus, by buying

and selling properties in a tax deferred exchange, owners can reallocate their resources in a way that results in their owning properties that produce the best returns and most efficiencies for them.

6. Use Â§1031 proceeds to make needed capital improvements to replacement property. Often distressed property requires some sort of capital improvement to effect a turnaround. Owners buying distressed property as replacement property in a Â§1031 exchange can use proceeds from the sale of the relinquished property to make improvements to the replacement property and credit the cost of such improvements against the amount needed to be reinvested in the exchange, provided an improvement exchange is performed. Proceeding with an improvement exchange under such circumstances allows an owner to defer a greater share of the proceeds from the sale of the relinquished property than would otherwise be possible. The specific requirements that must be met to perform an improvement exchange are beyond the scope of this article. Owners interested in performing such an exchange strategy should consult with an expert well in advance of buying or selling investment property.

The above is a summary of just a few of the many benefits that may be derived by performing a Â§1031 tax deferred exchange with proper advance planning. Note that these and other benefits are often totally overlooked when expert advice is not obtained at an early stage in the transaction. As always, owners should consult their legal and tax advisors before proceeding with any transaction. Getting a Qualified Intermediary with the appropriate financial backing, expertise and experience involved early is frequently the difference between an excellent and a poor result from a tax standpoint and can have a significant impact on an owner's bottom line.

Pamela Michaels is an attorney and vice president of Asset Preservation,Â Inc., Manhattan, N.Y.