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PROPERTY REPORT

New 1031 Deal Takes High Prices Into Account

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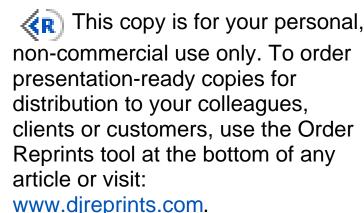
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A New York-based real-estate brokerage company has come up with a 1031-exchange plan that gives an investor the ability to sell a property in today's hot seller's market and park the gains on the sale until the market shifts to a more favorable environment for buyers, all while minimizing the risk of losing those gains, generating a market-rate return and deferring taxes.

Sound too good to be true? That depends on the Internal Revenue Service.

Using a real-estate 1031 exchange, also known as a like-kind exchange, investors can sell a property and defer the capital-gains taxes by buying another property of equal or greater value. To qualify for the tax-deferral under section 1031 of the Internal Revenue Code, the investor must identify a replacement property within 45 days of the sale and purchase it within 180 days. But with competition for real-estate assets boosting prices in many markets, investors increasingly are not only concerned about finding a replacement property, but about overpaying for the property. They are also finding that the value of the property they are looking to purchase far exceeds that of the property they are selling as part of the exchange.

Kenneth Zakin, a senior managing director at Newmark & Co. Real Estate Inc., says the 1031-exchange structure the company devised for a client may be particularly attractive to investors "who want to sell at the top of the market, but don't want to buy at the top of the market." He says the structure was created in consultation with a law firm and one of the Big Four accounting firms to help ensure it passes muster with the IRS. The parties don't want to be identified, he adds.

Mr. Zakin says Newmark's client sold a building at "a significant profit" and wanted to protect its proceeds, but also wanted the capital available in three to four years. Newmark matched that client with another client that owned a diverse portfolio of single-tenant net-lease properties, in which the tenants pay property taxes and maintenance expenses. The client acquired the portfolio from the owner, who then leased the properties from the buyer at a discount to what the properties generate in rent. That enabled the former owner to continue to collect rent from the tenants in the properties.

The terms allow the buyer to sell the portfolio back to the seller within four years at a fair market price to be determined by an appraiser, with a floor -- based on the portfolio's original price less depreciation -- and a ceiling -- based on a prenegotiated cap. The buyer picked up the costs of the transaction.

But some observers aren't convinced such a deal will qualify for the deferred taxes under IRS rules. "People have tried to figure out how to park 1031 proceeds like this in the past," says Louis Weller, a

principal at Deloitte & Touche LLP's national real-estate tax services group in San Francisco, who wasn't involved in the transaction. But "no one wants to make these into formal programs," Mr. Weller says, because it could make the client an IRS target.

Mr. Weller says that a seller looking to do a 1031 exchange must keep in mind that the IRS requires replacement assets be "held for trade or business or investment," and prohibits exchanges in which "it is clear that a replacement asset is purchased with an intent to resell it within a short period of time."

The IRS, through a spokeswoman, said it doesn't comment on specific 1031 exchange structures.

There's no stated requirement regarding how long an investor must hold property, but "at least a year is a good rule of thumb," says Andrew Short, a partner that specializes in tax law at Paul, Hastings, Janofsky & Walker LLP. Still, with puts and calls in place, "that could arguably impact the taxpayer's intent," says Mr. Short, who notes that he wasn't involved in advising Newmark. "That would be a tough argument for the IRS to win, but one that someone should be concerned about."

Mike Frankel, national director of real-estate tax services with Ernst & Young LLP, adds: "What makes a tax consultant comfortable [with any 1031 exchange] is the risk. ... The less risk, the weaker the tax position." Mr. Frankel wasn't involved in the Newmark deal.

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