This Deal Shows Why 1031 Market Has Skyrocketed

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IRVINE, CA--A recently closed transaction is a textbook example of how and why **1031 exchanges** are powering an already healthy **multifamily** market and pushing Orange County into record territory, **Colliers International** executives tell GlobeSt.com. But, while values have risen to record levels, investors-who have to pay as much a 40% in capital-gains taxes on their investment properties if they sell them outright and pocket the profits-have an alternative, SVP **Patrick Swanson** and associate **Brenden Felix** say.

Sometimes it's an unsophisticated investor who only wants to leave a legacy property to family heirs without having those heirs inherit, along with the property, a mammoth tax bill. Thanks to the **IRS,** they can avoid that if they trade up into larger properties. This guarantees the nation will have a stock of **housing,** but also allows investors to realize the gains not in cash, but in their new properties' values.

We recently sat down with Swanson and Felix to discuss their example of this phenomenon.

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GlobeSt.com: Can you summarize this so-called textbook deal you closed?

Swanson: Our Irvine-based team represented a private investor in Santa Ana, CA, who sold a 28-unit multifamily property and conducted a classic IRS-sanctioned **1031 Tax Deferred Exchange** by trading into a larger 59-unit complex. Through this process, the client more than doubled her **apartment** holdings, increased her annual income and obtained a new depreciation schedule from the IRS, all benefitting her. The final selling price was almost $7 million, $1 million more than she originally thought the property was worth.

Felix: After two of our competitors failed to dispose of her property, we were instrumental when we explained how a 1031 exchange worked. She had no idea about it. What we did was trade the "down-leg" property, which consisted primarily of post-World-War-II-vintage houses the state obtained through imminent domain during **construction** of new freeways in Los Angeles, for an "up-leg" property twice the size and twice the value of her current holding.

GlobeSt.com: Is this something many private, individual investors need to know?

Swanson: Yes. When our team first met with the seller, in order to understand her real estate investment objectives, she expressed concern that the 28-unit property she owned in Santa Ana required more management attention than she was willing or able to give it, including deferred maintenance that eventually would become the responsibility of her heirs if she kept the property, something she wanted to avoid. That's when the team recommended an IRS-sanctioned, tax-deferred 1031 exchange, something she knew nothing about.

Felix: The IRS allows owners of investment properties to avoid capital-gains taxation if they "exchange" their current property for one of greater value, thereby avoiding onerous taxes imposed by the federal government when an investor sells a property outright for the profit alone. To encourage investors to remain in the market and provide a basic stock of housing, it will defer any capital-gains taxes if you swap yours for a larger, more-valuable property, and that's what we did for her. Why our competitors did not do this, or advise her to do this, is still a mystery.

GlobeSt.com: What did you do that your competitors did not?

Swanson: After deciding on the exchange transaction, our team did something its two competitors did not do: we worked with the client to increase her current property's value by resolving some of the deferred-maintenance issues, including raising rental rates on a select number of units that were long overdue to be improved upon. The result was increased interest among potential investor-buyers at a significantly higher value. Additionally, we made sure to market this asset proactively to the entire brokerage community in order to seek out all potential buyers.

GlobeSt.com Why hadn't this been done by the two previous listing brokers?

Swanson: It may have been the fact that they either were unaware or inexperienced in 1031 exchanges or unaware of the exchange potential, or they just may have thought they could make a quick commission by simply selling the property outright and letting the owner worry about the capital-gains tax. If any of those reasons were the case, it's truly unethical. No matter the value of a client's holdings, you must treat every client the same. How many times has a small, individual investor, sometime down the road, become a major private investor? Many times, and that's why we treat everyone with the same degree of professionalism. We never figure out how much the commission is going to be. It's just something I have drilled into my team members. Either enjoy the process regardless of the commission or choose a different profession.

GlobeSt.com: How long did this transaction take?

Swanson: Not long at all, since the multifamily market in Orange County remains one of the strongest anywhere in the country. We quickly found a newer and larger property that featured 59 units, double the number she had owned, with an original build date of 1988--much later than her previous investment, so maintenance going forward would be much less then on her previous, older and smaller investment.

This is the art of the deal, since we focused on her investment and personal goals and met them, whereas two of our competitors who had the listing ahead of us could not. Because we were focused on the process--not our payoff--we were able to meet her needs. Once you start adding up your commission before you've sold a property, you are in trouble.

Felix: When brokers look too far ahead and start adding up how much they are going to make on a deal instead of filling their pipelines and getting deals into the process before an asset is even listed, it always seems to end poorly for the broker.

GlobeSt.com: What was your client's reaction, and what was yours?

Felix: It was a win-win for all parties, and now our client, who undoubtedly will come to us next time she needs assistance, has the tax benefits she was seeking. Above all, however, on a more personal level, which was the most important part of this transaction, she now has a more valuable legacy asset she can leave to her family heirs, with far less headaches than she had before. You have to know the real goal of your client, which often, with individual investors like this one, was not just the business side, but the personal side, as well. It was a very satisfying transaction for us and for her."