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TRIPLE NET OR TAX?  
WHY THROW YOUR MONEY AWAY?

MARKET RESEARCH REPORT

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*What is a Section 1031 Exchange?*

Gains from the sale or exchange of property are generally a recognition event (i.e. taxable) for federal tax purposes. §1001(c)<sup>1</sup>. However, under §1031, real estate owners who sell their investment, rental, business or vacation real estate (the “Relinquished Property”), and reinvest the net proceeds in other “like kind” property (the “Replacement Property”) are able to defer the capital gains tax imposed on the sale of the Relinquished Property. Section 1031(a)(1) provides:

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.

The effect of the 1031 exchange is to categorize the exchange as a continuation of a proprietary interest and thereby abate the mandated recognition requirements of §1001(c). Section 1031

allows real estate owners to structure the exchange in one of two ways.

The first and more traditional method, the forward exchange, commences upon the closing of the Relinquished Property (the “Exchange Date”). Within 45 days of the Exchange Date, the seller must designate candidate properties and properly identify them to the IRS. Sellers must then close on the Replacement Property, thereby completing the exchange, within 180 calendar days of the Exchange Date. A seller may target: (i) up to three properties regardless of value; or (ii) a group of properties with a combined value that does not exceed 200 percent of the fair market value of the Relinquished Property at the time of the sale.

Secondly, if a seller is unable to sell the Relinquished Property prior to the closing of the Replacement Property, the seller may engage in what is called a reverse exchange. Generally, in a reverse exchange, the Replacement Property is purchased by an exchange facilitator at the direction of the Seller. The exchange facilitator then holds title to the property in escrow. Upon the sale of the Relinquished Property, which

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<sup>1</sup> Internal Revenue Code Section 1001(c). All future references to code sections refer to the Internal Revenue Code unless otherwise stated.

must be completed within 180 calendar days as well, the exchange facilitator then deeds the Replacement Property to the seller and the exchange is completed.

*What are the tax savings and aspects to a 1031 Exchange?*

Section 1031 permits taxpayers to defer tax not avoid it. Therefore, the taxpayer, subject to the exceptions as illustrated in the examples below, receives a carryover basis in the Replacement Property equal to the adjusted basis of the Relinquished Property. This ability to defer taxation is a main reason that like kind exchanges are a powerful investment technique.

While taxpayers may be required to recognize some gain as a result of the exchange, the gain recognized will most likely be less than that owed if the taxpayer chose to dispose of the property without the tax deferral benefits of §1031.

For example, Jerry owns a parcel of real estate with an adjusted basis of \$45,000.00 and a fair market value (“FMV”) of \$75,000.00. If Jerry simply wants to dispose of the property, he would recognize and realize gain of \$30,000.00. Accordingly, Jerry would then owe \$4,500.00 in tax upon the disposition of the parcel.<sup>2</sup>

Instead, now assume that Jerry currently owns the same real estate parcel but it is encumbered by

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<sup>2</sup> Based on the assumption that the property has been held for over one (1) year and qualified as a I.R.C. §1221 capital asset used in either the taxpayers trade or business or for investment purposes. Also, any depreciation recapture that may be required to be recognized has been ignored.

\$25,000.00 of debt and he seeks to exchange his parcel for one owned by Kramer, instead of disposing of it. Kramer’s parcel has a FMV of \$95,000, an adjusted basis of \$60,000.00 and is encumbered with debt of \$55,000.00. In the exchange, Kramer will also pay Jerry \$10,000.00 in cash. For the purposes of this example, it is assumed that Jerry will exchange his parcel for Kramer’s and visa versa.

In this transaction and under §1001, Jerry has gain realized in the amount of \$30,000.00.<sup>3</sup> Yet, because the nonrecognition provisions of §1031 mandate nonrecognition rather than making it elective, Jerry may not recognize the \$30,000.00 in gain. Unfortunately for Jerry, however, the exchange is not tax-free. Under §1031, taxpayers are required to recognize gain to the extent of any “boot” received. Boot is defined as any cash or other property received in the exchange. In this example, Jerry received \$10,000.00 in cash. The IRS therefore requires that he recognize gain in the amount of the boot, \$10,000.00.

While the boot recognition rules do expose Jerry to some tax liability as a result of the exchange, that detriment is not without some benefit. The recognition of income has forced a modification of some of the tax attributes associated with the real estate, namely the adjusted basis. After the exchange, Jerry would have increased his adjusted basis from \$45,000.00 in

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<sup>3</sup> Gain Realized equals the FMV of the property exchanged minus the adjusted basis in such property. X exchanged land worth \$74,000.00 with and adjusted basis of \$45,000.00.

the Relinquished Property to \$75,000.00 in the Replacement Property.<sup>4</sup>

By complying with the requirements of §1031, Jerry has deferred federal capital gains tax, avoided the taxation of depreciation recapture and increased his adjusted basis in the asset in addition to receiving the desired Replacement Property.

### *Selecting a Replacement Property*

Selecting Replacement Properties is not as easy as one would suspect. While investors have a myriad of options available to them, including but not limited to vacant land, apartment buildings or industrial property, it may be difficult for the investor to choose among the various options. The Boulder Group believes that the choice is actually very simple. Purchasing net leased credit tenant properties is the simple and obvious choice. Net leased credit tenant properties are essentially equivalent to being a corporate bond and therefore are an extremely secure, leverageable and liquid investment that provides a management-free cash flow.

Upon trading into a triple net leased property, there is no management required. The landlord's sole duty is to deposit the rent check every month. Net leases typically obligate the tenant to pay expenses including real estate taxes, insurance and building maintenance.

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<sup>4</sup> The adjusted basis in the Replacement Property is computed by adding the Gain Recognized (\$10,000.00) and Debt Assumed (\$55,000.00) to the adjusted basis of the Relinquished Property (\$45,000.00) and then subtracting out the Cash Received (\$10,000.00) and the Debt Relieved (\$25,000.00).

Income from investment grade tenants generate returns above those of corporate bonds. Most net leases range in duration for ten to twenty five years with the average lease being contracted for twenty years. In addition to the increased returns, these lengthy durations eliminate the tenant turnover that is commonly associated with other real estate investments such as apartment or industrial buildings.

Due to this tenant security, net leased properties have a greater leveragability than most other real estate investments. Some net leased properties can secure financing with as high as a 90% to 95% loan to value ratio.

The lack of required active management and the secure nature of the lease afford for the easy and frequent transferability of credit tenant properties. Such liquidity is rare in the real estate market.

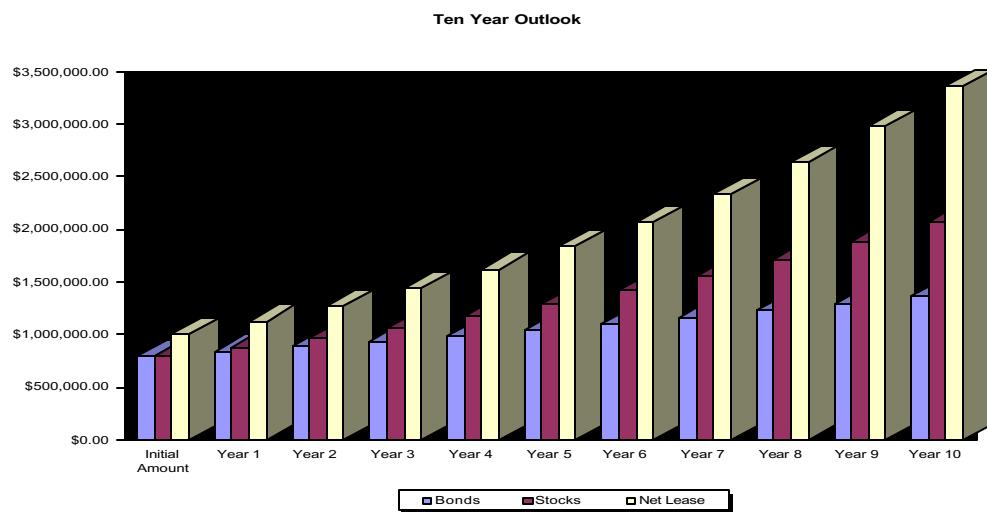
While benefits of net leased properties, over other forms of real estate investments, are clear, those benefits are increased when combined with the tax deferral regime of §1031.

### *Net Leases v. More Traditional Investments*

As stated above, net leased investments generate greater returns than those of corporate bonds. Surprisingly, credit tenant net leased investments actually provide for greater returns than the historical average of most stocks and bonds as well.

According to The Vanguard Group, stocks have a historical return equal to 10% of the initial investment whereas bonds have historically returned 5.5% annually. Based on a standard Walgreen's triple net lease, assuming that the property was financed on a ten year term and amortized over 30 years, net lease landlords can expect a 12.9% average annual rate of return.<sup>5</sup> This analysis additionally omits any appreciation in the value of the real property.

The following table illustrates the expected returns from a net lease investment over a ten year period based on the above referenced historical rates of return:<sup>6</sup>



While the numbers speak for themselves, it should be clear that investment in the net lease sector is far superior to that of stocks or bonds. The returns for net leases are greater than 150% of those for stocks and slightly less than 250% of those for bonds.

<sup>5</sup> This projected rate of return assumes a cash on cash return and principal paydown

<sup>6</sup> The above chart is based on a \$1,000,000.00 income stream from the sale of the Relinquished Property and 20% depreciation recapture for the reinvestment into stocks and bonds.

While the rates of return for net leased properties may be less than those for other real estate investments, such as apartment and industrial buildings, inherent with those properties is the burden of management, tenant turnover, a volatile market and less liquidity.

Comparing active versus passive investments does not generate comparable returns or analysis. Additionally, more active real estate investments carry with them risk that is not associated with the passive net lease counterpart.

When the advantage of net lease returns are combined with the ability to defer taxation on the sale of the Relinquished Property and the freedom of no asset management, it is surprising that people invest in anything but net leased properties.

Jeff Rothbart is The Boulder Group's Research Director. Mr. Rothbart, a licensed Illinois attorney, received his Juris Doctor from IIT – Chicago Kent College of Law and his Masters of Law in Taxation from Northwestern University. The Boulder Group is a leading investment real estate firm, providing a full range of brokerage, advisory, and financing services nationwide to a substantial and diversified client base, which includes corporations, REITS, individuals, partnerships, developers and institutional investment funds. Founded in 1997, we are one of the only real estate firms in the country focused exclusively on 1031 exchanges and net leased income properties.