JO Knows options for 1031 Exchanges Part I

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1031 exchanges are a valuable option for real estate investors. The advantage of deferring a taxable gain can greatly impact the available capital to invest in your next property. There are times when a real estate investor may not be able to find another rental property, or they do not want to deal with tenants, toilets, and trash. Luckily, there are some options to complete a 1031 exchange. In addition to the traditional avenue of exchanging one or multiple parcels of real estate for one or multiple parcels of real estate, real estate investors have two other options on the table when utilizing a 1031 exchange that allows the same deferral of gains on the sale of real estate: Tenancy in Common (TIC) interests and Delaware Statutory Trusts (DST). In Part I, we will discuss TICs, and in Part II, we will discuss DSTs.

TIC interests work similarly to owning real estate outright; however, in a TIC, all investors acquire an undivided proportional interest in the acquired property at the same time and have an undivided interest in their portion of the real estate assets and share in all items of income, expense, and debt. The advantage of a TIC structure is that each investor can acquire their interest in the TIC with 1031 proceeds or after-tax proceeds, independent of one another. One investor may come with after-tax capital, and another may come with 1031 proceeds.

While this may seem like a contradiction to the notion that 1031 proceeds cannot be used to acquire a partnership interest and continue to defer the gain on the sale of the relinquished property, owning a TIC interest is considered direct ownership of their real estate, the 1031 rules are deemed to have been followed (assuming that all other 1031 hurdles have been met). This can be a powerful option for real estate investors looking to aggregate their capital with another investor while still looking to defer the gain on a sold property.

TIC structures, while advantageous, are limited in their flexibility, however. TIC structures must be pro-rata in accordance with the capital each investor puts into the deal, and income, deductions, and cash distributions must also be pro-rata. Each investor reports their share of the income and deduction items on the tax return of the entity that holds the TIC interest rather than receiving a K-1 from a partnership. On the eventual sale of the real estate, each investor can then make their own independent decision on whether to engage in another 1031 or take their cash back and recognize the gain on the sale.

1031 exchanges into or from TIC interests are available to real estate investors who hold real estate for rent. Additionally, 1031 exchanges can be executed where the investor acquires a mix of TIC interests, DST interests, and outright acquisitions of other real estate, enabling the investor to have much more flexibility than is traditionally thought. Before making any decision about selling or exchanging a property, some advanced planning is needed to ensure compliance with the 1031 rules. Your first step should be to discuss the opportunity with a CPA who knows these rules and has significant experience with real estate. He or she can assist you in engaging a qualified intermediary to facilitate the transaction. The real estate team at JO knows how to structure and properly account for these transactions.

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