The Optimal Exchange Strategy – Transaction Timing Control

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This is the first in a series of brief notes on the subject of optimizing 1031 exchanges in today's CRE marketplace. It is addressed to real estate owners and investors as well as the brokerage, legal and accounting communities that assist them. Most experienced CRE professionals have some experience with 1031 exchanges but many do not appreciate the full range of sound options that are available. In challenging market conditions, it makes sense to understand and use all of the available tools to help ensure success and reduce risk.

This particular note discusses optimizing 1031 transactions in terms of the control of buy/sell timing and managing the 1031 deadlines. Subsequent notes will describe the integration of 1031 with lending strategies, cost segregation strategies and several effective advanced strategies for increasing tax deferment potential in today's CRE world. Our thoughts are informed by information gathered in hundreds of discussions with investors and CRE professionals and by conducting the resulting 1031 transactions all over the country in recent months.

The term "optimization" means getting maximal benefit – strategically and financially - from an exchange for *you*, the person or entity doing the exchange. This implies that the form of the exchange used (forward or reverse) is determined only by what is best for you and not what is best for your 1031 Accommodator. As simple as this may seem, it is an approach that is usually not volunteered or encouraged by QIs.

In today's CRE market, there is a consistent and sometimes overwhelming shortage of high-quality property for sale. The market is strongly aligned in favor of sellers. This shortage is perhaps most acute in the segment consisting of investment-grade, income-producing assets. The primary and secondary regional markets for multi-family housing and triple-net properties, for example, are intensively competitive and significant cap-rate compression is normal in these locations. With the likely continuation of low interest rates for (near-) cash investments and the attractive arbitrage between CAP rates and the cost of leverage, this type of competition and pressure is not expected to abate in the near-term.

If you are contemplating a 1031 exchange in order to achieve an investment objective, this market - favoring sellers to an unusual extent - must be navigated carefully in order to achieve your investment goals *and* keep your capital continuously deployed, that is, defer the tax on the gain from the sale. Hence, the first aspect of optimizing a 1031 exchange that I describe is "transaction control" and relates to the *timing* of the acquisition of the Replacement (or "New") Property in an exchange.

Here is the danger: if you start a “forward” or “delayed” 1031 exchange, you'll likely be able to sell what you are planning to exchange with relative ease. If not, fire your Broker and get a new one. But then, having sold your Relinquished (or "Old") Property, you now become a *buyer* in a seller's market. Furthermore, you may very well be a *desperate buyer* because you have 1031 exchange deadlines to satisfy! The 1031 statutes require you to identify potential New Properties within 45 days of the close of the Old Property sale and to acquire one or more of the identified properties within 180 days. If you are unable to identify any properties within 45 days, your exchange has failed and the QI is *required by statute* to return your exchange proceeds immediately. It’s “game over” and you are paying the tax. If you identify one or more candidate New Properties and then are unable to acquire any of them, your exchange will fail and the QI is *required by statute* to keep your exchange proceeds until the 180-day exchange period has expired. Again, it’s “game over” and you are paying the tax but, adding insult to injury, the QI keeps your cash for 6 months! Yes, even if you decide not to exchange on the 50th day, for example, if you have identified potential New Property, the QI *must* keep your money for the full 180 days.

Of course, if you are able to successfully identify and acquire within the 1031 deadlines, then the forward exchange will work and the desired results will be achieved. However, in the current market, simply finding some number of reasonable potential New Properties can be a huge challenge. And, it does happen, with scary frequency, that an investor identifies three properties and is unable to acquire any of them, perhaps because each was lost to a competing bidder or to a foot-dragging lender or...whatever. The risk of not being able to complete an exchange once the Old Property has been sold is much higher in today’s market than at any time in recent memory.

Enter the *reverse* exchange. This form of 1031 exchange is accomplished by acquiring the New Property *first* and selling the Old Property within 180 days of the purchase. The role of the QI is to hold title to one of the properties in the exchange, rather than to hold the cash proceeds of the Old Property sale, as in a forward exchange.

It is very important to understand that there is also a 45-day identification requirement in a reverse exchange but it applies to properties that you *already own*, that is, potential Old Property. In essence, the 45-day ID deadline in a reverse is satisfied by deciding which of the assets you will try to sell. And, once you have taken the time to find and acquire a New Property that satisfies your investment objectives, you now become a seller in a seller’s market! This can be profoundly different because you will be the beneficiary of the seller’s market rather than one of its “victims” - trying to buy assets for which the competition is intense. You should determine for yourself how much risk to your overall strategy is mitigated by taking the time to acquire what you need or want and then be able to identify and sell candidate Old Properties from among those in your portfolio. Many, many CRE investors have come to realize that this is better way.

However, there are two objections that come up frequently. First, acquiring the New Property first means that the funds from the sale of the Old Property are not yet available and other money must be found to make the acquisition. Second, the fees for doing a reverse are said to be high and the complexity difficult to deal with.

If you have no other way to make the acquisition first, then your only option is a forward exchange and the rest of this discussion may be irrelevant.

A much more sophisticated way to look at both of these issues is to look at the *cost of exchanging.* To get an idea of the real cost of exchanging, consider the following factors. First, in a forward exchange, once the Old Property is sold, you receive no financial benefits from it at all; if the Old Property was income-producing, then the rent you used to collect goes to zero and there is no further benefit from depreciation or appreciation of the asset in the current market. Further, the cash proceeds of the Old Property sale will be held by a QI, with the financial benefits of that cash being taken by the QI as its revenue. You get (almost) nothing.

By contrast, and this is one aspect of reverse exchanges that is often not well understood, for reverses involving income-producing properties, as the exchanger, you receive the rental income (and obligations) from *both* Old *and* New Properties during the exchange period. For example, if your Old Property generates $5,000/month in rent and you are exchanging into a New Property that generates $10,000/month, then during the exchange period (up to 180 days), you are receiving rent totaling $15,000/month! The fact is that a dual rent stream almost always offsets both the fees for the reverse exchange and the cost of the money need to make the acquisition prior to the sale. The arbitrage between CAP rates and the cost of money is nearly always favorable, otherwise we would not be in a seller's market! Furthermore, depreciation deductions can be taken for the property not held by the QI during the reverse exchange period and there may be significant appreciation in the value of both properties during the exchange period.

If it is possible to buy first, there are several other things to keep in mind: 1) cash that you supply to make the acquisition will usually be replaced immediately after the sale of the Old Property, which lowers the cost of money advanced to make the purchase, 2) contemporary reverse exchanges are often very well integrated with CRE lending processes, resulting in easier closings and in debt that is long-term and need not be mezzanine or bridge financing and 3) committed QIs are now deploying state-of-the-art reverse exchange processes that subsume complexity for the exchanger, allow significant flexibility for pesky problems like environmental analyses and implement asset security devices that mitigate virtually any risk of failure.

The bottom line for many CRE investors is that in a forward exchange, significant income is being "left on the table" with no real compensating benefits while in a reverse exchange, the ROI on the invested capital and other financial benefits can be substantial and attractive while the complexity has plummeted. This is one of the facts about reverse exchanges that many QIs either do not understand or prefer to downplay. In a subsequent note, I'll provide a more detailed description of exchange ROI, the overall cost of exchanging and how these calculations can be done using all the relevant factors.

Lastly, if you can’t sell or decide not to sell your Old Property after starting a reverse, you simply keep both properties, meaning that you have no tax to pay because you haven’t sold anything. That is usually a more attractive outcome than that of a failed forward exchange. In addition, it is possible to extend a standard reverse exchange beyond 180 days should there be a delay in selling the Old Property. It’s neither simple nor cheap to do so but it is possible and may make sense if the problem is big enough. Once a forward exchange has started, it is not possible to extend either deadline unless a natural disaster occurs.

To summarize, the risks of using a forward exchange in today’s market are that 1) your exchange fails because you cannot identify and/or acquire New Property in time, 2) your equity is held by a QI for up to 180 days and generates no income for you and 3) if the exchange fails, you have to pay the tax on the gain from the Old Property sale and have no subsequent exchange options for that property. By contrast, using a reverse exchange means that 1) you accomplish your investment objective first and then act as a seller in a seller’s market, 2) during a reverse, your capital is at work for you rather than the QI, potentially generating income and other financial benefits during the exchange period that you would otherwise not receive and 3) if the reverse fails, the two options are a) keep both properties and have no tax obligation because no Old Property has sold or b) extend the reverse beyond 180 days if the financial parameters justify the incremental cost and effort.

All things considered, the reverse exchange may be the informed CRE investors “secret weapon” for achieving advantages, both strategically and economically, in today’s challenging CRE market.