PUBLICATION

Opportunities and Obstacles: §1031 Like-Kind Exchanges Involving Tenant-in-Common Properties

January 30, 2008

"Like-kind exchanges" allow an investor to swap property and defer the capital gains tax. Section 1031 of the Internal Revenue Code allows an investor to defer taxable gains on the sale of certain types of investment property if the investor "exchanges" that investment property for similar or "like-kind" investment property. Real property can be exchanged as like-kind property. One type of real property may be exchanged for another. So long as the real property is investment property only, the type of real property swapped does not matter. A warehouse/distribution property may be swapped for a shopping center or vacant land may be swapped for an office building. Interests, however, in business entities, such as a partnership interest, shares of a corporation or membership interests in an LLC do not qualify for §1031 tax-deferred exchange treatment, even if those business entities manage or hold investment real property.[1]

The investor must strictly follow the statutory procedure for accomplishing a "like-kind exchange." In order to qualify as a §1031 tax-deferred like-kind exchange, the investor must strictly follow the rules set forth in §1031. Among other rules, the investor must identify the property to be sold (the "relinquished property") as §1031 exchange property in the sale agreement. Upon closing of the sale of the relinquished property, a third-party "qualified intermediary" holds the sale proceeds for the investor. Within 45 days after the closing on the relinquished property, the investor must identify the property to be acquired (the "replacement property"). The investor may identify multiple replacement properties. The investor must then close on the replacement property within 180 days after closing on the relinquished property. The investor must instruct the qualified intermediary to use the funds held from the relinquished property for the purchase of the replacement property, and the replacement property will be directly deeded to the investor, thereby accomplishing the exchange without the investor "holding" or "using" the proceeds from the sale of the relinquished property. If the closing on the replacement property takes place after the 180 day deadline, the exchange loses its tax-deferred status.

Unwieldiness of the "like-kind exchange." The §1031 "like-kind exchange," while attractive, can be deceptively unwieldy when put into practice. For example, investors may find it difficult to identify appropriate and desirable replacement property in the 45-day window and to close the sale in the 180-day window, particularly if complications arise with the purchase of the identified replacement property. If the acquisition of the replacement property falls through and these deadlines are exceeded, the investor may lose tax-deferred status. Furthermore, if the investor does not want to incur new debt or invest additional capital in the replacement property, the investor is limited to properties at a similar price point and therefore with similar qualities as the relinquished property.

Undivided fractional interests in real property can be transferred as a "like-kind exchange." In 2002, the IRS released Revenue Procedure 2002-22 ("Rev. Proc. 2002-22"), which established that an undivided fractional interest in real property held by tenants-in-common (TIC) did not constitute an interest in a business entity, thereby allowing exchanges of TIC interests in real property to qualify under §1031. Importantly, due to the broad variety of real property which may be "exchanged" under §1031, an investor may relinquish a wholly-owned building for a TIC interest in a larger, more expensive and more desirable piece of replacement property, and vice versa. Accordingly, the acquisition of real property by a group of investors in a TIC ownership structure, rather than as a partnership, corporation or limited liability company, gives the investors more flexibility. Not only does the investor have access to a greater selection of replacement properties at virtually customizable prices, but also, through pooled investment, the investor has access to higher classes of and more expensive (and possibly more lucrative) properties than he or she would have on his or her own.

Rev. Proc. 2002-22 established the following conditions that must be met for a TIC interest in real property to be eligible for a 1031 exchange:

1. *Tenants-in-Common.* The investors must hold the property as TICs.
2. *Number.* There may be no more than thirty-five (35) TICs in any one TIC ownership structure.
3. *Not a business entity.* Although the TICs typically lease space in the real property to tenants and hire a management company to manage the property (if it is improved), the TICs may not collectively hold the real property as a business entity. This means that the TICs must not collectively establish a corporation, partnership or LLC to hold the real property, hold themselves out to be a corporation, partnership or LLC or file a tax return as a corporation, partnership or LLC. Not surprisingly, the TICs may not pursue any business activities other than the routine management, maintenance and repair of the real property.
4. *Co-ownership agreement.* The TICs instead, "may" (and indeed, should) enter into a co-ownership agreement governing the management of the property. The IRS, in Private Letter Rulings 2003272003 and 200513010, provided guidance regarding the terms of an acceptable co-ownership agreement. In essence, the co-ownership agreement should provide that the TICs will hire a management company and lease the property as well as provide other terms consistent with Rev. Proc. 2002-22. The TICs may enter into leasing, loan and brokerage agreements with regard to the real property. In addition, the TICs may enter into any number of ancillary agreements, so long as they do not violate the provisions of §1031 and Rev. Proc. 2002-22.
5. *Voting and transfer rights.* The TICs must retain voting and approval power over aspects of the management of the real property, and must retain the right to transfer, partition or encumber their interest in the real property (although the right to partition may be waived).
6. *Profits and losses.* The TICs must share proportionate profits and losses from the operation of the real property, proceeds and liabilities from the sale of the real property, and liability for debt secured by any blanket liens on the real property.
7. *Fair market value transactions.* The TICs' transactions with each other and third parties with regard to the real property must be on a "fair market value" basis. For example, call options, rights of first offer and lease agreements must all be based on fair market value.

The TIC ownership structure has unique risks and pitfalls. Most of these risks can be addressed in the co-ownership agreement and by forming "disregarded entities" (such as single-member limited liability companies) for each TIC to hold that TIC's interest in the property. Even though TIC ownership structures are often promoted by "sponsors" in neat, tight packages, we highly recommend that prospective participants in a TIC ownership structure conduct careful due diligence not only with regard to the prospective real property, but also with regard to the sponsor, the management company in place and fellow TICs. Some risks of TIC ownership structure are:

8. *Unlimited liability.* Each TIC has unlimited liability with regard to the property, and may, in some cases, be liable to creditors of other TICs.
9. *Financing difficulties.* Some lenders may not make separate loans to each TIC for the purchase of the real property. Instead, they will require one loan covering the entire property. In such a situation, if one TIC defaults on his or her obligations to service his or her proportionate share of the debt, it could put the entire TIC ownership structure into default.
10. *Additional contributions.* The TICs must make all necessary additional contributions for the maintenance, repairs and other costs of managing the real property when needed. Further, TICs, the sponsors and the management company are not allowed to advance these expenses to fellow TICs.

11. *Possible partition.* Death, bankruptcy, divorce, transfer by a TIC or other events may have a pronounced adverse impact on the remaining TICS, either by forcing partition or a transfer. Partition is the dividing of real property belonging to the TICs. In such a case, a court could order the real property to be sold and for the proceeds to be distributed to the TICs. The TICs should agree to waive their right to partition in the co-ownership agreement.
12. *Securities Laws.* In some circumstances, a TIC interest may be deemed under Federal or State law to be a security.
13. *Misrepresentation by sponsors.* Sponsors and promoters of TIC ownership structures have been known to misrepresent them as "tax-free" (they are "tax-deferred"), and to have prepared co-ownership agreements and ancillary agreements which may actually disqualify the TIC interest from qualifying under §1031.
14. *Increased IRS Oversight.* As TIC ownership structures become more prevalent, the IRS has indicated its intention to increase its oversight and review of TIC interests involved in §1031 exchanges.

Conclusion. The availability of tax-deferred status for the purchase and sale of TIC interests in real property opens up many new opportunities for investors. Although the TIC model of holding real property has been a creature of American common law since its inception and of British common law for years before that, it is finding new life as a valuable tool for accomplishing the pooling of capital by investors into vehicles that qualify for "likekind exchanges." The legal concepts underlying the nature of a TIC ownership structure, therefore, are somewhat new to the modern real property investment world. As such, and as with any sophisticated investment vehicle, care must be taken in selecting, structuring and participating in a TIC ownership structure. If care is taken when approaching a TIC ownership structure, however, the flexibility afforded the intrepid investor can be a powerful tool.

1. A single member LLC, however, may be ignored for this purpose and the property owned by such LLC may be deemed to be owned by the single member.