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A day in the life of a certified exchange specialist: Some current taxpayers' questions and concerns

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Rather than concentrate on a single topic, I have decided to take you inside a day in the life of a CES by sharing real taxpayers' current questions and concerns.

Q: I want to buy a house as my replacement property in a 1031 exchange to rent to my brother and his fiancé. Will the IRS consider this a "like-kind" property under Section 1031 even though a relative is renting from me?

A: If this truly is a rental property, you should have a legitimate lease with the tenants paying fair market rent rates for that particular area. Declare your deductions, report rental income and expenses on your return, and hold the property for at least two years. In this manner, you are truly keeping with the like-kind requirements despite the related party, tenant.

Q: Must the property I am selling be similar or identical to the property the I am acquiring in exchange?

A: The term "like-kind" property is defined in Section 1031(a)(1) as "property held for productive use in a trade or business or for invest-

ment..." Depending on what asset you are exchanging, the property can be personal, intangible or real property, however, the property must be held for the purpose defined by the Code and not primarily held with the intention of selling it. The key element to remember is that unlike personal property, real property is like-kind in nature or character and not to its grade or quality. Personal property is like kind as to its product class or asset group.

As for real property exchanges, the taxpayer must keep to the IRS term as defined above. The taxpayer may exchange a vacant lot in Maine for an apartment complex in New York. It does not have to be similar in use, as long as it is an investment or business use property. The taxpayer may sell one property and acquire two replacement properties, or sell three properties and acquire one replacement property to consolidate and more easily manage their investment.

Tenancy-in-common or TIC investment property is becoming more and more popular in recent years. It is an alternative choice in acquiring replacement property to complete one's 1031 exchange. A TIC investment structure allows an investor to share in the ownership of real estate that may not be affordable to own as an individual.

In March of 2002 the IRS issued Revenue Procedure 2002-22, which put forth guidelines in which an undivided fractional interest in TIC arrangements would be an

acceptable option and qualify as "like-kind" property for completing 1031 exchanges. Tenancy-in-common ownership is one way to own property whereby multiple investors can each have an interest in a property. Each co-owner will have a separate deed for their undivided fractional share of the whole property. In addition, each co-owner will have the same ownership rights. The total number of co-owners will vary depending on the size of the property but the maximum is not more than 35 investors. A husband and wife would be treated as a single co-owner. So, if you are exchanging one real estate investment for another and do not want the headaches of managing the property, TIC properties may be a viable option and will provide reliable income. Additionally, TIC properties make for a good backup property in the taxpayer's identification process when closely approaching their 45-day deadline and either no property is identified or uncertainty lies with the taxpayer's choice. The taxpayer will still be able to defer their capital gains tax on the relinquished property and complete a successful exchange.

If the taxpayer is exchanging personal property such as an airplane, then the taxpayer must purchase an airplane and not an automobile in the exchange. The property must be within the same general asset class and/or product class. It is most important for one to divide

multiple personal properties into separate exchange groups before engaging in a multiple property asset exchange, in order to determine what multiple asset groups need to be acquired to coordinate a successful exchange.

If the taxpayer is not sure which class the asset belongs to, an accountant can determine the proper class through the North American Industry Classification System (NAICS), a code system that designates a business' activity classified by its industry. In fact in a recent private letter ruling (PLR 200912004), a successful exchange was considered by the Service although the personal properties were not in the same asset group or product class. Section 1.1031(a)-2(a) provides that an exchange of properties that are not of like class may still qualify under Section 1031 if the assets are of like kind. Thereby concluding properties can be in different asset classes and still be like kind in some cases.

More detailed information can be obtained by contacting me, your attorney, a tax advisor or other professional intermediaries associated with the Federation of Exchange Accommodators. It is always important to consider the Code's safe harbors and complete your due diligence before engaging in an exchange.

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