

## How Long-Term Leases Factor into 1031 Exchange Transactions

Leasehold interests may be either relinquished property or replacement property in an exchange. [Reg. §1.1031 (a)-1 (c) (2)] A leasehold interest with a remaining term of 30 years or more is considered “like-kind” property to a fee interest in any other real estate held for productive use in a trade or business or for investment. If a leasehold has an unexpired 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)]

Leasehold interests are more important than ever with tax reform because personal property exchanges have been eliminated from section 1031. This puts additional pressure on the definition of “real property” for like kind exchanges, and 30-year plus leases are included under that definition.

### GROSS VS. NET LEASEHOLD INTERESTS

A gross lease often obligates the lessor only to pay a portion of expenses of the leased property. 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 of 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 EXCHANGE INTO LONG-TERM LEASES AS §1031 REPLACEMENT PROPERTIES?

Many real estate investors have accumulated substantial real estate portfolios over a period of many years. In many instances, these investors have performed a 1031 tax deferred exchange into replacement properties. The exchange transaction has allowed them to eliminate 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 most 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.



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## ADVANTAGES OF NET LEASES

- Exchanges into long term leases are attractive in markets where people cannot easily find replacement properties because inventories are low.
- Investors can depend on predictable cash flow, typically with standard cost-of-living adjustments already built **into** the lease.
- Tenants typically are well-recognized national companies, often with audited financial statements which can be thoroughly reviewed by the lessee.
- Long term leases present very few management headaches.
- Long term leases allow real estate investors to benefit from revenue streams without triggering the recognition of capital gain taxes.

The long-term lease option is beneficial in scenarios where an exchanger/buyer is having trouble obtaining financing in time to meet their 1031 exchange deadlines. The attorney can then structure the deal as a long-term (30-year +) lease with an option to purchase allowing them to complete the exchange.

As always, be sure to consult with your tax advisor and attorney on this and other 1031 Exchange-related transactions. For more information on 1031 Exchange-related topics, please contact Steven Rosansky Esq., Senior Director of Exchanges, at (949) 836-7604 | [steven@peakexchange.com](mailto:steven@peakexchange.com)



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