

Unraveling The Complexities Of 1031 Exchanges And The TIC Market

Investors and commercial real estate professionals dabbling in this space must grasp myriad details and guidelines.

BY JOHN GRAHAM

While the 1031 tax-deferred exchange market has been around since the 1920s, its offspring - the tenants in common (TIC) industry - is still in its infancy, but becoming increasingly robust and lucrative.

The challenge for investors and commercial real estate professionals lies in truly understanding what a TIC is and how it derives from the 1031 tax deferred exchange, as well as learning how to navigate the market. Professionals must also understand the market's fluctuations and restrictions (there are many).

The Internal Revenue Service (IRS) tracks, on average, \$150 billion in 1031s per year in the U.S. We estimate that the total capitalization of the investment real estate market is approximately \$6 trillion and that the private, non-institutional portion of that market is about \$3 trillion. It is further estimated that the majority of that \$3 trillion is "1031ed" on a continual basis. A safe estimate on the 1031 capitalization for private investors would be \$2 trillion. This is a large and, except for the IRS and TIC components, extremely decentralized industry.

The TIC market is a subset of the overall 1031 market. Last year, about \$4 billion of equity was placed through the securitized TIC market. It is estimated that about that same amount was placed in the nonsecuritized market, meaning about \$8 billion in equity was placed last year. Under the assumption that the deals are 50% leveraged, this means that the TIC market is approximately a \$16 billion per year business. So, the TIC/1031 structure represents about 10% per year of the total 1031 volume right now.

TIC transactions comprised a negli-

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gible volume of the 1031 market before March 2002, and the market only stabilized in the \$8 billion-per-year range over the last couple of years. This is important to understand because, while the overall 1031 market has been around for decades and has a market capitalization in the trillions of dollars, the newer TIC market has only been around for five years and probably has an overall market capitalization under \$50 billion. This is why expectations of a secondary TIC



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market are premature. Even if 2% of the TIC market divested annually (an unrealistically large number), that is still only a \$1 billion market, which is very small for a secondary market.

1031 basics

The 1031 tax deferred like-kind exchange rules allow property owners to sell real estate and replace those assets with real estate of the same or greater value. It is also worth noting that the investor must also replace the equity and the debt. Not replacing the debt with an equal or greater amount of debt results in a tax liability or "boot" in a 1031 exchange.

Generally, properties of greater value are achieved by a higher debt-to-equity ratio on the replacement property than the relinquished property. This assumes that appreciation has occurred and the loan has amortized to an extent where the relin-

quished property is being sold underleveraged.

Any real estate qualifies, meaning one can sell an apartment building and replace it with forest land. The property can be income-producing or not. The key issue is that the taxes on the gain after calculating the basis

(which involves computing depreciation and capital costs during the hold) are deferred as long as the investor follows the rules.

The word "investor" is also impor-



tant because if the IRS determines that you are a trader in real estate - that is, someone who buys and flips - you may not qualify for tax deferral. The tax deferral lets the investor grow the value of his real estate portfolio, net worth and, hopefully, cash flow over a lifetime of exchanges. The 1031 investor is then able to give the real estate to his heirs with a stepped-up basis, which simply means that the deferral ends and the tax liability goes away for the heirs. In addition, with a couple of exceptions, most states follow the IRS on this tax rule.

The rules for 1031 tax deferrals are simple, but can be stressful. There are strict timing issues with no exceptions. Most 1031 exchanges occur as follows:

1. The investor sells the relinquished property.
2. The net proceeds (equity left after debt and transaction expenses are paid) are sent and held by a qualified

intermediary, so the investor never has personal control of the proceeds.

3. When the relinquished property is sold, the IRS clock starts ticking.

4. The investor has 45 days from the sale date to identify up to three replacement properties.

5. The investor must close on his replacement property or properties within 180 days from the date he sells his relinquished property.

The IRS revenue procedure that defines the TIC does not address tax deferral. TIC is a structure for 1031 tax-deferred exchanges for real estate investors. Simply put, it allows up to 35 investors with proceeds from relinquished properties to put those proceeds together and buy a single property.

It is important to note that this is not considered a partnership because partnership interests are not like-kind with real estate and do not qualify for 1031 exchanges. Each investor instead owns a direct fractional interest in the new real estate investment as a tenant in common or co-owner with the other co-owners. In other words, each investor owns an individual piece of the investment that he does not share with the other owners. The fractional interest qualifies for 1031 exchange at time of sale just like any other relinquished property and may be replaced with another TIC investment or direct real estate.

TIC intricacies

Similar to the beginning of the real estate investment trust (REIT) industry in the early 1990s, TICs are currently subject to a good deal of discussion and a matching amount of confusion. Some clarification, therefore, is warranted. Most of the TIC investments today are focused within core investment real estate product: office, industrial, multifamily and retail. The properties are usually stabilized, cash-flowing from closing and have little, if any, value-added component to the pro forma. Today, TIC offerings are structured either as

securities (regulated by the Securities & Exchange Commission (SEC)/National Association of Securities Dealers (NASD)) or as real estate.

TIC offerings designed as real estate may be broken into sponsored and nonsponsored categories:

- Nonsponsored real estate TIC offerings usually involve a small group of investors who often know one another, and they form a TIC structure to purchase a property together as tenants in common and not as a partnership, so they may qualify for 1031 treatment.

- Sponsored real estate TIC offerings are TIC investments that are packaged by a third party for the co-owners. These offerings are usually less expensive to structure than TICs offered as securities. Licensed real estate brokers may also participate in the fee structure for selling the fractional interests to the co-owners.

Sponsored TICs as securities are packaged as investments under the securities private placement guidelines for qualified investors, which set net worth and income hurdles for investors. The fractional interests are offered through securities broker dealers and their registered reps. The broker dealer community specializes in TIC advisory services in three formats:

- The broker dealer itself primarily specializes in TIC.

- The broker dealer offers TIC through an in-house alternative investment group which, in turn, sets licensing, training and experience guidelines for its registered reps who offer TIC to clients.

- The broker dealer offers TIC in a fee-sharing arrangement with another broker dealer that specializes in TIC.

The securities structure for TICs is highly regulated compared to the nonsecurity TIC investment, which often adds additional costs to the offering. All TICs are regulated equally under the IRS revenue procedure, but TICs offered as securities are also regulated under SEC/NASD securities guidelines.

Brokers and bankers

Currently, fee opportunities for real estate brokers and real estate representatives are limited. However, the National Association of Realtors is reported to be working on behalf of the real estate brokerage community on fee sharing for its members when they bring equity into TIC offerings. Meanwhile, a number of firms nationally have emerged which offer a dual licensing structure for their representatives specializing in the TIC market. Seeking to eliminate jurisdiction conflicts, the representatives from these firms hold both real estate and securities licenses.

But sourcing and buying properties for TIC investment are not much dif-

ferent than the sourcing and purchase of real estate generally. Most sponsored TIC firms have a bridge equity structure that allows the sponsor to purchase and then re-sell the real estate in fractional interests at a later date. This is not a requirement under any TIC guideline, so the sponsor's capital structure and track record are critical in the decision to invest in a sponsored TIC interest. The alternative is that the TIC buyer may try to line up fractional interests after the property is tied up, which is a closing risk for the seller and the tenants in common.

Generally, TIC buyers are looking for stabilized real estate with credit tenants. TIC buyer platforms may be structured to purchase properties under \$10 million to over \$100 million. It is also difficult for TIC buyers to assume debt, especially if it is securitized. The extra time needed to work with the special servicer virtually eliminates debt assumption as a TIC sourcing option.

The debt market has evolved significantly since 2002, when lenders were just learning the TIC market. Today, there are more lenders in the space, including Citi, JPMorgan, Eurohypo and Wachovia. Tens of billions of dollars of TIC loans have been securitized. The number of allowed borrowers has grown from 10 to 35 maximum investors. At the same time, lenders have fine-tuned their underwriting strategies, requirements for sponsor performance, TIC borrower approval, nonrecourse carve-outs, and reserves.

Reserves, in particular, are important to consider in the TIC structure. Because it is more difficult to call capital in the TIC structure than in other real estate ownership, large reserves in the form of either additional equity or loan holdbacks are required up front in many TIC transactions. The result of this specialized underwriting and structuring is that, today, debt offered by lenders to experienced TIC sponsors is usually 105 to 120 basis points over five-, seven- or 10-year Treasuries. Debt rates for sponsored TIC offerings are often much better than what small individual investors or nonsponsored TICs can achieve.

The TIC structure enables investors to diversify their exchange proceeds into multiple properties by market, product type and pro forma timing. At the same time, most sponsored TIC offerings pay investors property cash monthly, and the IRS requires that all key ownership decisions (leasing, financing, capital spending, annual budget, property management and disposition) are made by the co-owners. This allows investors to own real estate, defer taxes, achieve monthly income, and retain control of all major ownership decisions while freeing themselves from daily property management. ●