Collaboration is Key for 1031 Buyers to Avoid Missteps, Tax Obligations for Single-Tenant Net-Leased Retail Assets

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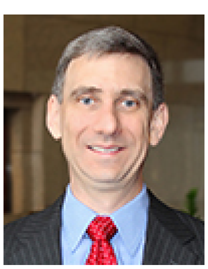
Single-tenant, net-leased properties (STNL) are among the most sought-after investments in the market, and over 40 percent of all STNL properties acquired are purchased by investors in a 1031 exchange. Finding the right properties can be challenging and competitive, and factoring in the time restrictions of a 1031 exchange further complicates the issue, particularly when deals can be derailed for a myriad of reasons. Many of these pitfalls can be avoided or limited by leveraging a team of well-versed experts, from property brokers to tax professionals, reducing the odds of an investor getting shouldered with a hefty tax obligation.

An infrequent but potentially catastrophic event that can derail a 1031 exchange is a tenant exercising a right of first refusal (ROFR). Approximately one-in-five leases include such a provision, and most tenants infrequently take advantage of the opportunity. Experienced real estate professionals often know which occupants tend to favor acquiring their buildings when given the opportunity. Corporate-owned McDonald's restaurants are among the most frequent tenants exercising a ROFR when presented with the chance. Although targeting these deals does not automatically derail a 1031 exchange, having a viable backup property is important in these situations.



Other hurdles can derail a flawlessly executed 1031 exchange, though some of these arise from investors' low tolerance to obstacles related to the replacement property. An issue with the title, for instance, can frighten away buyers that are up against the clock. These challenges are often easier to overcome than they appear on the surface, but investors will often move onto another identified property to avoid the hassle. Environmental reports can also serve as an impediment to a deal, both with the target property or adjacent assets. If buyers become too concerned about minor setbacks that are prevalent in many STNL acquisitions, options may dwindle during the allotted reinvestment period, creating a tax obligation.

Barry Wolfe, Marcus & Millichap

Although utilizing industry professionals can minimize the chance of an unforeseen tax liability, sometimes finding the ideal property, lease terms and tenant can prove to be unsuccessful for buyers with resolute standards. These challenges are exacerbated due to the aggressive capital chasing STNL listings. As a result, the best deal may not always be apparent when the process for identifying replacement properties is initiated, but rather may appear after careful consideration of available inventory.

Buyers willing to cast the broadest net may find opportunities where the property details, including tenant and lease terms, are ideal but a "boot," or some taxable income from the sale that doesn't qualify as a "like kind" property, remains. In many of these instances, investors that consult with their accountant find the tax liability on such a small amount is a worthwhile sacrifice to acquire an asset that checks all of their other boxes.

Although several factors can partially or fully derail a 1031 exchange, the largest challenge is often the buyer themselves. Uncompromising replacement criteria or intolerance of minor deal hurdles will erode time and limit options as the window closes. Additionally, investors without the proper support can waste precious days in the hyper-competitive market.

Having a detailed plan in place with a team of experts at the beginning of the process is the highest predictor of keeping a 1031 exchange on track and arriving at the target destination. An astute investment professional works closely with a 1031 exchange buyer to craft a game plan that takes into account potential surprises yet still leaves ample time to complete the successful acquisition of a desired property.

— Barry Wolfe, Senior Managing Director of Investments, Marcus & Millichap