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TICs: ALTERNATIVE INVESTMENT VEHICLES

Tenant-in-common investments are proving to be a popular alternative to traditional real estate investments.

Michael Houge

Tenant-in-common (TIC) investments are surging in popularity as a property investment vehicle in an overheated market. Last year, there were approximately $800 million to $1 billion worth of TIC transactions completed. This year, TIC transactions could range from $3 billion to $6 billion.

TIC History

Using TICs as a property ownership structure has been popular for many years. It was first used to keep farms and estates intact, while allowing for multiple individual owners or heirs. In 1995, some practitioners started using the TIC structure in conjunction with Internal Revenue Service (IRS) Code 1031 Tax Deferred Exchange (IRC 1031), allowing for multiple individual owners to effect their exchanges into single properties, while retaining the capital gains tax deferral benefit of IRC 1031. These investors were willing to accept the risk of IRS approval (because they used an attorney's opinion letter as security) and they completed these transactions.

Sponsors

Today, most TICs are designed to allow up to 35 individual investors to provide the equity (and debt) necessary to purchase a large, institutional-quality property, through a Sponsor. The Sponsor acts as the investment catalyst and usually retains an asset management role after the property closing.

Each individual investor obtains a deed of ownership (albeit pro-rata), as well as the depreciation, cash flow, mortgage interest deduction, principal reduction and property appreciation associated with the transaction.

Last year, there were approximately 10 national TIC sponsors offering various investment opportunities. There are now between 30 and 40 national sponsors, and the numbers are growing. Most of the big national firms are either in the game or have plans to enter it soon.

What Changed?

In March 2002, the IRS ruled favorably in a private letter ruling (IRS Revenue Procedure 2000-22), publishing, for the first time, guidelines for IRS submission of further transactions involving TIC structured deals for 1031 Tax Deferred Exchanges. This ruling gave professionals a "road map" for structuring transactions to meet IRS scrutiny. Revenue Procedure 2000-22 opened the floodgates.

The main point of this ruling was to maintain the individual ownership of the property and to ensure that the replacement property, if a TIC, would not resemble a partnership. The IRS does not want real property owners to reap the benefits of IRC 1031 while trading into a limited or general partnership. Revenue Procedure 2000-22 lays out fifteen guidelines to ensure this does not happen. For a copy of the IRS Revenue Procedure 2000-22, visit http://www.safeharborproperties.com/IRS.pdf.

1031 Pressure

There is a plethora of 1031 money flowing into the national real estate market. Deloitte & Touche estimated that between $50 billion and $60 billion in 1031 Tax Deferred Exchanges were completed in 2003, while another $25 billion failed. This pressure seems to have no reason to abate. Most professionals agree that almost every individual commercial real estate transaction at least considers a 1031 exchange in order to take advantage of capital gains tax deferral. TICs are now another alternative.

While 1031 exchanges gain popularity, direct investment in real estate as an alternative to other investments (stocks, bonds, commodities, etc.) is also heating up. This increased activity is fueled by positive media coverage of real estate investments, low interest rates, poor performance in other sectors and the increasing age of the baby boomer generation. Many baby boomers are seeking lifestyle changes, but they want income, appreciation in value and some kind of control over their investments. TICs are a good alternative for this sector.

Some of the benefits of TICs are:

• The ability to invest into multiple TICs, and mitigating risk through portfolio diversification.

• The opportunity to invest in much larger, institutional-quality properties, which usually provide better tenants, professional management, less deferred maintenance and more potential for appreciation.

• Passive, direct ownership that allows for lifestyle changes while maintaining property level controls.

• The tax benefits of direct ownership including the IRC 1031 Tax Deferred Exchange.

• Many TICs have pre-arranged non-recourse financing, reducing investor headaches.

Some of the pitfalls of TICs are:

• IRS Revenue Procedure 2000-22 is not code. Each TIC will have to survive audits and the associated risks.

• Sponsors are like partners; some are good and some are not.

• Exit strategies may not be clear at the property level.

What is Next?

TICs are gaining in popularity and will become a significant form of syndicated property ownership. The TIC market will experience the growth realized by other syndications (real estate investment trusts, limited partnerships and general partnerships) as the investment market continues to increase. There will be many quality TICs created by good quality sponsors, but there will also be some bad TIC transactions as well. Professionals will be faced with the prospect of selling and buying properties or advising and managing people associated with TICs. It is imperative for them to be educated about TICs and either get involved or watch the TIC business boom around them.

Michael Houge is principal and CEO of Minneapolis-based Upland Real Estate Group/Safe Harbor Properties Exchange.

FRANCE PUBLICATIONS, INC.
3500 Piedmont Road
Suite 415
Atlanta, Georgia 30305
TEL: 404-832-8262
FAX: 404-832-8260