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Apples for Apples? The Evolution of the 1031 Exchange Takes a New Turn

by Racy Haddad Gordon

Although typically the vast majority of commercial real estate buyers and investors do not utilize the wealth-building advantages of the 1031 exchange, today's options for real estate investors just got hotter with the ever-increasing use of the 1031-TIC-721 exchange.

Most investors looking to purchase a profitable piece of commercial property have heard of 1031 like-kind exchange transactions. The 1031 exchange is a strategy that allows a real estate investor to defer capital gain taxes on the sale or disposition of qualifying property. Normally, on the sale or disposition of the investment property, federal and state capital gains and depreciation recapture taxes will be triggered, which will leave the investor with less money to reinvest after such costs are paid. This traditional approach has made it difficult for taxpayers to trade up in value or increase their cash flow and net worth.

Under Section 1031 of the Internal Revenue Code, investors can defer their capital gain and depreciation recapture taxes, and thus, end up with 100% of their net proceeds from the sale of investment property. These proceeds are then available to reinvest in another like-kind replacement property. This deferral allows the investor to trade up in value and improve his cash flow as he ends up with access to all of his proceeds under the sale.

One recent variation of the 1031 exchange is the increased use of the 1031 Tenant-In-Common (TIC) exchange programs. The 1031 TIC exchange allows sellers of investment property to effectuate an exchange by buying an ***interest*** in real property instead of purchasing an entire piece of property as a single owner. For example, an investor can now sell a piece of property that he owns, such as an apartment complex, in exchange for a fractional ***interest*** in a TIC property, such as a retail development, with other owners. Instead of selling one piece for one piece, or an apple for an apple, that investor may sell one piece for ***one interest*** in a larger, institutional-grade property, such as an office building, multi-family apartment complex, warehouse/ distribution center or retail shopping center.

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In addition, an investor may diversify his proceeds from the sale into several interests in different property types ending up with a ***fractional interest*** in several properties in different geographic locations. The end result is that each investor receives a proportional fractional distribution of the income generated from each property.

With the increased flexibility and income-building advantages that have created the momentum behind the 1031 exchanges, some real estate companies are increasing the options available to individual investors even more by allowing them to exchange TIC ownership in a single property for partnership units in a Real Estate Investment Trust (REIT). These exchanges put an end to the old apples-for-apples approach to real estate reinvesting and create tremendous financial alternatives for investors. These options offer investors more economic flexibility while freeing them from the day-to-day management of their properties.

Section 721 of the Internal Revenue Code allows a taxpayer to exchange rental or investment real estate for shares in a REIT. This is called a 721 exchange or an upREIT. Typically, investors utilize the upREIT in conjunction with selling property and acquiring a like-kind replacement under Section 1031 of the Internal Revenue Code. Once the replacement property, such as the TIC property, has been held for twelve to eighteen months or more in order to demonstrate the taxpayer's intent to hold the property and qualify for 1031 treatment, the replacement property that was purchased is then contributed into a REIT in exchange for shares of stock in the REIT. Ultimately, the 721 exchange allows the investor to exchange out of his or her investment real estate portfolio by converting into shares of a REIT, which may produce more flexibility and liquidity when publicly traded.

Generally, these exchanges provide excellent opportunities for resourceful buyers to structure transactions that historically have not been possible through the typical sale/purchase methods. The real advantage, however, is that now investors can move their equity from property to property and ultimately into a REIT while deferring the capital gains taxes. The end result is that REITs allow for large diversified investment portfolios, which reduces risk while affording higher returns for the small investor. It appears that what started out as an apples-for-apples methodology has now evolved into a revolutionary investment process and a win-win for small, medium and large investors!

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