*from the June 2003 issue of*
nashville post
www.nashvillepost.com
Nashville's Business Monthly Magazine

*reprinted for*
OMNI Brokerage, Inc.
*www.omni1031corp.com*

# »EYE ON INVESTING: TIC Interests

## An emerging investment vehicle may be the answer to investors' prayers

BY BRIAN A. COURTNEY

Fifteen months ago, the IRS threw real estate investors a savory, marrow-filled bone when it issued Revenue Procedure 2002-22. Although the measure fell short of officially blessing the swap of real property for tenancy-in-common (TIC) interests as a good 1031 exchange, its 15-point set of guidelines added much-needed definition to a somewhat loosey-goosey transaction type that previously was fraught with risk.

Prior to the revenue procedure, a huge cloud of uncertainty existed as to how the IRS would define a partnership interest relative to a 1031 exchange. Such exchanges allow investors to defer capital gains on the sale of an investment property by purchasing another (like-kind) property of the same or greater value. However, they forbid trading into partnerships or partnership interests in real property, which means co-tenancy arrangements must be delicately structured to avoid partnership status.

"The IRS said they would not issue any type of general ruling or give any hard and fast rules," explains Nashville attorney and 1031 exchange expert J.V. Crockett III, of Corbett Crockett & Leckrone. "But this revenue procedure essentially lays out the criteria the IRS wants to see in a deal before they'll consider a private letter ruling." (In these situations, a private letter ruling is an insurance policy of sorts from the IRS stating that it does not view a specific investment as a partnership or business entity. Syndicators are not required to obtain such rulings before marketing TIC interests but sometimes do so to reassure investors.)

Not surprisingly, real estate syndicators who package and promote co-tenancy programs to investors looking for solid investments at the other end of their 1031 exchanges enthusiastically embraced Rev. Proc. 2002-22. It was the water they needed to make gravy, and from all indications, there's plenty of gravy to be made. Syndicators, also known as sponsors or promoters, promptly began identifying suitable TIC properties and peddling them to accredited investors (those with individual/joint net incomes of $200,000/$300,000 or an individual/joint net worth of $1 million). Today, "sponsors of these properties are coming out of the woodwork," says Gary Beynon, chief executive of OMNI Brokerage Inc., a Salt Lake City-based broker-dealer that focuses on identifying, evaluating and offering approved 1031-TIC programs to its clients.

While real estate investors and their professional advisors on the whole were encouraged by Rev. Proc. 2002-22, they were not completely convinced that it provided the safe-harbor assurances sought from an official IRS ruling. If they bought into co-tenancy arrangements later labeled de facto partnerships by the IRS, there would be severe tax consequences.

Interest in 1031-TIC programs has increased measurably during the past year or so. This warming trend can be attributed to the surge in syndicators nationally and the corresponding TIC properties being marketed by them. The trend also reflects a softer economic environment in which record-low interest rates and a weakened stock market are driving droves of new investors to the real estate market. But perhaps the biggest carrot being offered to investors by sponsors of 1031-TIC programs is the opportunity to trade their smallish, management-intensive apartment complexes or retail strip centers for a passive, undivided interest in institutional-grade properties.

As word has spread, more and more investors are beginning to view the purchase of TIC interests as a possible answer to their 1031 exchange prayers. And while such properties may very well be just that, local experts are advising investors to proceed with extreme caution. Here's why.

### The good news first

It would take two hands to count the numerous benefits attributed to acquiring TIC interests. In reality, investors looking to complete 1031 exchanges are swayed most by a few key points.

For starters, TIC interests are readily available, making time-sensitive 1031 exchanges easier to complete. Investors have a mere 45 days from the date a real estate asset is sold to identify a new property in which to re-invest the proceeds. What's more, they have just 180 days from the sale date of the original property to close on the new purchase. These relatively short time frames sometimes pressure investors looking to complete 1031 exchanges to "settle" for replacement properties they might not have bought otherwise. Investors also have far less leverage when negotiating because they know the clock is ticking.

Even more enticing for smaller investors—say, those looking to invest a few hundred thousand dollars to a few million—is the opportunity to share ownership in institutional-grade properties with blue-chip tenants along the lines of Walgreens or Caterpillar Financial.

"For smaller investors, this is attractive because it allows them to pool their money with other people and invest in big, safe deals with triple-net leases and strong credit tenants. Otherwise, the little guy could not get into these types of investments," Crockett says.

R. Todd Ervin, a tax attorney with Boult Cummings Conners & Berry, says many of the TIC interests being marketed by sponsors today are akin to selling bonds because the property's value, to a large degree, is tied to the credit of its tenant or tenants. "[Sponsors] might take a $20 million property and offer it in $500,000 chunks, so investors are getting a high credit, bond-like investment. Local investors could certainly benefit from being able to invest in something like that," he says.

For 1031 exchanges, you might have a part-time investor who owns and self-manages a 20-unit apartment building. The investor is nearing retirement and wants to sell the property in exchange for a secure passive investment that generates a better return than the stock market and as good or better than the property being sold. If structured properly, purchasing TIC interests can achieve all these things, plus defer taxes on the apartment building sale.

Yet another draw, according to Crockett, is sponsors' ability to tailor an investment to meet the investor's exact needs. This is significant because in standard 1031 exchanges, investors may have to purchase more than one property to fully re-invest their funds and avoid capital gains taxes. "I've seen [syndicators] say, 'Tell us how much you want to spend, and we'll sell you that much interest. We'll just figure out what percentage interest that will buy you.'"

Of course, this assumes the investor can meet the minimum investment level, which is "typically $250,000 but sometimes lower," OMNI's Beynon says. His firm currently does due diligence on TIC properties offered by more than 40 sponsors and is actively doing business with about a dozen of them. The average investment is $400,000 to $500,000, with the smallest deal involving a $5 million property. The largest, an ongoing investment deal as of April, involves the $56 million Puente Hills Mall, a 1.2 million-square-foot mall east of Los Angeles.

### The seedy underbelly

While investors may be dazzled by the glittery aspects of TIC interests, Crockett and Ervin stop well short of giving them an all-out endorsement relative to 1031 exchanges. Among Crockett's concerns are the mechanics of how as many as 35 people who potentially may not know one another come together to invest in a property.

"You can't operate on a handshake basis, and the more people involved, the greater the need to have some sort of formal organizational structure to manage the asset," Crockett says. "When you start implementing an organization structure, it reeks of being a partnership. And that spells trouble."

Many of Crockett's other concerns pertain to the relative newness of using TIC interests to complete 1031 exchanges. He says there is not enough history to see how they'll ultimately play out, in general, for investors. "Once you get in, how do you get out? What's the process for re-marketing these interests? Are you going to get penalized because the buyer won't have total control of the property?"

Boult Cummings' Ervin points to another sticking point. "There are many restrictions, including one that says certain decisions require unanimous consent. This can be a very difficult threshold to reach when you have 20 to 30 investors involved," he says.

Revenue Procedure 2002-22 guidelines as they relate to voting say that major decisions such as the sale of the property, leases of all or a portion of the property, financing, management contracts and the hiring of any manager must be unanimously approved by co-owners.

Crockett points out that another revenue procedure guideline places severe limitations on the ability of co-owners to lend money to one another for expense-related purposes. "I've seen deals where you have two or three owners who agree to evenly split income and expenses. If one of them should go through a divorce or falls on tough times, the other owners might agree to carry you for a while. Theoretically, this is not permitted according to Revenue Procedure 2002-22."

And there are several other things investors need to consider before pulling the trigger on 1031-TIC syndications. Up-front fees associated with TIC interests offered through a securities broker-dealer can range from 15% to 25% of the total investment amount. That said, some investors may find it difficult to justify these fees, especially considering the capital gains tax rate is generally only 20% to 25%. Additionally, these co-tenancy arrangements may be subject to capital calls for expenses and debt service if property suffers a major setback, such as losing one or more major tenants.

### Bottom line

There are some very healthy benefits to purchasing TIC interests to complete 1031 exchanges, but do not lose sight of all the issues that need to be considered. "Go in with your eyes wide open," Crockett says. NP

## Favorable Exchange

Last year, the IRS specified 15 conditions under which it will consider requests for private rulings on co-ownership exchanges in Revenue Procedure 2002-22. The move effectively gave syndicators, broker-dealers, investors, tax and legal experts, and other interested parties guidance on how co-tenancy agreements on tenant-in-common (TIC) properties should be structured to qualify as good 1031 exchanges. Here are some of the key provisions:

» Each co-owner must hold title as TIC under local law, and title to the property as a whole cannot be held by an entity recognized under local law.

» The number of co-owners cannot exceed 35 (husband and wife treated as one person).

» Co-ownership cannot be treated as an entity (i.e. no partnership tax return, no conducting business under a common business name and no holding oneself out as a "partner" of other co-owners).

» In terms of voting, major decisions such as sale, lease and financing must be unanimous. Other matters require a simple majority.

» Each co-owner must retain the right to transfer, partition and encumber interest without approval of anyone else.

» Revenues and expenses must be shared among co-owners in proportion to their ownership interests.

» Co-owner activity must be limited to those customarily performed in connection with the ownership of passive real estate.

*—BAC*