

Second Thoughts about Tax Deferred Exchanges

By Michael L. McCune and Dale C. Eisenman, CCIM

It seems as if every buyer and seller I talk to and work with is either involved in or contemplating a tax deferred exchange (IRC Section 1031). With all those buyers and sellers involved in 1031 exchanges it may seem sacrilegious to question whether a tax deferred exchange is a path you should follow as a seller. It seems self-evident that if you can defer paying taxes on long-term capital gain you should. My experience in real estate tells me that the answer is not so obvious or simple. After you see the analysis and my comments you may have second thoughts about the value of 1031 exchanges and will want to work with your accountant before committing to a 1031 exchange.

The Mechanics

Chart I - Assumptions	
Property 1	
Purchased for	\$700,000
Basis at Sale	\$500,000
Sale Price	\$1,000,000
Loan Balance	\$600,000
Property 2	
Purchased for	\$1,500,000
Acquisition Loan	\$600,000
Sale Price after 5 Years	\$1,717,000

Chart I shows the basic assumptions and Chart II summarizes my findings on a typical sale and reinvestment, for both a 1031 exchange and a taxable sale. I have analyzed the results using Internal Rate of Return comparisons before and after tax that reflects the larger amount of cash available due to the tax deferral of the 1031 exchange. To save you from pouring over several pages of spread sheets, I have given you only the basic assumptions and results, but you can find all the gory details at www.midcoastproperties.com or www.selfstorage.com/argus/online/1031calculations.pdf. You are welcome to share and confirm the results with your accountant. He will be able to analyze your contemplated transaction for you. Our accountant at Argus says that he routinely runs this type of analysis on many real estate deals and that most of the time the results produce the same answer, that the 1031 exchange is either near a break even or negative result on an after tax basis.

You must run the numbers to see how it works for you, “eyeballing” it just doesn’t work! An Argus broker can help you or your accountant with the basic model, but only your accountant knows your whole tax situation.

The Results and Why It Works

Chart II - Measures of Performance	Sell and Buy	Exchange
Before Tax IRR	28.39%	32.41%
After Tax IRR	21.77%	22.26%
After Tax Capital Accumulation	\$660,695	\$670,614
After Tax Annual Growth Rate of Capital	19.38%	19.74%

As you can see there is no real after tax advantage to using the 1031 exchange for our example transaction. Although the analysis may show a before tax advantage in some other cases, experience shows that it will usually be small. The after-tax-internal rates of return are barely different and do not reveal much of a compelling argument for a 1031 exchange in this case. The reasons for this relative parity are that the current depreciation tax deductions are reduced in the exchange transaction, (less continuing tax savings) because the tax basis of the sale property is carried forward into the new property. Also because of that lower tax basis you pay a higher capital gains tax on the next sale, thus reducing the overall after tax return. Think about it, what Uncle Sam giveth he later taketh away.

What Are the Other Downsides of 1031 Exchanges?

The Right Property: Finding the right (best) property can take more than 45 days, rushing into a bad deal to save very little in taxes could in the long run turn out to be a very bad decision. Think about how long you spent buying the property you plan to sell. The model shows that as little as a 1% change in the return will dwarf the after tax savings in almost any deal. What makes the overall transaction work is how good the next property is, not how much you saved in taxes on the last one!

Higher Capital Gains Rates: Capital gain rates are at their lowest in a very long time and the Federal deficit has never been higher. This would suggest to some politicians (those so inclined to raise taxes)

that rates might go higher or alternatively be at ordinary rates in the future. If this happens in any significant magnitude, any amount of **gain** you defer in a 1031 exchange today will not only **limit your cost recovery deduction (depreciation)** in the future, but you risk paying a much higher rate on them in the future.

Negotiating Disadvantage: Once a property seller knows that you are a 1031 buyer, he knows that you have to select the property in a very short time. Such time pressures can materially shift the negotiating advantage to the seller. Negotiating a lower price can be very difficult if the seller knows his property is on your list. Keep in mind that once a 1031 property is identified the closing must take place within 180 days of the time the relinquished property was sold. That closing requirement can create additional pressures on the buyer to accept unfavorable terms or conditions.

What to Do?

The net result is that there are a lot of people who are adamant about using 1031 exchanges. However, you must analyze your specific situation with your accountant, show him this analysis, and tell him you want to know the facts. But most importantly, remember that the primary object is to own good, profitable real estate that makes you a lot of money and not to beat Uncle Sam out of few (if any) bucks for a short time. He always gets even. Lastly, don’t overlook the non-monetary disadvantages of 1031’s I have pointed out; they are all too real and sometimes costly!
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