The Benefits of 1031 Exchanges Into T.I.C. Investments & Exit Strategies
By Anne Baber, Invesment Real Estate Broker

While the Southern California real estate market is still hot, we are seeing some changes in the market place. Prices are still high, but they are not increasing at the same previous rate and seem to be leveling off. Also the inventory is increasing, but there is still a healthy demand for product. For the most part, rental rates are still increasing and the economic outlook is still strong for the remainder of the year. This is great news for Sellers who want to take advantage of today's high prices. Also, by utilizing the 1031 exchange you can defer your federal tax liability and keep Uncle Sam's tax dollars working for you.

There is of course bad news. If you want to defer capital gains taxes, and are considering an exchange, you are in effect buying in the same market place in which you are selling. That means high prices, low cap rates and probably less cash flow than you were previously enjoying.

WHAT IS A TAX DEFERRED EXCHANGE?

A tax-deferred exchange is a method whereby a property owner trades one property (relinquished property) for another property (replacement property) and does not incur any federal tax liability in the transaction. In an ordinary sale transaction, the seller is taxed on any gain realized by the sale of the property. In an exchange, the tax is deferred until some time in the future if and when the property is sold. To be a fully tax-deferred exchange, the replacement property must be equal or greater in both equity and debt. The requirements and time frames of the IRS must be carefully met in order to qualify for an exchange and defer taxes.

A SAFTEY NET MECHANISM FOR 1031 EXCHANGES

In today's Seller's market, probably the most daunting task required of an exchange is finding and identifying the replacement property within 45 days after the close of escrow (possibly the fastest 45 days of your life). What if you can not find a suitable replacement property within the short time frame allotted by the IRS?

Tenant in Common (TIC) investments can be reserved as a safety net if a suitable replacement property cannot be found in the allotted time frame. Most Sellers do not want to be in a position where they cannot complete their 1031 exchange, which will trigger a taxable event. Instead of losing the exchange, the investor can use the TIC interest to complete the exchange and thus defer their tax liability.

The TIC interest is resalable, subject to the TIC agreement and financing requirements. A secondary market includes the sponsor, the other TIC owners and those who have the same objectives. Because of its availability and liquidity, the TIC interest is an excellent vehicle to use as a parking place for proceeds from a 1031 exchange while enjoying a good rate of return. The owner-investor can always exchange out at a later date when a suitable property has been located.

WHAT ARE TENANT IN COMMON (TIC) INVESTMENTS?

Very simply, tenant in common is a form of holding title that allows investors to own an undivided interest in a property. This enables small investors to own a % interest of an institutional quality multi-million dollar project that they otherwise could not afford. Investors acquire a deed for their portion and receive a prorated share of the monthly rent (income), tax benefits and appreciation – without any management obligations. The debt is already in place. The owner simply brings cash to the deal and assumes a portion of the non-recourse mortgage. The tax reporting is on one's Schedule E – the same as a direct owner is dong now. However, a replacement property's larger basis permits new tax deductions – for more tax savings. The best part is that, unlike partnerships, this structure leaves control in the hands of the investor-owner.

As a tenant in common, one can get out of doing management, defer capital gains taxes, increase both cash flow and tax deductions, increase appreciation potential, have more safeguards with triple net, high-credit tenants, maintain direct ownership and also save estate taxes. The option of partial ownership gives Buyers the opportunity to diversify their real estate holdings by purchasing TIC interests in multiple properties. A TIC can get you more while you do less. Accordingly, this arrangement can solve several problems for owners looking to make their lives less complicated.

USING THE 1031 EXCHANGE AND TIC'S A RETIREMENT VEHICLE.

TIC investments can benefit owners who are tired of the three "T's"; toilets, termites and tenants and would like to rid themselves of management headaches and retire. A straight sale would trigger a taxable event and the Seller would probably owe a hunk of change to the IRS in addition to the State.

A more favorable scenario would be to defer your capital gains taxes and maintain an attractive income stream, a portion of which will be sheltered. This can be realized by using a transaction structure that brings together the tax benefits of the 1031 exchange and the ownership advantages of tenancy in common (TIC).

ADVANTAGES OF TENANT IN COMMON EXCHANGES

- Higher returns on institutional-grade properties.
- Easy to comply with 1031 exchange identification rule
- Financing in place; easy to match debt and equity.
- Professional management in place.

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