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FINANCE

# Finding suitable replacement property

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Once again I want to take you to the land of 1031 exchanges and talk about the methods most prominently used to accomplish the transaction. In the last article, if you recall, we talked about the advantages of using the IRC subsection 1031 to exchange property to allow you to delay the capital gains tax on the sale of your property and even possibly eliminate the tax if you hold it for your estate. We will not reintegrate those advantages to a full extent, but only mention that your 1031 exchange could continue to build wealth at a more rapid rate than paying the taxes on a normal sale of your real estate or some other asset eligible for a 1031 exchange.

Generally, one of the hardest parts of the exchange is finding a suitable replacement property for the property you are going to relinquish. Finding an individual property is often a problem because you may not find something that appeals to you, or its value may not match up with the value of the property you wish to sell (relinquish). Another issue is property management. You may find yourself at an age where you no longer want to manage the property yourself. That leaves finding a property manager to take care of the daily headaches: upkeep, leasing, tenant improvements, etc. Property management carries additional costs and the risk of a manager who may not have your best interests in mind. So, what can you do to find properties that fit your investment goals?

Prior to 2002, most exchanges were handled in the traditional one-on-one exchange. Some were done using the Tenancy-In-Common (TIC) structure; however, prior to 2002 this structure did not carry any real blessing from the IRS as to its validity in conforming to the code. In 2002, the IRS issued Revenue Procedure 2002-22 which listed 15 points to be used when effectuating a 1031 exchange using the TIC structure, (I won't go into the 15 points here, but your financial advisor or tax specialist can help you). Basically, the sponsor of the property creates and sells undivided fractional interests in the property. The percentage of ownership you have in the property is based upon the amount of exchange money you have and the number of fractional interests you purchase. You will be a co-owner of the property with up to 35 other investors – this number varies depending upon the purchase price of the building and lender requirements, but can never be more than 35. Because you own fractional interests in the property, the IRS will treat you as individual owners and not as partners for federal tax purposes as long as the TIC structure follows the revenue procedure outlined above.

There are risks associated with any investment and real estate is no different. The TIC structure also carries certain risks of which you should make yourself aware. You will be required to sign various agreements. These can include, but are not all inclusive of the following: a property management agreement which details the duties and compensation of the property manager hired to run the property. You still retain the right to approve all leases, both renewals and new tenants in the property. It also gives you the right to approve the property manager on an annual basis. You will have a tenants-in-common agreement to determine rights and remedies of each of the co-owners. There will be a purchase agreement, loan agreements and several other documents commiserate with closing on any real estate offering. In many cases, the lease renewals, property manager and the determination of when to sell the property must be agreed upon unanimously by all of the TIC owners. Many of the agreements carry clauses in the event that a majority of the co-owners agree to do something and a minority of the co-owners hold out. These clauses could force the minority to do something which it does not wish to do, and that is a risk factor.

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One of the advantages of using this method is the variety of tenant-in-common properties that are available to the person who wishes to use a 1031 exchange. Many of these properties are purchased and syndicated for sale to the TIC market by well-established real estate companies that have developed, acquired and managed many millions of square feet of property across a wide geographic base and through several real estate market cycles. The due diligence, property condition reports, environmental studies, market analysis, etc., have been done by these professionals or other third parties and is all available for your review prior to making your exchange. In many cases you can even go directly to the property for a tour yourself. The prior due diligence done by the real estate syndicator should in no way substitute your own review of the offering, including your attorney and tax advisor. Because each property comes with a varying investment amount it is possible that you can diversify your real estate holdings while still deferring your taxable gain. In other words, you can split your exchange money from the sale of your property into several properties. It also allows you to diversify geographically. So, if you are looking at a 1031 exchange, you may want to consider a TIC. Just keep in mind that there are many rules to the exchange and you want to make sure you are involved with those who have the experience to handle your exchange properly. It may be just the thing you are looking for to simplify your real estate portfolio.

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