GLUED TOGETHER, BUT MILES APART: HEADLEY'S SECTION 1031 LIKE-KIND PROPERTY EXCHANGE

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Published in 2001 in *The Journal of Finance Case Research*

CASE DESCRIPTION

The primary subject matter of this case concerns a Section 1031 Like-kind property exchange and the deferral of capital gains taxes. Secondary issues include the mechanics of an exchange and the deferral's implications for real estate, accounting, finance and law. The case is appropriate for senior level undergraduates and first year graduate students. The case is designed to be taught in one class hour and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

In a typical transaction involving the sale of an asset and the purchase of another, the IRS taxes any realized capital gain on the initial sale. Section 1031 of the Internal Revenue Code (the code), however, allows for holders of any "property held for productive use or investment" to sell the property at a price greater than its adjusted basis and defer part or all of the taxes on the capital gain, provided the new asset purchase meets the terms of the section. After executing the "exchange," the cost basis of the newly acquired asset is decreased by the amount of the capital gain. Thus, the payment of tax is deferred until the sale of the new asset, provided that sale is not itself part of a new tax-deferred exchange. The widest use of this section is in the sale and subsequent purchase of investment real estate.

In this case, we examine a Section 1031 real estate exchange conducted by Headley Graham, the owner of Graham Properties, a Florida sole proprietorship. Headley sold one of his older properties and wanted to purchase a much newer larger property, but he had to keep knowledge of the new property purchase from the developer who was buying the old property. This was true even though that developer's purchase of the older property was required for the newer property funding. Think about it. If the developer was made aware of the pressure that Graham was under in his planned exchange, he could use that knowledge to lever additional concessions from Headley prior to completing the old property purchase. Keeping the two deals "glued together," while simultaneously keeping them "miles apart," proved quite a task for Headley.

WALGREENS, VENETIA PLAZA AND A SECTION 1031 EXCAHNGE

Remarks in *The Wall Street Journal* early in 2001 and in *Business Week* in mid-2000, affirm that Walgreens, a national drug store and consumer products retailer, is profitable and is opening 500 new stores in 2001. With 3,100 outlets in 41 states and Puerto Rico, it has been growing at a similar frenzied pace since the mid-90's. As part of this expansion, the firm opened over 20 stores in the Jacksonville, Florida area between 1996 and 1999. That city's Westside, noted for densely populated concentrations of military, government and other middle class employees, was very attractive to Walgreens early in 1997. Among the locations most appealing to the retailer was a site at the corner of 103rd Street and Ricker Road, owned in part by Headley Graham.

In easy proximity to Interstate 295 and located at the lighted intersection of a six-lane thoroughfare and a major neighborhood artery, the site was occupied by three property owners and encompassed a total area of 300' x 315'. Figure 1 reveals Headley's portion; all three parcels were required for Walgreens to construct its new store.

The developer had withheld the identity of the ultimate user of the site. He feared that knowledge would encourage the existing owners of the 103rd Street properties to raise their prices. Headley, through his own local sources, discovered that the prospective purchaser was indeed Walgreens, a well-heeled and creditworthy national retailer. This shadowy pattern of withholding information, between the developer and the owner of Graham Properties, permeated, by seeming necessity, many of the discussions between Headley and the developer's real estate agents. This added enormously to the uncertainty for Graham Properties as it moved forward with the 1031 exchange.

In a series of offers and counter-offers handled by the Maltese Realty Group of Jacksonville for Walgreen's developer, a final purchase price of $405,000 for the 103rd Street site was agreed to early in the summer of 1997. As shown in Table 1, Graham Properties had purchased the property in October of 1983 for $84,000, had used the generous 15-year depreciation rules available at that time, and after improvements and operations for 14 years had depreciated the property down to $21,659 at year's end 1997.

The actual closing of the 103rd Street sale took place on December 31, 1997. In Table 1, we see that net sales proceeds available to Graham Properties totaled $376,705. A capital gain of $355,046 was earned with the sale. The sole proprietorship was confronted with the option of either paying approximately 20% of this gain in taxes, or $71,009, or of reinvesting the entire sales proceeds of $376,705 in a new "like-kind" property, thus deferring the capital gains tax. As in Table 1, the alterative to reinvesting all the sales proceeds was to pay the tax and be left with $305,696 after the sale. A much newer property, Venetia Plaza, of 24,000 square feet, was available for purchase for $1.06 million (before closing costs). It is also described in Table 1. Headley thought it was a dandy candidate for a Section 1031-exchange.

Headley was aware that Section 1031 of the Internal Revenue Code allowed for the deferral of capital gains taxes, but he was uncertain of the precise mechanics of an allowable exchange. He retained a tax attorney and learned much about tax deferral. Capital gains tax deferment is allowed provided that the sale proceeds are reinvested in "like-kind" property. The terms of the section are somewhat involved, and the IRS has yet to provide specific guidelines on its implementation. Nonetheless, the code allows that an appreciated capital asset can be sold and its capital gains tax deferred if several basic criteria are met.

First, the property sold must be "investment" real estate (not inventory real estate of the sort held by developers for long periods and not homesteaded residential real estate, which enjoys special tax-treatment in other sections of the code). Also, the funds derived from its sale must never be in the direct control of the seller; the property is either directly exchanged for the new property or the funds are held by an approved escrow agent – such as a title company or an attorney – until the new property's purchase.

Second, the new property must be purchased within *45 days after the closing of the sale of the "old" property* (this rule has now been relaxed to allow purchases of replacement properties *before* the appreciated property's sale). If the seller does not expect to complete the exchange within 45 days, he must provide the escrow agent before the old property's sale, a list of three properties that are under consideration for purchase. Up to six properties may be listed, contemplating the purchase of more than one property to take full advantage of the section, provided the total market value of the six properties is less than 200% of the sale price of the old property. Assuming that the new property purchase does not take place within 45 days of the original sale, a property listed with the escrow agent must be bought within 180 days of the sale of the "old" property or by the time of the taxpayer's next income tax filing, whichever comes first.

Third, the basis of the newly acquired property, for later depreciation and capital gains tax computation purposes, will be the purchase price of the new property reduced by the untaxed capital gain. The capital gains tax is not forever avoided; it is merely deferred. For example, if a $1,000,000 property is acquired in a 1031 exchange and a $200,000 capital gain is deferred in the transaction, the initial basis of the new property will be $800,000.

Prior to the 31st of December, 1997, Graham Properties had several concerns: First, the sale to Walgreens of 103rd Street was not certain, but Headley felt it was necessary to move ahead with plans to conduct a like-kind exchange and defer the capital gains taxes in the event a sale took place. He knew that commercial property purchases often require six to nine months of planning and the terms of Section 1031 do not allow such a long period to "put together" a deal. This first concern was further complicated by his desire to keep knowledge of the 1031 exchange "secret" from the Walgreens' developer. The terms of the 103rd Street purchase contract allowed the developer to withdraw *after* Headley had committed to the purchase of Venetia Plaza in the Fall of 1997! If the developer had known of the criticality of his monies to fund Venetia Plaza, he could use the threat of withdrawal – *at the last possible moment* - to extract a lower price on 103rd Street. So, Headley obviously needed to guard knowledge of the new property purchase from the buyer of 103rd Street. The developer and Maltese Realty expected that the 103rd Street sale *might* lead to a 1031 exchange, but knowledge of its certainty would put the developer at a distinct advantage, as he could then lever additional terms from the owner of Graham Properties.

Second, the owner of Venetia Plaza was aware of the 1031 purchase of its property, but was not willing to wait indefinitely for the sale to close; the contract with the seller "expired" on the 19th of January, 1998 and Headley needed some way to close on the purchase of Venetia Plaza *after* January 19th in the event that Walgreen's developer had not closed his purchase of 103rd Street *before* January 19th. Although Venetia Plaza stood on its own as a good investment, independent of the tax deferrals it allowed, its purchase would not be possible without the funding provided by the 103rd Street property sale.

Third, Graham Properties required financing for the balance of the purchase price on Venetia Plaza. As noted in Table 1, $376,705 would be provided by the sale of 103rd Street, but around $700,000 in financing was necessary to purchase the newer property. To convince a lender of the suitability of Venetia Plaza as collateral for the new first mortgage of around $700,000, the newer shopping center would have to illustrate an ability to support such a loan.

Finally, Venetia Plaza was a much larger property than 103rd Street, so Headley needed to determine the ownership vehicle for Venetia Plaza and the manner with which the property would be managed if it were purchased. Whether to continue ownership of this property, as with others, as a sole proprietorship, was an issue also confronting Graham Properties.

As Headley's attorney commented during the weeks leading up to the purchase of Venetia Plaza, keeping the two deals "glued together, but miles apart" while keeping the purchaser of 103rd Street in the dark, was quite a task. This all transpired while the seller of Venetia Plaza was, by necessity, fully informed of the progress on the sale of 103rd Street. So, the two deals were kept glued together to placate the seller of Venetia Plaza, but were held miles apart to insure against giving the developer additional leverage.

DECISION POINT: THE SALE OF 103RD STREET AND SECTION 1031 EXCHANGE CONSIDERATIONS

Final planning for Venetia Plaza's purchase began in earnest when the first half of Graham Property's "deal," the 103rd Street sale, took place on December 31, 1997. The sale of 103rd Street was completed according to the terms mentioned above and outlined in Table 1. Funds were escrowed with a qualified intermediary, a title company, pending Graham's purchase of Venetia Plaza. He could have chosen not to complete the sale and pay taxes instead, though no deferral would have been allowed had he *ever* been in direct control of the sales proceeds. The code allows for this change of heart, though the tax liability would be due as if no deferral was contemplated at the initial sale. Given the data above and contained in Tables 1 – 4, the following issues confronted Headley as he considered whether and how to complete the tax-favored exchange:

Financing

Data in Table 2 reveal the need for over $700,000 - or a purchase price of $1,094,832 less 103rd Street funds of $376,705 - in funds requirements for Venetia Plaza beyond the monies provided by the sale of 103rd Street. From the data in Table 3, describe how Venetia Plaza could support a loan of the size needed to complete the purchase. Information at the bottom of Table 4 shows that a local insurer offered Graham Properties $690,000 in financing at 8.25% per year with monthly payments and an 18-year amortization, but there was a catch. The financing could not be repaid for 5 years (Headley was "locked out"), and in years 6-10, could only be repaid with declining prepayment penalties of 5, 4, 3, 2 and 1%. If $20,000 is paid ahead of the regular loan amortization in year 6, for example, a prepayment penalty of $1,000 would be due; the prepayment penalty would be $800 in year seven. After 10 years the loan could be repaid without penalty. Other local banks offered 8.5% financing, 20-year amortizations with monthly payments and 5 year "balloons," where the entire loan balance would be due in 5 years; none of these bank loans, however, restricted prepayment. What are the costs and benefits of the two different types of loan packages? What is Graham Properties "paying" for the prepayment option with the local banks? What are the differing risks confronting Graham Properties with both the permanent financing with a lockout and the 5-year financing with no lockout?

Legal and Managerial Issues

Headley held his other investments as a sole proprietor. For a larger property such as Venetia Plaza, is that an appropriate ownership vehicle? He also managed his other properties, though he lived outside of Jacksonville. Venetia Plaza had been under management for some time, and the manager wished to continue with the property. Both a more complex ownership vehicle, such as a Subchapter-S corporation or Limited Liability corporation, and a property manager would be costly. What are the benefits of indirect ownership? Should a property manager, such as the one already running Venetia Plaza, be retained?

Risks of Reinvestment

Graham Properties was not forced to buy Venetia Plaza. Why might Headley have foregone the new property purchase? Why might he prefer to pay the capital gains taxes and be left with a much smaller sum following the sale of 103rd Street?

Options to Extend Time to Closing

Although the text above reveals that 103rd Street sold in a timely fashion, Headley was concerned that its sale would be delayed beyond the termination of the Venetia Plaza purchase contract. What options were available to delay closing on Venetia Plaza if 103rd closed after January 19, 1998? *Hint:* One way for developers to control property they may wish later to purchase is with option contracts, where non-binding unilateral contracts are used to "tie-up" a piece of real estate until a later purchase.

Income and Cash Flow Analysis

Information in Table 3 reveals *historical* information on the profitability of 103rd Street and *forecasted* data on the cash flows generated by Venetia Plaza. Investors commonly examine real estate investments with the Cash Flow Before Income Taxes (CFBT) measure in Table 3. This is simply the property's Net Operating Income (NOI) reduced by debt service. An Equity Dividend Rate (EDR) can then be calculated as the ratio of the CFBT divided by the investor's equity. Graham Property's equity in Venetia Plaza to start with is the funds available from the 103rd Street sale plus the $28,127 required (see "Additional Funds Requirement" in Table 2) to complete the sale after the financing of $690,000. In Table 2, we see the buyer's equity in Venetia Plaza is $404,832. What is Venetia Plaza's first year EDR? Refer to the data on the mortgage financing in the tables. Calculate the first year's interest charges on the mortgage. The depreciable basis of Venetia Plaza will be approximately 80% of the $739,786 adjusted basis from Table 2. Using straight-line depreciation, calculate the first year's depreciation with a 39-year tax life, the code's standard for commercial real estate. What will be the new property's first year cash flow *after* taxes (CFAT)? Assume an owner's tax rate of 39%. (*Hint.* CFAT = CFBT – Taxes. Taxes = Taxable Income (TI) times the tax rate. TI, in turn, is equal to NOI reduced by interest and depreciation.)

Value of the Tax Deferral

Although he was not contractually required to go ahead with the Venetia Plaza purchase, the owner of Graham Properties was aware of both the tax consequences measured in Table 1 and the desirability of Venetia Plaza outlined in Table 3. He had conducted an analysis similar to the one in Table 4. He believed that both Scenarios I and IV in Table 4 were unlikely and attached a subjective probability of 10% to each. He attached equal probabilities of 40% to Scenarios II and III in Table 4. Generate a weighted average expected sales price and funds availability for Graham Properties upon sale at the end of 2000. Supplement this analysis with an estimate of the cash flows available to Graham Properties in each year of a presumed three-year ownership horizon ending on December 31, 2000. Assume income and expenses are constant over the three years and use the data in Table 3 to assist you. Ignoring income taxes but allowing for capital gains taxes as in Table 4 and assuming a 12% discount rate, what are the total expected cash flows, from income and subsequent sale, generated by Venetia Plaza? Would you, as a consultant, advise Graham Properties in late 1997 to buy the new shopping center? What expectations would cause you to advise against the purchase? If you delay a tax of $71,009 for 3 years, ignoring taxes, what is the present value of your deferral?

REFERENCES

Anonymous (2001). Walgreen Says Net Gained Nearly 24%, Continues Expansion. *The Wall Street Journal* (January 3), A-6.

Marcial, Gene G. (2000). Greener at Walgreen. *Business Week* (July 2), p.203.

TABLE 1
SECTION 1031 TAX DEFERRRAL AND PROCEEDS AVAILABLE ASSUMING NO TAX DEFERRAL

SALES INFORMATION	
Gross Selling Price	$405,000
Costs of Sale	(28,295)
Net Proceeds to Seller (Transferred to Escrow Agent)	376,705
Adjusted Basis of 103rd Street	(21,659)
Capital Gain	355,046
Deferred Capital Gains Tax (20%)	$71,009
SALES PROCEEDS AVAILABLE ASSUMING NO TAX DEFERRAL	
Net Proceeds to Seller	$376,705
Capital Gains Tax	(71,009)
Funds Available after Capital Gains Tax	$305,696

TABLE 2
PURCHASE INFORMATION AND NEW VENETIA PLAZA BASIS

PURCHASE INFORMATION	
Contract Purchase Price	$1,060,000
Costs of Sale	34,832
Gross Amount Due from Venetia Plaza Buyer	1,094,832
New Buyer Financing	(690,000)
Funds Due From Venetia Plaza Buyer	404,832
Proceeds Escrowed from 103rd Street Sale	(376,705)
Additional Funds Requirement for Buyer	$28,127
NEW BASIS OF VENETIA PLAZA AFTER ALLOWING FOR DEFERRED CAPITAL GAIN	
Gross Purchase Price	$1,094,832
Deferred Capital Gain	(355,046)
Venetia Plaza Basis upon Purchase by 103rd Street Seller	$739,786

*Prior its sale, there was a mortgage on 103rd Street, but it was paid off with funds from a new mortgage on another property. This allowed for a “cleaner” sale and for funds not reduced by a mortgage payoff to go to Graham Properties’ escrow agent at the time of the sale of 103rd Street.

TABLE 3
SELECTED PROPERTY FEATURES AND INCOME COMPARISONS

PYSICAL FEATURES	103rd Street	Venetia Plaza
Square Feet of Buildings, Land Area	5000, .57 Acres	24,000, 1.83 Acres
Age of Buildings	34-40 years	14-20 years
Number of Tenants	5-6	14-17
INCOME COMPARISONS		
Average Gross Rent per Square Foot*	$8.20	$9.9167
Operating Expense Ratio as % of EGI	25%	29%
Gross Potential Income	$41,000	$238,000
(Vacancies, estimated for each)	(4,100)	(35,700)
Effective Gross Income (EGI)	36,900	202,300
(Operating Expenses)	(9,225)	(58,667)
Net Operating Income (NOI)**	27,675	143,633
(Debt Service)	N/A	(73,704)
Cash Flow Before Income Taxes	$27,675	$69,929

*This measure can be misleading for the Venetia Plaza property, as over $20,000 per year in rents are paid at Venetia Plaza for rights to the parking lot. These rents are received for overflow parking rights for the next-door neighbor and for a land lease by a cellular service provider.

**Measures of Net Operating Income are approximated for 1997 for 103rd Street, the last year of ownership by Graham Properties, and for 1998 for Venetia Plaza, the first year of ownership by Graham Properties. Net Operating Income figures for both properties are adjusted. These adjustments account first for the precipitous vacancies on 103rd Street in 1997 as the property was vacated by relocating tenants. Adjustments are provided also for Venetia Plaza to account for the 19 days in January of 1998 for which the New York seller still owned the property.

TABLE 4

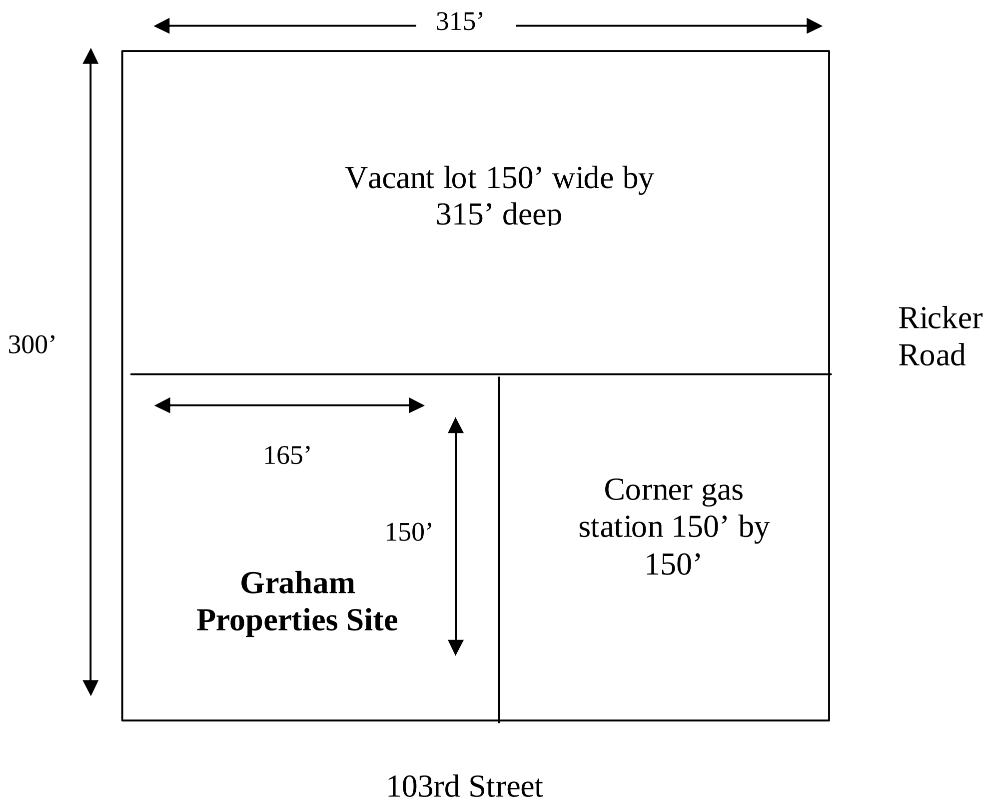
INVESTOR CASH FLOWS UPON SALE OF VENETIA PLAZA AT YEAR'S END, 2000, UNDER FOUR DIFFERENT SCENARIOS

SCENARIO I – ALLOWING FOR NO APPRECIATION	
$1,060,000 Sale Price less 3% Costs of Sale (Net Proceeds)	$1,028,200
Adjusted Basis after 3 Years Depreciation (See Table 2)	(694,261)
Capital Gain	333,939
Capital Gains Tax (20%)	(66,788)
Funds Available (Net Proceeds less Capital Gains Tax)	961,412
Mortgage Balance at 12-31-2000*	(641,025)
Net Funds Available to Graham Properties in Scenario I	$320,387
SCENARIO II – 3% ANNUAL APPRECIATION IN VALUE	
$1,158,291 Sale Price less 3% Costs of Sale (Net Proceeds)	$1,123,542
Adjusted Basis after 3 Years Depreciation (See Table 2)	(694,261)
Capital Gain	429,281
Capital Gains Tax (20%)	(85,856)
Funds Available (Net Proceeds less Capital Gains Tax)	1,037,686
Mortgage Balance at 12-31-2000	(641,025)
Net Funds Available to Graham Properties in Scenario II	$396,661
SCENARIO III – 5% ANNUAL APPRECIATION IN VALUE	
$1,227,082 Sale Price less 3% Costs of Sale	$1,190,270
Adjusted Basis after 3 Years Depreciation (See Table 2)	(694,261)
Capital Gain	496,009
Capital Gains Tax (20%)	(99,201)
Funds Available (Net Proceeds less Capital Gains Tax)	1,091,068
Mortgage Balance at 12-31-2000	(641,025)
Net Funds Available to Graham Properties in Scenario III	$450,043
SCENARIO IV – 10% DECLINATION IN VALUE	
$954,000 Sale Price less 3% Costs of Sale	$925,380
Adjusted Basis after 3 Years Depreciation (See Table 2)	(694,261)
Capital Gain	231,119
Capital Gains Tax (20%)	(46,224)
Funds Available (Net Proceeds less Capital Gains Tax)	879,156
Mortgage Balance at 12-31-2000	(641,025)
Net Funds Available to Graham Properties in Scenario IV	$238,131

*$690,000, 8.25% mortgage, 18-year term and monthly payments starting on March 1st of 1998.

FIGURE I

Walgreens Site and Graham
Properties' Portion



Walgreens' developer required all three sites, including the 2 sites adjacent to the Graham Properties' lot. To provide for traffic flow, parking and a single-story building of approximately 15,000 square feet, most sites for new Walgreens stores are at least 90,000 square feet. This location on Jacksonville's Westside is typical of those purchased by Walgreens; it is located 5/8 of a mile west of Interstate 295 on a six-lane portion of 103^{rd} Street at the lighted corner of 103^{rd} and Ricker Road.