



Trading Places

Real estate investors who want to do a Section 1031 exchange and get out of property management can now do so -- carefully.

By Donald Jay Korn

March 1, 2003- Owning real estate in the path of development can be a mixed blessing. "One of my clients had an industrial property near the Phoenix airport," says Michael Black, a financial planner in nearby Scottsdale, Ariz. "The property was going to be condemned, the city purchased it instead, and my client faced a tax bill of around \$500,000."

In such situations, a "like-kind" exchange may be a savvy move. The sales proceeds can be held by an unrelated intermediary until they are used to buy a replacement property. If the investor winds up with no cash profit or debt reduction, taxes can be deferred under Section 1031 of the tax code.

Black's client went one step beyond what might be considered a normal 1031 exchange. "Instead of replacing his old property with a new one, he acquired a partial interest in a shopping center in Florida," says Black. "So far, things seem to be working out well."

Such co-ownership exchanges appear to be taking place more frequently, thanks in part to a Revenue Procedure issued by the IRS last year. "In some cases, these types of exchanges, commonly known as tenants-in-common (TIC) transactions, may be appropriate for clients," says Black. "But there are substantial variations from one deal to the next, so you need to proceed carefully."

Although 1031 exchanges are common among real estate investors, certain issues may dim the allure of one-for-one property swaps. In order to assure the tax deferral, a preset schedule must be maintained. Replacement properties must be identified within 45 days of the sale of the original property, and a deal must be consummated in a total of 180 days.

"Identifying a replacement property and closing on time can be a big problem," says Steve Bandini, a CPA with Eisner LLP, an accounting firm in New York. "If one specified property doesn't work, an investor may be left with a second or third choice, which might not be satisfactory."

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What's more, some clients will be disposing of investment real estate because they no longer want the daily responsibilities of property management. "At some point owners get tired of the three Ts: tenants, toilets, and trash," says Luke McCarthy, president of Evergreen Development, a real estate firm in Pasadena, Calif. "They'd like to move on to tennis, travel, and time off."

The solution to these problems, according to a number of sponsors, is the TIC exchange. "An investor will sell the original property and place the sales proceeds with an intermediary, just as in any 1031 exchange," says Ron Raitz, president of Real Estate Exchange Services in Marietta, Ga. "Instead of acquiring a replacement property outright, however, the investor will buy a share in a larger, potentially more attractive property." With \$1 million, for example, a client might purchase a 10% interest in a \$10 million property.

Partial interests can be found readily, if a sufficient number of offerings are available, with varying amounts of cash required to suit prospective investors. Thus, they can be specified within the 45-day deadline, and the entire deal can be closed within the 180-day window. "Ideally taxes can be deferred, property management will become someone else's responsibility, and the client can trade up to Class A, institutional-grade real estate," says Bandini.

Of course, not every syndicated swap will be ideal. "Planners should devote some effort to evaluate each transaction," says Black. "Several factors need to be considered, including the tax risks."

In co-ownership exchanges, the biggest tax risk is the loss of tax deferral. "The tax code requires that tax-deferred exchanges be like-kind," says Walter Van Dorn, a tax attorney with Kirkpatrick & Lockhart in Boston. "Real property must be exchanged for real property. If real property is exchanged for a partnership interest, tax deferral won't be permitted. Therefore, if the ownership structure of the new property is deemed to be a partnership among the investors who have traded in their properties, those investors may owe capital gains tax."

The IRS issued a Revenue Procedure in early 2002 to clarify the tax issues, Van Dorn says. "Rev. Proc. 2002-22 confirms that an exchange into a co-ownership structure may qualify as a like-kind exchange and defer taxes," he says. "The IRS set out 15 requirements to be met in order to receive a favorable private letter ruling." (See box below.)

In practice, says Van Dorn, few sponsors are likely to apply for letter rulings before trying to raise money from investors because the process is onerous and expensive. "It's also time-consuming," says McCarthy. "However, many sponsors are making an effort to comply with most or all of the conditions spelled out in the Revenue Procedure, and they're getting legal opinions that state like-kind treatment probably will be upheld."

Complying with all 15 points may not be practical, Raitz notes. "Nevertheless, 11 or 12 points of agreement probably are better than five or six," he says. "This Revenue Procedure gives you an opportunity to minimize tax risk, provided you have a strong legal opinion."

Greg Paul, president of Omni Brokerage, a Salt Lake City-based broker-dealer specializing in these transactions, reports that TIC offerings have increased since the appearance of Rev. Proc. 2002-22. "I think the IRS struck a fair balance," he says. "It opened the door to TIC exchanges but did not throw open the floodgates so widely that a lot of questionable deals will come on the market."

The number of TIC exchanges is barely more than a trickle now, at least when compared to real estate mutual funds or the broad property market. Tim Snodgrass, chief operating officer of Argus Realty Investors in San Juan Capistrano, Calif., estimates that TIC exchanges raised around \$500 million of investors' equity last year.

"The greatest impact of the Revenue Procedure was not on investors but on broker-dealers and planners, who are becoming more aware of these transactions and more comfortable



that the tax benefits can be sustained," he says. "As awareness and comfort increase, more offerings are likely to become available."

With more offerings, more planners may be doing more investigation of future co-ownership exchange deals. "In addition to the tax risks, you should be concerned about fees," says Black. "The people who put these deals together need to be compensated, but clients will be hurt if they overpay."

Kevin Bradburn, chief operating officer at Omni Brokerage, puts the average fee total at approximately 15% in these deals. Does it make sense to pay 15% in fees to defer taxes at 20% (capital gains) or 25% (recaptured depreciation)?

"Taxes actually may be higher if you count state taxes," says Bradburn. "Even so, I don't think it's a matter of simply paying fees to defer or even avoid taxes. Clients get other benefits from these exchanges. Many of them want to continue to hold real estate in their portfolio; these transactions allow clients to stay in the real estate market, as passive investors, while receiving substantial cash flow."

Assuming that the tax opinion is solid and the fees seem reasonable, one more element must be in place -- the economic prospects of the acquired real estate. That is, an appealing property must be offered at a fair price. "Good cash flow often attracts investors in these types of exchanges," says Raitz.

Cash flow indicates the property's rental income is more than covering expenses, including debt service. "My client who had the property near the Phoenix airport is now receiving 9% from his interest in the Florida shopping center, and he's pleased with the way things have worked out," recalls Black.

Investors also may be pleased by the diversification offered by co-ownership exchanges. "One of my clients had an industrial warehouse in Bridgeport, Connecticut," says Peter McCrea, vice president of 1031America.com, replacement property consultants in New Canaan, Conn. "He wanted to spend less time managing this property, and he wanted to diversify his holdings."

After selling this building, \$800,000 was placed with an intermediary. "Our client told us that he wanted to put this money into three different types of properties, in different states, with different sponsors," says McCrea. "Therefore, we placed him into three different TIC programs: a restaurant in Ohio, an apartment building in Arizona, and an industrial property in Texas. Each one took \$200,000-\$300,000 in equity. Now he's diversified, he has no management responsibilities, and he has cash flow from each property."

TIC exchanges may offer diversification, but liquidity is another issue. What if a client wants to cash in, even if that means paying the deferred tax?

"We've been involved in these transactions for years, and we've only had two cases where the owners wanted to sell their interests, in order to free up some capital," says McCarthy. "We're now working on arranging sales to other owners. However, investors in these properties should always look at them as long-term holds. In fact, most of our investors want to hold on until they die and then pass on these assets with a step-up in basis."

Investors also need to consider the tax consequences of shifting from active to passive ownership of property through a TIC exchange. If investment property owners with adjusted gross incomes (AGI) of over \$150,000 have losses on the ventures, the losses must be suspended rather than deducted. After a 1031 exchange (single property or TIC), the suspended losses remain suspended, according to Bandini. However, the suspended losses may be used to offset income from new properties, perhaps resulting in tax-free cash flow for the property owner.

On the other hand, investment property owners with AGI under \$100,000 can deduct up to \$25,000 in losses each year, if they are actively involved in their properties. After a TIC exchange, they won't be able to take current deductions if they are not active managers,

Bandini says. Any pass-through loss would have to be suspended.

Despite the potential drawbacks, a TIC exchange or exchanges might fit into a client's long-term financial plan. "Cross-selling opportunities also may arise," says Snodgrass. "Once you help a rancher trade for an interest in a large piece of real estate, you may be able to help with his estate plan, his securities portfolio, and so on."

Regardless of whether property swaps serve as door openers for financial advisers, recommending them to clients may pay off. "Planners with the property securities licenses may be able to receive fees or commissions for putting clients into these transactions," says McCrea. "A lot depends on what arrangements your broker-dealer has made, but it is possible for a planner to receive compensation for helping clients with such property exchanges." In these deals, money as well as property will change hands, and some might wind up in planners' pockets.

Ten Reasons the IRS Will Approve a Multi-Owner Swap

In Revenue Procedure 2002-22, the IRS specified 15 conditions under which it will consider requests for private rulings on co-ownership exchanges. Robert Klein, CPA and a tax partner in the Woodbridge, N.J. office of BDO Seidman, has identified the most important ones, which are listed below:

- Co-owners must hold legal title as tenants-in-common (TIC) under local law.
- The number of co-owners cannot exceed 35 (husband and wife being treated as a single person).
- The TIC cannot file a partnership or corporate tax return or hold itself out as a business entity.
- Major decisions such as sale, lease, and financing must be unanimous. For other actions, a majority vote is sufficient.
- Each co-owner must be able to transfer or mortgage his or her undivided interest without the approval of anyone else. However, the program sponsor may be given a right of first offer. In addition, restrictions on the right to transfer or encumber the interest by a lender in customary commercial lending practice are not prohibited.
- All revenues and expenses of the property must be shared among co-owners in proportion to their interests.
- Co-owner activity must be limited to those customarily performed in connection with the ownership of passive real estate. In determining "activity," all activities of an agent as well as the co-owner are taken into account.
- The commonly owned property must be subject to a true lease, with rent reflecting the fair rental value of the property.
- A lender holding a mortgage on the property cannot be related to any co-owner, sponsor, property manager, or tenant.
- Payment for the fractional interest must reflect its fair market value and cannot depend on projected income or profits.--DJK

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