Investors find shelter in real estate exchanges

Tenant-in-common deals provide attractive options

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The real estate agent brought the elderly couple anunsolicited offer for the small store they've owned for nearly three decades.

They were torn by the decision. They didn't really want tosell the store, loved the monthly income from the place but wanted to travelmore and get out from behind the maintenance and bookkeeping. In addition, theyhad an opportunity to buy a big piece of an apartment complex with members oftheir bridge club, an attractive spot very similar to the community where theynow lived.

The couple did not want to sell the store and pay a hugecapital gain. So, they decided to sell the place and roll the funds into theapartment complex and take advantage of the latest wrinkle in the tax-deferredexchange arena called TICs, or tenant-in-common investments. This strategyallows investors who sell an investment property to buy ownership interests inanother property (or properties) instead of buying an entire"like-kind" property to qualify for an exchange and defer capitalgains taxes on the sale.

While TICs have been around for years and have beenstructured by a number of savvy property-exchange specialists, they wereofficially blessed last year when the Internal Revenue Service issued a set of15 guidelines laying out the ground rules for successful TIC deals. Interestincreased immediately, especially from investors who had no easy way oflocating other investors who wanted or could only afford a piece of anotherproperty.

Here's how TICs usually work: A "sponsor" such asreal estate investor or broker, will identify and arrange to purchase anapartment building, shopping center or office building. The sponsor will then makeavailable a TIC purchase opportunity to other investors through friends andother brokers. These potential buyers can either buy a TIC interest outright ortransfer the proceeds of a previous property sale in order to qualify as anexchange, which allows them to defer capital gains just like theaforementioned couple who sold the store.

As TICs become more common, investors can choose from avariety of investment options offering diversification by location and propertytype.

"TICs produce another option for the exchangeprocess," said Richard Morse of Washington Exchange Services Inc."For investors who want to stay in the larger scheme of things, it'sdefinitely something to consider. It's especially great for property owners whosimply don't have the money to make big-time repairs.

"Most of my customers exchange residential property one home for another home or a home for a duplex. It's just the investmentstrategy that seems most comfortable for them. They feel they simply know homesbetter and are closer to them. Everybody's different"

A tax-deferred exchange (commonly known as IRS Section 1031Exchange) is really, in Morse's words, "legally sanctioned fiction."The transaction will proceed just as a "sale" for you, your realestate agent and parties associated with the deal. However, provided youclosely follow the exchange rules, the IRS will "sanction" thetransaction and allow you to characterize it as an exchange rather than as asale. Thus, you are permitted to defer paying the capital gain tax.

An exchange occurs when you trade real property that isother than your home or second residence for other "like kind" realproperty that you have held for trade, business, or investment purposes. Thelike-kind definition is very broad. You can dispose of and acquire any interestin real property other than a home or a second residence. For example, you cantrade raw land for income property, a rental house for a multiplex, or a rentalhouse for a retail property.

Section 1031 specifically requires that an exchange takeplace. That means that one property must be exchanged for another property,rather than sold for cash. The exchange is what distinguishes a Section 1031tax deferred transaction from a sale and purchase. The exchange is created by usingan intermediary (or exchange facilitator) and the required exchangedocumentation.

By pooling the proceeds of these investors, TICs combine thetax and estate planning benefits available to investors through 1031 exchangeswith the potential advantages of owning a share of an institutional-qualityinvestment property. Investors receive their monthly distributions (afterexpenses), while giving up the maintenance and administration chores associatedwith managing property.

And, not everybody loves managing property especially whenthey are retired and want to travel.

TomKelly's new book "How a Second Home Can Be Your Best Investment"(McGraw-Hill, $16.95) was co-written with John Tuccillo, former chief economistfor the National Association of Realtors and is now available in localbookstores. He can be reached at news@tomkelly.com.

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