

An Exit Strategy That Defers Tax Liability Using the 1031 Exchange and TIC Investments

by Anne Baber, Investment Real Estate Broker

“The Times, They Are a Changing.....”

While apartment building values have leveled or declined slightly, prices are still relatively high. If you are considering selling your investment properties, sooner might be better than later. The Southern California investment real estate market is in transition. The long awaited drop-off is happening and some economists have stopped using the term “soft landing” to describe California’s real estate market. The Realtors Association has lowered its 2006 sales prediction from a 2% slip to a 16.8% drop. Sales prices have leveled off and inventory has increased.

The trends for Apartment building sales (five to 50 units, built prior 1978) in Los Angeles county for the past four quarters shows the average cap rate has leveled off to just under 5% and the average cost per unit has leveled off to around \$134,000.

Interestingly, during this same time period the number of transactions and the total dollar volume of sales has been trending downward. This could indicate that the pool of willing buyers is becoming smaller. Perhaps buyers are sensing a change and are going back to the economic principal of a return on investment in the form of cash flow. The softening of the market is not unexpected, as it has been widely anticipated that interest rates would increase, thus impacting market values. Perhaps the decade of unsustainable exuberance is over!

Geographical Diversification

The beauty of TIC investments is that they allow an investor the ability to invest in different regions of the nation which are in upward trends in the real estate cycle. Tenant-in-Common investments (TICs) coupled with the 1031 tax deferred exchange have exploded in popularity within the last few years. This is due in part to the IRS ruling in 2002 that TIC shares qualify as a 1031 tax deferred exchange vehicle, providing that the sponsors meet certain guidelines. In addition, Baby Boomers entering retirement have increased demand for TIC investments in other geographical regions of the nation that are poised for growth and are in an upward trend in the real estate cycle. These properties typically generate good cash flow and have attractive appreciation potential. By using the 1031 exchange, sellers are deferring their capital gains liability by exchanging into TIC Investments in diversified geographical areas and thus are keeping Uncle Sam’s dollars working for them.

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 federal tax liability in the transaction. In an ordinary sales 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 replacement property is sold. To be a fully tax-deferred exchange, the replacement property must be of equal or greater value 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.

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 percent interest of an institutional quality, multi-million dollar project that they otherwise could not afford. Investors receive a deed for their portion and receive a prorated share of the monthly rent (income), tax benefits and appreciation – without any management obligations for the day to day operations. 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 doing now. However, a replacement property’s larger basis permits new tax deductions

– for more tax savings. The best part is that, unlike a partnership, this structure leaves control in the hands of the investor-owner.

Advantages of Tenant in Common Ownership

- Flexible size to match your needs
- Pre-arranged financing
- No management hassles
- Potential increased after tax cash flow
- Economics of scale
- Can be identified & closed in a timely manner
- Investment can be diversified into more than one property.

As a tenant in common, one can obviate management responsibility, defer capital gains taxes, increase both cash flow and tax deductions, increase appreciation potential, have more safeguards with triple net, high-credit tenants and maintain direct ownership. 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 TICs as 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). The investors receive monthly distributions that now typically reflect annual yields of 6.5% to 7.5% of the cash invested in addition to the annual appreciation that is realized upon sale.

A Safety Net Mechanism for 1031 Exchanges

In today’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.

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