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IN DEPTH: COMMERCIAL REAL ESTATE

IRS steers trend in 1031 exchanges

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Special Contributor

GREATER METROPLEX -- Tax-deferred exchanges have been part of the Internal Revenue Code since 1921 and are one of the last significant tax advantages remaining for real estate investors.

One of the key advantages of an IRC Section 1031 exchange is the ability to dispose of property without incurring capital gains tax liability, thereby allowing the earning power of the deferred taxes to work for the benefit of the investor instead of the government.

As the rules and cases have evolved overwhelmingly in favor of taxpayers -- especially with regard to real estate -- exchanges have become almost as easy as retirement account rollovers. A seller hires a qualified intermediary to document the sale as an exchange, the QI holds the proceeds to prevent the seller from being in constructive receipt of taxable consideration, potential replacement property is identified within 45 calendar days after closing, and some or all of those properties are acquired within 180 calendar days after the sale. This format is called the delayed exchange. For real estate, any properties held for use in the taxpayer's business or held as an investment qualify for tax deferral.

The challenge

Some investors hesitate to perform an exchange because the requirement to identify all replacement property by the 45th day can be challenging. In addition, it can be difficult to locate replacement property of exactly the right equity and value needed for a fully deferred exchange. For a fully deferred exchange, the taxpayer must reinvest all the net proceeds and maintain at least the same level of investment, net of closing costs.

A potential solution

A potential solution is to acquire a tenant-in-common property ownership interest. A TIC interest represents co-ownership between two or more investors. In essence, rather than owning 100% of a

smaller property, the investor receives a separate deed to an undivided interest, thus owning a fractional interest in a much larger property with other individual owners. A properly structured TIC should not be a joint venture or a partnership. Instead, each co-owner should have the same rights as would a single owner. A management agreement or operating agreement links the co-owners. In many cases, a TIC program provides the flexibility for a taxpayer to specify the exact amount of property that must be purchased to meet the exact exchange requirements.

Many investors have opted for TIC property ownership because they can enjoy the benefits of appreciation, cash flow, annual depreciation and flexibility without management problems. Tenant-in-common ownership offers:

- **Value:** Co-ownership allows more money to be pooled for a larger purchase. By combining multiple owners, a much larger property can be purchased.
- **Quality:** Additional money provides the opportunity to acquire higher-quality properties. In many cases, an investor can attract nationally recognized companies with strong financial records that can support long-term property values.
- **Superior leases:** Larger companies can afford longer leases, providing the best possible contracts for the co-owners.
- **Geographic diversification:** Since TIC properties are available throughout the country, investors can spread into different regions as well as benefit from opportunities in other states.
- **Economic diversification:** Multiple tenants representing different businesses increase the odds of a positive cash flow
- **Financial diversification:** With the opportunity to invest in several properties rather than just one, any risks can be spread among numerous properties.
- **Passive involvement:** TIC property is generally management-free.

The legal risk

Taxes cannot be deferred by selling real estate and buying a partnership interest -- a partnership interest is specifically excluded from Section 1031 tax deferral. With TIC programs, the question is whether the arrangement is so much like a partnership that the IRS may consider the substance to constitute an ineligible transaction despite the form of a deed conveying a real-property interest.

Guidance

On March 19, the IRS issued Revenue Procedure 2002-22, specifying the conditions under which the service will consider a request for a ruling that an undivided interest in rental real estate will be considered an interest in real estate and not an interest in a partnership or business entity. While this revenue procedure does not constitute a safe harbor that automatically validates any certain program, the advance-ruling requirements are likely to become a litmus test for many sponsors of TIC programs.

To fall within the suggested guidelines, a sponsor must submit detailed information about each co-owner and the property. In addition, the ruling request must contain a complete statement of all the facts relating to the tenant-in-common ownership including those relating to promoting, financing and managing the property.

Furthermore, the IRS ordinarily will not consider a request for a ruling unless 15 conditions described in the revenue procedure are satisfied. Examples are the maximum number of investors (35), whether the arrangement files a partnership return (prohibited) and how profits and losses are shared -- they must be proportionate. This list of conditions, for now, is as close as we get to the long-awaited safe harbor hoped for by sponsors who structure TIC programs used in exchanges.

In the meantime, interested exchangers should have their legal and tax advisors evaluate each TIC program and Revenue Procedure 2002-22.

Most conservative taxpayers will probably invest only with sponsors who have obtained an advance ruling or at least have tailored their programs accordingly.

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