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WEALTH STRATEGIES

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Changing tactics in a 1031 Exchange May Save Investors Taxes, or Why use a 1031 Exchange when you've lost money on a Real Estate Transaction?

The client invests as a family limited partnership entity. It originally invested $1,000,000 into a TIC property 10 years ago. The sale of the relinquished property 2017 resulted in sales proceeds of $546,540 before taxes. This represented a substantial loss. A number of investors in this situation would not have completed a 1031 exchange. They would have chosen to pay their taxes. If this entity had not entered into an exchange, the tax liability of approximately $465,000 would have reduced the original $1,000,000 investment to approximately $81,500, a 92% haircut.

The unfortunate situation is that investors often don't analyze the tax implication of their situation until it is too late to structure meaningful taxation strategies. To fully defer taxes with a 1031 exchange, one has to acquire property with equal or greater debt and use all of the money.

The client originally considered exchanging into multiple apartment DSTs with the $546,540. If the entity bought normally leveraged assets (e.g., 50% LTV) and used all of the money, there would have been debt boot, which is taxable. In this case, all of the money would have been used but there would still be tax liability of about $210,000. To avoid debt boot, the client needed to buy an asset with very high leverage to satisfy the "equal or greater debt" provision to fully defer taxable gain.

After establishing the basis, I calculated the required allocation into a highly leveraged Zero-Coupon 1031 replacement property to offset debt and assist with full deferral of taxable liability. "Highly leveraged" means, as assets increase in leverage (a greater percentage of debt to equity) the debt level can get high enough that there is no cash flow. That's the maximum leverage that can be obtained. Zero-Coupon assets are often levered with a debt coverage ratio of one-to-one. In other words, income from the property is equal to the mortgage payment. There is no income.

Since this was a substantial departure from the client's intended approach, I asked for and was granted permission to speak with her CPA because my focus is the tax consequences of all structured investment strategies. The CPA verified and supported my analysis and conclusions. I discussed my findings with my client who, after consulting with her CPA, agreed with and executed my proposed tax deferral plan.

The zero coupon holding period is expected to be 8-10 years. The net effect was that with anticipated mortgage pay down of the Zero-Coupon asset, my client could recover most or all of the dollars lost in the previous transaction. I'm now completing my second set of exchanges for this client, and her CPA is referring me business.

Regards,

Robert L. Boggess
CEO - Chief Strategic Officer

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