Make the Exchange

Talk to clients about using 1031 exchanges to diversify their portfolios or to plan their estates

By **Phil Sblendorio,** senior vice president and regional business manager, Farmers & Merchants Bank

Most real estate pros think of 1031 exchanges only one way — as a method for delaying the capital-gains tax on the sale of an investment property by transferring the equity to a like property. In fact, there are two additional applications for 1031 exchanges that can provide tremendous benefit to you and your clients. They can be used as tax-free vehicles for adjusting or diversifying real estate portfolios and as estate-planning tools.

With today's high property values, low interest rates, low capitalization rates and great available terms, now is the time to talk to your clients about evaluating their financial goals, needs and options.

Evaluating portfolios

Using 1031 exchanges to diversify or adjust a portfolio can be beneficial for numerous reasons. If your clients are in one or more of the following situations, then you might be well-served to suggest that they make some changes:

- **Geographically clustered portfolio:** We know what happened after Hurricane Katrina, not to mention the 1992 riots in Los Angeles and various U.S. earthquakes. If your clients' properties are clustered in one geographic area, there's a real risk that the entire portfolio could be wiped out with one regionwide disaster. Spreading properties out could be of great benefit.
- **One property type:** Many real estate investors make the economically risky decision to put all of their money in one property type. Instead, they could use a 1031 exchange to sell some of the portfolio and diversify into other property types (such as retail, office, industrial, commercial, multifamily or mixed use). The result will be a portfolio that can absorb a variety of economic conditions or changes.
- **Changing area:** Neighborhoods, cities and regions are not static. Your clients may own properties in areas that are not going in the direction originally anticipated. For example, clients might own apartment buildings in a declining neighborhood or industrial property in an area that is being rezoned. Suggest to them that they rebalance the portfolio with properties in regions that more closely fit their investment goals.
- **No upside potential:** Many properties are fully developed with little upside other than rent increases. But if your clients have the sophistication or a management team to handle more-complicated transactions, they could exchange into property that has an upside potential (such as a retail center that has excess parking on which a restaurant pad can be added).

- **Aging properties:** Some of your clients may own older properties that are approaching the end of their economic lives and showing their age. To avoid the expense and headache of managing properties that need a lot of repair (and possibly full rehabs), they can use 1031s to exchange into newer, lower-maintenance properties.
- **Tied-up equity:** In recent years, many markets have seen a big run-up in property values. Chances are, many of your clients have a lot of equity locked in their holdings. With today's rates and terms, as part of a 1031-exchange portfolio-adjustment plan, they can also take advantage of nonrecourse conduit loans for the purpose of debt diversification. It might make sense to refinance all of the properties, placing the highest debt and best rates on specific properties while freeing up equity from the rest.
- **Too much complexity:** Here's where we really get into estate planning. Many investors purchase a variety of commercial properties, each of which requires significant work and expertise to manage. As the investors age, they may no longer have the energy to keep up with it all — or they may worry about

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Phil Sblendorio, a 24-year banking veteran, is a senior vice president and regional business manager at Farmers & Merchants Bank. F&M, California's strongest bank since 1907, specializes in two types of commercial real estate lending: long-term financing for properties less than $5 million and highly creative gap financing of as much as $50 million. Sblendorio can be reached at (310) 265-3201 or Phil.Sblendorio@fmb.com. For information about F&M Bank, an equal housing lender, visit www.fmb.com.

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what will happen after they pass away. Are the beneficiaries capable of, willing to and interested in managing the portfolio the way it should be managed? With exchanges, investors can simplify the portfolio into easily managed properties that have locked-up leases with national tenants.

Building a portfolio-adjustment plan

Before making any changes, it's a good idea to analyze the portfolio, run the numbers and create a 1031-exchange portfolio-adjustment plan. Ask your clients about their long- and short-term goals. Ask them if they are in any of the above situations. If so, explain to them as a value-added service the reasons they should consider diversifying or adjusting their portfolio.

For example, say Tom has a real estate portfolio consisting of 12 multifamily properties, all located in Los Angeles, with a combined market value of $21 million. He owes a total of $6 million and has encumbrances spread out on all 12 properties averaging about 29-percent loan to value (LTV); each property has $1.75 million in value and $500,000 in debt.

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Tom decides that now is an opportune time to make some major changes to decrease the risk in his portfolio. He works with his advisers to create a portfolio-adjustment plan that will diversify his portfolio geographically (into three regions) and by property type within each region (25 percent commercial, 25 percent retail, 25 percent industrial and 25 percent multifamily). Tom also plans to diversify and spread out his risk by leveraging one or two properties in each property type or location at its maximum to pay off his other properties completely.

To implement this plan, Tom exchanges 11 of his 12 properties; obtains nonrecourse, high-LTV conduit loans on five of the properties; and uses the extra money to pay off the other seven properties in full. When the dust settles, Tom will have 12 properties — five with encumbrances and seven fully paid. He also will have a diversified portfolio and $12.25 million in freed equity against which he can borrow to expand his holdings.

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With today's high values, it is possible that some of your clients may decide now is the time to sell, pay the taxes and walk away with the profits. But if they decide to stay invested in real estate, consider suggesting that they develop a 1031-exchange portfolio-adjustment plan. It will allow them to create a portfolio that will better suit their risk preferences, goals and needs.