ZERO CASH-FLOW INVESTMENTS

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Zero Cash Flow ("ZCF") Investments are powerful tax-deferral tools used by some of the most financially successful real estate investors. ZCFs utilize 1031 exchange rules to defer capital gains taxes, while allowing cash out and/or debt replacement. These investments offer tremendous upside, very little initial investment, and utilize leverage that investors are not personally liable for.

What is a ZCF Property/Investment?

A ZCF property is a highly leveraged asset secured by a long-term, triple-net lease of an investment-grade tenant (Amazon, CVS, etc.). The tenant's rent payment is used to directly pay down the loan used to acquire the property. The NNN lease secured loan gives lenders a greater sense of security, so they are willing to loan out larger amounts than usual. Investors are not personally liable for the debt used to purchase the underlying property, leaving their balance sheets free to do other deals. There is no cash flow distributed to investors, deeming the term "zero cash flow," or "zero".

The majority of investors in ZCFs do so for 1031 Exchange benefits, but they can be extremely attractive for other reasons as well. The following hypothetical scenarios show how ZCFs can be used in different types of transactions.

Utilizing a ZCF for Debt Replacement.

A ZCF satisfies the 1031 Exchange debt replacement requirement for an investor who sells a property with a large amount of existing debt. An example would be an investor who sells their property for $15M, with $13M in debt to replace. Locating a $15M replacement property with a bank loan of $13M is near impossible. A simple solution would be to purchase $15M in ZCF properties with an equity requirement of about 10%-15%. The investor satisfies the exchange rules, defers their capital gain taxes, and now owns a pro-rata share of triple-net leased properties.

A non-exchange buyer might need to purchase an asset that will produce net tax losses to offset passive income in their portfolio. ZCFs normally shelter tax in their early years through depreciation and mortgage interest deductions.

How can you take cash out with a 1031 Exchange transaction?

An investor with a large amount of equity in a 1031 Exchange transaction can benefit greatly from a ZCF due to their unique paydown/re-advance feature. This feature is perhaps the number one reason why ZCF properties are so popular for 1031 Exchanges. This allows the investor to meet the requirements of a tax-deferred exchange, while cashing out a significant amount of their equity. Investors can use the cash withdrawn for whatever they want - without the fear of violating exchange rules. Here is an example of how the paydown/readvance feature works:

Christine Narayan 720.220.5663 | Christine@apexcapmgmt.com
Sawsana Sekrieh 720.401.7504 | Sawsana@apexcapmgmt.com

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Let's assume an investor has $10M of sales proceeds after selling their investment property; with $8M in equity and $2M in debt. In order to defer the taxes associated with selling they would have to potentially find another property for $10M. The investor identifies a ZCF with 80% LTV (Loan to Value). The leverage in the replacement ZCF is very high, so the investor would only need to hold $2M in equity to satisfy a $10M 1031 Exchange. The investor would need to keep the $2M of required equity invested in the ZCF. The additional $6M of equity is readvanced back to the investor as cash, completely tax free.

What if you don’t have debt to replace but still want to obtain cash out in a 1031 exchange?

Let’s assume an investor’s property is sold for $9M with no existing debt. They can buy a ZCF Amazon Sortation Facility with 10% equity and 90% leverage. They instruct the lender that they would like to exercise the paydown/readvanced feature. Only $900,000 is needed to satisfy a $9M exchange due to the 90% leverage used, so the lender wires the investor $8.1M after closing. As a result, all taxes are deferred, the 1031 Exchange is completed, and $8.1M of tax-free cash is obtained, without the typical 45/180-day limitations. The investor also owns a pro-rata share of an Amazon Sortation Facility with a 20+ year NNN lease, which is usually free and clear at lease end.

What happens with the equity invested in a ZCF?

The investor builds more equity in the ZCF as the tenant pays their rent payments. The monthly rent payments get applied to service the loan securing the property and equity begins to accumulate. The goal is to own the property free and clear at the end of the term, but this varies with each property and how it is structured.

Questions? Contact Us.

ZCF properties have many advantages for 1031 Exchange investors. The aforementioned examples and benefits display how they can potentially compliment your portfolio. Every scenario is different according to each investor’s needs and objectives. ZCFs can allow cash flow, tax deferral, and debt replacement when used properly. However, with every investment there is inherent risk. Apex Capital Management is here to help you every step of the way with ZCF and other DST investment options. Feel free to check out our website at www.apexcapmgmt.com for more information. We look forward to helping with your 1031 Exchange and DST Options.

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Christine Narayan 720.220.5663 | Christine@apexcapmgmt.com
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