A New Distribution Channel for REIT Properties

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Recent guidance for Tenancy in Common (“TIC”) programs is providing an opportunity for REITs to distribute their excess or non-strategic properties to a growing market of investors involved in tax deferred exchanges. The decline of the equities markets, favorable interest rates, and expanded use of Internal Revenue Code §1031 like-kind exchanges have all led to a significant increase in real estate investment. Moreover, the demand for passive real estate investments as an alternative to equities and fixed income securities has dramatically increased. This article will discuss the “win/win” opportunity provided to the REIT industry and to individual investors through combined use of §1031 and TIC programs.

Recent guidance for Tenancy in Common (“TIC”) programs is providing an opportunity for REITs to distribute their excess or non-strategic properties to a growing market of investors involved in tax deferred exchanges.

Section 1031 is one of the more generous sections of the tax code. It provides that no gain or loss will be recognized on the transfer of an investment or business-use asset, if that asset is exchanged for like-kind property that also will be held for investment or business use. Since no gain is recognized, all capital gains taxes will be deferred. By structuring the sale and replacement purchase of real estate as a §1031 exchange, a corporate taxpayer can achieve tax deferral savings of approximately 35% of the gain. Savings for an individual taxpayer range from 20–25% of the gain.

Satisfying the “like-kind” criteria is easy for real estate assets. All real estate in the United States is like-kind to all other domestic real estate, regardless of whether it is commercial, industrial, multi-family residential or unimproved. An apartment building, warehouse or vacant land may all be swapped for a shopping center because they are all “like-kind”. Mature individual investors often prefer a more passive form of real estate investment than their previous holding. REIT shares do not qualify for like-kind exchange treatment, but undivided fractional interests in real estate are like-kind to a fee interest in real estate.

Thus, a predominantly industrial REIT may start the cycle by swapping a non-strategic retail property for a more appropriate industrial property, with the purchaser of the relinquished retail property being a TIC Sponsor, which is generally a company offering commercial real estate with a Tenancy in Common investment method. Section 1031 allows this transaction to avoid recognition of gain, and permits deferral of all gain and recapture taxes. At the same time, the individual investor may swap out of an actively managed multi-family property into a fractional interest in the larger, professionally managed retail property disposed of by the REIT.

How does an investor turn the sale of an apartment building in Michigan and the purchase of a 6.6% tenant in common interest in a shopping center in Illinois into a Like-Kind Exchange? Actually, it’s pretty easy. The tax laws do not require the swap to be simultaneous. In fact, most exchanges are non-simultaneous, for the simple reason that a purchaser of investment real estate is not likely to have acceptable property to exchange back to the seller of the acquired property. In a non-simultaneous exchange, the buyer’s purchase money is used to acquire replacement property from a third party seller. The tax laws give the real estate owner (“Exchanger”) 180 days from the sale of the old property to acquire the new property. The Exchanger is allowed to continue to search the market for acceptable replacement property during the first 45 days of this 180-day period. Additionally, the Exchanger is even permitted to “identify” alternate replacement properties.

The §1031 investor has always desired a simple alternative to traditional replacement property options as a cure for the onerous 45-day identification deadline. These circumstances have led to a tremendous increase in demand for Tenancy in Common ownership structures or “TIC” properties. These TIC properties are typically commercial real estate assets that have been specifically structured by TIC Sponsors for fractional ownership by multiple investors. The co-owners (tenants in common) have true fee ownership of the asset but remain passive with respect to the day-to-day management of the facility. The burgeoning TIC industry has worked directly with the IRS and Department of Treasury to provide an approved means for the Like-Kind Exchange investor to utilize this important new solution.

In March 2002, the IRS released Revenue Procedure 2002-22 which details 15 tenets of TIC ownership, covering issues such as number of co-owners and form of title-holding entities, ability to transfer, and the requirement that all co-tenants share proportionately in the

profits, losses and blanket debt. Importantly, the IRS allows TIC owners to enter into management and brokerage agreements respecting the property. This guidance provides investors and their advisors the basic map of what to look for in a TIC structure to ensure compliance with §1031 regulations.

Tax deferred exchanges under §1031 continue to grow in use and have recently been estimated[1] between $200 and $400 billion in transactional volume on an annual basis. As these highly structured serial transactions increase, so too, grows the need for an inventory of ready replacement property. The TIC deals solve that problem by making institutional quality real estate accessible to the individual investor. Independent investors now have the ability to invest in asset classes, property values and credit tenant leases that were previously available only to REITs, pension funds and large real estate organizations. Likewise, REITs must continually dispose of certain properties in order to continue the distribution of dividends, maintain market value and sustain growth.

TIC structures and the sponsors that create them provide excellent exit strategies for REITs and other institutional owners. Under GAAP rules and the REIT Modernization Act, REITs cannot act as sponsors themselves without losing significant tax benefits. However, a REIT can utilize a TIC Sponsor to distribute its excess property, and then complete its exchange with acquisition of another large property

[1] Study by Deloitte & Touche, LLP.

15 Requirements for §1031 Compliance in a TIC Program

1. Ownership must be a true tenancy in common fee interest in the real estate, with each tenant receiving a deed.
2. Ownership is limited to 35 persons, except that husbands and wives, and all persons who acquired their interests from the same inheritance, are treated as a single person.
3. The co-tenants may not operate as a partnership or other business entity.
4. Limited co-ownership agreements, running with the land, are permitted. For example, an agreement may provide a right of first refusal on behalf of the other co-tenants, the Sponsor or lessee, for sale at fair market value prior to a co-tenant's exercise of the right to partition.
5. The co-tenants must retain ***unanimous*** voting rights to approve a sale, lease, blanket mortgage, and management contract. Other actions may require approval of a simple majority of co-owners. The co-owners are permitted to give a managing agent a limited power of attorney for specific actions, but a global power of attorney is strictly prohibited.
6. Restrictions on alienation are prohibited except those required by a lender in accordance with customary commercial lending practices. The co-owners, sponsor or lessee may have a right of first offer prior to another co-owner's transfer of its interest, as well as a right of first refusal prior to partition (see #4 above).
7. Upon sale of the property, the co-tenants must share the net proceeds after satisfaction of any blanket debt on the property.
8. There must be a pro-rata sharing of all income and expenses related to the property among all of the co-owners. Advances to a co-owner to meet expenses are prohibited, except on a very short-term, full recourse basis, not to exceed 31 days.
9. Blanket debt must be shared on a pro-rata basis among the co-owners, thus the debt to equity ratio offered by the sponsor must be the same for all purchasers.
10. A co-tenant may issue a call option to purchase his interest at fair market value; however, put options to sell to the sponsor, lessee, lender, other co-owner, or related party to any of these, are prohibited.
11. The co-tenants may not engage in business activities relative to the property, other than those customarily performed in connection with maintenance and repair of rental real property. It is important to note that all activities of the co-owners, their agents and related persons, with respect to the property, will be taken into account, except those of co-owners whose ownership interest has duration of less than six months.
12. The co-tenants are permitted to enter into management and brokerage agreements, which must be renewed at least annually. The manager is permitted to maintain a common bank account for rent receipts and to offset expenses prior to disbursement of net revenues to the co-owners. Net revenues must be disbursed at least quarterly. The managing agent is permitted to provide income / expense statements for co-owners, obtain or modify insurance, and negotiate lease and debt modifications, subject to approval of the co-owners. Management and brokerage fees must be calculated on a commercially reasonable, fair market value basis for the services provided. They may not be dependent upon income or profits derived by any person from the property.
13. All leases must be bona fide for federal tax purposes with fair market value rent. Although percentage rent arrangements (based upon sales receipts) are allowed, rents based on a percentage of income from the property, cash flow, increases in equity or similar arrangements are prohibited.
14. Lenders, whether the debt is secured by a mortgage on the entire property, or merely a specific undivided interest in the property, may not be related persons to a co-owner, sponsor, manager or lessee.
15. Payments to sponsors for an undivided interest in the property, or for services rendered, must be based upon the fair market value of the real estate or services. Any fees based upon income or profits derived by any person from the property are prohibited.

more suitable for its portfolio, without recognizing any gain on the original sale, and fully deferring the tax liability. Then, the TIC sponsor takes this large property acquired from the REIT and sells it in undivided fractional 'pieces' to individual investors at a slight premium. In some cases, the TIC sponsor will retain the REIT as professional manager of the property well beyond the initial transaction. This will provide both Earnings Per Share ("EPS") and Funds From Operations ("FFO"), critical components of REIT valuation.

The TIC industry has grown rapidly in an effort to serve an ever-increasing demand. An individual investor's due diligence should include investigation of whether a particular Sponsor and the program structure offered are reputable, reliable and likely to pass an IRS audit. Important factors to evaluate include experience, diversity and hidden fees. Some Sponsors manage their own properties. Some only offer one asset class. Many have fees that are generated when the property is sold which may not be disclosed up front.

Some Sponsors have worked extensively with regulatory authorities to ensure total §1031 compliance; others have not. Legal Opinions have now become the currency that Sponsors offer their clients for comfort, but not all legal opinions are equal. Major law firms will offer Opinions ranging from "Substantial Authority" (less than 50% likelihood of withstanding an audit), "More Likely Than Not" (51% for, 49% against), "Should" (51-80% favorable) to a "Will" Opinion, the highest level (80-95% certainty of acceptance by the IRS). The primary factor determining the level of Opinion is the number of IRS tenets that the Sponsor has complied with in setting up its TIC structure. While a number of Sponsors are offering excellent real estate investments that do not comply with all 15 criteria issued in the Revenue Procedure, only full compliance will ensure tax deferral for the §1031 investor.

EXAMPLE

Individual investor sells an apartment building and acquires a 6.6% TIC interest in a $25 million shopping center, anchored by credit tenants, such as Sears, Borders and OfficeMax. The TIC program requires a ratio of $1 equity: $2 debt. This investor is able to leverage $550,000 of equity into a $1.65 million investment in a larger, diversified, professionally managed property, achieving a passive investment while deferring all capital gains taxes.

	EXCHANGE	SALE WITHOUT EXCHANGE
FMV Apt Bldg	$750,000	$750,000
Debt	200,000	200,000
Net Proceeds	550,000	550,000
Tax Basis	114,000	114,000
Gain Recognized	**-0-**	**$636,000**
Tax Due	-0-	$134,000
Tax Deferral Savings	***$134,000***	***-0-***

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The key to this tax deferred distribution channel involves not only a quality TIC program and Sponsor, but also the use of a reputable, institutional Qualified Intermediary. Tax laws prohibit the Exchanger from holding or controlling the sale proceeds during the interim between sale and purchase. The sale proceeds are sent directly from the closing to the Qualified Intermediary, an independent third party, who will hold these "exchange funds" in a restricted account and subsequently disburse them directly to the seller of the replacement property.

Care should be taken when selecting a Qualified Intermediary. Many individuals, such as agents, related parties and the Exchanger's attorney, accountant and real estate broker are disqualified from acting in this capacity. Moreover, an institutional Qualified Intermediary can protect this very time-sensitive transaction from problems arising from the bankruptcy, death, disability or other ill-timed legal difficulty to which individuals and small businesses are prone.

REITs, working with TIC Sponsors and Qualified Intermediaries, have an excellent opportunity to dispose of excess holdings on a tax deferred basis, and to provide an inventory of much needed diverse, secure and passive real estate investments to both §1031 and non-tax driven investors alike. The Section 1031 like-kind exchange is one of the last legal tax incentives available to all taxpayers. Tax rules allow the REIT to exchange out of redundant properties and into those more appropriate for its portfolio at the beginning of the distribution chain. Similarly, at the other end of the chain, the individual investor may exchange actively managed real estate for an undivided Tenant in Common interest in professionally managed, institutional grade, replacement real estate. Section 1031 allows both the REIT and the individual investor to defer all of the capital gains taxes on their respective transactions.

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