nerej CELEBRATING 55 YEARS

Five section 1031 replacement property options for investment and business real estate owners

September 26, 2007 - Spotlights

Owners of investment and business property considering the sale and reinvestment of their real property have choices that are far greater than their own neighborhood. Section 1031 exchanges require that the new or replacement property be "like-kind" but that definition has expanded to include diverse investments; here are five examples of replacement property opportunities.

Personal

Residence Option

Yes, you can convert your investment property to personal use. Clients looking to make a life-style change are often intrigued by this option. Simply, acquire the property that you want using a section 1031 exchange and rent it for two years. This satisfies the investment intent and later you can abandon your investment intent and use the property 100% personally. If you own this property at least five years and have used it for two of the five as your personal residence, at the time of sale, you will be eligible for the section 121 personal residence exclusion ($250,000/$500,000). Section 121 can be utilized every two years and there is no maximum limitation on its use.

Estate Planning

Gifting of real property is a popular way to transfer assets from one generation to the other. This can be accomplished by exchanging a piece of investment property to a single-family residence that can be rented to your family member at fair market rent. Since you need to continue your real estate investment, rent it for two years and then begin a gifting process. Currently you can make a gift of $12,000 per year per person. This option allows you to assist your family member with one of the most important choices they'll ever make, buying a home, while you're still here to provide the advice and counsel necessary.

Passive (TIC) Option

Tenant-in-common (TIC) ownership provides an opportunity to own institutional property without the hassles of managing tenants. Total annualized returns range from 6% to more than 15% with the right property. Now you can collect your earnings from the management company and never again talk to a tenant!

By regulation (revenue procedure 2002-22) a qualifying TIC is limited to 35 or fewer investors, has outside management, and the owners retain approval rights over the most important issues affecting the property. Extensive due diligence is performed by the sponsor and full disclosure of the performance assumptions is provided to prospective investors.

TIC investments will provide an opportunity to own institutional type properties, eliminate the management burdens, and provide for diversification, lower risk and increase cash flow. TIC interests can be exchanged again and again. While there isn't a ready market if you want to get out before sale, the returns and lack of direct intervention provide a stable investment alternative. TIC's are typically sold with 50% non-recourse debt.

UP-REIT Option

An UP-REIT is an umbrella partnership real estate investment trust. Once again, exchange your current investment property and purchase an interest in an UP-REIT. REIT's regularly carve off one or more buildings from their diverse holdings for investment clients to acquire using 1031 funds. After a period of seasoning, the UP-REIT is folded back into the REIT.

The disadvantage is that once you have moved your investment into this model, it cannot be exchanged again without paying the capital gains tax, however, REIT shares are typically publicly traded.

Gas & Oil

Royalty Option

This should give you an idea of how broad the definition of "like-kind" is when it comes to real estate. Investors receive legal title to the percentage of royalties purchased. Generally these will be mineral rights for oil, gas, or timber properties. These have existing cash flow and documented stability and growth. Properties incur no monthly expense or liabilities related to additional development, making it easier to track their performance and yield. Thanks to an active auction market, liquidity is available. Also, these interests may be exchanged again later. Debt is not involved.

George E. Foss, III is president and Christine Latulip, is vice president of Edmund & Wheeler, Inc., Littleton, N.H.