



# 1031 Exchange Services

Charles J. Ajootian, Esq. President and Counsel

Winter 2005

## Tenant-in-common ("TIC") Interests as Replacement Property

*Investment property owners have an attractive new mechanism for reinvesting without paying capital gains taxes*

Now is one of the best periods in history to "exchange" investment real estate. But for many property owners contemplating an exchange, the question is: Can I reinvest in non-traditional, non-management-intensive real estate?

Thanks to a recent Revenue Ruling, the answer is "yes". Nationwide, exchanging property owners are increasingly using their exchange proceeds to reinvest in non-traditional, passive-ownership real estate, through a vehicle known as a Tenant in Common interest, or a "TIC".

The framework for Tenant in Common investing has been approved by the IRS, and as a result the number of TIC transactions in 1031 Exchanges in the U.S. has increased dramatically in the past two years.

*Here's how it works:*

*An investment property owner ("Mary") enters into an Exchange with a Qualified Intermediary and after her sale closing her Exchange Account is credited with \$400,000. She then reviews, with the help of her advisors and with the help of a broker knowledgeable in TIC's, several prospectuses from around the U.S. detailing properties being offered as TIC vehicles for Replacement Properties for 1031 re-investers. All broker fees are paid by the TIC developer. Mary selects a \$10 million dollar office building in Atlanta tenanted with one or more Fortune 100*

*We do not sell or recommend any particular TIC project.*

*In furtherance of our mission, we serve as the Exchange*

*Intermediary for investment real estate owners who*

*want to effectuate 1031 Exchanges with their real estate*

*whether they want to reinvest in traditional or TIC real estate,*

*and we can refer parties interested in TIC Replacement*

*Properties to one or more brokers who have a high level*

*of expertise in this newly developing specialty.*

companies. Mary's exchange account of \$400,000 entitles her to a deed granting her a 4% ownership interest in the entire building. Her yearly share of the rent from the project will typically be about 7.5% of her investment amount, and will be net of all of the traditional expenses associated with real estate, and without any management responsibilities. Note that if she had not done an Exchange, and had paid all of her capital gains taxes, Mary typically would have ended up with much less money to rein-

vest. By exchanging into a TIC, Mary will in effect be getting part of her return on money that would otherwise go to the U.S. and State governments. Mary's neighbor, John, also sold investment real estate worth \$400,000, but he did not do an exchange because he did not want to reinvest in traditional real estate, and did not know about TIC's. Because of his low basis, he will have to pay a capital gains tax of \$75,000

see **Tenants-in-common**

*(continued on page 3)*

### MISSION STATEMENT

We help investment property owners maintain and build their wealth in real estate

### 1031 Exchange Services Newsletter:

Communicating timely and valuable information about Tax-Free Exchanges of investment real estate under IRC Section 1031

## New Twist on Interplay Between Sec. 1031 and Sec. 121

Section 121 of the Internal Revenue Code allows taxpayers to exclude recognition (taxability) of their gain (up to \$250,000 of gain for an individual taxpayer and up to \$500,000 of gain for married taxpayers) on the sale of their primary residence, provided they have utilized the property as their principal residence for 2 out of the 5 years immediately preceding the sale. In the past, some taxpayers have exchanged into replacement property, rented the property for 2 years, and then have “changed their mind” and have decided to live in the replacement property as their primary residence. Then after two years of primary residency in the Replacement Property, they

have sold the property tax-free under Section 121 of the Code (except for limited recapture of depreciation), without the necessity of reinvesting the proceeds into replacement property.

A new twist to this scenario is that it will now take five years to accomplish what some taxpayers previously accomplished in four years. The good news is that despite adding a year to the prior scenario, the new amendment for the first time creates a statutory validation of the “change in use” concept with regard to Replacement Property acquired in an exchange. On October 22, 2004, President Bush signed into law HR 4520, which contains the following provision affecting IRC Sections 121 and 1031:

**PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE –** If a taxpayer acquired property in an exchange to which Section 1031 applied, subsection (1) {of IRC Section 121} shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property.

The result of this additional requirement to IRC Section 121, effective for principal residence sales occurring on or after October 22, 2004, is that anyone who exchanges under IRC Section 1031 into a rental house as a replacement property, which house they subsequently convert to personal use, will have to wait at least five years from their acquisition of that house before they can sell it as their residence and exclude any gain under IRC Section 121. They must still also make sure that they meet the “two out of five years” principal occupancy test.



Minimum 2-year Residency



### Principal Occupancy Test\*

\*For Property Acquired in an Exchange

## BITS & PIECES

### Reminder for '04 Exchanges:

Complete your exchange first, then file your 2004 return. If you commenced an exchange in the latter part of 2004, do not file your 2004 income tax return until you have completed your exchange by buying all of the replacement property that you intend to acquire. By filing your 2004 tax return you are declaring that any exchange you commenced in 2004 is over. There is no appeal from this rule and you will not be allowed to correct this mistake by filing an amended return. If your 180<sup>th</sup> day is calculated to be after April 15, 2005, and if you need all of your 180 days to make your acquisition, you must extend the due date of your return in order to get the full 180 days.

**Foreign Real Estate in 1031 Exchanges:** United States real estate is defined under IRC Section 1031 as

any real estate within the fifty States, the District of Columbia, and (subject to certain conditions) the U.S. Virgin Islands. Foreign real estate is defined as any real estate not contained within the afore-mentioned jurisdictions. Section 1031 of the Code explicitly states that U.S. real estate is not like-kind to foreign real estate, and vice-versa. What this effectively means is that if you set out to exchange real estate located in the United States, you must acquire only real estate that is also located in the United States. Your "exchange" will be deemed to be invalid if you acquire "replacement property" outside of the U.S. Correspondingly, if you set out to exchange real estate which you own outside of the U.S., you will accomplish a valid exchange only if you acquire property which is also outside of the U.S.

## Foreign



## Domestic



### Tenants-in-common

*(continued from page 1)*

and will be left with \$325,000 to re-invest. He can look forward to getting a safe 3% return on his \$325,000 or maybe he will take a chance on the stock market.

Unless he is very lucky, he will not do as well as Mary, who will enjoy a 7.5% return on her full \$400,000 and will probably also enjoy appreciation on her recorded ownership interest in her Atlanta office building.

The moral for investment real estate owners and their advisors is that there is now an attractive way to get out of highly-appreciated, management-intensive real estate, without paying state and federal capital

gains taxes for the privilege of making a change. Call us for further information and guidance on this excellent vehicle for maintaining wealth in real estate via a successful exchange.



### COMPLIMENTARY BOOKLET

Call Charles J. Ajootian, Esq.  
@ 401-331-0083 for your free copy.

*Materials herein have been prepared by Charles J. Ajootian, Esq., President of and Counsel to 1031 Exchange Services, Inc., a Providence, RI based Qualified Intermediary firm which engages in tax-deferred exchanges throughout the United States. The materials herein should not be considered a substitute for competent professional advice concerning your particular exchange.*

*Newsletter Design: Marketing Extensions, Inc., Providence, RI (Richard K. Papazian)*