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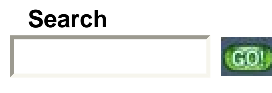

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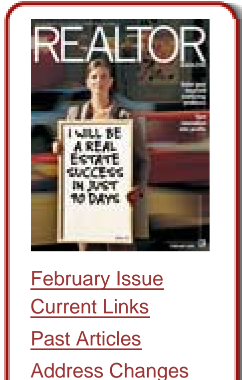

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Commercial Market Trends

Tenancy in common cures 1031 headaches

BY ROB HANNAH

The increased interest in 1031 transactions by property owners looking for tax-deferred commercial real estate ownership opportunities has masked one small problem: It's not always easy for practitioners and their clients to find good matches for the properties that they want to exchange.

That's a problem your clients can say good-bye to if they're part of the growing number of property owners who are tapping an emerging transaction structure that brings together the tax benefits of the 1031 exchange with the ownership advantages of tenancy in common.

As commercial real estate professionals know, the IRS requires 1031 exchanges to be conducted between like properties and match dollar for dollar. If there's a mismatch, the owner either pays more for the new property or pays taxes on profits realized from the trade.

There's also a formidable time issue. Owners have only 45 days to identify an exchange. That means you have to help your client find a property that's both financially like the client's current property and makes sense for the client's ownership needs.

Tenancy in common can help ease both the match and the timing problem by letting your client match an old property with a portion of a larger property, or portions of several smaller properties, rather than with just a single matching property.

In one version of this transaction, property owners exchange their property for ownership in portions of another, larger property as tenants in common. They then acquire a deed to their portion of the large commercial property. They receive monthly rent with no management obligations. The leases are all "absolute net," so the investor-owners aren't liable for certain management issues. The debt is already in place and the owner simply brings cash to the deal and assumes a portion of

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the nonrecourse mortgage.

The best part is that, unlike partnerships and syndications, this structure leaves total control in the hands of the investor-owners.

As long as owners are acquiring or disposing of fractional interests in a like property, this innovative structure complies with Section 1031 of the Internal Revenue Code, so owners can defer all capital gains and recapture taxes.

For owners, this structure is a means of replicating the same diversification in real estate that they've always maintained in stocks, just as they do with REIT investments. But the key difference between this and REIT investments is that the owner maintains control of the asset. With REITs, you are a shareholder in a company that maintains control of the assets. And REIT stock does not qualify as replacement housing under Section 1031 of the tax code.

In essence, this structure enables the average investor to participate in an echelon of real estate that was previously reserved for corporations, pension funds, REITs, and the very wealthy. Your clients can become owners of properties that are typically valued between $18 million and $70 million and are geographically diverse. Yet they can purchase an undivided interest for as little as $100,000. The price of admission has never been so available and so affordable. One caveat: Be sure to consult with a tax expert if you're considering using this tenants-in-common structure for a 1031 exchange.

Rob Hannah is a principal of Tax Deferred Services LLC in Chicago, a specialist in structuring Section 1031 tax-deferred exchanges. More information on the tenants-in-common structure is available at www.tds1031.com. Hannah can be reached at 312/321-3960.

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