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1031 exchange investors can do better than just finding right-sized matches for their sales.

Bill Dwyer

In the current real estate market, most taxpayers faced with a capital gains tax issue are relieved simply to find replacement properties that match the size of their sales. A very fortunate few are able to locate properties in their preferred locales, with desirable tenants and quality leases. And even those fortunate few face the daunting task of negotiating reasonable prices with very confident sellers.

The decline of cap rates on traditional replacement properties in the past several years has fueled the growth of an industry niche that focuses on properties that trade more like bonds than like real estate. These single-tenant properties are underwritten with long-term, management-free leases and credit-rated tenants, usually the result of a sale-leaseback offering by the tenant at its corporate level.

A CMBS lender will evaluate these characteristics and provide financing not based on the location, but on the credit of the tenant, leading to a financing of the rent stream itself. The financing proceeds will reach levels approaching 85 to 90 percent loan-to-value in many cases.

The benefit to the taxpayer in this scenario is the opportunity to exchange into a credit-tenant property with a long-term "bond" lease and the ability to finance out most of the value of that property after acquisition. For institutional taxpayers, partnerships or individuals, this strategy offers flexibility and liquidity so that cash proceeds can be deployed into other initiatives (whether that might be additional real estate or a core business).

Unfortunately, the taxpayer is only able to recognize depreciation in the replacement property to the extent that there was depreciable basis in the relinquished property. Depreciable basis is used to offset ordinary income. Tax guidelines require the taxpayer to transfer the remaining depreciable life in the relinquished property to the replacement property. But even if the replacement property has a full depreciable life remaining, the taxpayer may only depreciate as much depreciable basis as remained in the relinquished property. And no basis transferred from the land component of the relinquished property is depreciable.

The highly leveraged credit-tenant property niche provides the taxpayer a compelling replacement solution in the event of a low-basis sale. To complete an exchange, the debt can be set to an appropriate level since the taxpayer must leave in the replacement property at least as much equity as was in the relinquished property. Subsequent to exchange, the taxpayer may leverage up, deriving up to around 90 percent of the value of the sale in tax-free refinancing proceeds. Debt service is covered by rent payments from the investment-grade corporate tenant.

Furthermore, certain property categories — industrial, hospitality, office and even some retail — offer component depreciation or cost segregation. Identifiable fixtures and equipment on the premises can be depreciated on an accelerated schedule of 5 or 7 years. While the 5- and 7-year assets do not count as real property (real estate) for the purposes of the 1031 exchange, they can nevertheless be acquired for as little as 10 cents on the dollar (in a highly leveraged property offering) and can provide dramatic after-tax benefit to the low-basis exchanger due to the accelerated depreciation, offsetting more taxable income sooner.

In some cases, the equity invested in the property can be recovered in 3 to 4 years through tax savings. For example, the taxpayer sells a $10 million property with no depreciable tax basis. For an extra $300,000, the taxpayer may acquire $3 million of fixtures and equipment to offset as much taxable income, deriving that much in savings in the 5, 7 or 15 years following the exchange. So a taxpayer in a $10 million 1031 exchange can acquire a $13 million dollar replacement property that has $3 million of fixtures and equipment and only end up leaving $1.3 million to $2 million of equity in the transaction, while deriving dramatic savings on income tax.

Assume that the $3 million of furniture and fixtures is 5-year depreciable property. Under MACRS (Modified Accelerated Cost Recovery System) mid-year depreciation guidelines, as opposed to straight-line depreciation method, the taxpayer would have $600,000 of depreciation each year for 5 years, or one fifth of the basis of the furniture and fixtures each year. (Other depreciation would be derived from the taxpayer's carry-in basis and remaining depreciable life). Using a 40 percent ordinary income tax rate, there would be $240,000 of tax savings recognized in the first year. And by the end of year six, the taxpayer would have recognized $1.2 million of tax savings, nearly a total recoup of the equity required going in.

If a property such as this is purchased independent of a 1031 exchange by a qualified real estate owner/operator, the real property component is also fully depreciable (on a 39-year schedule). All of the depreciation components can then be used to offset other real estate income.

Hospitality, industrial and distribution-center properties most commonly offer this accelerated depreciation, and, among these, hospitality is most likely to pack a large cost-segregation punch. Within the credit-tenant property niche of these sectors, properties often come with component cost-segregation schedules already in place, but for those without componentized depreciation, cost-segregation studies may be purchased.

Acquiring property with component depreciation has significant value for both the taxpayer in a 1031 exchange as well as the real estate owner/operator.

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