1031 Exchange Solutions: A Quick Reference Triple Net Leased Properties (NNN) vs. Tenancy in Common Investments (1031 TICs)

While many savvy investment property owners recognize this as an opportune time to dispose of their property, they are also discouraged to find that it is an unpleasant market to locate a suitable exchange property to satisfy their 1031 exchange. The current market is a "seller's market" and competitive bidding has raised prices and reduced yields of investment property.

San Francisco, Ca September 13, 2005 - While many savvy investment property owners recognize this as an opportune time to dispose of their property, they are also discouraged to find that it is an unpleasant market to locate a suitable exchange property to satisfy their 1031 exchange.

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Investors seeking less actively managed real estate opportunities often elect to invest in Triple Net Leased Properties (NNN) or Tenancy in Common Investments (also called 1031 TICs). Both investments require little active management by the investors and typically provide predictable monthly cash flow to investors.

Which one is best for your specific needs? Here I provide a comparison across each key investment criterion: liquidity, investment size, diversification of tenants, diversification of properties, tax and other risks, transaction costs, lease structure, and debt financing.

Liquidity
(As a frame of reference, remember that when compared to stocks, bonds, and publicly traded investments, real estate investments are generally considered illiquid.)
NNN: The liquidity of NNN properties is moderate relative to other real estate investments. Investors in NNN have 100% discretion regarding decisions to sell, transfer or hold the property. Liquidity is a function of the current demand for the type and quality of property.

TICs: TICs are less liquid than NNN properties. TIC investors own an undivided, fractional interest in the TIC investment, and investors should plan to hold their TIC investment for the holding period (typically 5-10 years, as described in each individual offering memorandum) and sell with the TIC group.

TIC investments can generally be conveyed at any time, to any qualified buyer, based on lender requirements and in accordance with the TIC agreement. On the other hand, an established secondary market for TIC interests does not exist, therefore decreasing liquidity. Additionally TIC agreements often grant a right of first refusal (at the fair market value) to the co-investors or to the TIC sponsor in the event that a TIC owner wishes to sell.
Investment Size
NNN: NNN property investments are typically more than $1.0 million. Although smaller properties exist, they are scarce.

TICs: Minimum investments in TICs are as low as $200,000 for some properties, with the average minimum in the $500,000 range.

Diversification of Tenants

NNN: NNN properties often are leased to only a single tenant. Although single tenants are often marked “investment grade” as listed by recognized credit rating agencies (and therefore in theory less risky), this offers little diversification if a tenant vacates or is unable to make lease payments.

TICs: TICs are often multi-tenant properties and therefore offer the benefit of diversification. Multiple tenants decrease the dependence of the investment on any individual tenant.

Diversification of Properties
NNN: Because of the higher minimum investment amount, investors may lack sufficient equity to purchase multiple properties.

TICs: Lower minimum investments make it easier for investors to diversify among multiple properties.

Tax Risks
NNN: NNN properties are “real property” and are eligible for 1031 exchange provided the investor follows the IRS Guidelines for the Exchange.

TICs: TICs carry some tax risk as TIC investments must be carefully structured to be considered “real property” by the IRS, rather than as a partnership interest (which is not eligible for a 1031 exchange) (see IRS Revenue Procedure 2002-22).

Other Risks
NNN: Properties carry real estate risks including but not limited to market risks, tenant credit risk, tenant renewal risk, natural hazard risks, etc.

TICs: In addition to all the risks listed for NNN Properties, TICs carry additional risks such as sponsor risks, tax risks (as noted above) and others.

Transaction costs
NNN: Investors can expect to incur real estate fees (often paid by the seller), transfer taxes, escrow and title fees, legal fees, due diligence fees, loan fees, etc.

TICs: In addition to standard real estate transaction costs listed for NNN Properties, TIC investments involve additional transaction costs such as sponsor fees, broker/dealer commissions, legal fees, advertising and marketing fees, etc. These additional transaction costs are referred to as “load” and should be examined on a per transaction basis, as they vary by deal and by sponsor.

Lease Structure
NNN: NNN leased properties are typically leased on a long-term basis, which makes the return of the investment predictable. The downside is that long-term leases are typically flat; you won't see increases in value for possibly 10 years or more. As investment property value is a derivative of the income generated by the property, flat lease structures limit the opportunity for appreciation of the property. Also note that, similar to a bond, single tenant, long-term leases have the potential to decrease in value as the lease expires.
TICs: As many TICs are multi-tenant properties, there is often the opportunity to renew leases on a regular basis at market rental rates, thereby increasing the income (and value) of the property. Shorter leases, however, also present risks that the property will have higher vacancy than expected, adversely affecting the cash flow to the investor.

Transaction Complexity

NNN: Investors purchasing NNN lease properties will typically have to negotiate with the seller to finalize the terms of the purchase, secure a loan for the property, perform any due diligence required, and often compete with other bidders to obtain the property.

TICs: Because TIC offerings are often “packaged” with management and financing in place, TICs simplify the 1031 process for the passive real estate investor. Additionally, since each investor acquires the property at the offering terms no negotiation is involved. Also, because each property typically can accommodate 20 or more investors it is often less competitive to secure a TIC interest.

TIC offering memorandums include disclosure statements, a TIC agreement, and a loan agreement, among others. Although the paperwork is lengthy, it can usually be completed in a few hours once you and your legal and financial advisors have fully reviewed it.

Final Thoughts: A Bit More on TICs
TIC properties may be any of the major property types including office, retail, apartment or industrial. They may also be located all across the nation. As a TIC owner, each investor owns an undivided, fractional interest in an entire property and shares proportionately in the net income, tax shelters, and gains or losses.

Each TIC owner receives a separate property deed and title insurance for their portion in the property investment. This gives them the same rights of ownership that a single owner would enjoy. Because TIC offerings are often “packaged” with management and financing in place, TICs may simplify the 1031 process for the passive real estate investor.

TIC investments provide simplicity by eliminating active management headaches. Individuals who are ready to relinquish the day-to-day burdens of being a landlord, or who own land and would like an income producing property, may benefit from TIC investments. TIC programs provide a "mailbox management" investment that may save investors time and money.

Furthermore, TIC ownership allows investors the ability to diversify your 1031 exchange into more than one property, and to own potentially larger, institutional-quality properties. Cash flow is generally paid monthly and is tax-sheltered via depreciation pass-through and interest deductions, and in many cases a portion of your net income is tax sheltered. You may also experience appreciation over the time that you hold your property.

With all of the added benefits of TICs, including the elimination of management headaches, diversification, and monthly cash flow, it is easy to understand why the TIC market is attracting so much attention. The Q2 2005 Edition of OMNI NEWS offers a glimpse of where this market is heading: the securitized TIC marketplace has grown from placing close to $167 million TIC equity in 2001 to placing $1.73 billion in 2004, and it is estimated that over $4.27 billion TIC dollars will be placed this year. This is why seasoned investors, “baby boomers” seeking to build extra retirement income, and others are turning to TICs to meet their 1031 exchange requirements.

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This information is intended merely to be a general discussion, not deemed to be investment or legal advice. Real estate and TIC investments are not suitable for all investors. Individual investors should consult their tax advisor, CPA, and financial advisors prior to making any investment decisions.

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