

Tenancy in Common Interests - A Replacement Property Solution for Exchanges

Exchangers engaged in a like-kind exchange of real estate often face difficulty in finding replacement property to complete their exchange. IRC §1031 allows the Exchanger only 45 days to identify replacement property. In addition, §1031 requires the replacement property to be located in the United States (assuming the relinquished property is in the U.S.); have a value equal to or in excess of the relinquished property for full tax deferral; and be acquired within 180 calendar days of the closing of the relinquished property. Although the definition of real estate in §1031 is expansive – all U.S. real estate is like-kind to all other U.S. real estate - many Exchangers have a tough time complying with the time deadlines and other exchange requirements in finding a satisfactory parcel to complete their exchange transaction. Corporate Exchangers are often in a position of not being able to easily find real estate that meets the needs of §1031 as well as their other business considerations, such as location, size, zoning, and cost. Similarly, individual Exchangers must consider geography, management issues, and investment value when choosing a replacement parcel. These considerations, in addition to §1031's strict requirements, are an ever-present factor in real estate like-kind exchanges.

One possible satisfactory solution when an Exchanger cannot find an acceptable parcel for use as replacement property is for the Exchanger to acquire a tenancy in common ownership interest in real property ("TIC property") to satisfy the like-kind requirement of §1031. In today's marketplace, a TIC property is generally commercial real estate whose ownership has been split into fractional shares. Exchangers, who are typically unaffiliated with each other, then own their respective fractional shares, much like stock ownership. Each Exchanger, as a tenant in common, owns an undivided fee interest in the property equal to his proportionate share of the real estate. In addition to his equity interest, the Exchanger also acquires a proportionate share of any non-recourse debt secured by the property. As a result, by acquiring an undivided fee interest in real property, the Exchanger complies with the like-kind replacement property requirement of §1031.

TIC ownership can be used for any type of real estate but most of these types of properties are shopping centers, strip malls, office buildings, or other types of larger commercial real estate. Acquisition of a TIC property gives the Exchanger considerable flexibility. Along with providing a means for a desperate Exchanger to complete his exchange, the TIC structure affords the Exchanger the opportunity to acquire investment grade property, obtain a consistent monthly cash flow, and participate in any appreciation without the necessity of purchasing the entire parcel. A TIC investment is passive and the property is professionally managed. Financing, negotiating leases, payment of taxes, and other responsibilities of ownership are all performed by the property manager. The Exchanger need not even be located in the same geographic region as the TIC property.

TIC ownership is not for the casual investor. As with any real estate transaction, it is important to "do your homework". Exchangers interested in acquiring a TIC property should consult their real estate advisor for a listing of TIC providers ("sponsors"). The Exchanger should discuss their specific needs with the sponsor and obtain information about available TIC properties. Before proceeding with the purchase, the Exchanger should feel comfortable with the sponsor's advice and thoroughly review the materials and information on the TIC property provided by the sponsor. Once the Exchanger has decided upon his investment level and selected the appropriate TIC property, the TIC sponsor should then guide him through the transaction, providing all necessary documentation and disclosures.

TIC ownership has been around for many years, but its use as a replacement property solution is relatively recent. Many real estate brokers, syndicators, and investment companies offer some form of the TIC product. In recognition of the increased interest in TICs, the IRS issued 15 guidelines to assist Exchangers in determining if their TIC ownership will qualify as replacement property in an exchange. Rev. Proc. 2002-22 (2002-14 IRB 733). These guidelines address items such as: the allowable number of co-owners; the right to transfer or encumber the interest; the proportionate sharing of profits, losses, and debt; and the ability of the co-owners to enter into a management or brokerage agreement for the property.

Most TIC sponsors have attempted to craft their TIC programs to substantially comply with the guidelines set forth in Rev. Proc. 2002-22. An Exchanger considering the acquisition of a TIC interest to complete a §1031 exchange should research the various TIC sponsors to a) select a sponsor whose TIC program either complies with these guidelines or, in the alternative, b) select a TIC sponsor who can provide the Exchanger with an opinion of legal and tax counsel that the structure of their TIC arrangement complies with the requirements of §1031. In addition, the Exchanger should consult with their own legal and tax counsel to ensure that the acquisition of a particular TIC interest as replacement property satisfies the requirements for their exchange.

Brief Exchanges

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