

NEW REAL ESTATE EXCHANGE VEHICLE FOR SMALL INVESTORS

Promoters are marketing a new tax-savings program that may help some owners of investment real estate sell existing property and reinvest in new property, yet postpone or avoid paying taxes on any profits. But investors should proceed cautiously before pursuing this strategy, recommend many financial planners.

The tax strategy involves trading small, privately held investment property, such as an office building or farm, for fractional, direct ownership in larger commercial property(s). The program, called a “tenants-in-common real estate exchange,” is a new wrinkle in the long-established 1031 “like-kind” exchange. An IRS ruling in 2002 sparked growing interest in this type of transaction.

A TIC exchange starts on the same basis as the standard 1031 exchange. First, the property must be real property used for a trade, business or investment, such as rental houses, apartments, office buildings, farms or warehouses. Primary or secondary residences don’t qualify for exchanges, though some vacation homes do. The owner may want to sell the property and buy new property in order to upgrade, diversify or consolidate holdings, reduce management burden, or increase income. The idea is to accomplish this sell-and-buy process while either deferring capital gains taxes until years later, or avoiding them altogether by passing the property on to heirs upon the owner’s death.

In a typical 1031 exchange, the owner first sells the property, with the funds going directly into a trust account. He or she then has 45 days from closing to identify one to three potential replacement properties and another 135 days to close the deal (known as a 180-day exchange period). In general, as long as the cost of the replacement property is equal or more than the sale price of the relinquished property, tax on the gains from the sale are deferred. If the replacement price is less, the difference, called “boot,” is subject to tax. Also, any equity that’s not rolled over into the new property, regardless of the replacement cost, is subject to capital gains tax.

While owners can conduct this exchange on their own, most use “qualified intermediaries” to hold the sale funds and help identify often hard-to-find like-kind property. That’s where the tenants-in-common concept developed. The idea emerged to have owners exchange their single-owned property for fractional direct ownership in institutional-grade property run by a property manager.

In 2002, the IRS issued guidelines to clarify how such exchanges should be set up so they qualify as a tax-deferred exchange. For example, the number of co-owners cannot exceed 35, they must be tenants in common and not partners, and each co-owner must be able to transfer his or her interest without undue restrictions by the other owners.

This ruling, which the IRS is expected to further clarify, sparked a flurry of promotion of TIC exchanges. Promoters point to the ability to reduce personal involvement in the property management and to invest directly in institutional-quality property. Depending on the amount available to invest, an investor could spread the sale funds among up to three separate properties in a single exchange. If invested well, the property should spin off regular income and produce price appreciation.

But investors must navigate numerous hurdles with TIC exchanges. First, they must be certain the exchange qualifies for the tax deferral. The guidelines issued by the IRS are just that: guidelines. Unless the exchange obtains a private letter ruling from the IRS, its tax status is not certain. Some experts caution that a TIC exchange might *appear* to be qualified yet have potentially fatal flaws, such as too many restrictions on the individual co-owners or not set up in the proper business format (LLCs have been the most successful).

Another challenge is that TIC investments are highly illiquid. There is virtually no secondary market outside of the co-owners for selling fractional interests, though that could change if TICs become more common. Investors also need to watch for potentially high fees charged by exchange intermediaries that could all but wipe out the tax benefits.

Before leaping into a TIC, explore other options with your financial advisor. For example, it might make more sense to simply sell the property, pay any taxes owed and buy new property. If you want institutional property, a real estate investment trust (REIT) might make a better choice.