COMMERCIAL INVESTMENT Real Estate

Exchanges

Maximizing Multi-Asset Exchanges

Use This Tax Strategy to Your Advantage.

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Many real estate professionals are familiar with Internal Revenue Code Section 1031 tax-deferred exchanging as a way to defer taxable gain from investment property sales. Tax-deferred exchanges can provide investors with an opportunity to keep their equity working for them both now and into the future.

Most exchanges are performed on a delayed basis and involve the sale of real property. However, exchange transactions also may include personal property, such as appliances, computers, furniture, or equipment. To avoid undesirable tax consequences in these situations, consider using a multi-asset exchange, in which personal property can be exchanged and taxes are deferred.

A good working knowledge of multi-asset exchanges is helpful, especially when working with clients who own investments that include a high percentage of personal property.

What Is a Multi-Asset Exchange?

In a Section 1031 like-kind exchange, you can dispose of business or investment property (relinquished property) and acquire qualified like-kind property (replacement property) without recognizing taxable gain. The gain merely is carried forward into the new property, and the tax due is deferred. In a multi-asset exchange, multiple tax components that are not like-kind are sold together in a single transaction.

What is the definition of like-kind? In the case of real property, the code defines like-kind as any real property held for investment or productive use in a trade or business. With the exception of personal homes, second homes, and "dealer" properties (held primarily for sale), you can exchange most investment real estate for other investment real estate.

The definition of like-kind for personal property, however, is considerably narrower and requires that items be in the same asset or product class. For example, although the Internal Revenue Service considers the land and buildings housing a hospital and a restaurant like-kind for an exchange, the inventory, furniture, and fixtures are not necessarily like-kind. Thus, a bed in a hospital is not considered like-kind with a cash register in a hotel, even though both items are used in conjunction with a business.

Unlike broadly defined real property, you can exchange personal property safely only for like-kind property within the same classification. Thirteen general asset classes, defined in Treasury Regulations Section 1031 (a)2, and numerous product classes set forth in the Standard Industrial Code manual, categorize like-kind personal property. The IRS considers depreciable tangible personal property within the same general asset class like-kind, unless it is found in a separate product class.

Most multi-asset exchange properties involve a substantial percentage of qualified personal property, including restaurants, hotels, nursing homes, television stations, and retail businesses where the owners also are selling the underlying real estate. According to IRC Section 1031, if personal property constitutes 15 percent or less of a sale's value, it does not have to be identified separately. However, in such cases, accounting questions and tax consequences still may arise if a multi-asset exchange is not used.

If the personal property's value exceeds 15 percent of the sale price or if the participants desire to allocate personal property, values should be assigned in the initial sales agreement. The contract should state a value for the real estate and separately list the amounts for any personal property. Ideally, a separate exchange agreement covering the personal property would include a complete inventory list broken down by classification with corresponding values. At closing, the personal property could be sold under a separate bill of sale. By stating the values of the real and personal property separately, the owner has a road map to use in selecting, matching, and ultimately, negotiating values for replacement property.

Is a Multi-Asset Exchange a Viable Option?

As a real estate professional, you can assist your client in determining whether a multi-asset exchange is a viable option by asking the following questions.

Does the client want to continue to own real estate? If the client would prefer to pay the tax on the transaction and reinvest the proceeds in some alternative form of investment, a multi-asset exchange probably is not needed.

Would the property offered for sale qualify for a multi-asset exchange? Determine if the real estate has been held for investment and if a significant amount of depreciated personal property is involved in the sale.

Is the potential tax liability on the sale great enough to warrant consideration of a multi-asset exchange? Ask the client or its tax adviser to provide information about the tax consequences of the potential sale to determine the gain on the personal property. It may be more cost-effective and efficient for the client simply to complete an exchange on the real estate portion and pay any tax due on the sale of the personal property.

What estimated values would be assigned to the real and personal property components in a sale? It is important when considering potential replacement properties to understand the values you will need to match from the relinquished property. This knowledge goes a long way when you begin negotiating the sales contract.

Multi-Asset Exchange Strategies

Multi-asset exchange transactions may become complicated due to negotiations about timing and values assigned to various components. Consider the following strategies to maximize your client's position.

Understand the various components of the property offered for sale and have an idea of the adjusted taxable basis of each. Enlist the aid of a client's financial adviser who is knowledgeable about the property, the related tax situation, and multi-asset exchanges. You may wish to use an intermediary firm that routinely handles this particular type of transaction. By doing your homework, you will be better able to maximize your client's position when contract negotiations begin.

Investigate the availability of potential replacement properties prior to listing the relinquished property for sale. If you are representing the seller, you will need a thorough understanding of the potential properties that best match the Section 1031 requirements of your client. If no suitable replacement properties are available at an acceptable price, your client may elect to delay any transactions or to withdraw the property from the market.

Establish your client's priorities before negotiations begin. Minimize or eliminate any values assigned to nonqualifying components of the property, such as goodwill. The IRC does not recognize goodwill as qualified property in an exchange transaction. Consequently, any value assigned to goodwill in a relinquished property sale will fall outside of the exchange and be taxable. If the value of the real estate solely cannot substantiate the contract price, the remaining value should be assigned to depreciable personal property and goodwill. How much value you assign to each may vary. Any recapture-of-depreciation gain that results from not matching these components on personal property is taxed at the maximum federal rate of 39 percent. Goodwill cannot be replaced but is taxed at capital gain rates.

Negotiate for extensions in the sales contract. In a delayed exchange, an exchanger has 45 days from the date of the sale of the relinquished property (sale date) to identify potential replacement property and 180 days from the sale date to close on such property. The seller and the seller's broker must be certain that the timing requirements for the acquisition of the replacement property can be met based on the closing dates negotiated for the sale of the relinquished property. A seller may wish to delay closing the relinquished property if no suitable replacement property can be identified or closed within the requisite time periods. Whenever possible, it is advisable to negotiate options for an extension on closing dates.

Assigning Values

In a successful transaction, the values of the various components of the relinquished and replacement properties should match as closely as possible. If the values of the replacement property components equal or exceed those of the relinquished property, the tax on the sale can be deferred. If the corresponding component values are less than those of the relinquished property, only a portion of the tax may be deferred, resulting in a partial exchange. Since flexibility exists in the assignment of values in situations in which the components do not match, you may wish to assign a supportable value that would be most beneficial to your client.

Conversely, if you represent the purchaser in a transaction, you may wish to assign greater value to the personal property with a faster depreciation schedule and less value to components that are depreciated more slowly (such as improvements) or to the nondepreciable components (such as land) in the transaction. In the event the seller exercises any allowable extensions, the client still must be able to meet any loan closing requirements and other objectives.

Car Wash Case Study

The owner of a car wash in Michigan (the client) decided to retire and relocate to Florida. He had owned the car wash for 10 years, during which time it appreciated in value substantially. He initially considered selling the car wash outright but realized that the sale would generate a substantial gain and a corresponding large tax liability. Because he was interested in reinvesting the sale proceeds in a new car wash near his retirement home in Florida, the client decided to use a Section 1031 multi-asset exchange.

The client listed his car wash for $1.3 million and quickly received a full-price offer. The potential purchaser was pre-approved for a loan. In the initial contract, the purchaser minimized the value of the land and building in order to get a quick, easy appraisal.

Despite the full-price offer, the client wanted to determine what potential replacement property was available in Florida before proceeding with the exchange. After several trips to Florida, he finally located a car wash that he considered to be a good prospect. Based on initial discussions with its owner (the seller), he learned that the car wash and underlying land could be purchased for $1.3 million. Although this appeared on the surface to be a perfect match, further discussions revealed that the seller had strong opinions regarding the relative worth of the various components of his business and was not willing to negotiate very much. When compared to the initial values assigned by the purchaser, differences emerged in the preliminary values assigned (see chart).

Unfortunately, with the values assigned, the client still would be liable for taxes on $600,000 of goodwill — the nonexchangeable asset.

With minimal opportunity to negotiate with the seller, the client negotiated for changes in the contract for sale of his relinquished property. The purchaser initially had allocated values with his primary goal being an easy appraisal of the land and building. A quick phone call to an appraiser revealed that a higher value could be justified for both the land and the building. Further discussions revealed that the equipment and goodwill values had been determined without much forethought.

Before approaching the purchaser about making some changes, the client determined that the equipment had a fair market value of approximately $200,000. After some negotiations and assurances from the lender, the client was able to assign final values (see chart).

With the changes in values, the client lowered his gain from goodwill to $200,000, a vast improvement over the initial transaction. This change alone resulted in a net tax savings in excess of $100,000. Although the purchaser was not as prepared to negotiate his position, he still benefited from the allocation of $200,000 to the equipment because it offered a more favorable depreciation schedule.

Client Benefits

Successfully completing a multi-asset exchange that maximizes the benefits to a client requires a variety of skills, knowledge, and preparation. Knowing the right questions to ask is vital to developing a contract strategy. A real estate professional who is knowledgeable about the many facets of multi-asset exchanges is an invaluable resource to a client considering this exchange option.

Because this article is limited in scope, certain exceptions and technical details are omitted. When considering any type of exchange, always consult a real estate, legal, or tax professional who is knowledgeable about exchange transactions.