New Dogs Old Tricks

THE 1031 EXCHANGE

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The 1031 section of the tax code is a significant benefit to taxpayers. Tax-deferred exchanges have been a part of the Internal Revenue Code (IRC) since 1921. These exchanges are a notable portion of all real estate transactions in the United States. For real estate professionals estimating total just compensation[1] in expropriation, careful consideration and appropriate adjustments must be made when using exchange properties in the Sales Comparison Approach.

The 1031 Exchange, as it generally relates to real estate, is a tax vehicle by which a property owner can divest him/herself of an asset and acquire different property on a state and federal tax-free or gain-deferred basis. This must be done within very strict tax rules. A sale of property and subsequent purchase of a replacement property does not work, there must be an exchange.

The real estate professional should be aware that this type of transaction may not reflect market value (i.e., the price is above what may be considered typical for a specific property type). This is because of possible premiums being paid by exchange participants in order to avoid significant tax penalties.

Section 1031 of the Internal Revenue Code states that "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."

To participate in this program, owners must swap the property (relinquished property or down-leg) for other property of a similar or like kind (replacement property or up-leg). Like kind relates to the nature and character of the property, not the grade or quality. Therefore, real properties generally are of like kind, regardless of whether the properties are improved or unimproved, of the same type (apartment or retail), or if there are multiple replacement properties.

Swapping a property means a property owner must either first sell the relinquished asset and place the precedes within the control of a qualified intermediary or have the intermediary take and hold title to the replacement property before the taxpayer finds a buyer for his relinquished property (reverse exchange). The intermediary purchases the replacement or relinquished property and transfers title (direct deeding) to the exchange participant.

Under the code, participants must have held the relinquished property and hold the replacement property for a certain period of time to qualify. The replacement property must be of equal or greater value, which also includes the equity portion.

Because the relinquished property may be sold before the replacement property is found, undue pressure may be placed on the exchange participant to avoid capital gains tax. The maximum tax rate on net capital gain has been reduced for individual taxpayers for sales, exchanges, or conversions of assets after May 5, 2003. The lower rates (from 20% to 15% and from 10% to 5%) apply to assets held more than one year (and installment payments received after that date). Taxes are deferred, not eliminated. As an example, the tax benefits from a California exchange are set out as follows:

Federal capital gains tax = 15%
California state tax = 11%
Total tax deferral = 26%

Plus 25% Depreciation Recapture

The property owner must find a replacement property within 45 days of the relinquishment property's sale. This must be done in writing. The owner has only 135 days after the replacement properties are identified and a total of 180 days to actually purchase the replacement asset from the sale of the relinquishment asset. This is restricted to when the owner's taxes are due.

After 45 days have expired, it is not possible to close on any other property which was not identified in the 45-day letter. Failure to submit the 45-day letter causes the exchange agreement to terminate and the intermediary will disburse all unused funds in possession to the taxpayer.

When using exchange properties within the Sales Comparison Approach, consideration must be made in order to avoid over-valuing the subject property. Although many transactions are completed at market, studies have been conducted showing that above market prices have been paid, thus warranting an adjustment in the valuation process. Presently there is approximately $50 billion per year in exchange transactions.

One such study was done in the Phoenix apartment market in 2001 by Andres Holmes and Barrett A. Slade. They found that exchange participants paid approximately 7.9% above market for the replacement property.[2]

Because of the official approval by the Internal Revenue Service, reverse exchanges may ultimately become the favored method for 1031 exchanges. As the replacement property has already been acquired, the remaining risk for selling the relinquishment property is notably mitigated. Although the author of this article is not aware of significant studies of reverse exchanges and adverse affects on price; the inverse of the Holmes and Slade research may prove true, as some participants may not readily trade their relinquishment assets within the IRS safe-harbor guidelines, which may cause them to sell at a discount.

A recent development under the 1031 tax code is the Tenant-in-Common (TIC) industry. TICs are legal structures that defer capital gains tax for two or more owners sharing the ownership of a real estate asset. They are not a partnership but are individual ownership, and can be sold like other fractional interests. Like the typical exchange participant, investors are seeking to re-invest the relinquishment property sales proceeds by using 1031 to defer their taxes.

The IRS has clarified in Revenue Procedure (Rev Proc) 2002-22, issued in 2002, which considers the condition under which the IRS may consider the purchase of a TIC interest an investment in real estate. According to Rev Proc 2002-22, "The central characteristic of a tenancy in common...is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants...the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property."

The TIC therefore receives a deed at closing and undivided percentage interest in the entire property. TIC participants receive 100% of the cash flow and 100% of the profit proportionate to their ownership percentage. Investors pool their capital with other investors to own properties that are of higher quality, in superior locations and tend to produce higher returns on equity then they could generally own. Ownership interests (percentages) of each TIC may be equal or unequal. Benefits and obligations are shared by TICs in proportion to percentage interest in the property as specified in the Co-tenancy Agreement. This governs the rights and obligations of the TICs.

This financial instrument mitigates the risk of finding and closing the replacement property. Presently only 2% of exchange transactions are TIC programs. It is anticipated that in less than five years, 10% will be TICs. The affect on market value, if any, like the reverse exchange, likely remains unknown from a statistical level of relevancy as of the publishing of this article.[3]

In conclusion

...appraisers must use caution when considering these replacement property transactions for use as comparables in the sales comparison approach. Specifically, appraisers must eliminate these sales from the list of possible comparable sales or they must perform a thorough investigation of the transaction to reliably estimate the conditions of sale adjustment.[4]

REFERENCES

[1]United States Constitution, Bill of Rights, Amendment V: No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a grand jury, except in cases arising in the land or naval forces, or in the militia, when in actual service in time of war or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

[2]Andrew Holmes and Barrett A. Slade, "Do Tax-Deferred Exchanges Impact Purchase Price? Evidence from the Phoenix Apartment Market," Real Estate Economics 29, no. 2 (1998): 567-588.

[3]Orell C. Anderson, "Real Estate Market Trends Seminar," The Southern California Chapter of the Appraisal Institute, January (2004): Personal discussions with key market participants.

[4]Barrett A. Slade, PhD, "Conditions of Sale Adjustment: The Influence of Buyer and Seller Motivations on Sale Price," The Appraisal Journal, Winter (2004): 50-56.