1031 Exchange Replacement property options

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One of the benefits of structuring a transaction as an IRC §1031 tax deferred exchange is the ability to purchase replacement property which is of a different type than the relinquished property. Unfortunately, many people get caught up in the requirement that the property sold and the property to be purchased must be "like kind" in order to qualify for an exchange. In fact the term like kind does not mean that the same type of property must be purchased, it merely means that you must sell and purchase real estate held for business or investment purposes. Accordingly, there are various types of real estate investments that exchangers can choose form.

Traditional Real Estate Investments One of the most common types of replacement property is the purchase on another piece of "traditional" real estate such as an apartment building, office building, industrial property, rental home, or vacant land. Exchangers often structure their transactions as exchanges to trade up into larger more profitable properties. There is no requirement that an exchanger buy the same type of property it sold.

Net Lease Properties Most people driving down a street in a do not realize that many of the major chain stores they pass, such as a CVS, Walmart, Burger King, or KFC, are actually real estate investments for someone other than the company occupying the store. In order to fuel their expansion many companies build their own stores, sell them to a real estate investor, and take back a long term lease. These types of investments are know as net lease properties, triple net lease properties, or credit tenant leases. The reason why these types of investments are attractive to exchangers is that generally the tenant is responsible for the maintenance, upkeep, and payment of the mortgage and taxes on the property. The owner of the property gets a monthly check for the "net" amount after these expenses have been deducted and does not have any management responsibilities. Another reason these properties are attractive is because many of these leases are guaranteed by a national chain, which many times gives an exchanger a credit worthy tenant, hence the term credit tenant lease. Companies with higher credit ratings can negotiate better leases because they are more stable. Conversely, companies with lower credit ratings can expect to pay more. Lastly, these types of properties are attractive because they can be sold or refinanced whenever the exchanger chooses. A purchase price of $1M for even the smallest of these properties means investors must have substantial funds to purchase this type of investment.

Tenant in Common (TIC) Tenant in common properties, also known as TIC properties, share some of the traits of net lease properties, such as the lack of management responsibilities by the exchanger and the receipt of a net check each month for the rent by the exchanger. TIC properties are different because by definition its owners are co-owners with other people in the property. The co-owners in the property have been grouped together by companies known as sponsors who structure these types of transactions. Sponsors will identify a property to be purchased, determine how many investors will take part in the purchase, arrange for financing on the property, and act as the property manager. For example, a TIC sponsor may purchase a $20M property with twenty investors each contributing $1M each. The benefit of a TIC property is that many times investors can purchase a small portion of credit worthy building, whereas they would not be able to buy anything credit worthy on their own. Another reason why exchangers like this type of investment is that the sponsors always have new properties coming on the market to buy. If an exchanger is running out of time and does not know what to buy, these properties can become an attractive alternative. In return for these benefits a TIC owner has very little control in the property, may not take cash out of the property in a refinance, and must generally wait until a predetermined date to sell the property.

Real Estate Investment Trusts (REIT) Real Estate Investment Trusts, or REITS as they are commonly known, are an extremely rare type of replacement property for 1031 exchanges. Contrary to popular belief an exchanger may not sell real estate and purchase shares in a REIT to complete a 1031 exchange. Instead exchangers must enter into an agreement with the REIT to either purchase all or a portion of a property which will later be contributed to the REIT. The structure can be complicated and also results in the exchanger having to recognize a capital gains tax if the interest in the REIT is sold.

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