MINNESOTA
REAL ESTATE JOURNAL

Friday May 07 2004

The growing popularity of TICs

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Since the first installment of this article last December (MREJ, 12-8-03), the popularity of either owning real estate in the form of a tenant-in-common (TIC) as opposed to an LLC or investing or trading into a syndicated TIC equity is increasing. We have seen an increase in the number of properties in the Midwest being syndicated and sold, as well as an increase in inquiries from TIC syndicators looking for assistance in one form or another. Also, our clients, at an ever-increasing rate, continue to look to a direct investment in real estate as an investment diversification strategy. Some clients have invested directly into syndicated TIC interests, which by its terms act very similar to an investment grade bond. Others have used syndicated TICs as replacement property as part of a Section 1031 like-kind exchange. Finally, on our private equity sourcing, in raising and placing capital we continue to evaluate the structure of our clients' investment as a TIC to be a potentially much more flexible and secure form of ownership than an LLC with multiple parties, each with varied interests and needs.

Revenue Procedure 2002-22 is directly responsible for the popularity of TICs. It was under the pressure of TIC syndicators that the IRS reluctantly issued the revenue procedure. What is unfortunate, however, is that the IRS did not limit the scope of the procedure to just syndicated TIC transactions. Rather, it covers the non-syndicated real estate investment as well. Consequently, all real estate investors (and their advisors) need to be intimately knowledgeable of its impractical, overly broad and unduly burdensome requirements.

Revenue Procedure 2002-22 lists 15 conditions taxpayers must meet to seek a private letter ruling ("PLR") from the IRS for determining whether a TIC interest will not be considered an interest in a partnership for purposes of a Section 1031 like-kind exchange. This is important because a partnership interest is not an approved form of investment for Section 1031 purposes.

Unfortunately, many real estate owners and their advisors are of the mistaken belief that Revenue Procedure 2002-22 is law and, therefore, their investment must meet each of its 15 requirements even though a PLR from the IRS will not be sought. Not so. The procedure is a rule-making tool, under which only one PLR to date has been issued. The concern about the revenue procedure is the lack of guidance to date and the corresponding risk that an unknowledgeable IRS agent, in reviewing a non-PLR transaction, will look to Revenue Procedure 2002-22 for guidance as if it were the law in this area.

The fact is that many of the revenue procedure's 15 requirements are not well founded in the existing tax law governing partnerships, TICs or otherwise. The Internal Revenue Code and its regulations provide very little guidance into what constitutes a partnership (or a TIC) for tax purposes. The guidance in this area is primarily derived from case law. In determining whether a taxpayer has a partnership (or some other form of legal entity), the courts have relied on a fairly long list of factors (a facts and circumstances test). Rather than following the direction of the courts, the IRS, unfortunately, in creating its list of 15 factors, made some unsubstantiated legal conclusions where there is little, if any, legal authority and took some positions potentially contrary to existing tax law.

So why did the IRS create a list of factors, some not fundamentally based upon existing tax law, for determining whether a partnership exists for private letter ruling purposes? The only reasonable explanation seems to be that in its reluctance to issue guidance under pressure from the TIC industry, it set forth a very restrictive set of requirements aimed at a burgeoning industry where potentially tax abusive investments (TIC syndicated investments) would be sold. In an effort to regulate that industry from a tax perspective, it responded with very stringent rules.

Unfortunately, as stated above, Revenue Procedure 2002-22 was not limited to TIC syndicated investments or taxpayers. It applies to all of those taxpayers who have owned real estate as a TIC for years and those non-syndicated real estate investors where a TIC (as opposed to an LLC) makes more sense for them. Consequently, the IRS has put its handcuffs on every TIC transaction and every TIC investor.

The space allowable in the Minnesota Real Estate Journal for this article is insufficient to adequately discuss the merits (or lack thereof) of each of the revenue procedure's 15 requirements versus the real legal requirements for determining whether an investment in a partnership or real estate exists. What is fascinating, however, is that prior to issuing Revenue Procedure 2002-22, the IRS has ruled in favor of certain TIC transactions that would now be invalid under the revenue procedure. Furthermore, the IRS has a long history of arguing against a partnership structure in favor of some other form of entity or investment to avoid a taxpayer favorable result. Here, the IRS is taking an opposite position arguing for a partnership structure to avoid another taxpayer favorable treatment -- TICs. Taking contrary positions in the tax law is not an anomaly for the IRS when it seeks to enforce situations that best suits it.

Practically speaking, we have yet to see one TIC situation where all 15 requirements could be met. Why? Because in a true 1031 situation, each replacement property transaction has its own unique set of economic circumstances (i.e., debt/equity and FMV) and, accordingly, its own potentially set of tax consequences. The revenue procedure is not concerned with practical transactions and investor debt, equity and tax requirements. Revenue Procedure 2002-22 wants to put each investor/taxpayer, all of whom have economically varied transactions with very different potential tax consequences, on the same economic and tax playing field, which in reality does not happen. Nevertheless, each TIC transaction should be structured with an eye towards meeting as many of the Revenue Procedure 2002-22 requirements as possible. The trick, however, is knowing which of the 15 rules are more flexible than others.

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