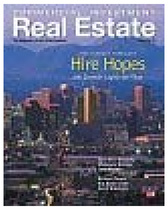
COMMERCIAL INVESTMENT Real Estate
The Magazine of the CCIM Institute



Jan.Feb.05
<< Contents

Editorial Calendar
Media Planner
Reprints
Issue/Article Orders
Current Advertisers
Contact

The ABCs of TICs

Learn the fundamentals of this 1031 exchange strategy.
by Ronald L. Raitz, CCIM, CES

Print-friendly format

Interest in structured tenancy-in-common ownership as replacement property for 1031 exchanges has grown dramatically since the Internal Revenue Service issued Revenue Procedure 2002-22 in March 2002. One of the largest TIC deals took place last October when 32 investors purchased the Village at Orange shopping center in Orange, Calif., for more than $100 million in a transaction put together by Passco Real Estate Enterprises.

While TIC deals offer individual investors the opportunity to pool funds, secure more financing, and take on ownership interests without property management headaches, they can be very complex transactions. Commercial real estate professionals should learn the ins and outs of TIC exchanges to understand the business opportunities — and challenges — of this investment option.

TIC deals were initiated in the early 1990s by entrepreneurs, or sponsors, who recognized the need for replacement property that could provide stable cash flow, effortless management, and viable alternatives for small investors — primarily those with less than $500,000 cash. Wealthier exchangers seeking the same investment criteria often buy more expensive triple-net-lease properties.

But more than 60 percent of exchange transactions involve proceeds of less than $400,000, according to a Deloitte & Touche study. To meet these investors' needs, sponsors purchased more expensive, income-producing properties and then sold fractional interests to 1031 buyers.

Because partnership interests do not qualify for 1031 exchange and co-ownership interests do, the TIC ownership structure was selected over a partnership vehicle. Upon selling a TIC property, each owner decides independently if he or she will cash out or execute an exchange.

Some initial investment structures included preferred returns and back-end participation, which are common in most partnership transactions. However, many tax professionals worried that the IRS would consider TIC owners a de facto partnership because of the common partnership characteristics consistent in many of the offerings.

Rev. Proc. 2002-22 clarified this issue. The guidance targeted 15 different areas that the IRS considers to distinguish partnerships from TIC structures; sponsors use the procedure as a road map to create compliant transactions.

The Sponsor's Role

Sponsors come from various industry segments, ranging from real estate investment trust subsidiaries to ongoing real estate investment companies to small entrepreneurs that see TIC deals as business opportunities.

Sponsors' duties include finding suitable property and successfully putting it under contract, performing the necessary due diligence, acquiring financing, entering into selling agreements with targeted broker/dealers, completing TIC interest sales, managing the property or arranging for property management services, sending monthly disbursements to TIC owners, sending annual summary statements to owners, and initiating or overseeing the property's sale and distribution of proceeds.

Sponsors structure TIC transactions either as real estate or securities offerings. (See

Ronald L. Raitz, CCIM, CE
of Real Estate Exchange S
Marietta, Ga. He is a licen
representative and serves
Federation of Exchange A
Board of Directors. Contac
579-1155, ext. 10, or
rraitz@rees1031.com. Sec
by Omni Brokerage, Inc., r
NASD/SIPC.

Securities or Real Es

One of the biggest issues
tenancy-in-common intere
they are sold as securities
Some sponsors package t
as real estate because the
product is property. Others
transactions as securities
selling environment — the
supervise the entire bundl
meets the accepted definit
securities.

That definition was establi
1946 landmark U.S. Supre
ruling in *SEC v. W.J. How*
known as the *Howey* test,
that if investors are groupe
anticipate a profit on their
is derived by the sole bene
else's work, it is considere

The biggest difference bet
estate and securities appr
regulation. Real estate op
caveat emptor, or buyer be
environment. Broker packa
include disclaimers that pr
brokers and sellers from a
concerning the presented
Potential buyers are expec
own due diligence prior to

In contrast, the securities i
regulated, primarily by the
Exchange Commission. Th
securities must be license
registered, and they must
securities requirements su
private placement memora
selling only to accredited i

While there has been no c
on TIC transactions, in Au
National Association of Se
sent letters to several TIC
requesting detailed inform
TIC structures and indicati

sidebar.) Those that choose to comply with securities requirements must produce a private placement memorandum that discloses everything relating to the property and any potential investment risks. Included are such items as what the sponsor paid for the property, the sponsor's profit, selling commissions that will be paid, and the risk involved.

Some sponsors acquire property before selling the TIC interests to exchangers. Because the sponsor fully controls the property, there are no timing issues for exchangers. But it also is a more costly way of doing business.

Other sponsors pool together the different exchangers' proceeds to acquire the property. In these situations, an individual seller or a lender can hold up a closing, which could negatively affect time-sensitive exchangers. However, if executed successfully, this arrangement alleviates additional acquisition costs.

According to Rev. Proc. 2002-22, sponsors must take their profits upfront. Due diligence costs, securities fees, commissions, financing expenses, and other acquisition charges increase the property's overall price. Such fees, expenses, and profits are known as the load: the markup the exchanger is paying for a prepackaged investment that requires less cash.

The loads vary from sponsor to sponsor and transaction to transaction. Generally speaking, in a 10 percent load scenario, if the sponsor has put the property under contract at an 8.5 percent capitalization rate, it would be sold to the TIC investors at an approximate 7.5 percent cap rate, or 100 basis points less.

Financing also varies. Some sponsors use lower-cost interest-only loans to gain positive leverage. Others use amortizing loans, with five-, seven- or 10-year call provisions. Loans to TIC owners usually are nonrecourse and most sponsors have pre-negotiated with banks or other lenders to allow the individual interests to be conveyed to another accredited investor, therefore allowing a loan assumption on that portion. Loan to value ranges from all cash to 75 percent. First-year cash-on-cash returns usually start in the 7 percent to 8 percent range and increase depending on the tenant profile.

Sponsors also handle or arrange for the property management functions. Some charge market rate management fees while others charge slight markups. In addition, the disposition strategy that most sponsors employ usually is controlled by the lease length and/or the loan's call date. Typically, there is a disposition commission due to the sponsor that includes payment to any other outside participating broker. These fees can range from 3 percent to 6 percent of the price.

The Broker/Dealer's Role

If TIC sponsors package transactions as securities, they must meet certain Securities and Exchange Commission standards. To sell securities, one must be licensed as a registered representative and be affiliated with a broker/dealer. This relationship is basically that of an independent contractor except that the registered representative only can sell product that the broker/dealer approves. In addition, the broker/dealer solicits or is approached by sponsors to sell their offerings. Broker/dealers complete due diligence on the offerings to make sure that the investment is solid and not a potential liability to the company. If an offering is approved, the broker/dealer signs a selling agreement with the sponsor. To give their products the most exposure, sponsors usually sign selling agreements with multiple broker/dealers.

Accredited Investors

Securities laws are designed not only for disclosure, but also to emphasize suitability. Because real estate investments have risks and it is possible for investors to lose their money, the SEC wants to ensure the participants in these transactions have financial substance.

Securities laws require that offerings be publicly registered, but there are some exemptions. TIC interests are Regulation D Private Placement offerings and are exempt from public registration if sold only to accredited investors. To be considered accredited, an investor must have a minimum $1 million net worth or have earned $200,000 per year for the past two consecutive years if single or $300,000 per year if filing a joint tax return. If the party is an entity, it must have a $5 million net worth or each of the stockholders, partners, or members must meet the accredited standards separately.

believes such investments
definition of a security. Thi
time a regulatory body has
structure as a securities a
analysts.

Although real estate profe
caught between the two di
regulatory industries, ever
that sell TIC interests as r
subject to SEC discipline.
some differences in interp
which structures the SEC
penalties for unauthorized
sales are steep and comm
estate professionals shoul
issue lightly.

While sponsors that structure TIC interests as real estate transactions don't have to comply with these requirements, they run the risk of running afoul of the SEC. (See sidebar.)

Business Expansion Opportunities

TIC transactions offer numerous opportunities for commercial real estate professionals to expand their businesses. For instance, some real estate pros become TIC sponsors, while others stick to the selling side, obtain the necessary securities licenses, and become affiliated with broker/dealers that specialize in these types of products. Some have focused on sourcing property for sponsors. TIC transactions also can help commercial real estate brokers build new business through referrals.

There may be times when an exchanger has acquired a replacement property, but has a small amount of cash left over. Because minimums for TIC transactions start at around $150,000, this structure can be a good option to consider.

In addition, a broker may have worked diligently to meet a client's needs, but the deal starts to fall apart near the 45-day replacement property identification period. Because they are packaged deals, TIC structures may appeal to clients who are short on time.

Points to Consider

Clearly TIC investments offer certain exchangers many advantages. Yet there also are several areas that could be problematic if not clearly understood by buyers.

Foremost, liquidity options are limited. Although most TIC interests can be sold independently to other accredited investors, there is not a ready-made resale market. This is mostly a result of little supply. Most TIC purchasers have been in a falling cap rate environment and have done very well on their investments. However, TIC investors should understand that they are part of a group investment, which primarily is structured for everyone to stay together for the length of the transaction.

Although some registered representatives have extensive real estate experience, most TIC interests are sold by people with a securities background. Therefore, in most cases, a non-real estate person is promoting the potential benefits of a real estate investment. While some representatives have taken the time to become better versed in real estate analysis, with positive leverage, acquisition prices above appraisal, unrealistic reversionary assumptions, and funding-stipulated cash flow from reserves sprinkled throughout the different transactions, it is somewhat unrealistic for someone with only a securities background to fully understand how to decipher these elements.

In addition, all transactions are not created equally. Some broker/dealers take a conservative approach and weed out the properties that don't make sense. Others are not as conservative and may sell investments that do not have realistic assumptions.

Finally, just as real estate commissions cannot be paid to non-licensed parties, commissions and fees for the sale of securitized real estate only are paid to people that have the proper securities licensing. Only registered representatives can sell and be compensated for transactions that their broker/dealers approve. Aside from a nominal prospect fee of $100 or less, no referral fees or other compensation can be paid to anyone who isn't properly licensed. This is unfortunate because the commercial real estate broker may be the best qualified to do the due diligence on the deal.

Securitized TIC interests are a good match for 1031 buyers that are looking for steady cash flow and no management hassles on their replacement acquisitions. For commercial real estate professionals who would like to participate in these types of investments, it is important to understand the securities laws, the distribution and marketing regime for securities, and the potential liabilities of crossing over into the securities world. While TIC interests are not perfect replacement properties for all investors, these transactions do meet the investment objectives of a certain segment of the 1031 market.