

Leasehold Interests

A Leasehold Interest Can Be Considered Like-Kind Property

1031

Knowledge



One of the most foundational issues in the 1031 industry is the question of what exactly is encompassed by the term “like-kind.” For investment real estate, the like-kind requirement in Section 1031 is interpreted broadly, and so most real estate will be considered like-kind to other real estate. In certain cases, a leasehold interest may be regarded as like-kind to a fee interest in real property. In an exchange, leasehold interests may be either relinquished property or replacement property in an exchange. [Reg. §1.1031 (a)-1 (c) (2)] To be considered like-kind to other real estate, leasehold interests must have a remaining term of 30 years or more; if a leasehold has a remaining term of less than 30 years it is not treated as a qualifying Section 1031 property. However, if the lease provides for optional renewal periods, these periods can be included in determining whether the leasehold has 30 years or more remaining. In one case, a lease with an initial term of 5 years and ten optional renewal periods of 5 years each was held to be “like-kind” property since the taxpayer had the right to use the property for up to 55 years. [R & J Furniture Co. v. Comm., 20 T.C. 857 (1953)]

GROSS VS. NET LEASEHOLD INTERESTS

There is a key distinction to be drawn between “gross” and “net” leasehold interests. A gross lease often obligates the lessor only to pay a portion of expenses of the leased property. On the other hand, a net lease (often referred to as a net, net, net or NNN lease) requires the tenant to pay, in addition to the fixed rent, expenses associated with the property, such as taxes, insurance, utilities, maintenance, etc. The obvious advantage of a NNN lease to property owners is that many of the routine management burdens of ownership are the responsibility of the tenant.

WHY SHOULD EXCHANGERS CHOOSE LONG-TERM LEASES AS REPLACEMENT PROPERTIES

Some taxpayers have accumulated substantial real estate portfolios over a period of many years. In many instances, these taxpayers have performed a 1031 exchange into replacement properties. The exchange transaction has allowed them to defer the payment of capital gain taxes and rollover equities into larger and better performing properties. Now that they have met many of their long-term investment objectives, they desire to increase their monthly cash flow and simultaneously reduce the management problems typically associated with many real estate investments. An ideal solution is to exchange into a net leasehold interest, providing excellent cash flow with very few responsibilities associated with the ongoing management of the property.

THE PRIMARY ADVANTAGES OF NET LEASES

1. Predictable cash flow, typically with standard cost-of-living adjustments already built into the lease.
2. Tenant typically is a well-recognized national company, often with audited financial statements which can be thoroughly reviewed by the lessee.
3. Very few management headaches. Lessor is responsible for taxes, utilities, maintenance and insurance.

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