A 1031 Exchange Vehicle for Small Investors

By Beth Mattson-Teig

National Real Estate Investor, Mar 1, 2003

Investors have long used 1031 Exchange deals to defer taxes when swapping old properties for new ones in their portfolios. Now, thanks to a 2002 Internal Revenue Service ruling, the pool of commercial properties has expanded greatly for small investors.

The ruling pertains to “Tenant in Common,” which allows individuals to own a fractional interest in a 1031 property, such as a shopping center or office building. The IRS ruling was an important step in providing assurance that TIC properties qualify as viable 1031 Exchange options.

The combination of the IRS ruling and a growing awareness of this 1031 investment structure has released a flood of investment dollars into TIC deals. The TIC structure opens the door to ownership in larger, higher-valued and better-located properties than an individual could afford independently. And it puts investors into long-term, triple-net leases or professional managed properties, letting them avoid the hassles of property management.

Here's how a TIC deal works: Suppose an investor has $250,000 to reinvest in a “like-kind” exchange. At that price, his options may be limited to relatively small stand-alone properties such as a Walgreen's or Blockbuster. But by pooling his $250,000 with the capital of other TIC investors, that same investor has access to a much larger and diverse inventory of investment properties such as office buildings, shopping centers or industrial facilities.

“It is a fledgling industry, but we believe it has potential to be akin to something like mutual funds,” says Cary Losson, founder and president of 1031 Exchange Options in Lafayette, Calif. Just as mutual funds opened up stock buying opportunities to the general public, TIC offers similar opportunities for direct real estate ownership, Losson says.

“I think we are going to see this industry absolutely explode and become truly commonplace in the next three to four years,” Losson predicts. 1031 Exchange Options closed more than $100 million in TIC transactions during 2002 — triple the volume of 2001. The company expects its business to jump to between $300 and $400 million this year.

Impact of the IRS Guidelines

Although the TIC structure has been in use for more than a decade, it's clear that the new IRS guidelines issued in March 2002 helped ignite growth. Specifically, IRS Revenue Procedure 2002-22 clarified the circumstances under which the IRS will recognize the TIC structure as a viable 1031 Exchange option.

“There had been a lot of confusion regarding TIC in a lot of areas,” says Randy Blankstein, president of The Boulder Group in Northbrook, Ill., an investment brokerage and TIC sponsor. “This created the structure where investors could be confident the IRS was on board for 1031 exchanges.”

The IRS Revenue Procedure helps clarify whether multiple owners have an interest in real property, or are a partnership and therefore not eligible for the

1031 Exchange program. The IRS is working on further clarity, and the agency is expected to issue additional guidelines as early as this summer.

RETAIL articles
INDUSTRIAL articles
HOTEL articles

A Supply Shortage

TIC ownership solves a growing problem among 1031 Exchangers — a shortage of like-kind properties — a requirement for favorable tax treatment. “The capital from 1031 dollars far outweighs the product opportunities in the marketplace,” says Todd White, senior vice president and director of transactions at Dallas-based Macfarlan Real Estate Investment Management.

Demand is being driven by investors fleeing equities as well as by small commercial property owners heading into retirement who are looking to simplify their finances through passive ownership.

Another part of the supply problem is that the bulk of 1031 investors are chasing similar properties. The majority of 1031 Exchanges are valued below $500,000 — 45% according to Deloitte & Touche — which further limits the pool of viable exchange options. Consequently, 1031 Exchange investors clamoring to find viable buying opportunities in a crowded market are discovering the beauty of co-ownership via TIC deals.

Enjoying the Upside

Although most sponsors — those firms in charge of assembling TIC deals — set the minimum investment at $250,000, a few niche players cater to investors with as little as $50,000 to invest. “We are, in effect, a bridge between these markets. We make institutional properties available to the retail buyer,” says Rob Hannah, CEO of Tax Strategies Group LLC, a firm that specializes in structuring and selling TIC interests.

Not only do TIC deals let smaller investors into the market and provide them with greater access to better buildings, they also give real estate owners a way to swap out of management-intensive properties. Patrick and Judith Geoghegan, a retired couple who live in Oakland, Calif., recently closed on their fourth TIC transaction in the past two years with 1031 Exchange Options.

The Geoghegans sold off their residential real estate in the Bay area, including a duplex, triplex and a single-family rental property, and rolled approximately $3 million into TIC deals that gave them a stake in commercial properties, including the Kahana Gateway Plaza, a retail and office project in Maui, Hawaii; Jeronimo Business Park, a mixed-use retail facility in Mission, Viejo, Calif.; Sacramento Corporate Center, a Class-A office building in Sacramento, Calif.; and Titan Plaza, a Class-A office building in San Antonio, Texas.

“To this point, we have been pleased with the results,” says Patrick Geoghegan. He had made a habit of visiting his rental properties almost daily to do everything from pick up trash to oversee repairs. “We prefer to have the professional management,” he adds. The couple saved nearly $700,000 in capital gains taxes they would have incurred in a sale, and they are now receiving an annual return between 7.5% and 8.5% on their money.

Indeed, another benefit of the TIC deals seems to be higher income for many investors. According to Losson, his clients averaged net cash flow returns of 2.5% prior to trading into a TIC property. TIC owners can expect a combined return of about 18% annually, including cash flow and property appreciation, he adds.

And, in many cases, the rewards come with lower risk. 1031 Exchange Options, for example, recently closed on the TIC purchase of the Congress Center in Chicago. The new Class-A office building now has 20 owners with a minimum investment of $1 million. The net return on cash flow started at 6%, but will increase to 9.5% later this year when a tenant rent concession is due to expire. That is an amazing return for a low-risk building that includes stable tenants such as the Department of Treasury, General Electric and North America Health & Life, Losson notes.

Pitfalls

The TIC phenomenon is not risk-free. The biggest downside occurs when a deal falls through and prevents an investor from successfully completing a 1031 Exchange in the allotted time period. If an investor fails to close on the exchange, the investor is forced to pay a hefty capital gains tax on the original property sale. The IRS gives exchange investors 45 days to identify a like-kind property from the closing date on the sale of the original property, and 180 days to close on the purchase of the new property.

“That's why you don't see people with huge amounts of money doing these types of deals,” says Michael Frieman, a senior asset manager at Triple Net Properties LLC in Denver.

Someone with $8 million, for example, will buy his or her own property rather than assume the risk of paying the capital gains tax if the deal doesn't close. The greater the number of TIC investors involved in a particular deal, the greater the risk that something could go awry. Legally, the maximum number of TIC investors is limited to under 35.

Investors also need to consider exit strategies. Most TIC deals have a long-term structure. However, the holding period can vary from three to five years to upwards of 20 years for the dissolution of the interest and sale of the property.

The first recourse for investors trying to liquidate their holdings is to sell their ownership piece to the sponsor or fellow investors, often at a discount.

“If you can't sell it to the sponsor or one of the other investors currently in the property, you will have a difficult time getting out,” Blankstein says.

Ultimately, investors need to scrutinize the deal and how it is structured. In many cases, a sponsor will have only one property at a given time. “What we find is that those clients that go to an individual sponsor, will be pushed hard into whatever that property is,” Losson notes.

The TIC market is broadening as sponsors offer a variety of structures to appeal to all investors. 1031 Exchange Place is one company that is pursuing the smaller investor. Clients are typically transitioning from a duplex or four-plex and, like the Geoghegans, are looking for a more passive management structure as they head into retirement.

1031 Exchange Place LC, based in Orem, Utah, created its own sponsor entity two years ago. RealtyNet specializes in serving clients with a minimum investment of $50,000 who want to buy part ownership with a cash investment. “We launched RealtyNet to serve people we were dealing with who were falling through the cracks,” says Gary Leavitt, principal of 1031 Exchange.

Typically, most TICs require a $250,000 minimum investment, and investors leverage the real estate to secure higher valued assets.

Lenders Still Wary

TIC deals could become widespread, if more lenders come on board. Most investors want to leverage real estate to get a higher return, but many lenders are still not comfortable with the TIC structure. The deals are cumbersome from an administrative perspective because they do involve multiple owners. Lenders also are wary of the risks associated with bankruptcy due to the non-recourse nature of the loans.

Some lenders avoid TIC transactions altogether. However, sponsors are forming relationships with lenders that are comfortable with underwriting TIC transactions. “What's happening is that the form of the deal, the form of the loan — all those things are becoming more standardized,” Frieman says.

Lenders also are establishing policies on risk, and are offering clear guidelines on what they will or won't accept in terms of TIC borrowers.

The bottom line is that as TIC ownership becomes better understood and the mechanics become more sophisticated, this form of tax-deferred real estate investing will become more popular. Blankstein is optimistic about the potential opportunities. “We think in two or three years the sector is poised for good things.”

Beth Mattson-Teig is a Minneapolis-based writer.

Tenant-in-Common Ownership PROS

- Creates access to a larger pool of investment properties.
- Provides the ability to acquire higher-quality, institutional-grade properties.
- Enables investors to trade time and labor intensive properties for more passive forms of real estate ownership.
- Triple-net lease structure provides stable returns with dividends averaging 8% to 9%.

CONS

- Additional guidelines have yet to be issued by the IRS.
- Investing with a group of co-owners multiplies the risk of potential problems at the time of closing.
- Investors may have difficulty selling out of a TIC deal prior to the arranged exit strategy.
- Many lenders are still wary of the TIC structure, and some avoid TIC deals altogether.