NAREA

Address: 14034 S. 145 E.
STE 100
Draper, Utah 84020

(801) 931-5571

info@nareagroup.org

HOW TO INCORPORATE A 1031 TAX DEFERRED EXCHANGE IN A REAL ESTATE SYNDICATION

By Ken Holman

In general, a syndication is a group of individuals or organizations combined in a joint effort to undertake some specific duty or carry out specific transactions or negotiations. Some examples of syndications are:

- A group of individually-owned furniture stores or tire stores who form a buying syndicate to purchase goods and products directly from the manufacturers.
- A group of television stations or radio stations who form a broadcasting syndication to purchase a license to broadcast television programs or radio programs without going through a broadcast network.
- A group of lenders who form a loan syndication to fund various portions of a loan for a single borrower because the borrower requires an amount too large for a single lender to provide or when the loan is outside the scope of a lender's risk-exposure limits.

Real Estate Syndication

In real estate, a syndication is the pooling together of equity capital from multiple individuals or entities to acquire investment real estate. Usually, the real estate syndication will buy or develop, operate and sell a single real estate investment or multiple real estate investments. A typical form of ownership for a real estate syndication is either a limited liability company, a corporation, or a partnership, either full partnership or a limited partnership.

Raising equity capital from investors is complicated but manageable if you know the rules and regulations associated with the sale of securities and the requirements of a 1031 Tax-deferred Exchange.

It is always advisable to seek the counsel of an experienced securities attorney who is familiar with the rules and regulations governed by the Securities and Exchange Commission (SEC) and the individual state securities divisions and to use a Qualified Intermediary when handling a 1031 Tax-deferred Exchange.

With regard to the sale of securities relating to real estate, below are the basic laws, rules and regulations that govern the securities industry and those who sell these securities. The following review is not meant to be comprehensive. It only covers some of the basic rules involved in the sale of securities.

Securities Act of 1933

The Securities Act of 1933 was the first legislative action that began to regulate the sale of securities to the public. It has two basic objectives:

1) To ensure transparency in providing investors with sufficient financial information that they can make informed investment decisions; and
2) To establish laws to prohibit deceit, misrepresentations, and other fraud in the sale of securities.

This Act requires that all securities be registered and that full disclosure be given to the investors.

What is a security?

A security is a financial instrument or a tradable asset of some type. Securities can be categorized in three broad categories:

1) Debt securities (banknotes or bonds);
2) Equity securities (stocks or interests in partnerships or limited liability companies (LLCs); and
3) Derivative securities (futures or options).

Since most real estate transactions involve a limited liability company (LLC) or some other form of ownership where each investor owns a percentage of the entity owning the asset, the sale of these interests fall within the purview of the SEC and are considered to be securities.

Securities Exchange Act of 1934

The Securities Exchange Act of 1934 is a law that governs the secondary trading of securities in the United States. It established the Securities and Exchange Commission (SEC) to enforce federal securities law. The Securities Act of 1933 regulates the original issues of securities in the primary market and the Securities Exchange Act of 1934 regulate the secondary trading of those securities.

The Registration Process

In general, securities sold in the U.S. must be registered. The registration forms companies file with the SEC provide essential facts such as:

- A description of the company's properties and business;
- A description of the security to be offered for sale;
- Information about the management of the company; and
- Financial statements certified by independent accountants.

There are some exemptions from the registration requirement. They include:

- Private offerings to a limited number of persons or institutions;
- Offerings of limited size;
- Intrastate offerings; and
- Securities of municipal, state, and federal governments.

By exempting many small offerings from the registration process, the SEC seeks to foster capital formation by lowering the cost of offering securities to the public. Most real estate syndications involving the sale of interests in an LLC owning a single real estate asset fall under the exemptions from registration requirement since they are private offerings to a limited number of persons or institutions, their offering size is limited, and often they are intrastate offerings.

Regulation D (Reg D)

Regulation D (Reg D) is a Securities and Exchange Commission (SEC) regulation governing private placement exemptions. Reg D allows smaller companies to raise capital through the sale of equity or debt securities without have to register their securities with the SEC.

Reg D offerings are advantageous because they allow entities to obtain funding faster and to avoid the costs associated with public offerings. However, even though these transactions may involve only a few investors, the entity raising the capital still needs to provide adequate disclosure documentation, even though it is significantly less than what is required for a public offering.

Reg D offerings are not exempt from antifraud, civil liability, or other provisions of the federal securities laws. The issuers of Reg D offerings are still obligated to provide material information. They must also comply with applicable state laws relating to the offer and sale of securities. State regulations, where Reg D has been adopted, may include filings of notices of sales and the registration of individuals who receive compensation in connection with the sale and offer of securities.

Among the other requirements of Reg D, the issuer of the securities must provide in a reasonable time in advance of the sale, written disclosures of any prior "bad actor" events.

Regulation D Rule 504

Rule 504 of Regulation D provides an exemption from the registration requirements of the federal securities laws for companies who offer and sell securities if up to $5,000,000 in any 12-month period. These securities are restricted, meaning they cannot be sold for a year without being registered.

Companies that comply with Rule 504 do not have to register their securities offerings with the SEC, but they must file electronically a document with the SEC known as Form D within 15 days after the first sale of their securities.

The laws and regulations of Rule 504 will not be discussed in any further detail in this treatise because most issuers for the sale of real estate-related securities follow Rule 506 of Regulation D. According to a report done by the SEC, 99% of reported Regulation D offerings used Rule 506, despite the fact that two thirds of the Issuers could have used Rule 504 based on offering size. The primary reason they used Rule 506 is that all states recognize Rule 506 as written at the federal level, which makes it easier to stay compliant with state blue sky laws.

State Blue Sky Laws

In addition to federal securities laws, every state has its own set of securities laws—commonly referred to as "Blue Sky Laws"—that are designed to protect investors against fraudulent sales practices and activities. While these laws vary from state to state, most states typically require companies making offerings of securities within the state to register their offerings before they can be sold, unless a specific state exemption is available. Blue Sky Laws also license brokerage firms, their brokers, and investment adviser representatives.

Regulation D Rule 506

Rule 506 of Regulation D is considered a "safe harbor" for the private offering exemption of Section 4(2) of the Securities Act. Companies using the Rule 506 exemption can raise an unlimited amount of money if they satisfy the following standards:

- The company cannot use general solicitation or advertising to market the securities unless they accept investment capital from only Accredited Investors pursuant to Rule 506(c);
- The company may sell its securities pursuant to Rule 506(b) to an unlimited number of "accredited investors" and up to 35 other non-accredited investors, however, the "non-accredited investors" must be sophisticated—which means they have sufficient knowledge and experience in financial and business matters (or they hire an investment adviser, accountant, or attorney who has sufficient knowledge and experience in financial and business matters) to make them capable of evaluating the merits and risks of the prospective investment;
- The company must decide what information to give to accredited investors, but it cannot violate antifraud regulations of the federal securities laws but, if non-accredited investors, participate in the investment, they must receive the same disclosure documents as those used in registered offerings, which includes all the information they make available to accredited investors.

- The company must be available to answer questions by prospective purchasers;
- The company must meet certain financial disclosure requirements; and
- The company must inform the investors that the securities received are "restricted," meaning they cannot be sold for at least a year unless the securities are registered.

Accredited Investor

To be considered an Accredited Investor, the following qualifications must be met:

- Corporations, partnerships or other financial institutions with more than $5,000,000 in assets who are not formed expressly for investment purposes;
- Non-profit organizations;
- Entities owned entirely by accredited investors;
- Individuals with assets worth more than $1,000,000, excluding their primary residence, or who earn at least $200,000 a year in the last 2 years and expect to make at least the same amount in the current year;
- Married couples with assets worth more than $1,000,000, excluding their primary residence, or who earn at least $300,000 a year in the last 2 years and expect to make at least the same amount in the current year.

Form D Filing Requirement

While companies using the Rule 506 exemption do not have to register their securities, they must file a report with the SEC known as "Form D" after they sell their first securities. Form D is a notice that includes the names and addresses of the company's owners and promoters. If the company fails to file Form D, they are not in compliance with federal securities laws and may jeopardize the "safe harbor" provisions of Rule 506.

Form D must be filed within 15 days after the first sale of securities has taken place. The date of the first sale is the date on which the first investor is irrevocably contractually committed to invest. If the due date falls on a Saturday, Sunday or holiday, it is moved to the next business day. The SEC doe not charge any filing fee for submitting or amending a Form D notification.

Form D notices and amendments are filed online using the SEC's EDGAR (Electronic Data Gathering, Analysis and Retrieval) system. To file using the EDGAR system, a company must have its own filer identification number (called a "Central Index Key" or "CIK" number) which includes a set of password-like access codes. To get the access codes, the company must submit basic information to the SEC at its Filer Management page and also submit a copy of a notarized paper document containing the same information on Form ID.

General Solicitation Defined

Rule 506(c) permits issuers to broadly solicit and generally advertise an offering, if they adhere to the following requirements:

- All purchasers of the offering must be accredited investors;
- The issuer must take reasonable steps to verify that the purchasers are accredited investors; and
- The issuer must satisfy the other conditions of Regulation D such as notification to investors that the securities are restricted, the filing of Form D within 15 days of the first sale of securities in the offering, and other conditions.
- Each state may also have other notice filings and may collect fees.

Private Offering Memorandum or Private Placement Memorandum

Although the SEC does not require issuers to provide a disclosure document to accredited investors, it is still wise to do so. This document is typically called a Private Offering Memorandum or Private Placement Memorandum. These two document names are used interchangeably and refer to the same disclosure information.

1031 TAX-DEFERRED EXCHANGES

Section 1031 Like-Kind Exchanges

Under Section 1031 of the Unites States Internal Revenue Code (26 U.S.C. §1031), the exchange of certain types of property may defer the recognition of capital gains or losses due upon sale.

To qualify for Section 1031 of the Internal Revenue Code, the properties exchanged must be held for productive use in a trade or business or for investment. Stocks, bonds, and other properties are expressly excluded by Section 1031, though securitized properties are not excluded. The properties to be exchanged must be of like kind, or of the same nature or character, even if they differ in grade or quality. Properties of a like class are like kind properties. Personal property used predominantly in the United States and personal property used predominantly elsewhere are not like kind properties.

Real properties generally are of like kind, regardless of whether the properties are improved or unimproved. However, a real property within the United States and a real property outside of the United States would not be like kind properties.

Under Treasury Regulation §1.1031(k)-1(c)(5)(i), property that is transferred together with a larger item of value that does not exceed 15 percent of the fair market value of the larger property does not need to be identified within the 45-day identification period but still needs to be exchanged for like kind property to defer gain.

Cash to equalize a transaction cannot be deferred under IRC 1031 because it is not of like kind. The cash is called boot and is taxed at the normal capital gains rate.

If liabilities assumed by the buyer exceed those of the seller (taxpayer), the realized gain of the seller will not only be realized but recognized as well. If, however, the seller assumes a greater liability than the buyer, the realized loss cannot be offset by any realized and recognized gain when receiving boot such as cash or other personal property considered boot.

Originally, IRC 1031 cases needed to be simultaneous transfers of ownership. But since Starker vs. U.S. (602 F.2d 1341), a contract to exchange properties in the future is practically the same as a simultaneous transfer. It is under this case, decided in 1979, that the rules for election of a delayed 1031 exchange originated. To elect the 1031 recognition, a taxpayer must identify the property for exchange before closing, identify the replacement property within 45 days of closing, and must acquire the replacement property within 180 days of closing. A Qualified Intermediary must also be used to facilitate the transaction.

Frequently, the most difficult component of a 1031 exchange is identifying a replacement property within the first 45 days following the sale of the relinquished property. The Internal Revenue Service (IRS) is strict when it comes to allowing any extensions of time.

Summary of IRC Section 1031 Like-Kind Exchanges

Section 1031(a) of the Internal Revenue Code (26 U.S.C. §1031) states the recognition rules for realized gains (or losses) that arise as a result of an exchange of like-kind property held for productive use in a trade or business or for investment. None of the realized gain or loss will be recognized at the time of the exchange. The property to be exchanged must be identified within 45 days and received within 180 days.

Section 1031(b) states that when a like-kind property is exchanged and boot is received, the gain is recognized to the extent of the boot.

Section 1031(c) covers cases similar to those in 1031 (b), except when the transaction result in a loss. The loss is not recognized at the time of the transaction but must be carried forward in the form of a higher basis in the property received.

Section 1031(d) defines the basis calculation for property acquired during a like-kind exchange. It states that the basis of the new property is the same as the basis of the property given up, minus any money received by the taxpayer, plus any gain (or minus any loss) recognized on the transaction. If the transaction falls under 1031(b) or (c), the basis shall be allocated between the properties received (other than money) and for purposes of allocation, there shall be assigned to such other property, an amount equivalent to its Fair Market Value at the date of the exchange.

Section 1031(e) stipulates that livestock of different sexes do not qualify as a like-kind exchange.

Section 1031(h)(1) stipulates that real property outside the United States and real property located in the United States are not of like kind.

Starker Tax Deferred Exchange

The sale of the relinquished property and the acquisition of the replacement property do not have to be simultaneous. A non-simultaneous exchange is sometimes called a Starker Tax Deferred Exchange (named for an investor who challenged and won a case against the IRS). *See Starker v. United States*, 602 F.2d 1341, 79-2 U.S. Tax Cas. (CCH) paragraph. 9541, 44 A.F.T.R.2d 79-5525 (9th Cir. 1979).

For a non-simultaneous exchange, the taxpayer must use a Qualified Intermediary, follow guidelines of the Internal Revenue Service, and use the proceeds of the sale to buy more qualifying, like kind, investment or business property. The replacement property must be identified within 45 days after the sale of the old property and the acquisition of the replacement property must be completed within 180 days of the sale of the old property.

Section 1031 is most often used in connection with sales of real property

Some exchanges of personal property can qualify under Section 1031. Exchanges of shares of corporate stock in different companies do not qualify. Exchanges of partnership interests in different partnerships and exchanges of livestock of different sexes do not qualify. However, as of a 2002 IRS ruling, Tenants in Common (TIC) exchanges are allowed. For real property exchanges under Section 1031, any property that is considered real property under the law of the state where the property is located will be considered like kind so long as both the old and the new property are held by the owner for investment or for active use in a trade or business or for the production of income.

The replacement property must be of equal or greater value

In order to obtain the full benefit of the deferral of gain, the replacement property must be of equal or greater value and all of the proceeds from the relinquished property must be used to acquire the replacement property. The taxpayer cannot receive the proceeds of the sale of the old property; doing so will disqualify the exchange for the portion of the sale proceeds that the taxpayer received. For this reason, exchanges (particularly non-simultaneous exchanges) are typically structured so that the taxpayer's interest in the relinquished property is assigned to a Qualified Intermediary prior to the close of the sale. In this way, the taxpayer does not have access to or control over the funds when the sale of the old property closes.

Proceeds are held by a Qualified Intermediary

At the close of the relinquished property sale, the proceeds are sent by the closing agent (typically a title company, escrow company, or closing attorney) to the Qualified Intermediary, who holds the funds until such time as the transaction for the acquisition of the replacement property is ready to close. Then the proceeds from the sale of the relinquished property are deposited by the Qualified Intermediary to purchase the replacement property. After the acquisition of the replacement property closes, the Qualified Intermediary delivers the property to the taxpayer, all without the taxpayer ever having constructive receipt of the funds.

All gain is locked up in the exchanged property

The prevailing idea behind the 1031 Exchange is that since the taxpayer is merely exchanging one property for another property or properties of like kind there is nothing received by the taxpayer that can be used to pay the taxes. In addition, the taxpayer has a continuity of investment by replacing the old property. All gain is still locked up in the exchanged property and so no gain or loss is recognized or claimed for income tax purposes.

Boot and Tax Implications of the 1031 Exchange

Although the term boot is not used in the Internal Revenue Code, it is commonly used when discussing the tax implications of a 1031 Exchange. Boot is an old English term meaning "something given in addition to." Boot received is money or Fair Market Value of other property received by the taxpayer in an exchange. Money includes all cash equivalents, debts, liabilities, or mortgage of the taxpayer assumed by the other party or liabilities to which the property exchanged by the taxpayer is subject. Other property is property that is non-like-kind, such as personal property, a promissory note from the buyer, a promise to perform work on the property, a business, etc. Many ways exist for a taxpayer to receive boot. The most common sources of boot include the following:

- *Cash boot* taken from the exchange will usually be in the form of net cash received or the difference between cash received from the sale of the relinquished property and cash paid to acquire the replacement property or properties. Net cash received can result when a taxpayer is trading down in the exchange.
- *Debt reduction* boot occurs when a taxpayer's debt on the replacement property is less than the debt which was on the relinquished property. Debt reduction boot can occur when a taxpayer is trading down in the exchange. Debt reduction boot can be offset with cash used to purchase the replacement property.
- *Sale proceeds* being used to pay non-qualified expenses. If proceeds from the sale are used to service non-transaction costs at closing, the result is the same as if the taxpayer had received cash from the exchange and then used the cash to pay these costs. Taxpayers are encouraged to bring cash to the closing to pay for the non-transaction costs like rent pro-rations, utility escrow charges, tenant damage deposits transferred to the buyer and any other charges unrelated to the closing.
- *Excess borrowing* to acquire replacement property. Borrowing more money than is necessary to close on replacement property will not result in the taxpayer receiving tax-free money from the closing. The funds from the loan will first be applied toward the purchase. If the addition of exchange funds creates a surplus at the closing, all unused exchange funds will be returned to the Qualified Intermediary, presumably to be used to acquire more replacement property. Loan acquisition costs with respect to the replacement property should be brought to the closing from the taxpayer's personal funds. Taxpayers usually take the position that loan acquisition costs are being paid out of the proceeds of the loan. However, the IRS may take the position that these costs are being paid with exchange funds. This position is usually the position of the financing institution also.
- *Non-like-kind property* which is received from the exchange in addition to like-kind property.

Boot Limitations

Exchangers should adhere to the following guidelines:

1) Always trade across or up, but never trade down to avoid the receipt of boot, either as cash or as debt reduction or both. The boot received can be offset by qualified costs paid by the exchanger.
2) Always bring cash to the closing of the replacement property to cover loan fees or other charges which are not qualified costs.
3) Avoid receiving property which is not like-kind.
4) Don't over finance the replacement property. Financing should be limited to the amount of money necessary to close on the replacement property in addition to the exchange funds which are brought to the replacement property closing.

Time Limits

The Section 1031 exchange begins on the earliest of the following:

1) The date the deed records, or
2) The date possession is transferred to the buyer.

The Section 1031 exchange ends on the earlier of the following:

1) 180 days after it begins, or
2) The date the exchanger's tax return is due, including extensions, for the taxable year in which the relinquished property is transferred.

The identification period is the first 45 days of the exchange period. The exchange period is a maximum of 180 days. If the exchanger has multiple relinquished properties, the deadlines begin on the transfer date of the first property. These deadlines may not be extended for any reason. A deadline that falls on a weekend or holiday does not permit extension.

If the identified replacement property is destroyed after the expiration of the 45-day identification period, it does not entitle the exchanger to identify a new property, however, the exchange may be terminated by this event. Mistakenly identifying the wrong property does not permit a change in identification after the 45-day identification period expires.

IRS rules control the length of time that the replacement property must be held before it may either be sold or used to enter into a new tax-deferred exchange.

Qualifications for a 1031 Exchange

To qualify for a 1031 Exchange, certain rules must be followed:

1) Both the relinquished property and the replacement property must be held either for investment or for productive use in a trade or business. A personal residence cannot qualify for a 1031 Exchange.
2) The assets must be like-kind. Real property must be exchanged for real property, although a broad definition of real estate applies and includes land, commercial property and residential property. Personal property must be exchanged for personal property, although there are some complicated rules surrounding the exchange of personal property.
3) The proceeds from the sale must be reinvested in a like-kind asset within 180 days of the sale.
4) Restrictions are imposed on the number of properties which can be identified as potential replacement properties. More than one potential replacement property can be identified as long as one of the following rules is satisfied:

a. **The Three Property Rule.** Up to three properties can be specified regardless of their market values. All identified properties are not required to be purchased to satisfy the exchange; only the number of properties needed to satisfy the value requirement.
b. **The 200 Percent Rule.** Any number of properties may be specified as long as the aggregate Fair Market Value of all replacement properties does not exceed 200 percent of the aggregate Fair Market Value of all the relinquished properties as of the initial transfer date. All identified properties are not required to be purchased to satisfy the exchange; only the number of properties needed to satisfy the value requirement.
c. **The 95 Percent Rule.** Any number of replacement properties, if the Fair Market Value of the properties actually received by the end of the exchange period is at least 95 percent of the aggregate FMV of all the potential replacement properties identified. In other words, 95 percent (or all) of the properties identified must be purchased or the entire exchange is invalidated.

Steps Required to Accomplish a 1031 Exchange

The following sequence represents the order of steps in a typical 1031 exchange:

Step 1: Retain the services of a qualified consultant, which could be an attorney or tax accountant, who specializes in 1031 tax deferred exchanges or a Qualified Intermediary.

Step 2: When selling the property, include a cooperation clause in the sales agreement such as, "Buyer is aware of the seller's intention to complete a 1031 Exchange as part of this transaction and hereby agrees to cooperate with the seller in accomplishing same, at no additional cost or liability to the buyer."

Step 3: The escrow officer or closing agent should contact the Qualified Intermediary to order the exchange documents.

Step 4: Enter into a 1031 Exchange Agreement with a Qualified Intermediary in which the Qualified Intermediary is named as the principal in the sale of the relinquished property and the subsequent purchase of the replacement property. The 1031 Exchange Agreement must meet the IRS requirements, especially as it pertains to the proceeds.

Step 5: The escrow instructions are amended to name the Qualified Intermediary as the seller. Normally, the deed is still prepared for recording from the taxpayer to the true buyer. This is called direct deeding. It is not necessary to have the replacement property identified at this time.

Step 6: The relinquished property is closed in escrow with the closing statement reflecting the Qualified Intermediary as the seller. The sales proceeds go to the Qualified Intermediary. (Make sure the funds from the sale are placed in a separate, completely segregated account to insure liquidity and safety.) The closing date of the relinquished property escrow is Day 0 of the exchange and that's when the exchange clock starts ticking. Written identification of the address of the replacement property must be sent within 45 days and the identified replacement property must be acquired by the taxpayer within 180 days of this date.

Step 7: The taxpayer sends written identification of the address or legal description of the replacement property or properties to the Qualified Intermediary, on or before Day 45 of the exchange. It must be signed by everyone who signed the Exchange Agreement and it may be faxed, hand-delivered, or mailed either to the Qualified Intermediary, the seller of the replacement property or his agent, or to a totally unrelated attorney. If mailed, send the notification by certified mail, return receipt requested to prove that the time requirement was met.

Step 8: The taxpayer enters into an agreement to purchase the replacement property. Include the cooperation clause and amend the escrow instructions to reflect the Qualified Intermediary as the buyer.

Step 9: Prior to the 180th day, the replacement property is closed and the Qualified Intermediary forwards the exchange funds and proceeds to the escrow. The closing statement for the replacement property reflects the Qualified Intermediary as the buyer. A final accounting is then sent by the Qualified Intermediary to the taxpayer evidencing that the taxpayer never had constructive receipt of the funds.

Step 10: The taxpayer files Form 8824 with the IRS (and similar document to the state as required) when the tax return is filed.

1031 Exchange - Example 1

An investor buys a retail strip mall for $200,000 and sells it after six years for $250,000. This would result in a gain on sale for which the investor would typically have to pay federal capital gains tax, state capital gains tax, and a depreciation recapture tax based on the depreciation he or she had taken on the property for the time the investor has owned the property. If the investor invests the proceeds from the $250,000 sale into another like-kind property or properties, using a Qualified Intermediary and without getting constructive receipt of the proceeds from the sale, then the taxes that would have been required to be paid would be deferred.

COMBINING A SYNDICATION WITH A 1031 TAX-DEFERRED EXCHANGE

Real estate syndications are usually handled through a limited liability company or some other entity. However, when obtaining equity capital from a 1031 Exchange, the cash received from the exchange likely cannot be invested directly with the LLC. That would disqualify the exchange because it would not be considered "like kind."

As discussed, a "like kind" exchange would be real estate for real estate. Consequently, the LLC owning the property would be required to sell a portion of the real estate held by the LLC directly to the 1031 exchange investor. That would require the LLC to enter into a contract with the 1031 exchange investor.

Assuming the required timeframes are met for the exchange, the LLC would then sell the property or a fractional interest in the property to the 1031 exchange buyer, whereupon the LLC would receive the cash from the sale.

As part of the transaction, since the 1031 exchange investor wants to be part of the larger real estate development, the two parties, i.e., the 1031 exchange investor and the LLC would enter into a Tenant In Common (TIC) agreement to mutually own the property.

Tenants in Common (TIC) 1031 Exchange

1031 Exchange – TIC Example

The owner of a detached house on 3 acres of land is transferred to another state by his employer. Rather than selling the home, which will no longer be his personal residence, the owner chooses to rent it out for a period of time. After 10 years, he decides to sell and wants to buy an apartment building. He will receive a sizable amount of cash through the sale of his rental property, but knows he needs other partners to have sufficient equity capital to qualify to purchase the property. He arranges to purchase the apartment building using a 1031 Exchange and finds other partners willing to invest in the apartment building with him. They form a Tenant In Common Agreement and purchase the property through that entity, each receiving a partial ownership in the property.

Tenants in Common (TIC) is a form of real estate asset ownership in the United States in which two or more persons have an undivided, fractional interest in the asset, where ownership shares are not required to be equal and where ownership interests can be inherited. Each co-owner receives an individual deed at closing for his or her undivided percentage interest in the entire property. In short, a TIC owner has the same rights and benefits as any single property owner.

Although the TIC form of ownership has been used for many years, its popularity has increased dramatically in recent years due to an IRS ruling where TICs are permitted to enter into 1031 tax deferred exchanges. Owners of smaller properties often have difficulty in identifying suitable replacement properties within 45 days and closing within 180 days. 1031 TIC Exchanges have made it possible for several smaller owners to band together and purchase a larger property as Tenants in Common and thus, defer the payment of capital gains tax. In order to do this, a TIC 1031 Exchange must meet all the same requirements as any other 1031 Exchange would be required to meet.

To insure the 1031 exchange investor receives equal treatment regarding distributions on the new development, it is important to spell out in the TIC agreement the actual ownership the 1031 exchange investor would have in the new development, otherwise they could be treated differently from the members of the LLC.

This means the 1031 exchange investor could have a different ownership interest in the development project that they have in the ownership of the land. For instance, say the total value of the property held by the LLC before the exchange was $1,200,000 and the LLC agreed to sell an ownership interest in the land for $300,000, the 1031 exchange investor would then own a 25% interest in the land.

Now assume the property being developed is expected to cost $20 million and the equity capital being raised for the development is $6 million or 30% of the cost of the project. The other 70% would be funded through debt financing. Based on this illustration, even though the 1031 exchange investor owns 25% of the land, they would contribute the land for an interest in the development of 0.5% of the overall project ($300,000 ÷ $6,000,000 = 0.05 or .5%).

To make sure that the 1031 exchange investor and the members are treated fairly in terms of distributions when the development project is completed, the TIC agreement should mirror language contained in the Operating Agreement for the LLC. This insures all the parties are being treated the same.

There are some pitfalls when doing these types of transactions. When it comes to obtaining debt financing for the development project, the 1031 exchange investor will have to subordinate their interest in the land to a first trust deed. This may require the 1031 exchange investor to sign all the lender's loan documents.

One way to avoid this cumbersome process is to have the 1031 exchange investor execute a limited power of attorney. A power of attorney is a legal document that gives one person the authority to act on behalf of another person in all legal or financial matters.

A limited power of attorney is a legal document that gives one person the authority to act on behalf of another person only for a particular purpose or to perform a specific act. It allows the principal (the 1031 exchange investor) to give only specific powers to the agent (the Manager of the LLC).

By having a notarized limited power of attorney, the Manager of the LLC then has the legal authority to sign on behalf of the borrowing entity, the TIC, which facilitates transacting business in the name of the TIC.

Since this is a relatively complicated transaction, especially if there is more than one 1031 exchange investor, it is advisable to seek the council of a competent real estate attorney.