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Calif. Firms Struggle To Find Exchange Properties Amid Boom

By **Andrew McIntyre**

Law360, Los Angeles (August 10, 2016, 4:55 PM ET) -- Investors have for some time used so-called 1031 like-kind exchanges to pass capital gains tax obligations to new properties, but given the real estate boom in California, real estate firms in the state are having trouble finding suitable replacement properties and are considering other structures, which come with their own sets of complications.

The surge in prices in major Golden State metro markets, coupled with limited availability of new properties, is complicating investors' search for 1031 replacement properties, and investors are eyeing tenant-in-common and Delaware statutory trust structures as other ways to avoid paying taxes on gains.

"They're having a hard time finding replacements of sufficient value to qualify for this. That's a big struggle that you're seeing a lot of," said Afshin Beyzaee, a partner at Liner LLP.

"People sell their property and are scrambling. You get outbid. You can't find what you're looking for. It kind of becomes a vicious cycle. You've built up this giant built-in gain over time. If you don't do a 1031 exchange now, you've got a big tax bill," he added.

Under a 1031 exchange, when a property is sold, the sale proceeds go into a so-called accommodation account, where it sits until a replacement property is found, which must be done within 45 days.

Such exchanges defer capital gains tax obligations, passing them to the next property. In the event that the owner of the next property dies, the tax obligation that's been carried forward may not be owed in full, although that depends on how the estate tax for the property is calculated.

While such exchanges have been popular, rising prices in California and a lack of inventory have made it harder to find suitable replacement properties within the required 45-day window.

As an example, an investor might buy a four-unit apartment complex, sell it and exchange into an eight-unit complex and then sell that and exchange into a 16-unit complex. Eventually, it will encounter difficulty finding, say, a 32-unit complex to exchange into, Beyzaee said.

"At some point, there are far fewer 32-unit complexes than four-unit complexes," Beyzaee said. "It becomes harder."

So investors are looking to other structures. TICs and Delaware statutory trusts, both of which often comprise dozens of investors, allow investors to buy pieces of properties as opposed to entire properties, which is becoming more attractive given the difficulty in finding single properties to buy under 1031.

Under a TIC structure, the title to the properties falls under the names of several investors in the TIC while in the Delaware statutory trust structure, the trust oversees the ownership, management and financing of the property. Although both are attractive given the difficulty of exchanging directly into a property through 1031, they come with complications.

“TICs and Delaware statutory trusts have a lot of restrictions on the way they can be set up and still qualify for this like-kind exchange treatment,” Beyzaee said. “It creates issues later if they have to do something with the asset that’s not within their original business plan.”

For example, if the market goes into a downturn and the investor needs to reposition the asset, it can be difficult if some of the other partners don’t understand the ins and outs of releasing, retenanting or refinancing, said Bob Baradaran of Greenberg Glusker Fields Claman & Machtinger LLP.

And properties in Delaware statutory trusts have to be income-producing.

“There are additional asset management headaches ... when they’re dealing with random unaffiliated third parties, who many times are not very sophisticated and who may become vocal and raise issues,” Baradaran said. “It becomes very unwieldy. You have situations … where the program didn’t go exactly as identified. And sometimes [investors] even lawyer up and become adversarial with the sponsor."

Still, despite the challenges in setting up such structures, investors are increasingly looking to them.

“There’s been quite an uptick in interest in the 1031 Exchange business lately, especially with the growth of Delaware Statutory Trusts,” Adam R. Salis of Salis Law wrote in an email.

And lenders particularly like the structure of Delaware statutory trusts as compared with TICs since in the former case, they only have to deal with one borrower, said Michael Polentz of Manatt Phelps & Phillips LLP.

"However, DSTs ... are very complicated from a tax perspective and must strictly follow the tax guidelines and procedures,” Polentz said.

While investors continue to look for ways to pass on tax liability to future properties, they also need to exercise caution, Baradaran said, and racing to do a like-kind exchange with the wrong property could lead to major problems.

Investors may save on taxes at the onset, but if they later have to sell the property for a steep loss, those savings and more can be quickly eroded.

“I actually think many investors make a mistake by getting into deals that are not the best deals to get into or appropriate for their risk profile, just to avoid the taxes,” Baradaran said.

--Editing by Christine Chun and Philip Shea.