COMMERCIAL INVESTMENT
Real Estate
The Magazine of the CCIM Institute

Sep.Oct.04

Tax Watch

The Home Advantage

This 1031 exchange tactic offers new investment opportunities in growing markets.
By Paul Lindsey, CCIM, CRE

Paul Lindsey, CCIM, CRE, is president of Coldwell Banker Success Southwest in Tucson, Ariz. Contact him at (520) 352-5201 or plindsey@cbsuccess.com.

Any broker who has worked with Internal Revenue Code Section 1031 tax-deferred exchange clients knows the frustration of trying to find a replacement property at the right price with the correct amount of debt before the 180-day window expires. For investors in growth areas with healthy residential development, exchanging into a portfolio of new homes can be an ideal solution.

Investor Benefits

Following are 10 reasons why investors should consider exchanging into a portfolio of new homes:

1. Numerous Choices. In many growing communities, home builders have been holding land in inventory for years waiting for the right time to develop it. Most have many different subdivisions in various stages of construction and generally are willing to sell homes from within several of the subdivisions at one time, which allows them to close out projects and take their sales staff to newer sites.

2. Right Price. Home builders can hit exchangers' price points right on the dollar by adding upgrades to certain units, and the more homes involved in the sale, the easier it is to reach the target. Such price manipulation is almost impossible with commercial properties.

3. Right Debt. Home builders also can hit debt requirements by spreading debt among the homes however the exchanger desires. Many large construction companies have financing arms and may give breaks for multiple loans, eliminating the need to deal with commercial lenders.

4. Available Warranties. New homes and their appliances are usually under warranty for several years, so exchangers' upkeep costs are minimal for the first few years. Warranties also eliminate the need for time-consuming and costly inspections.

5. Ample Tenants. Healthy rental pools, especially for new homes, usually exist in growth communities. Investors can work with property management companies to determine the market rental prices, models, and neighborhoods that attract tenants.

6. Partial Sales. If equity is needed, exchangers easily can sell one or two homes out of their portfolios. The gain on that fractional sale is taxable, but the tax will be much lower than it would be for an entire portfolio sale.

7. Safer Value Growth. New home appreciation usually outpaces resale home appreciation, so exchangers benefit from a quick jump in portfolio value during the first few years. In addition, the new-home values will continue to appreciate along with the resale home market, which is usually reliable compared with commercial property segments. Since appreciation is a function of more factors than just increasing rents, returns can be higher and risk is lower. Also, home rental agreements are typically one year, so investors easily can keep their rates on pace with the local market.

8. Less Down Time. Replacing new-home tenants is usually much quicker and less costly than retenanting commercial properties. Advertising, marketing, and commission costs are low, and the costs to prepare units for new tenants are minimal compared with office or retail buildings' build-out expenses and tenant incentives.

9. Risk Diversification. Investors can diversify their portfolios by owning homes at several price levels in different parts of a community. With commercial properties, owners are at the whim of local market forces that can adversely affect the capital invested.

10. Return Manipulation. Investors can determine their returns to a great degree by deciding how much debt to place on certain homes or by increasing the size of their portfolios.

Helpful Hints

When assisting clients in exchanging into portfolios of homes, commercial real estate professionals must keep in mind some caveats.

Be certain the portfolio contains homes to be built. The building time usually is about 100 to 120 days, which easily fits into the 1031 window. With new-home appreciation outpacing most other properties', an exchanger's investment may increase 5 percent to 8 percent before even taking possession. Exchange tax rules mandate that homes must be substantially complete, so investors can close even if landscaping or last-minute touches aren't finished.

When selecting a builder, pick one that consistently has several communities from which to choose. Investors stand a better chance of negotiating good prices and loans if they purchase all of the homes from the same developer. However, a portfolio's geographic and price point diversities are key elements in reducing risk; sometimes it may be beneficial to work with several builders to achieve the right mix. In such cases, builders should know the other parties involved, as the competition will work to investors' benefit.

Enlist a good residential broker to find properties and negotiate the details with the builder. Residential brokers will know what areas are likely to retain their value, as well as what amenities attract the highest-quality tenants at the highest rents. Brokers should prearrange referral fees if their clients plan to use the same residential broker to sell the homes in the future.

Be certain the builder understands that this is a portfolio sale and agrees to the same commission treatment as in a single-home sale. An ideal setup is for the residential broker to represent the builder exclusively and the commercial real estate professional to represent the exchanger exclusively. Otherwise, be sure that dual agency is permitted in the market and disclose the agency relationships in writing.

It's also a good idea to hire a reputable property management company to market the properties, screen for good tenants, and manage the properties in a manner that maintains their value. Be sure to include leasing and management fees in the pro forma, as well as referral fees.

The property manager should start marketing the homes before they are finished. A brand-new home is very appealing to tenants, and they may be willing to pay higher rents as a result. The leases should be treated like any other rentals .. first and last months' rent plus a security deposit.

The residential broker and the property manager should be involved in determining the homes' landscaping, color schemes, appliance mix, and amenity packages, as they usually have a better sense of what appeals to residential tenants than commercial real estate pros. Thus, the builder will know how to finish the homes and price them accordingly.

Other professionals to enlist include an accountant, a tax specialist, and an experienced facilitator. Be sure to take the time to explain this program and ensure these advisers are comfortable with the transaction reporting and allocations processes.