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Property Purchase Considerations in a 1031 Exchange

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When purchasing property for a 1031 exchange, there are multiple things which need to be taken into account. Here are simply several of the items which should be considered prior to selecting any property or any particular property type for purchase.

1. Taxation. Before considering any 1031 exchange I always recommend that property sellers get a written estimate from their CPA of the taxes due upon a sale. Even more helpful is a breakdown between depreciation recapture and capital gains taxes, as in the event of a partial exchange this will also be important. In some circumstances it is also probably more prudent to consider paying taxes than to do a 1031 exchange, depending upon the amount of taxes which are due and some of the factors below.
2. Price. Real estate pricing is very cyclical. Please be aware real estate cycles when you are considering purchasing a property. I have a lot of information about where different property types are in their investment cycle, as well as real estate pricing in general. Purchasing at the top of the market likely will limit potential gains, although other factors below come into consideration.
3. Debt requirements. 1031 exchanges require replacement of all debt for complete tax deferral. On properties where there is no debt, one of your big decisions is do you acquire property for cash or do you include debt? A corollary decision is do you consider recourse versus nonrecourse debt, and the answer to that will likely determine what type of property which you look for (as nonrecourse debt is only available on certain property types). The 3rd factor is what amount of debt to use, as all debt adds risk but higher leverage adds higher risk.
4. Location. Location is always important, and different types of properties will generally require different locations. In addition, some clients desire to have properties only in the areas where they are personally located, whereas other clients are more concerned about tenant financial strength and lease longevity. Restricting properties to particular locations will narrow investment choices and will need to be prioritized with some of the other considerations discussed here.

5. Management required. Property purchasers need to understand if they will be required manage a property personally or hire management of their replacement property. This obviously can be a factor related to lifestyle as well as costs incurred in managing the property and can obviously influence what type of property which you look for as a replacement property.
6. Tenant financial requirements. Strength of tenant is a huge issue related to what types of properties exchangers prefer and the prices they are willing to pay. Long-term leases to national credit tenants demand the highest prices. Lower on the list are regional tenants (usually corporate franchisees), and the lowest credit quality is either local tenants or individuals. Security of cash flow is directly dependent.
7. Type of lease. Many purchasers prefer a triple net lease where the tenant is responsible for all taxes, insurance, maintenance and repairs. Leases which leave the owner open to maintenance and repairs, tenant improvement costs, leasing commissions, and other expenses generally command better pricing, with the knowledge that your expenses can vary significantly and will be required to be paid by owners during the ownership of the property.
8. Lease length. Longer leases command higher prices.
9. Diversification needs. Basically there are 2 types of diversification which we look at, diversification in and out of real estate and diversification into multiple properties inside of real estate. Making a judgment call on this requires understandings of what percentage of a client's assets are allocated to real estate, and how much of that allocation is in any one particular property. In general I do not like to see more than 20% of a client's net worth allocated to a particular property, and any time I get over 50% allocated to investment real estate I also have some concerns. Other options to assist in diversification while still deferring taxes are also available.
10. Liquidity needs. Real estate is an illiquid asset, both while you are alive and as part of your estate. If there is a likely current, future or estate need for liquidity, it should be considered prior to investing into real estate. Some of the other options mentioned above can defer taxes and produce assets which are much more liquid.
11. Estate planning needs. A 1031 exchange is the opportunity to roll your property's tax basis over into a new replacement property. In general if these properties are held until death, the heirs will get a step-up in basis and the potential tax on the property may never be paid. This is the best tax deferral possible, only you have to die for your heirs to benefit from it. That being said, long-term tax deferral can be obtained in other ways which might benefit diversification or liquidity. In particular this determination is where a financial planner well-versed in real estate would be of significant benefit.