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1031 tax deferred exchanges made achievable: Lessons learned from the benefits of net lease

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After a multiple exchange trial by fire, one developer executive goes 1031 full time.

My full-emersion introduction to 1031 began nearly five years ago, when my then employer embarked upon a property sell-off involving 45 distinct partnerships and totaling in excess of \$200 million. Of these 45 partnerships, 28 elected to defer capital gains taxes via a 1031 tax deferred exchange. A seminal event, this full liquidation involved numerous moving parts and unforgiving deadlines.

Under the guidance of a boutique advisory firm, we turned our focus to the net lease market. Net lease properties can be purchased readily, like off-the-shelf products, in a range of sizes, assuring availability for an exchange when needed. Triple net leases place the management of the real estate on the tenants' shoulders and would enable the partnerships to transition from active to more passive ownership, backed by the guarantee and cash flow of high-credit tenant corporations. So, all of the acquisitions would target triple net leased properties, leased to investment grade tenants, on a long-term basis.

Two exchange alternatives presented themselves: exchange into highly leveraged (zero cash flow) net lease property which allows for minimal equity investment, and exchange into cash flow net lease deals which provide reliable return. We studied each partnership, its composition, tax structure and particular objectives, and customized strategies to achieve their long-term goals.

A mix of highly leveraged and cash flow properties was tailored to suit the diversification and return preferences of each partnership. With the 45 day clock already ticking, the team sifted the market. In six months, we had downsized, liquidated the entire portfolio, purchased over 40 replacement properties, and satisfied each partnership's requirement.

And I had successfully written myself out of a fine job! Intrigued by the strategic advantages afforded by net lease, I proceeded to join the advisory firm I had enlisted for the transaction, Net Lease Capital Advisors, out of Boston, which focuses entirely on combining the net lease market with finance and tax planning for better seller outcomes.

Today, I enjoy educating diverse clients who, though they have achieved success in their own arenas, often lack awareness of the benefits of net lease.

Lessons Learned

Execution: In 1031 exchanges, the tax payer gets one chance. Strict deadlines are triggered by the sale of the relinquished property; 45 days to identify replacement property, and 180 days to close. The process of buying a quality replacement investment in that time can be daunting due to the numerous moving parts involved, from a changing property market to the need to acquire funds in a tightening financing environment. Moreover, the seller of prospective replacement property has an upper hand in price negotiations, aware of the deadlines the taxpayer faces, and may even back

out. The net lease property's ready availability, long term lease, and corporate guarantee of rent income provides an effective antidote to the uncertainties faced in an exchange.

Scope: A combination of highly leveraged and cash flowing net lease deals offers diversification and may be combined to achieve precise outcomes of investment return and take-away cash. While net lease properties are widely available, niche experts can often locate off-market deals and deals still in the making, and are equipped to generate a wider range of alternatives tailored around particular financial goals.

Financing: Financing may drive a transaction, yet the finance markets are retracting as a result of the "subprime" upheaval and spillover to the CMBS market. In the past month, we have seen several sales fail or stall due to scarcity of acceptable financing. Portfolio lenders are filling the gap by offering a range of fixed rate debt, priced over treasuries or the Federal Home Loan Bank (FHLB). Mezzanine loans behind traditional CMBS loans now achieve financing as high as that associated with credit-financed net lease properties. Providing rates of below 6%, with loan terms of between 10 and 25 years, these lenders are sustaining a still active market.

Alternatives for replacement property, financing structures, credit, and strategic goals are numerous and changing. In this climate, the advice of specialists can be invaluable.

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