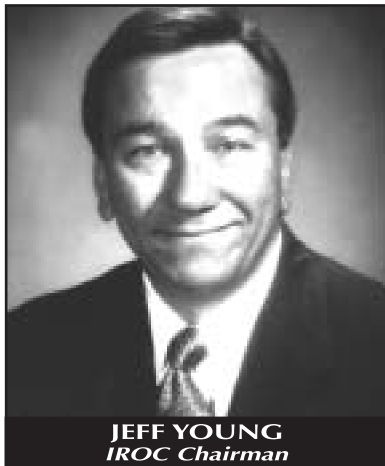
Independent Rental Owners Council

Tenant-in-Common Exchanges Worthy of Investors' Consideration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Editor's note: *The suggestions contained herein are meant as guidelines and are based on the experience of Independent owners. Please send your comments and questions to Jeff Young at First Financial Equity Corporation, 480-778-2041.*

The process of owning and managing investment property is, or at the very least, ought to be, part of an overall investment plan with defined goals and strategies.

For most people, one's investment life consists of two separate and distinct components: the accumulation phase, followed by the distribution phase. Simply put, the astute investor spends wisely, eschews debt and saves money, usually by spending less than one earns. That saved money, in turn, is invested into stocks, bonds, CDs, money markets and real estate. At some point in their life, they enter into a retirement or semi-retirement stage, where they will employ some or all of the income from their investments to support themselves. This may be supplemented with IRA distributions, pensions, social security payments and perhaps income from employment.

For the active real estate investor, however, there can exist some daunting challenges to converting property obtained over one's lifetime into a steady income stream while divesting oneself of the active management of those properties. For instance, selling the property outright and investing the proceeds in income-generating vehicles could incur an onerous tax burden. And every dollar paid in taxes in one dollar less that can generate future income. (While it is true that long-term capital gains taxes were cut in 2003, recapture of depreciation at sale is still taxed at 25 percent.)

Fortunately, a powerful solution exists in a little-known Internal Revenue Service (IRS) code provision under Section 1031. It is commonly called a 1031 exchange or tax-deferred exchange, and it can be a financial lifesaver to the investment property owner. Simply put, a property owner can sell a real estate investment asset and buy another "like-kind" real estate asset without incurring capital gain taxes.

For the property investor looking to now become a more "passive" investor, the 1031 Tenants-in-Common (TIC) exchange program can be the ideal way to retain real estate ownership and income, while deferring taxes and moving away from the day-to-day management of rental property. (Note that this can be a complicated process with some very rigid requirements that must be met, so each investor is encouraged to discuss a proposed property exchange with a qualified investment advisor and a tax advisor.)

Basically, the investor (seller) conducting an exchange is required to enter into an exchange agreement with a Qualified Intermediary (QI), which provides, among other things, that the net sales proceeds are transferred to the QI to be held for the benefit of the seller, that the seller identify up to three properties within 45 days of the date of such a sale, and that the seller close on the replacement property within 180 days of the sale.

Because the IRS defines "like-kind" property rather broadly, one could, for instance, sell his or her residential real estate used for investment purposes and purchase a TIC share in an office building, a regional retail mall, a light manufacturing or distribution center or even unimproved land. By contrast, one could not affect an exchange into Real Estate Investment Trusts (REITs), stocks or bonds or a personal residence. So not only can investors delay or eventually eliminate a large tax bill on sale by using the 1031 TIC exchange, they may invest in property that may provide more income, greater stability and better value appreciation over time.

When the investor conducts the exchange, the acquired property must be of equal or greater value than the relinquished property at equal or greater debt. Any net equity not reinvested is considered "boot" and is fully taxable.

In addition, the investor must use the QI to facilitate the transaction. The QI is the entity who acts as the middle person in the exchange, providing the oversight, structure, escrow services and expertise necessary to ensure that the transaction legally qualifies as an exchange under the 1031 Section of the IRS code. Though these exchanges are complicated, a good QI can make it seem very easy.

And lastly, and perhaps most importantly, is the sponsor (or provider). This is the company that chooses the property, conducts due diligence, arranges for the financing and provides for the property management after the closing on behalf of the investors. It should be a highly qualified, national real estate company with experience in the tenants -in-common field.

Certainly, a 1031 TIC exchange is not for everyone, and this article covered only the basics. However, the astute property investor would be wise to consider it as a reasonable alternative for future planning and for inclusion into a comprehensive estate plan. AMA