

Evolution and Revolution of the Like-Kind Exchange Market

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Executive Summary

Section 1031 has been part of the Internal Revenue Service tax code since 1921, but recent changes to §1031 and recent guidance provided by the IRS have significantly broadened the appeal and use of this provision within the U.S. commercial real estate industry. The exponential increase in §1031 transaction volume experienced over the past several years has generated recognition, both good and bad, for the many companies and investors who participate in this sector of the market.² In this article I hope to shed some light upon these new like-kind transactions, explain why certain investors have embraced them, and discuss recent trends and observations which may influence how this industry will evolve over the next several years.

What is an IRS §1031 Tax-Deferred Exchange?

An IRS §1031 exchange is a powerful wealth management tool that enables investors to defer tax consequences related to the sale of real property, provided that all proceeds from the sale are reinvested in “like-kind” property within a specified period of time and that certain other well-established procedures are followed. The numbers “1031” refer to the section of the IRS code (Section 1031) which stipulates the rules with which the exchanger must comply to successfully complete an exchange. *[To read the full text of IRS §1031, go to www4.law.cornell.edu/uscode/26/1031.html.]*

IRS §1031 was adopted in the 1920's to facilitate transfers of land among farmers, who, although land rich were cash poor and thus unable to pay taxes when exchanging one farm for another. Over the years, §1031 exchanges have been employed by sophisticated individuals, partnerships and corporations in an effort to manage their taxes and property holdings. For example, car rental companies have upgraded their fleet vehicles for decades by applying this tax-efficient method to their auto leases. According to recent IRS data (for the year 2000)³, industry experts estimate that annual volume of 1031 exchanges (for real estate and other types of properties) exceeded \$200 billion. Of that figure, about \$50 billion to \$60 billion of income was deferred, and between \$10 billion and \$30 billion of taxes were deferred. Corporations account for more than 50% of deferred gains, while partnerships and individuals account

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for approximately equal shares of the balance.⁴ Absent the use of an IRS §1031 exchange, investors must pay taxes on both the appreciation in value and the recapture of depreciation taken on the property. Given the significant appreciation in many different types of commercial real estate property over the past decade, the tax deferral benefit of a §1031 exchange can be considerable for real estate owners, and its use has been accelerating in recent years.

However, the very specific rules and rigid time constraints required to successfully execute a tax-deferred exchange have limited its use. It is estimated that more than \$10 billion in IRS §1031 property exchanges fail every year.⁵ The introduction of tenant-in-common legislation in 2002 exponentially expanded the feasibility and use of §1031 exchanges involving commercial real estate, as is more fully discussed below.

How does an IRS §1031 Tax-Deferred Exchange Work?

To accomplish an exchange, the seller (“exchanger”) deposits all of the proceeds from the sale of a property (known as a “relinquished property”) into a special trust account designated for purposes of consummating a tax-deferred exchange. These trust accounts are normally administered by Qualified Intermediaries (known as QI’s) or other financial institutions. The Exchanger has a maximum of 180 calendar days from the closing of the sale of the relinquished property to complete the acquisition of the new property (known as the “replacement property”). Within the first 45 days of this period, the Exchanger must designate and properly identify one or more replacement properties. An Exchanger, however, may not identify more than three properties, regardless of value, or a group of properties with a combined value that exceeds 200 percent of the value of the relinquished property. The funds deposited into the trust account can be used as earnest money for the replacement property once all IRS requirements for a §1031 transaction have been satisfied. If no replacement properties are identified in the first 45 days, or if the acquisition of the replacement property occurs more than 180 days following the sale of the relinquished property, the trust account will be disbursed, the proceeds will be returned to the Exchanger and the sale of the relinquished property will be taxed at the prevailing capital gains and/or ordinary tax rates.

What is a Tenant-in-Common (TIC) Structure?

A tenant-in-common is a form of estate in land, or ownership, whereby two or more individuals own a fractional share of a whole piece of property (e.g., if four people own an asset as tenants-in-common, each may own a 25% fractional interest). While tenancy-in-common has always been a common form of joint ownership, the release of Revenue Procedure 2002-22 in March, 2002 by the Internal Revenue Service

greatly enhanced the appeal and use of the TIC structure in §1031 like-kind exchanges involving real estate property. The 2002-22 Revenue Procedure set forth a series of 15 guidelines, which, if honored by a sponsor or a TIC investment program, would allow the sponsor to seek and obtain a favorable tax ruling. Specifically, the tenant-in-common interests created by the sponsor would be deemed “like-kind” property for purposes of §1031 and, as such, a qualified investment as replacement property necessary to accomplish an exchange. While the IRS specifically stated that these guidelines do not provide a “safe harbor” per se, in practice, to the extent TIC sponsors comply with these guidelines and obtain a legal opinion that the TIC offering “should not” be characterized as a partnership, a safe harbor has been created. *[To read the full text of IRS Revenue Procedure 2002-22, go www.irs.gov/pub/irs-drop/rp-02-22.pdf.]* In fact, the combination of IRS §1031 exchanges and fractional TIC ownership (“1031/TIC”) is proving so compelling that 1031/TIC exchanges are quickly becoming the most popular choice among individual real estate investors seeking replacement properties.

Traditional IRS §1031 Exchanges vs. §1031/TIC Exchanges

The chart below compares traditional IRS §1031 exchanges with 1031/TIC exchanges. The most significant difference between the two exchange structures is the ability of an individual real estate investor under 1031/TIC’s to purchase (along with other investors) a fractional interest in a much larger replacement property. This significant difference leads to a number of key benefits available in a 1031/TIC exchange, including:

- a far greater choice of replacement solutions than otherwise available under a traditional §1031 exchange, which decreases the likelihood that the exchange will fail because a replacement property could not be identified;
- the potential to acquire much larger and higher quality properties than may otherwise be affordable with the individual investor’s exchange dollars alone; and
- the ability to engage a highly-qualified professional company to lease and manage assets, which frees the individual investor from these duties and responsibilities.

Investor Profile & Appeal of 1031/TIC Offerings

The benefits of 1031/TIC exchanges hold particular appeal for the large sector of the U.S. population referred to as the Baby Boomers. These individuals, born between 1946 and 1964, number 78 million and account for the largest share of the U.S. population. Baby boomers are not just prolific, they are wealthy, own considerable

investment real estate and in the next five to 15 years will enter their retirement years, when investors typically shift their focus to preservation of wealth, current income and passive investments. The shift to passive property management, away from the dreaded “three t’s” of property oversight: toilets, trash and tenants, in favor of time spent with family, grandchildren, hobbies, and traveling, is a particularly strong motivation among retirees. The 1031/TIC investment products, which are income-oriented (offerings available in May, 2005 offered 6-8% current cash returns)⁶, actively managed by others and exchange-efficient, appear tailor-made for this demographic. Recent growth in transaction volume reflects this dynamic.

Comparison of Like-Kind Exchange Structures

	Traditional §1031	§1031/TIC
Permitted Ownership Form for Exchange Asset	100% fee ownership of single asset.	Fractional ownership of up to three assets.
Suitable Exchange Opportunities	Fewer; must find exact match for equity and debt	Greater choice
Property Type and Size	Typically smaller, less than \$5 million in value, often occupied by non-investment grade, local tenants	Larger, high construction quality buildings; values from \$10 million up to \$100 million; often include investment grade tenants
Diversification	None; single asset	Possibly more, because investment can be spread over a maximum of 3 assets, depending upon amount to invest
Property Management	Probably active; difficult or cost prohibitive to engage most professional third party property management companies for smaller single assets.	Most likely much more passive due to the employment of a third party property.
Leverage, Deal Structuring and Negotiation	Most of this work typically must be arranged by the exchanger.	Sponsor provides a “turn-key”, fully negotiated and structured transaction, including non-recourse debt in place.

According to broker dealers who have been active in the sale of 1031/TIC interests over the past several years, the typical investor purchasing 1031/TIC offerings has been an individual between 55 and 65 years old, with exchange proceeds averaging between \$350,000-\$500,000. These investors have typically invested in a single 1031/TIC

offering and preservation of principal was their primary investment criteria. In the past 12-18 months, this profile began to evolve in several interesting directions:

- The dollar value of exchange proceeds has increased significantly, as property values have skyrocketed in many markets, particularly in California, certain parts of the Sunbelt, and on the East Coast.
- Investors with exchange proceeds in excess of \$1 million have increased, and these investors have decided to purchase interests in multiple TICs to achieve diversification by geography, sponsor, property type, or all three.
- As slightly younger (45-55 year old) investors have entered the market, appreciation and a slightly greater risk tolerance have been added to the list of investment criteria; and
- A surprising number of farmers and families are selling land to home builders and reinvesting their proceeds via §1031 TIC offerings, a phenomenon experienced on both coasts and in the agricultural Midwest.

Tenant in Common Industry Growth⁷

Year	Equity Raised (\$ millions)	TIC Sponsors
2001	166	9
2002	357	15
2003	756	20
2004	1775	46
2005 (Q1)	981	
2005 (full year estimate)	4100	65

Source: Omni Brokerage, Inc.

Concern About Pricing and Fees

As with any market experiencing exponential growth, the 1031/TIC market has attracted a healthy dose of skepticism from those inside and outside the business. The two questions raised most often by skeptics are the prices being paid for properties, and the fees or “front end load” being charged to investors by TIC sponsors and broker dealers.

Addressing the pricing issue first, which partially incorporates the appropriateness

of the fees or loads charged to investors because 1031/TIC offerings are sold as “turn-key” investments, net of all fees and expenses, it would appear that the rapid growth in transaction volume would speak for itself. In the currently very competitive real estate market, where most participants are complaining that plentiful capital is overpricing every transaction, it seems unfair to single out 1031/TIC offerings for their unfavorable pricing. Also, an assessment of “appropriate value” to 1031/TIC investors must take into consideration the significant tax deferral benefits integral to like-kind transactions⁸, and the comparatively higher quality assets available through many 1031/TIC programs (which individual investors typically cannot buy on their own). It is true, however, that investors with tax motivations, especially those executing like-kind exchanges, face time pressures and may be willing to accept lower returns from an asset than would other, non-tax motivated investors. As such, TIC sponsors, who employ this capital to acquire assets, may have a pricing advantage versus other acquirers.

The appropriateness of loads and fees is also influenced by the unique demographic of the 1031/TIC investor. Front end fees and expenses typically range from 10-15% of equity raised, with a large portion of these expenses paid to the broker dealers who must, under securities laws, sell these investments (they are technically Regulation D Private Placements) and the TIC sponsors who structure the offerings and manage them over time. While these expenses may appear high, they are within the range charged by the large, private REITs such as Wells Real Estate and W.P. Carey. Also, TIC sponsors argue that an apples-to-apples comparison of the premium paid by investors to invest in the 1031/TIC format as compared with purchasing real estate on their own, should adjust for expenses investors pay in any real estate transaction, such as appraisal, environmental, engineering, legal, lender and other closing costs which are included in 1031/TIC offerings. With these adjustments, the up-front premium is lowered to 10% or less.

Comparison of 1031/TIC Offerings With 1980's Syndication Era

While there are some similarities between the 1031/TIC market and the tax syndication boom experienced in the 1980's, including rapid growth of transaction volume, relatively high front end fees and limited liquidity, there are also some major distinctions including:

- 1031/TIC investment objectives are primarily based upon real estate economics and cash flow (as opposed to the substantial tax benefits in the syndication era);
- 1031/TIC's focus on stabilized, generally well leased properties (whereas many tax syndications involved riskier development projects);
- 1031/TIC's typically employ far lower leverage, in the range of 50-60% of

- total capital (as opposed to 75% and higher ratios employed in the syndication era); and
- the ability of 1031/TIC investors to control their investments by, among other things, voting on all major leases, sales and re-financings, and management contracts (whereas some investors in syndication partnerships are still trying, two decades later, to remove the general partner and gain control of the property).

How Will TIC Sponsors “Stretch” To Find Deals?

As TIC sponsors encounter fierce competition for new acquisitions of stabilized assets, a few have begun to consider less traditional, potentially higher risk investment opportunities including hotel, assisted living, self storage, Class B (as opposed to higher Class A) and “turnaround” or value-add properties. Other TIC sponsors have ventured into secondary market locations, where higher yielding properties are available. As these sponsors “stretch” their acquisition criteria, it raises the question of whether they are introducing a level of risk which may be inappropriate for the typical TIC investor.⁹

DST’s: The New New Thing

Revenue Procedure 2002-22 is not the only significant recent guidance provided by the IRS in the realm of like-kind exchanges. Another ruling, issued in the summer of 2004 and still under review by industry participants, may further increase the number of investors who can participate in co-ownership like-kind exchanges, and contribute to even further growth in this market. This new ruling, Revenue Procedure 2004-86, deals with Delaware Statutory Trusts (DSTs) and suggests that it is possible in certain situations for sponsors to structure their offerings as DSTs and have them qualify as like-kind exchanges. From a practical standpoint, the inherent inflexibility of DSTs limits their use to long-term, triple-net leased properties or properties where a master lease is put in place. But even with these limitations, a significant number of assets would qualify. DSTs offer several potential significant benefits to sponsors, including

- a more lender-friendly structure, because, unlike TICs, which represent loans to multiple borrowers (up to 35 in each TIC offering), DSTs are single borrower, single ownership entity financings. Lenders don’t have to worry about serial foreclosures, and they don’t have to worry about underwriting the investors, because an investor in a DST has no votes and no powers to speak of. So, from the lender’s viewpoint, it is analogous to making a loan to an entity.¹⁰
- more investors—up to 100—can be brought into a DST deal, as opposed to a maximum of 35 in a TIC.¹¹ A greater number of investors means either

a larger property can be bought, and/or minimum investment requirements can be lowered, broadening the field of potential investors.

- the DST also makes the required paperwork much less cumbersome and less time-consuming, and thus less costly, for the investor. In a DST, the investor basically signs a subscription agreement, whereas with a TIC, each investor has to form a single-member LLC (which requires annual filings and fees) and undergo a separate underwriting by the lender.¹² Delaware Statutory Trusts represent currently represent less than five percent of all 1031/TIC exchanges.

Typical Transaction

One example of a typical like-kind transaction is the 1200 Ashwood 1031/TIC offering Griffin Capital closed in August 2004. In this transaction, Griffin acquired a five-story, 188,424 square foot, class A, multi-tenant office building located in the heart of the Central Perimeter, Atlanta's largest office submarket, in concert with 34 individual investors, the vast majority of whom were investing subject to a 1031 exchange. This 85 percent occupied building was acquired from an opportunity fund seller (who had held the building for five years), for \$28.61 million (\$151.84 PSF) including a \$2.93 million capital expenditure reserve for tenant improvements and leasing commissions. Fifteen and a half million dollars were borrowed non-recourse from J.P. Morgan Chase Bank, N.A. at 5.53% fixed for seven years and \$13.11 million was provided by 35 TIC investors (including Griffin Capital). Twenty-six of 35 investors live in California and their investment amounts ranged from \$165,000 to \$1.5 million. Initial cash yields to investors begin at 7% and are expected to increase 25 basis points per year; the projected internal rate of return is 12%.

Conclusion

The like-kind exchange market has experienced revolutionary change since the introduction of Revenue Procedure 2002-22 just three years ago. Transaction volume has nearly doubled every year for the past four years. While it is unlikely that this pace of growth can be maintained indefinitely, favorable demographic trends and recent developments point toward a continued expansion of like-kind offerings. Time will tell how existing 1031/TIC offerings perform relative to expectations, and whether or not regulators and the Internal Revenue Service will decide to change the last major tax deferral mechanism available to individual investors. Stay tuned.

Appendix I: Major participants in 1031/TIC Transactions

TIC Sponsor

The entity, typically an experienced real estate owner and investor that structures the investment, conducts due diligence, arranges the debt, raises the equity from Accredited Investors (using the services of Broker-Dealers and their Registered Representatives), manages the property (either internally or by hiring a third party), provides asset management services during the investment holding period, and sells the asset to realize returns for investors.

Qualified Intermediary (QI)

The intermediary (or middleman) required to hold, in a segregated trust account, the sales proceeds realized by the exchanger from the sale of relinquished property. The QI retains the proceeds until the earlier of the date the exchanger is prepared to close the acquisition or the replacement property and the expiration of either the 45-day identification period or the 180-day closing period.

Broker-Dealer and Registered Representatives

Broker-dealers are companies licensed by the National Association of Securities Dealers (NASD) to sell securities to investors, and Registered Representatives (often called Registered Reps or Reps) are licensed salespeople employed by or affiliated with the broker-dealers who are engaged to sell the securities.

Accredited Investor

An individual investor with a net worth, or joint net worth with his or her spouse, of more than \$1 million (inclusive of real property), or an individual with income in excess of \$200,000, or joint income with his or her spouse in excess of \$300,000, in each of the two most recent years and with a reasonable expectation of achieving the same in the current year. Generally, only accredited investors purchase 1031/TIC investments.

Endnotes

² Like many sectors of the increasingly complex and diverse U.S. capital markets, the TIC Industry has a unique group of participants. The major participants are listed and described in Appendix A.

³ IRS Data on like-kind exchanges is difficult to obtain, and the year 2000 is the most recent year that complete data is available, according to Lou Weller, principal of Deloitte, and a frequent lecturer and writer on like-kind exchanges.

⁴ IRS Data for 1999-2001 (the most recent periods available) as reported by Weller, Jefferies, MacDonald & Paul at TIC Association Annual Conference, March 6, 2005.

⁵ Deloitte and Touche study, 2003

⁶ Omni Brokerage industry statistics

⁷ As impressive as these growth data are, they may under-represent annual TIC transaction volume by as much as 100% because they omit TICs sold as real estate (i.e. they only include TICs sold as securities); as of May, 2005 there is no entity tracking sales of TICs sold as real estate so reliable transaction data for these exchanges is not available.

⁸ The two significant taxes deferred in like-kind transactions are long-term capital gains and depreciation recapture. As of this writing, these tax rates are 15% and 25% respectively. Additionally, state taxes, which vary, but can run as high as 11% in New York and California can be deferred as well.

⁹ When considering whether or not certain assets and risks are appropriate for TIC investors, it is important to remember the rank order of investor priorities which have shaped TIC underwriting in the past two years: first, preservation of principal, second, current income, and third, appreciation.

¹⁰ Michelle, Napoli, Editor, *TIC Monthly*, and author of "Finance Series Part III: Pros and Cons of the DST Structure", April 12, 2005 *TIC Monthly*. Article includes comments from Marc Goldstein, Principal and Co-founder of Creekstone Partners, Arnold S. Harrison, Partner, Jennifer & Block and Jeffrey Lavine, Senior Managing Director, Bear Stearns & Co.

¹¹ Ibid; Per Arnold Harrison, the 35-investor figure for TICs comes from the revenue procedure that spelled out IRS requirements for considering a private letter ruling request on those deals. There is no tax law or policy that limits the number of investors in a DST, rather, the 100-investor limit comes from the Investment Act of 1940. Generally if one sells securities and has more than 100 investors, then he is subject

to the 1940 Act unless they're qualified purchasers, meaning they have a net worth of at least \$5 million. This means the seller is the same as a public company with all the reporting requirements of a public company. Given that considerable burden, Harrison doubts anyone would ever do it.

¹² Ibid

