common interests
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feature

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Tenancy-in-Common investments create opportunities for property owners and managers *by Amanda Kaschube*

The idea seems simple: Pool money together, and purchase a bigger and better piece of the proverbial pie.

Such a simple idea in the form of a property ownership arrangement—tenancy-in-common—has resulted in great rewards for many property owners.

Tenancy-in-Common (TIC) allows two or more persons to have an undivided, fractional interest in a property asset. Ownership shares do not have to be equal, and beneficiaries can inherit the interests. Owners receive their proportional share of income, tax benefits and the property's appreciation.

"It allows small investors to acquire an interest in an institutional quality asset that is professionally managed on their behalf," said Christian Mirner, executive vice president of real estate for 1031 Exchange Options in California. "Being able to segue from sole ownership and defer the taxes and acquire a generally higher quality, institutional, more high-profile asset is a very logical progression for a real estate investor."

The progression and growth of TICs has been both stunted and helped by the U.S. government. Initially, the Internal Revenue Service recognized a TIC as a partnership, meaning all tax rules applied. Namely, when TIC owners wanted to sell their property, they were taxed heavily.

But the advent of Revenue Procedure 2002-22 by the IRS in 2002 changed the face of TICs, said Paul White, CPM, and regional manager for SCI Real Estate Investment in Miami.

"It's how the industry got kicked off: Now it makes sense to take the risk," he said. "Now we understand what we need to do to prevent the IRS from coming in and saying you're a partnership."

2002-22 qualifies a TIC for a 1031 Exchange, a section of the tax code allowing investors to exchange "like-kind" property. Basically, investors can buy and sell property without being taxed on their returns.

"The government wants to tax you, but as long as you change from like-kind property, they won't," said Eric Odum, president of Navigar Advisors, an independent TIC advisory, clearing through GunnAllen Financial Inc., in Tampa, Fla.

Odum said the 1031 Exchange allows investors to defer capital gains taxes that would arise from the sale of real estate. A successful TIC Exchange results in the investor being able to use 100 percent of the proceeds from the sale to purchase another investment property. Odum said the dissolution of the 1031 Exchange would have a catastrophic effect on the small-end market for investors.

"You'd have to pay taxes every time you sold a property," he said.

The minimum investment for a TIC is $100,000, but Odum said investing between $350,000 and $500,000 provides the best shot at a good deal. A high-end TIC property will be a Class A property featuring an investment-grade tenant with a B-plus or better on the Standard & Poor rating.

"It's like the difference between a mom-and-pop tire company and Goodyear Tires," Odum said.

Most TIC properties are held for four to ten years before investors sell. According to the 1031 Exchange, a replacement property—the new property being acquired by the investor—must be located within 45 days. The 45-day period begins with the close of escrow of the previous property.

Since the previous and replacement properties are considered "like-kind" properties, investors are not taxed on their capital gains. With the tax risk gone, Mirner said the volume of TIC business has increased each year.

IRS establishes tenancy-in-common guidelines

The Internal Revenue Service, in its Revenue Procedure 2002-22, set forth the following guidelines on what constitutes an official tenancy-in-common. To read the guidelines in full and for more specific information, visit: http://www.irs.gov/ pub/irs-drop/rp-02-22.pdf.

1 Each of the co-owners must hold a tenant-in-common title, either directly or through a disregarded entity.

2 No more than 35 people can co-own a 1031 property.

3 Co-owners cannot be treated as an entity.

4 Co-owners may enter into a limited co-ownership agreement that may run with the land.

5 Co-owners must approve the hiring of any manager, the sale or other disposition of the property, any leases of a portion or all of the property or the creation or modification of a blanket lien. A co-owner's unanimous approval is required for several actions. Co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the property.

6 In general, each co-owner must have the rights to transfer, partition and encumber a co-owner's undivided interest in the property without the agreement or approval of any person.

7 If the property is sold, any debt secured by a blanket lien must be satisfied, and the remaining sales proceeds must be distributed to co-owners.

8 Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest.

9 Co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

10 A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided the exercise price for the call option reflects the fair market value of the property determined at the time the option is exercised.

11 The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property.

12 Co-owners may enter into management or brokerage agreements, which must be at least annually renewable, with an agent, who may be the sponsor or a co-owner, but who may not be a lessee.

13 All leasing arrangements must be bona fide leases for federal tax purposes.

14 The lender with respect to any debt encumbering the property or with respect to any debt incurred to acquire an undivided interest in the property may not be a related person to any co-owner, the sponsor, the manager or any lessee of the property.

15 The amount of any payment to the sponsor for the acquisition of the co-ownership interest and the amount of any fees paid to the sponsor for services must reflect the fair market value of the acquired co-ownership interest or the services rendered and may not depend, in whole or in part, on the income or profits derived by any person from the property.

"It's become a notable force in the overall real estate market," he said. "TICs are competing with trusts, institutional investors and opportunity funds for the gamete of real estate products that are traded across the country on an annual basis."

While property owners are benefiting from TICs, the arrangements are also presenting advantages for property managers, Odum said.

"It creates another vehicle and another whole set of individuals to manage," he said. "There's a whole new set of players."

White, of SCI, said larger TICs will source out the day-to-day activities, like the leasing and asset management to local companies: TICs need qualified people to handle that, he said.

"It's more cost-effective to find the best in that market," he said. "It boosts CPMs."

Since TICs sometimes involve investors spread all over the country, hiring a local property manager to conduct local business on behalf of the co-ownership group makes sense, Mirner said. His company has business dealings in California, Tennessee, Georgia, Illinois and Nevada.

"Wherever there's potential opportunity and attention is being paid by institutional investors, those are markets where you'll see co-ownership groups acquiring assets," he said.

Dealing with and communicating with up to 35 co-owners is a major struggle for many property managers working with TIC investors, Odum said.

"It's not a simple ownership where you have one owner," Odum said. "So with major issues, you're essentially dealing with multiple owners and that can create a challenge."

But the challenge is necessary in the TIC arena.

"From the IRS standpoint, co-owners need to be involved at the real estate level in order to maintain the integrity of like-kind property for 1031 Exchange," Miner said.

From an economic standpoint, the growing real estate market will create a steady and growing flow of cash, and TICs will keep its profits circulating thanks to the 1031 Exchange.

"In a social context, there's an aging baby boomer population that's trying to figure out how to pass their wealth on to the next generation," Mirner said. "If they sold it outright, there would be a large tax liability that would negatively impact their net worth."

But with the TIC and 1031 Exchange, White said real estate could be converted into an annuity-type income that is a "great vehicle for passing real estate wealth on to children."

More pie anyone? □

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