SECTION 1031 AND ESTATE PLANNING

Most tax advisors are aware of Section 1031 and the opportunity it affords to defer otherwise taxable gain on the sale of business or investment assets. Section 1031 remains an under-utilized strategy in the estate planner's toolkit. Reasons to do a §1031 exchange are to:

1. Diversify asset holdings;
2. Exit active management; and
3. Convert a non-income producing parcel of real estate into an income producing parcel.

Like-Kind Property

In a Section 1031 exchange, the properties exchanged must be "like-kind." Virtually all owned real estate (fee ownership) irrespective of improvements, use, or occupancy. Owners can also exchange for an interest as a tenant-in-common, provided that the owners are not in a partnership for tax purposes. Revenue Procedure 2002-22 contains guidelines for a tenant in common arrangement to avoid being treated as a partnership. The broad like-kind standard for real estate offers tremendous opportunities to diversify, exit management, and convert to income producing properties.

Replacement Properties

To effectively use Section 1031, an owner must find replacement property meeting the owner's investment needs. Finding suitable replacement property within the short 45-day identification period remains one of the main challenges in doing a Section 1031 exchange. The availability of ready-to-buy replacement property for §1031 buyers has helped more §1031 buyers complete like-kind exchanges. Properties currently available are single tenant net leased property ("triple net") and tenant-in-common ("TIC") investment properties. Triple net properties are fee owned properties occupied by a single tenant (often with an investment grade credit rating) on a long term lease. Triple net properties can either produce a positive cash flow or a zero cash flow in which the rent pays the mortgage. Triple net properties are sold through brokers that specialize in this property type. TIC properties may be multi-family, industrial, office, or retail. TIC properties must be owned by 35 or fewer owners. TIC properties are generally structured to produce cash flow. TIC properties may be either master leased under a net lease to a single tenant or leased to multiple tenants with professional management. TIC properties are typically sold as securities through registered broker-dealers to accredited investors in private placement offerings.

Diversifying Real Estate Holdings

Diversification among real estate holdings is achieved by taking one or more larger parcels of real estate and diversifying into several smaller parcels of real estate. Diversification of different real estate investments can be accomplished by acquiring a portfolio of either triple net properties or TIC properties. Sometimes consolidation of real estate holdings is favored, but often spreading risk to different real estate markets, different asset classes (industrial to retail, etc.) is preferred. Another reason for acquiring multiple properties is to facilitate division and distribution to the beneficiaries of the owner's estate.

Acquiring Different Asset Classes

Other than diversifying into different real estate asset categories (multi-family to industrial), a taxpayer may want to diversify holdings into an entirely different asset class (real estate to securities). This can be achieved by refinancing the replacement properties to acquire other investments to balance a portfolio. Refinancing, of course, can be accomplished without doing a §1031 exchange. Triple net properties offer unique advantages because the tenant's credit rating accommodates a high degree of leverage on the property (90% is not uncommon). The ability to invest exchange equity to complete an exchange and borrow it out again ("paydown-readvance") is useful. Refinancing after the exchange is often done by 1031 exchange buyers, but should be discussed with a tax advisor.

Disposing Non-Income Producing Property

If a client owns a parcel of undeveloped land having significant equity and appreciation, the client may want to convert into an income producing asset. Both triple net properties and TIC properties may be suitable in this situation. Both triple net and TIC property can offer positive cash flow without the burdens of management. Any property must be individually evaluated on a financial, tax and legal basis.

Conclusion

Section 1031 is another useful tool that wealth advisors and their clients should consider using in appropriate circumstances. In any situation where disposing of real estate is contemplated, §1031 should be considered, since a taxable sale is rarely favored. Because of its ability to help achieve objectives in addition to tax deferral, §1031 offers the wealth advisor and client many advantages. Triple net and TIC property owners need to consider their exit strategy and the ability to sell and recover their original investment.