REAL ESTATE LAW

Tax-Free Exchange of Tenancies in Common

BY LAWRENCE H. JACOBSON

The tenancy in common (TIC) has survived into modern times as a method of concurrent ownership of real property. In a TIC, each owner legally owns a fractional interest—and is entitled to an undivided interest in the revenues from the property, subject to the rights of the other co-tenants.

HISTORICAL CHANGES

The TIC was historically popular with vacation home buyers, who used this form of ownership to share vacation properties with friends or family. In today's marketplace, however, TICs have become popular investment vehicles, allowing groups of investors to acquire fractional interests in large commercial properties. TICs permit co-tenants to reap the benefits of real estate ownership without being forced to participate in the nuances of day-to-day property management. In addition, TICs provide an opportunity for individuals to organize and acquire—for a relatively modest sum—an interest in a large investment property.

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SECTION 1031

Making TICs even more attractive is section 1031 of the Internal Revenue Code, which enables taxpayers to postpone the recognition of gain upon the sale of certain properties held for trade, business, or investment. (*See generally,* 26 U.S.C. § 1031.)

The basic requirement of section 1031 is that the property sold—that is, the relinquished property—must be exchanged for a "like-kind" property replacement that constitutes a direct interest in real property. The term like-kind relates only to the nature of the property, and therefore virtually all real property will qualify under the definition. In addition, the person or entity selling the relinquished property must be the same person or entity purchasing the replacement property.

Section 1031 does not view entities such as partnership or LLC interests to be "like" real estate. In a partnership or LLC, an investor merely owns an interest in a legal entity, which in turn owns the real estate. But unlike a partnership or LLC, a TIC is classified under common law as a form of direct ownership, and therefore an owner can use it as replacement property to satisfy the like-kind property criteria of section 1031. Moreover, recent IRS opinions suggest that a real estate transaction structured as a TIC will qualify for section 1031 exchange treatment, provided it strictly adheres to the requirements of IRS Revenue Procedure 2002–22.

Though problems with partition, probate, and management have led some investors to own commercial property through a partnership or LLC, the benefits of section 1031 have enticed many of them to convert their interests to TICs to facilitate tax-free exchanges. By using the TIC structure, investors maintain the flexibility of deciding individually, rather than as a group, whether they want to pursue tax-free exchanges.

THE *STARKER* DECISION

Prior to 1979, the Internal Revenue Code required parties in like-kind exchanges to transfer property simultaneously. However, in *Starker v. United States* the Ninth Circuit allowed "delayed" section 1031 exchanges to qualify for tax deferral. (602 F.2d 1341 (9th Cir. 1979).) After *Starker*, a section 1031 exchange can take place even if the parties to the exchange do not transfer properties simultaneously. This essentially gives investors the time necessary to find a desirable replacement property while still qualifying for like-kind exchange treatment.

The replacement property must be identified on or before the 45th day after the day on which the relinquished property is transferred. And it must be purchased by 180 days after the taxpayer transfers the relinquished property, or the due date of the taxpayer's return for the year in which the transfer is made, whichever is earlier.

COTTAGE INDUSTRY FOR TICS

During the past decade a cottage industry of syndicators, or "sponsor" companies, has developed to meet the demand for TIC interests as replacement properties. Under such arrangements, commercial real estate projects are fractionalized into TIC interests, which are in turn exchanged with investors seeking replacement properties.

Sponsors often facilitate, structure, and arrange financing for commercial real estate projects, as well as handle the property management. For example, a TIC owner who sells an interest to obtain the benefits of section 1031 has only 45 days to identify a suitable replacement property—and a sponsor may be able to expedite that process.

Alternatively, a TIC owner may contact a sponsor company and purchase a TIC interest in another property, receive income from that property, and reap the benefits of section 1031 quickly and conveniently. CL