COVID-19
Impact on Real Estate Markets Nationally
and
1031 Exchange Update
Including New 1031 Disaster Extensions

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Presented by

Scott Saunders – Senior Vice President

ASSET PRESERVATION, INC.
A STEWART SUBSIDIARY

Instructor: Scott R. Saunders

- Sr. Vice President of Asset Preservation, Inc. (API)
- API, a Stewart subsidiary, is a leading national qualified intermediary (QI) & has facilitated over 190,000 exchanges.
- 32 years of experience with 1031 exchanges.
- Over 180+ articles on exchanges/investment real estate.
- Quoted in the Wall Street Journal, CNBC, Forbes, U. S. News and World Report & many other publications.
- CE Instructor for many organizations and holds a degree in Economics from the University of California at Santa Barbara.
- President of the Federation of Exchange Accommodators, the 1031 industry trade organization (www.1031.org)

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Outline

- COVID-19 and the Stock Market
- COVID-19 and the Real Estate Market
- Buildings Don’t Provide Cash Flow
- What Should Investment Property Owners do in Times of Distress
- Optimism Prior to COVID-19
- Financial Crisis 2008 versus 2020
- Single Net Lease Market
- Strength of Banks and Corporations
- Commercial Real Estate Benefits from Stimulus Package
- Stock Market versus Real Estate Market
- 2020 is not Like 2008
- V or U Shaped Economic Recovery?
- Taxes: 2020 and Beyond
- Capital Gain Tax Rates
- 45/180 Day 1031 Exchange Deadlines
- April 9, 2020 1031 Exchange Disaster Extension Notice
- Opportunity Zones (OZ) & 1031 Exchanges: What Works and What Doesn’t?
- Contact Asset Preservation

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COVID-19 and Stock Market

- The COVID-19 pandemic has caused a massive decline in the stock market.
- Financial markets are in considerable turmoil with significant volatility.
- Major stock market indexes have entered into a bear market (20% decline or more).
- Much of the stock market decline is based on concerns of the country entering a recession.
- A significant portion of the stock market decline was fear-based and has included panic selling that has ran into circuit breakers put in to stop panic selling.

COVID-19 and Real Estate

- We can look back to recent historical events and shocks not directly related to real estate like the swine flu, the SARS epidemic, H1N1 to make estimated predictions of the impact of the COVID-19 pandemic on the US real estate market.
- We can also look at history and the policies put in place by other countries to predict the impact of this pandemic.
- Examine past US recessions and what caused the downturn and how this affected how long it takes to come out of a recession and the impact on real estate markets.

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COVID-19 and Real Estate

- Overall, the real estate market has been relatively stable during market disruptions like a recession.
- Since 1980, there have been five (5) official recessions in the US.
- In all but the 2008 financial crisis (Great Recession), inflation-adjusted home prices fell only 2.7% from the month before the recession began to the final month of the recession.

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COVID-19 and Real Estate

- Local real estate markets may act as a counter balance regarding potentially larger declines in the financial and stock markets.
- Real estate is typically a non-correlated asset compared to the financial and stock markets.
- When high earners see a large decline in their net worth, this this could reduce the demand for luxury residential real estate.
- This may (or may not) be balanced with fewer buyers looking to purchase luxury real estate as more focus on necessities versus luxury items in a downturn.

COVID-19 and Real Estate

- Some real estate markets will be strong and other markets will not fare as well. Markets that experienced rapid appreciation may be more vulnerable to a pullback on prices unless supported by strong demand forces locally.
- COVID-19 is leading to fewer interested buyers and some sellers choosing to not list their property.
- The fear of the economic impact of COVID-19 is scaring some buyers and sellers and this is showing up in fewer transactions.
- Recent shocks to the capital markets are also affecting the availability of obtaining suitable financing for both commercial and residential real estate transactions.

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COVID-19 and Real Estate

- Challenging and turbulent financial times provide an opportunity for real estate investors with liquidity and the willingness to ignore the short-term fluctuations to purchase good investment properties when others are paralyzed by fear.
- Real estate investors see the opportunity of having access to more real estate inventory, possibly better pricing, and historically low-interest rates.
- Cash is king.

COVID-19 and Real Estate

Residential Real Estate

- Median home price hit a record high of $300K. (Propertyshark.com)
- January residential real estate prices were up 7% year over year, and residential home sales were up 7% as well.
- National average rent increased by 36% in the past decade. (Yardi Matrix)
- Home prices rose faster than rents in largest cities.
- Number of renters surpassed 100M this decade. (US Census Bureau)
- Renter population grew twice as fast as owners.

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COVID-19 and Real Estate

In 2008, when the real estate market went down, rents have steadily increased almost every year. A summary of Residential Gross Rent History is below:

Year	US Median Rent
2019	$1,078
2018	$1,025
2017	$1,012
2016	$996
2015	$987
2014	$956
2013	$924
2012	$912
2011	$912
2010	$927
2009	$931
2008	$947
2007	$899

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COVID-19 and Real Estate

- What happens if mortgage and rent payments don't happen for a few months?
- Banks and institutional investors may suffer a cash crunch.
- During the Obama Administration, this led to a bailout for the banks and large investment firms.
- Individual property owners did not get a bailout.
- Most mortgage loans today have been placed with well-qualified borrowers with good credit scores.
- A significant residential real estate market downturn, like in 2008, is not likely in 2020.

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COVID-19 and Real Estate

- Hospitality segment, hotels, short-term rental property owners will see a big drop in rental income because vacations and large events are being cancelled nationwide. Leisure and business travel almost non-existent.
- Expect less demand for office properties as employers adjust and lease smaller spaces in the future as more employees work from home.
- Shopping centers and retail space face large hurdles as shopping moved online during the pandemic.
- Most renters are sheltering at home and few are able to travel far for anything. This has also led to empty hotels and empty short-term rentals like Airbnb.
- The tourism industry will be impacted for some time.

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COVID-19 and Real Estate

- Summer vacation plans are also being canceled and other short term rental property owners face additional cancellations and uncertainty.
- Since much of the income to service the debt on vacation properties happens over summer and at peak times in the winter, if these properties remain vacant, property owners may not be able to make mortgage payments which could decrease vacation property values.
- Long-term rental property occupied by long-term tenants will generally see stable property values.
- Investment property owners may need to make concessions to tenants in the short-term who have lost jobs or seen significant declines in incomes.
- Few multi-family and residential rental tenants have ample financial reserves so any loss in immediate income affects their ability to pay rent immediately.

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COVID-19 and Real Estate

- Local county courts or closed or operating on a skeleton staff.
- Property owners are not be able to evict tenants in the short-term and there is uncertainty as to when eviction may proceed. Late fees and penalties for late payment of rent are also on hold.
- There is a risk that employed but non-paying tenants may take advantage of the present COVID-19 situation.
- Investment property owners are worried they will need to carry the financial burden of a tenant that will not pay the rent because of the impact COVID-19.
- Some, but not all, lenders are working on short-term and temporary forbearance relief.

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COVID-19 and Real Estate

- A long-term economic problem could be difficult for housing if a significant number of people lose their jobs and income leading to less qualified buyers.
- In a recession, rents may stop rising.
- The residential real estate market is likely to do better than the commercial real estate. People need a place to live whether they own or rent.
- Residential vacancy rates will not change much because very few people are going to be moving in the short term.

Buildings Don’t Provide Cash Flow

- It isn’t the building or property that pays the rent.
- Tenants pay investment property rental income.
- The tenant, not the property, is the real asset.

What to do in Times of Distress

- Accordingly, property owners should focus on reaching out to tenants to discuss their ability to pay rent and/or make adjustments and a new payment plan based upon tenants being affected by COVID-19.
- It's better for investment property owners to receive some rental income versus no rental income at all.
- Reduced cash flow to offset debt service > no cash flow.

Optimism Prior to COVID-19

- **<u>Strong economic fundamentals prior to COVID-19</u>**
- Economy was strong
- Unemployment was low (under 4%)
- GDP up 3-4% range
- Ten years of continued economic growth
- Longest bull stock market in history

Optimism Prior to COVID-19

- **<u>Quality real estate remains in demand</u>**
- Domestically, the US is seen as a safe haven in times of economic distress worldwide
- Imbalance of supply
- Temporary shocks to some real estate segments (hospitality, student housing, retail, etc.) should be short-lived once things begin to get back to normal.
- Certain segments, like essential businesses (grocery and drugstores) see strong demand backed by long-term leases, stable tenants and favorable demographics.
- Industrial assets benefit from e-commerce trends.

Optimism Prior to COVID-19

- <u>**Quality real estate remains in demand**</u>
- The spread between the 10-year Treasury and average cap rates set a 30-year low.
- Real estate investors looking to maximize ROI can do well in today's market by locking in the lower cost of capital.

COVID-19 Impact on Financing

- **<u>Favorable interest rates</u>**
- Interest rates are at historic lows after recent cuts
- Federal Reserve cut rates to 0 - .25%
- <u>March 3:</u> 50 basis point rate cut
- <u>March 13:</u> Additional 100 basis point rate cut
- Federal Reserve committed more than $1T to Treasury and repurchase agreements and billions for additional quantitative easing
- Federal Reserve reduced reserve requirement ratios to 0%

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COVID-19 Impact on Financing

- March 17-18: Federal Reserve provides new funding source and buys commercial paper directly from companies
- Federal Reserve offers short-term loans directly to financial institutions
- Federal Reserve lends additional collateral to banks
- March 23: Federal Reserve makes sure businesses can access credit
- Federal Reserve purchases more Treasuries and CMBS
- Federal Reserve increases credit to the corporate bond market and creates new loan mechanism for many loans including SBA, credit card, auto, etc.

COVID-19 Impact on Financing

- $2.2T US stimulus plan (largest federal stimulus in history)
- US federal government focuses on getting money directly to taxpayers and small businesses.
- New SBA loan and other programs to support businesses and employment.
- April 9: $2.3T additional funds through the Federal Reserve with new loans to help support the economy.
- Observation: Long-term, the injection of trillions of dollars into the financial system by the federal government and the Federal Reserve will lead to inflation. Real estate has historically been a favorable asset class that keeps up with inflationary pressures.

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Recent Economic Downturns

Economic Shock	Duration	S&P 500	GDP	Jobs	Unemployment	Retail Sales
1973 Oil Crisis	16 mo.	-41%	-3%	-3%	4% - 9%	-3%
Iranian Revolution	16 mo.	-19%	-3%	-3%	7% - 11%	-3%
Iraq Invades Kuwait	8 mo.	-16%	-1%	-1.5%	5% - 8%	-3%
9/11 & Dot Com	8 mo.	-46%	+.4%	-2%	4% - 6%	-1%
Great Recession	18 mo.	-53%	-4%	-6%	4% - 10%	-13%

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Optimism Prior to COVID-19

The Past 18 Years

Core Retail Sales 2001 – 2019:	+44%
Median Household Income 2001 - 2019:	+23%
Household Debt: 2001	73%
Household Debt: 2008	98%
Household Debt: 2019	75%

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Optimism Prior to COVID-19

Commercial Real Estate (CRE)

- Vacancy rate 2004: 9%
- Vacancy rate 2019: 6% (Down)

- Loan to value 2004: 69%
- Loan to value 2019: 62% (Down)

Single Net Lease Segment

- Retail cap rates Q1, 2020: 6.15%
- Office cap rates Q1, 2020: 7.00%
- Industrial cap rates Q1, 2020: 7.05%

- Net lease transactions in 2019:$80B (up +35% from 2018)

- Primary interest in net lease is from 1031 exchange investors and private investors.

Optimism Prior to COVID-19

<u>Commercial Real Estate (CRE)</u>

- The US entered the COVID-19 crisis with many excellent economic fundamentals and in a very strong position for households, corporations and the banking sector.
- The US is currently facing both challenging health and economic problems.
- Social distancing and other measures are intended to “flatten the curve” and reduce the spread of the virus in hopes of not overwhelming current medical/hospital resources and staffing appear to be working.

Strength of Banks/Corporations

Bank Reserves

- Bank reserves 2007: $44B
- Bank reserves 2020: $1.7T

Profits

- Corporate profits 2001: $.7T
- Corporate profits 2019: $2.1T

Cash on Hand at Corporations

- Cash 2001: $.2T
- Cash 2019: $1.3T

Financial Crisis 2008 v. 2020

2008 Financial Problems

- Massive speculation
- Over-leveraging of CRE and residential real estate
- Risky derivatives and financial products

2008 Financial Institutions

- Federal Reserve action was not decisive
- Funds injected helped banks and financial institutions, not consumers (Wall Street versus Main Street)

2008+ Recovery

- Slow recovery. Financial system took time to repair

Financial Crisis 2008 v. 2020

<u>2008</u>

- S&P fell by 50% (Oct. 2007 to March 2009)
- But….the economic slowdown and stock market downturn was primarily *caused by a mortgage market in turmoil* which lead to the real estate market collapsing nationally.

<u>2020</u>

- Stock market correction a result of an *<u>outside event</u>* (COVID-19) and is not connected to the real estate industry.
- Current situation is more like the early 2000s and not The Great Recession starting in 2008.
- After 9/11, real estate recovered strongly.

Financial Crisis 2008 v. 2020

2020 Healthy Financial System

- Strong corporate balance sheets, banks well capitalized
- Households not carrying as much debt

2020 Crisis

- Unforeseen COVID-19 virus pandemic

2020 Damage

- Much of the US is not working resulting in huge job losses
- Companies shut down/idled, 23%+ have laid off employees

2020 Government Action

- Quick, substantial efforts by government & the Fed

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Stock Market v. Real Estate

Stocks

- 2019: Total return: +25%
- March, 2020: S&P falls 30%
- 20 year total return: +115%

Real Estate

- 2019: Average return: +7%
- 20 year total return: +359%

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New Stimulus Benefits Commercial Real Estate

- Lifts $500K cap on tax deduction for real estate depreciation for non-corporate taxpayers.
- Allows losses on depreciation over $250K for single filers and $500K for married filing jointly.
- Limitation on deductible business interest increased from 30% to 50% for both 2019 and 2020.
- 5-year carryback of NOL for businesses in 2018, 2019, 2020.
- Correct drafting error in TCJA and now allow for “qualified improvement property” (QIP) to be depreciated over 15 years and eligible for bonus depreciation.

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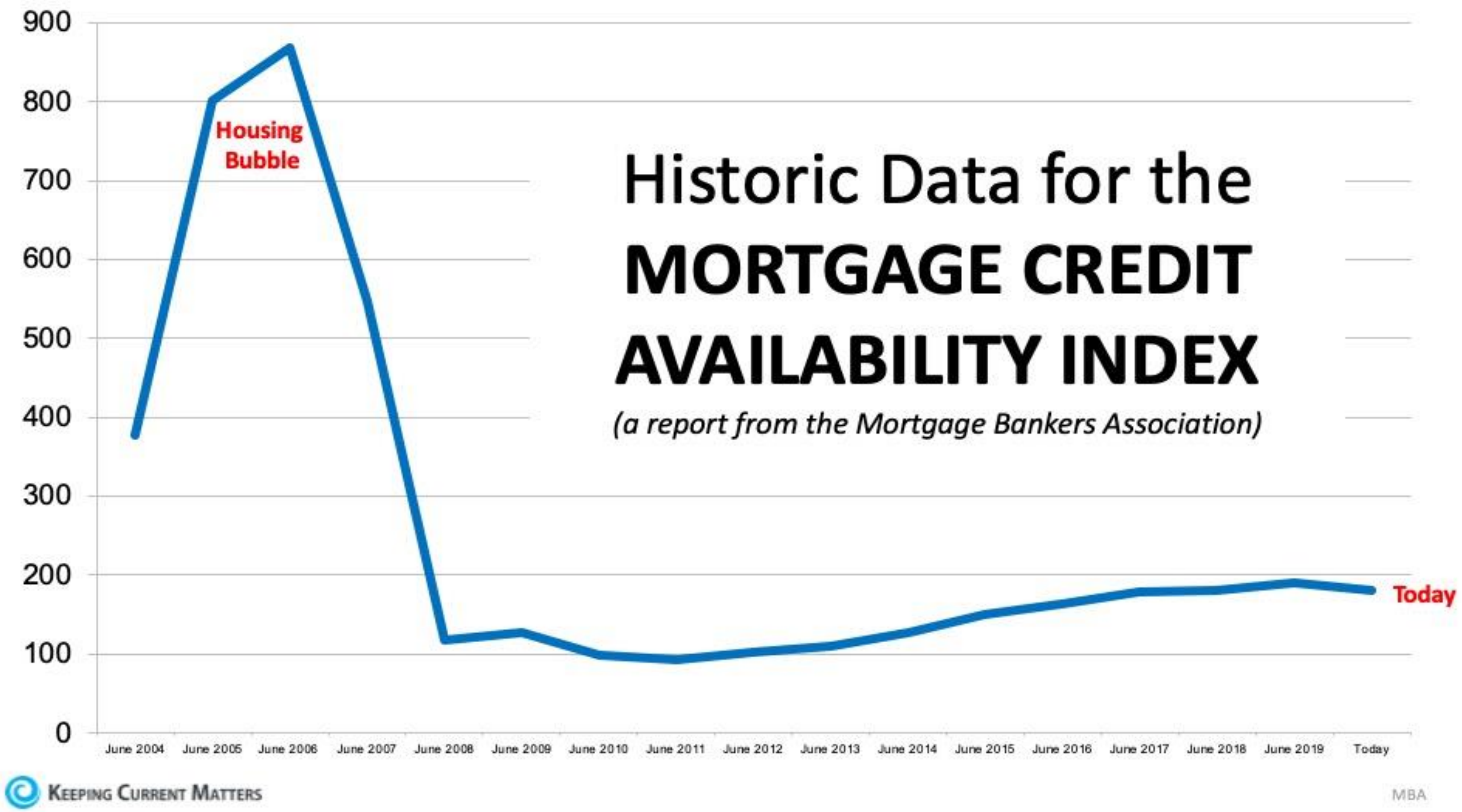
2020 is not 2008



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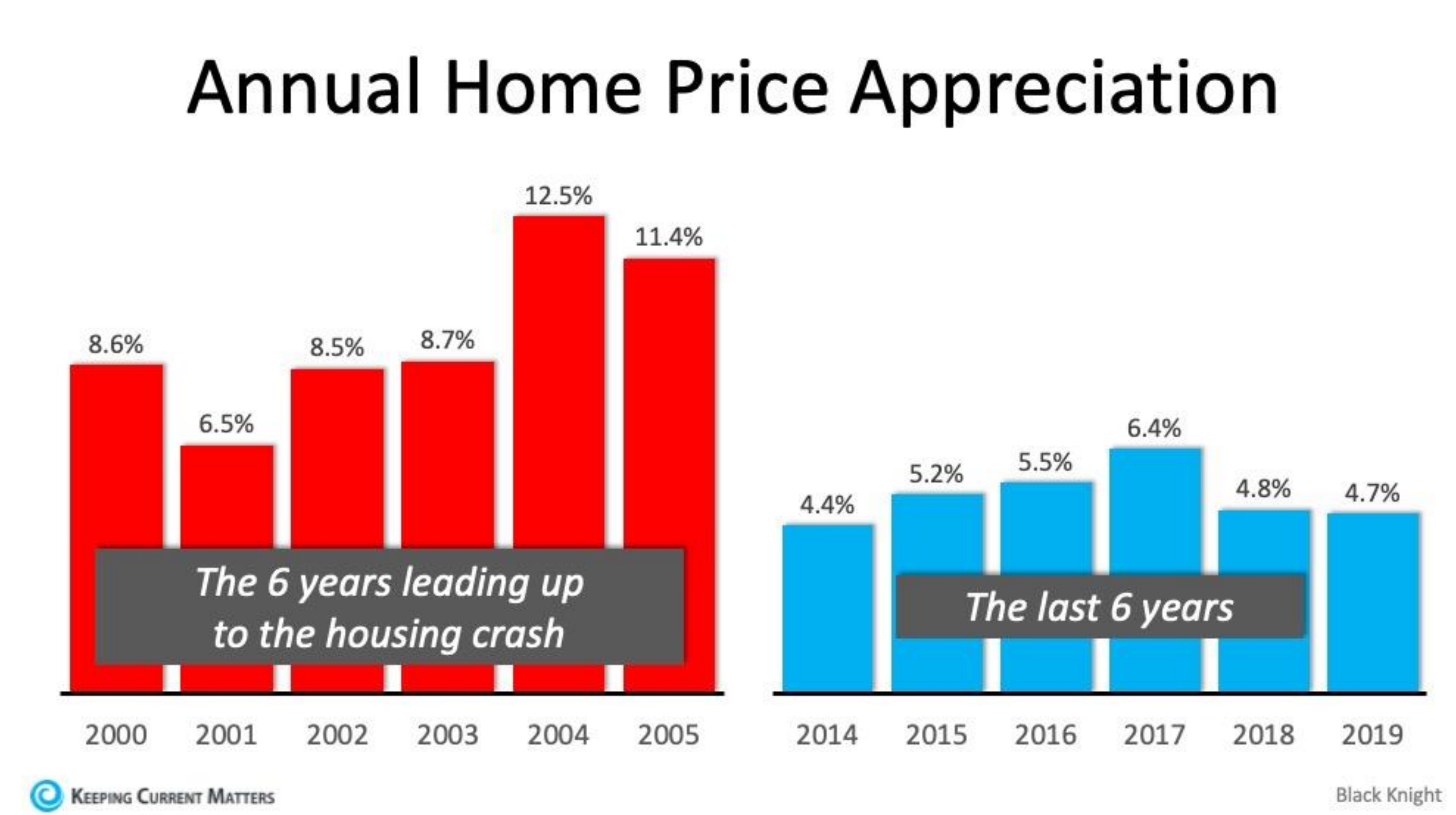

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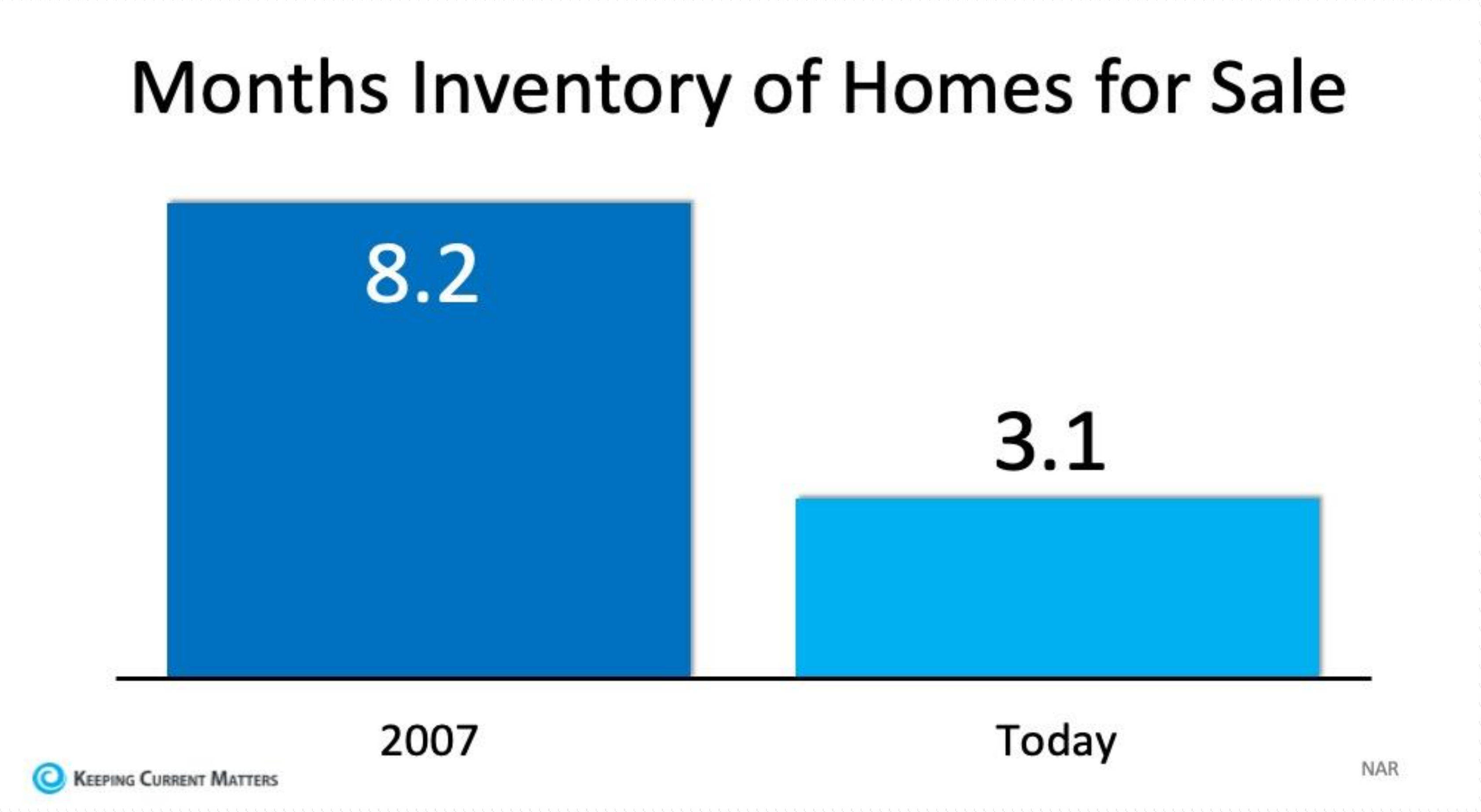

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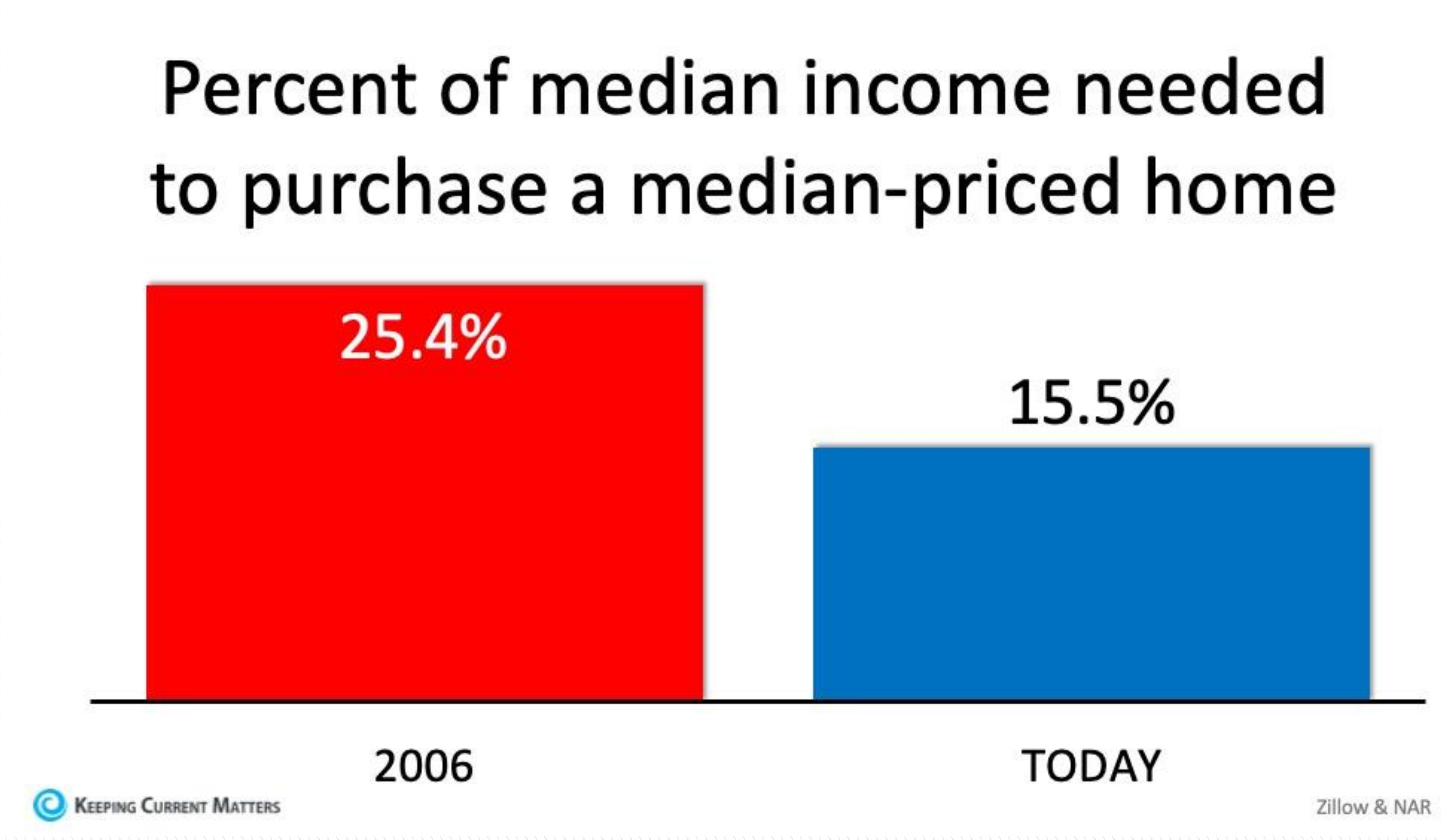

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2020 is not 2008

Total Home Equity Cashed Out

by Refinance in Billions

Then…

Year	Dollars
2005	$263B
2006	$321B
2007	$240B
Total	$824B

Now…

Year	Dollars
2017	$71B
2018	$87B
2019	$74B*
Total	$232B

**Using the first 3 quarter estimates from Freddie Mac and estimating $20B for the 4th quarter*

Freddie Mac

Keeping Current Matters

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V or U Shaped Recovery?

- Transactional activity will by slow during the COVID-19 crisis as a result of uncertainty.
- Underlying demand for investment real estate is high.
- Many who were heavily invested in the stock market are considering investing in real estate for less volatile returns and diversification.
- Once the crisis is behind the US, should be a significant bounce back in real estate investment transactions.
- V versus U Recovery: Unknown ….but does it really matter if the economy comes back strong post-crisis?

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Taxes: 2020+ and Beyond

- Senate Finance Committee: Ron Wyden’s “mark to market” annually and tax proposal
- Former Vice-President Biden: Eliminate 1031 exchanges
- Increase capital gain taxes to ordinary income
- Increase tax rates to pre-TCJA levels
- Wealth tax
- Uncertainty with taxes if all three branches swing to one party or the other
- How is the U.S. going to pay for all of the stimulus? Tax rates and tax revenues in the future must increase to pay for the U.S. debt.

Capital Gain Taxation

- 20% capital gain tax rate for high earners
- 3.8% “net investment income tax” (NIIT) pursuant to IRC Section 1411
- Capital gain taxation includes 4 components:
  1) Taxation on depreciation recapture at 25% - *plus*
  2) Federal capital gain taxes at 20% (or 15%) - *plus*
  3) 3.8% tax on net investment income - *plus*
  4) The applicable state tax rate (0% - 13.3%)

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Delayed 1031 Time Requirements

- **45 Day Identification Period:**
  The taxpayer must identify potential replacement property(s) by midnight of the 45th day from the date of sale.

- **180 Day Exchange Period:**
  The taxpayer must acquire the replacement property by midnight of the 180th day, or the date the taxpayer must file its tax return (including extensions) for the year of the transfer of the relinquished property, whichever is earlier.

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IRS 1031 Deadline Extension

- The IRS issued Notice 2020-23 on April 9, 2020.
- This Notice extended deadlines for taxpayers affected by the COVID-19 pandemic including Section 1031 exchange time deadlines.
- This Notice provides that any person performing a time-sensitive action listed in either § 301.7508A-1(c)(1)(iv) of the Procedure and Administrative Regulations or Revenue Procedure 2018-58, 2018-50 IRB 990 (December 10, 2018), which is due to be performed on or after April 1, 2020, and before July 15, 2020 (Specified Time-Sensitive Action), is an Affected Taxpayer. This includes the 45-Day Identification and 180-Day Exchange Period deadlines in both deferred and safe-harbor reverse 1031 exchanges.

IRS 1031 Deadline Extension

- If the end of a taxpayer's 45-day Identification Period or 180-day Exchange Period in a deferred exchange or the parallel periods in reverse exchanges under Revenue Procedure 2000-37 **falls between April 1 and July 15**, **the applicable period is automatically extended to July 15, 2020 ---** unless a taxpayer chooses to opt-out of the extensions.
- Taxpayers who choose to opt-out of these extensions should notify their qualified intermediary (QI.)

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IRS 1031 Deadline Examples

Examples

- The taxpayer’s relinquished property closes on April 5, 2020. The 45th day in their Identification Period is May 21, which is now extended to July 15, 2020. The taxpayer must close on replacement property by October 3, which is the 180th day of their Exchange Period since October 3 is after the last day of the disaster period which ends on July 15, 2020
- Taxpayer’s relinquished property closes on January 16, 2020. The 45th day in their Identification Period is March 1, 2020. The 45-day Identification Period is not extended because the 45th day is before April 1, 2020. The 180th day was July 14, 2020 which is extended one day to July 15, 2020 (the last day of the disaster period extension.)

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IRS 1031 Deadline Extension

- Only deadlines currently scheduled to occur between the dates of April 1 – July 15, 2020 are extended.
- Notice 2020-23 does not address deadlines that fall before or after this specific time period such as identification or exchange completion periods that ended before April 1 or pending exchange periods that end after July 15, 2020.
- This Notice is different from many previous IRS Disaster Relief Notices and does not provide clear answers to other Section 1031 deadline related issues.

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IRS 1031 Deadline Extension

- This Notice does not reference Section 17 of Revenue Procedure 2018-58, which provides an extension of 120 days or until the date specified in the Notice, whichever is later.
- It is uncertain and not clear in Notice 2020-23 if the 120-day deadline extension provided in previous IRS Disaster Relief Notices applies.
- Some taxpayers were seeking IRS extensions of dates falling after the date of the FEMA and Stafford Act declaration on March 13, 2020. Other taxpayers were hoping for a deadline extension to apply from the date of the FEMA disaster declaration on January 20, 2020.
- <u>Make investment/tax decisions based on known IRS guidance.</u>
- IRS plans to provide additional clarification.

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1031 into OZ Strategy: What Works

- 1031 exchange rules and OZ rules are separate provisions.
- However, an OZ can be a fallback position for 1031 investors.
- Investor initiates a 1031 exchange and does not find suitable replacement property within 45 days.
- Investor notifies QI that they haven't identified any replacement property and want 1031 proceeds back on day 46.
- QI releases exchange proceeds to investor on day 46.
- Investor has 135 more days (up to 180 days from the sale of relinquished property) to invest proceeds into an OZ Fund.
- Since changing strategy from 1031 to OZ, the investor only needs to invest the gain (not all net proceeds) into OZ Fund.

1031 into OZ Strategy: What Works

- Entity (must be a partnership or corporation, not a disregarded entity or can be an LLC that converts tax status to a partnership or corporation) completes a 1031 exchange.
- Post-1031 exchange, the entity then elects for OZ Fund status for the entity.
- Then new OZ Funds coming from deferred capital gain from another source are used to substantially improve the 1031 replacement property.
- This results in the deferred gain in the 1031 exchange being deferred past 2026 (until the investor sells in a later taxable sale) and separately the gain deferred in the OZ Fund used for improvements qualifying for OZ tax treatment, subject to the OZ rules.

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1031 into OZ Strategy: What Works

When selling a relinquished property held for investment, an investor has 3 options involving Section 1031 and OZ:

1. Initiate a 1031 exchange;
2. Invest gain into a OZ Fund;
3. Both: Split the proceeds and allocate some funds to a 1031 exchange and also invest some proceeds into an OZ Fund. Using this third combined 1031 exchange and OZ strategy, the basis of the relinquished property should be split pro rata with some gains attributed to the 1031 exchange and some gains going towards the OZ Fund.

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1031/OZ Strategy: What Doesn't Work

1. Cannot do a 1031 exchange into an OZ Fund.
   - The OZ Fund is a fund and not like-kind real property needed for 1031 exchange deferral.
2. Cannot identify property in 45 days and not purchase all the identified property and invest remaining proceeds in a OZ Fund.
   - Section 1.1031 (k)-(g)(6) specifies an investor must acquire all replacement property they are entitled to (i.e. all property identified within the Identification Period) or wait until day 181 (the expiration of the exchange period) to receive 1031 exchange proceeds from the QI.
   - If an investor receives proceeds from the QI on day 181, they are outside the 180 day reinvestment time period required by OZ rules and not eligible to invest into a OZ Fund.

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Contact Asset Preservation

COLORADO – Scott Saunders	888-531-1031	scott@apiexchange.com
HEADQUARTERS – California	800.282.1031	
EASTERN OFFICE – New York	866.394.1031	
WEBSITE	apiexchange.com	
EMAIL	info@apiexchange.com	

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