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Advantages of the Single Credit Tenant Alternative in a Section 1031 Exchange

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A significant number of private wealth advisors have reported that a majority of their clients hold real estate inherited from family members who either owned properties in connection with enterprises which no longer exist or are no longer owned, or who were actively involved in the real estate business.

These legacy properties often include warehouses, retail stores and centers, office buildings and apartment buildings with expensive third-party property managers and irregular rental receipts. Also, these properties are often not leveraged due to the lack of a qualified sponsor, which impacts the investment's return.

For those clients not actively involved in the real estate business and who are not able to receive any return through participation in management of the property, it may be prudent to consider converting real properties which are costly to operate, maintain and repair and which, due to third-party management, may not have achieved the maximum rental

income, to investments types which may be more stable and productive. Certainly advisors may prefer asset classes with which they are more familiar.

An attractive option for a real estate owner, as many real estate professionals know, is a "like-kind" or "1031" exchange pursuant to Section 1031 of the Internal Revenue Code. Section 1031 permits persons holding real property for investment, but not sale, including those in the CRE business and individuals, to be "exchanged" or sold, if certain requirements are met and specific procedures followed, and replaced with an investment property without current tax liability. Instead, recognition of the capital gain which otherwise would be recognized at the time of sale will be deferred until its ultimate disposition, to the extent such a sale is taxable.

An investor may want to consider replacing the legacy property with property leased to a single tenant with real-estate operating expertise which will operate, maintain and repair the property and directly pay or reimburse operating expenses, real estate taxes and insurance premiums. Often property operating costs and management fees will be substantially reduced or may be eliminated and, if the tenant is a credit tenant, its insurance coverage may be an acceptable substitute for certain coverage an owner would typically maintain.

These businesses may be established national and regional retail chains, pharmacies, fast food outlets, banks and urgent care and other health-related facilities which are owned or operated by public companies or their subsidiaries (and which may have delivered valuable attractive guarantees).

There is a developed market for these kinds of properties and many real estate brokerage firms have teams that specialize in their acquisition and disposition. Many of these tenants have considerable expertise with site selection, store and office design, operating efficiency and development generally. Lease terms are often significantly longer than those found in leases to independent operators, and if the tenant is strong financially, mortgage lenders will often be willing to provide financing when an investor would not otherwise qualify.

For the foregoing reasons, these properties are sought after, may be expensive, and often trade more quickly than other real estate properties.

For the investor and the investment advisor, the single credit-tenant lease option may present a more reliable income stream than that generated by a legacy property, which may be directed to other investment opportunities and improve diversification and returns. With the opportunity available under Section 1031 of the Tax Code to replace a CRE investment without the loss of capital attributable to capital gains taxes (at least at the time of sale), serious consideration should be given to the single, credit tenant property.

Section 1031 includes specific time requirements and other procedures that must be observed and an investor must be familiar with any issues which may affect her ability to dispose of or achieve reasonable proceeds from the legacy property (such as vacancies, physical condition and the need for repairs, loan prepayment penalties, or title issues), and the timing necessary to locate and analyze attractive replacement property candidates.

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Consequently, an investor should consult with a qualified tax advisor, identify a trustworthy intermediary to execute the like-kind exchange transaction, if appropriate, interview real estate brokers, and secure the advice of experienced legal counsel familiar with all steps necessary to structure, analyze, document and close the sale of legacy and acquisition and financing, if desired, of replacement properties.

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