



## **When to do a Property Exchange – a Case Study**

*By Ray Meadows CPA, CFA, President of Berkeley Investment Advisors*

A tax-free exchange of one investment property for another is expensive up front but in certain situations it is a great move financially. This article explains what exchanges are and looks at the costs and benefits to illustrate when an exchange makes sense financially. I will illustrate my points using recent properties listed for sale in Oakland and Fresno.

U.S. internal revenue code section 1031 allows deferral of gains on investment real estate when it is *Exchanged* for a “like kind” property and certain technical requirements are met. With a little planning the requirements are met and the gain on sale is deferred and incorporated into the new property’s tax basis<sup>1</sup>. Although we use the term exchanged, what is really going on is that person A, who wants to defer gain, arranges for an entity we’ll call B, to buy the property that A wants and exchanges it for A’s property. Usually B is the ultimate buyer of A’s property but B could also be a trust or other 3<sup>rd</sup> party that helps meet the legal requirements. In substance then, an exchange is really two transactions: the sale of the investor’s current property and the purchase of a different property. To avoid all taxes the replacement property must cost at least as much as the property sold and 100% of the owner’s equity must be re-invested.

Buying and selling real estate involves significant transaction costs as well as some tax consequences that would be avoided otherwise. Sales commissions in California are usually 5% to 6% of the sales price; closing costs might add a few hundred more to the seller’s costs. Buyers don’t pay commissions but the closing costs (mostly related to financing) could easily be 2% of the purchase price. Thus an exchange can cost 8% of asset value and an even larger percentage of the investor’s equity.

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<sup>1</sup> The price is lowered by the gain in order to compute tax basis.

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Another cost of trading for another property is the increase in assessed valuation for property tax purposes. If a property has been owned a long time it will normally have a low assessed value relative to market value and thus lower taxes than if it were newly purchased. When we exchange property, the new property is assessed at current market value – thus raising our effective property tax rate.

Owners consider exchanging when rents and value have increased to the point where the property is generating taxable income and the percentage of equity in the property is much larger than necessary. Both of these factors tend to depress returns on equity. Exchanging can boost leverage and tax deductions at the same time if the new property comes with a larger mortgage. These objectives can, however, usually be achieved more cost effectively by refinancing the property and using the excess cash generated to purchase a new property.

Another prime motivation for exchanging is to boost returns on investment and cash flow by trading a property that is relatively richly valued (relative to cash flow) for one that is relatively cheap. This is the case I will focus on for the remainder of this article. My example of a richly priced market is Oakland California and my inexpensive market is Fresno California. Surprisingly though, even within the city of Oakland we can find valuation discrepancies large enough to justify exchange costs.

Let's look at some properties recently available for \$995,000. Key statistics in \$1,000's for year 1 are as follows.

Property:	Huntington Ave Fresno	54 <sup>th</sup> Street Oakland	Merced Ave Oakland
Gross Forecast Rents	172	106	45
Net Operating Income <sup>2</sup> (NOI)	84	42	12
Available Mortgage	746	597	179
Equity & Working Capital <sup>3</sup>	269	418	836
Free Cash Flow <sup>4</sup>	25	0	0
Taxable Income <sup>5</sup>	5	(14)	(11)

Since we are illustrating exchanges the numbers above were estimated assuming the Oakland properties are the potential selling candidates and the

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<sup>2</sup> This takes into account vacancy, credit losses, operating expenses, and reserves for capital expenditures. It is cash flow before financing costs – this determines the size of the loan available.

<sup>3</sup> I assume 2% of property value as working capital: \$20,000 here.

<sup>4</sup> This is after debt service and replacement reserves but before tax

<sup>5</sup> Ignoring deductible closing costs.

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Fresno property is the property to be purchased. Thus I have assumed a property tax basis and depreciable basis for the Oakland properties consistent with 5 years of appreciation. For illustration I assume all properties are mortgaged as much as banks are likely to allow so as to properly compare *required* minimum equity investments. Also note the following valuation metrics.

Property:	Huntington Ave Fresno	54 <sup>th</sup> Street Oakland	Merced Ave Oakland
Gross Rent Multiplier (Price/Rent)	5.8	9.4	22
Cap rate (NOI/Price)	8.4%	4.2%	1.2%

The differences in valuation are striking and deserve some comment. I have deliberately chosen the best and worst deals in Oakland (at my given price point) to compare to the best deal in Fresno. When I talk about cheap and expensive here, I am not talking about the dollar price of a property – in my example all properties have the same price. Rather, I am talking about what you get back in terms of cash flow: a property with a larger cash flow for a given price is “cheaper” than a lower yielding alternative. Valuation differences such as those shown above can sometimes be explained by differences in risk and/or prospects for future appreciation. That is, a market with constrained supply, robust demand growth, and no political constraints on rental increases should experience rental growth and appreciation at higher rates than in a geographic (or socioeconomic) market with less favorable conditions. In such a situation we should expect to see more expensive valuation metrics (higher multiplier, lower Cap rate) in the high growth market compared to the low growth market.

Perhaps the expected growth differential explains the valuation differences here but it seems unlikely given that the rent control regulations in Oakland limit rent increases to the rate of inflation. An alternative explanation is investment market segmentation. By this I mean that non-institutional real estate investors (the ones buying properties of this size) tend to limit their investment universe to properties near where they live. If this is true then the vast wealth accumulated in the Bay Area, combined with limited investment opportunities in the area, could explain why properties in Oakland are priced so much richer than in Fresno where there is simply less capital chasing the investment opportunity set.

As for the differences between the 2 Oakland properties, there are at least 2 factors driving the valuation difference. The 54<sup>th</sup> Street property is in

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a much less desirable area than the Merced Avenue property and investors are willing to accept a lower return (by paying a higher price) to avoid the perceived risks of buying on 54<sup>th</sup> Street. The second factor at work here is that 3 out of 4 units in the Merced Avenue property are occupied by long term tenants who have benefited from the Oakland rent law. Though these tenants reduce the actual cash flow on the property, the price is set on the assumption that they can somehow be removed.

In any case, these valuation differences provide large cash flow benefits to owners of expensive property who exchange into cheaper property. Even if you believe appreciation can make up for the cash flow difference, it may be worth it to exchange if you are retired and your living standard is determined by cash flow (rather than appreciation). Let's work through the numbers to calculate our potential gains from exchanging.

Assume you are the owner of the property at 54<sup>th</sup> Street in Oakland. If you have leveraged the property as much as shown here (usually the smart thing to do) you will have break-even cash flow after setting aside reserves for replacements<sup>6</sup>. If we assume inflation in revenue and expenses of 3%, annual free cash flow will grow to \$4,740 in 5 years. If you exchange this property for the Fresno property you will pay \$80,000 in transaction costs, but since the equity required for the Fresno property is \$149,000 less (418K – 269K) you can do the exchange and still have another \$69,000 in cash to invest in other real estate or spend (it may be taxable in this case). By exchanging, you immediately boost annual cash flow to \$22,000 after-tax (\$25K pre-tax). In 5 years this will grow to \$30,000. By year 6 it will be worthwhile to refinance the Fresno property to pull out \$175,000 in cash for reinvestment (or spending). Clearly the benefits of the exchange justify the transaction costs (as painful as they may seem). A more extensive analysis indicates that the strategy recommended here should boost return on equity over the next 10 years from 5% to 13%.

Now let's look at the Merced Avenue property. We could pull out a whopping \$487,000 if we exchange this for the Fresno property. In this case we would definitely need to look for an additional property to exchange into so as to avoid tax on any gain. This property is so equity intensive (thanks to its depressed cash flow relative to value) that we could exchange it for 2 properties like the Fresno apartments and still have enough cash left over to buy a third property. Even within Oakland we could exchange this property for the 54<sup>th</sup> Street property and end up with much higher cash flows in the

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<sup>6</sup> Meaning capital expenditures for things like appliances or a new roof.

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future. In fact, at current rent levels the Merced property will likely generate negative returns as aging can reduce its value at a faster rate than cash flows grow. Given this, even an outright sale would be preferable to holding the property.

The purpose here is illustrative. Every situation has its own set of variables that must be analyzed. Berkeley Investment Advisors can do the analysis for your specific situation. We help you proactively manage your investments to maximize returns and/or cash flows so as to achieve your retirement goals.

#### **Contact Information:**

[RayMeadows@BerkeleyInvestment.com](mailto:RayMeadows@BerkeleyInvestment.com)

Tokyo phone: (03) 5114-8379

San Francisco phone (510) 367-3280