A 1031 Exchange Adventure!

A client of mine found itself in an interesting situation. The client was a family limited partnership that held a ½ undivided interest in a 3200 square foot store in a prime West Hollywood location. The basis, dating back to a death in 1966 was $22,500. The client's half of an unsolicited offer of over $6 million came to about $3million.

Some background:

At the time the offer was received, Gen 1 partners were in their 90's. This windfall created an early liquidation opportunity, but the tax bite would exceed $1 million. This property was ripe for a 1031 exchange. The problem was….what to buy for the up leg? Another store? an apartment building?

In a few years, it was a virtual certainty that the partnership would once again have one rental property to divide 9 ways when Gen 1 passed away. The family, a long - time client, asked me to come up with a strategy that accomplished the tax free exchange and accommodated the distribution of the estate upon their passing.

My Solution: The $3 million in proceeds split 9 ways comes to about $330k each……enough to buy a single family residence. I proposed a plan to acquire 9 or 10 single family homes which we would then rent to create a residential real estate portfolio that could be divided among the 9 limited partners (Gen 2) upon the last Gen 1 death.

Essentially, I was hired as a fiduciary to manage the entire 1031 exchange transaction from sale, to purchase, to rent up of the properties, an engagement that took me about one year.

Challenges:

One challenge was that under the statutes, the identification period of 45 days doesn't give a buyer much time to find up leg properties especially multiple properties at certain times of the year. To add to the 45 days, I set up, with the assistance of the bank (a line of credit) and the accommodator, a *reverse exchange* so I could start acquiring properties before the sale escrow closed. At the onset in late summer, inventories of single family homes on the market were low…it was hard to find good properties. The buyer of the Hollywood property took care of that for us by missing every time commitment in our sale escrow agreement and drowning us in paper. Three times I started putting properties in escrow then had to let them go because it appeared quite possible that the buyer would back out of the deal.

The final closing date (fairly secure with $700k hard money released) was the end of January, 2015 which meant the 45 day identification period would expire on March 15th. I started acquiring properties for the client in December and by the March 15th deadline had identified about 20 potential properties aggregating a total of about $6 million. The hardest part of this process is trying to tie up that many single family homes at a time of year when there are a lot of individuals in the market too! I contacted the nine limited partners to see if any of them wanted a rental house in their geographic area. Two indicated they wanted a rental property near their home. Both of those partners were able to find suitable up leg properties in their locale. Altogether, I purchased 10 homes, 4 of which were rented or "lease guaranteed" at the close of the purchase escrows.

Results:

Before the offer, the family had a one-half undivided interest in a property with 9 other Gen 2 individual owners from another side of the family. The property was leased to a tenant who was negotiating hard for reduced rent and other concessions. Without this sale, the family was facing either a rent concession or a vacancy that could last 6 months plus the cost of improvements to suit a new tenant.

After the exchange, this residential rental portfolio is generating about $120,000 in net cash flow to the partnership annually and it no longer has a "single property" exposure, but has 10 producing assets spread over 3 states. Of course, the management piece is significantly greater, but is handled by paid professionals. Also, the nature of a residential rental is such that unless the residence is trashed by a tenant, the rent-up period and related costs (vs. TI's in the case of a commercial rental) are much lower. Given the probable liquidation date, this strategy, as complex as it was, greatly facilitates the eventual distribution of the estate to the nine members of Gen 2. To a tax professional like me, it's downright elegant!

Thank You's.

The only way I could accomplish this engagement and have so much fun doing it was with the help of other professionals. Andrew Zimbaldi, Broker and Rich Wordes, attorney coordinated and quarterbacked the sale transaction between a very difficult buyer and a total of 10 individual sellers. I was truly grateful that the half I represented was in a partnership requiring only one signature!

Inside our firm, Stefan Massy and Robyn Manley were invaluable assistants. Also, a shout out to my partner, Don and the rest of the team for putting up with my frequent absences while looking at properties during our busiest season of the year.

Through my friend, Kathy Canfield of Meridian Properties, I was able to acquire 3 properties in Tennessee which greatly help overcome the low rent to value rates we see in Southern California. These three properties generate about 10% annual return. Partners #7 and 9 found me rentals in their locale, Paul Colucci, Jonathan Mann and Aaron Evans helped me find local properties and manage them for me, and finally CB&T banker, Bob Whitelaw and Exchange "Accommodator Extraordinaire," Kelly Pearl who made the acquisition of properties very easy indeed!

All of you helped make this one of the greatest accomplishments of my nearly 40 year career.

Many Thanks!

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