

**SEA OF CONTROVERSY:** Critics compare TIC sponsors to the maligned syndicators of the 1980s. Tim Snodgrass, a California-based sponsor, argues that TICs enable small investors to buy quality assets.

## Riding the TIC Wave

Small investors plan to funnel \$4 billion in equity into TICs this year, but are choppy waters ahead?

By Joe Gose

Virtually non-existent only a few years ago, the tenant-in-common structure has become the hottest investment vehicle in real estate. TICs, which allow small investors to acquire a fractional interest in institutional-grade assets, raised \$1.8 billion in equity last year and are expected to raise \$4 billion this year.

But the fledgling industry is mired in controversy and uncertainty even as TICs grow in popularity among investors. While most sponsors sell TICs as securities in accordance with Securities and Exchange Commission regulations, other sponsors don't. And there is widespread specula-

tion that sponsors may have an easy time passing struggling properties off as top performers to unsuspecting 1031 tax-deferred exchange buyers, investors who are eager to defer capital gains taxes and who are driving the demand for TICs. What's more, TICs have yet to face falling property values, bankruptcies or capital calls, critics say, and it's uncertain how the TIC structure would weather those storms.

"There are plenty of question marks," acknowledges Tim Snodgrass, president of Argus Realty Investors, a TIC sponsor based in San Juan Capistrano, Calif. "But even with the questions, I don't foresee a letdown in demand for this investment

vehicle in the next 10 years."

A convergence of factors has fueled the demand, most notably a tax ruling in 2002 by the IRS that made TICs more attractive to investors and retiring baby boomers.

"People have a need. They want to get out of managing their small properties, diversify their investments and upgrade to institutional assets," says Snodgrass, president and a co-founder of the Tenant-In-Common Association. The three-year-old organization was formed to promote ethical standards in the industry. "Ultimately, TICs fill that need."

Argus Realty has financed some 4.2 million sq. ft. of primarily office, indus-

trial and flex space via the TIC structure since 2000. Most recently a TIC comprising some 26 investors sponsored by Argus Realty paid \$51 million for five Class-A buildings totaling 285,000 sq. ft. in the Los Angeles-based Commerce Office Park. Argus Realty typically contracts to purchase a property and then forms a TIC to raise the equity needed to close the acquisition.

## Drivers behind the TIC boom

Argus Realty's acquisitions are but one example of the robust TIC activity. When combined with debt, the \$1.8 billion in equity raised by TICs last year financed at least \$4.5 billion of commercial real estate, according to Gary Beynon, chairman of Omni Brokerage, a Salt Lake City-based 1031 exchange intermediary. But total dollar volume generated by TIC transactions last year could be closer to \$9 billion, he adds, considering that Omni Brokerage only tracks sponsors who sell TICs as securities.

Baby boomers who have owned and managed small properties for years are fueling the explosive growth of TICs, which is also referred to as "co-ownership of real estate." As they near retirement, boomers are swapping those assets for interests in TICs via 1031 exchanges, which protect gains made from property sales from as much as a 50% tax hit.

Perhaps best of all, TIC investors are passive owners of real estate, which means that boomers get to give up the "sweat equity" element of being a small landlord, namely maintenance and repair duties.

"TIC investors typically have real estate experience, but they don't want to be involved with the three T's anymore — tenants, trash and toilets," Beynon says.

Generally, minimum investments in TICs range between \$100,000 and \$1.6 million, with an average minimum of around \$600,000. TICs pay monthly cash flow distributions that reflect annual yields of about 6.5% to 7.5%. Ultimately, TICs are aiming for total returns of 12%. Last year, Argus Realty sold the 195,540 sq. ft. San Diego Distribution Center to Modesto, Calif.-based Beard Land Co. for \$14.3 million. That deal provided an 18.11% annual return to the TIC investors, according to Argus Realty.

That's not going to be the case for every TIC investment, particularly as interest rates rise and the property markets cool, warns tax and real estate attorney James Rauschenberger, a partner with Arnall Golden Gregory in Atlanta. "It's great for people now, who may have \$2 million in cash and who are focusing on an 8% annual return that a TIC might provide as they retire," he says. "But what happens to their \$2 million principal in five years, or seven years?"

## Securities debate

TIC proponents say investment in any industry poses certain risks. But they certainly concede that vagaries permeate the TIC structure despite its wild popularity.

The most contentious issue is whether TIC shares are securities, and the controversy centers on the interpretation of the

"Howey Test," which stemmed from a 1946 federal court case. The court determined that an investment is a security if the "scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." In other words, it's a passive investment.

Most sponsors think TICs meet the Howey Test and structure co-ownership sales as SEC Regulation D (Reg. D) security offerings, which are exempt from registration. Among other demands, Reg. D requires that sponsors offer securities through private placement memorandums.

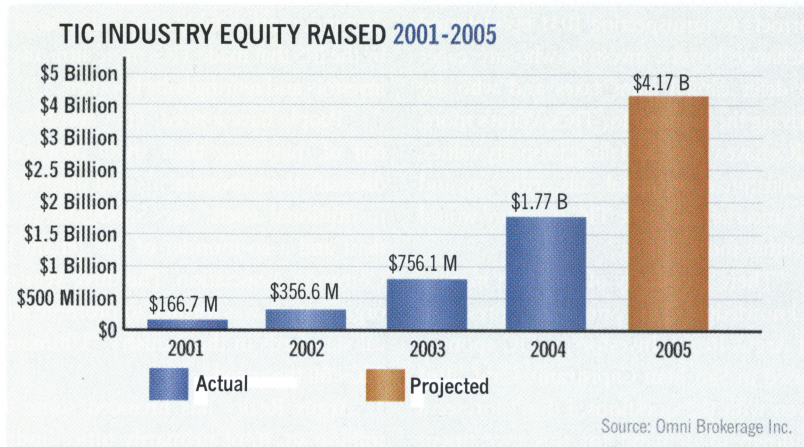
The memorandums provide full disclosure about the building being purchased, the TIC's sponsor, risks associated with the investment, third-party opinions and other details to help an investor make an informed decision. Reg. D also requires that securities be sold only by licensed broker dealers to accredited investors — generally people who have an individual or joint net worth of at least \$1 million, or who have an individual annual income of \$200,000, or joint annual income of \$300,000 for the two prior years.

Some sponsors, however, argue that TIC shares are not always securities. They sell TICs just as they sell property — through real estate agents to any willing buyer. Those sponsors contend that the question hinges on whether sponsors are operating properties for the benefit of TIC investors under the Howey Test.

Los Angeles-based SCI Real Estate Investments, a firm that sponsored \$300 million in TIC acquisitions last year, is one of the few large sponsors that doesn't sell its co-ownership shares as securities, and it typically retains a small percentage of ownership of assets alongside TICs.

But unlike most sponsors, who continue to act as property and asset managers after selling properties to TICs, SCI doesn't provide those services. Instead, the TIC selects third-party providers, says Marc Paul, president and co-chairman of SCI. When sponsors are performing those management duties, he adds, co-ownership shares likely are viewed as securities.

Douglas Johnston Jr., CEO of SCI, also argues that investors benefit by buy-



## The debate won't end anytime soon. The SEC has yet to propose any definitive guidelines on TICs.

ing TICs strictly as real estate rather than as securities. All sponsors charge fees of between 5% and 8% of the equity raised in a TIC, he says. SCI, for example, charges about 6% in fees. But selling the shares as securities can add an additional 5% to 7% in fees, which go to the securities dealers, he says. "Our salesmen are real estate brokers and are better suited to explain a real estate product," Johnston adds. "A seller of securities is a stockbroker."

### No direction

The debate won't end anytime soon. The SEC has yet to propose any definitive guidelines on TICs. In March, the National Association of Securities Dealers published a notice to members that reviewed the rules that broker-dealers needed to follow when selling TIC shares. The NASD stopped short of making a clear declaration, noting that TIC instruments "generally are securities for purposes of

federal securities laws and NASD rules."

David Bayless, a securities attorney in Morrison & Foerster's San Francisco office, says the NASD's notice indicates that the SEC is paying attention to TICs. "The SEC does not want to wait until something blows up and later on people ask, 'Where was the SEC?' They're starting to wake up to the fact that TICs are a big business," says Bayless, a former SEC district administrator.

Closer SEC scrutiny may not translate into specific rules tailored toward TICs, particularly as the SEC has its hands full with other matters, such as hedge fund registration. But if the commission suspects fraud — regardless of whether the sponsor has sold TIC shares as a security or real estate — it certainly will go after the sponsor, Bayless adds.

TICs also may fall under state securities laws. But Utah essentially stripped its securities division of regulating co-

ownership structures sold in the state when a bill sponsored by Al Mansell, a powerful Utah state senator and president of the National Association of Realtors, was signed into law in March. The law put TICs under the jurisdiction of the state's real estate division.

The action bewildered Chuck Newton, government affairs director for the Financial Planning Association of Utah. "Consumers who buy real estate in Utah through a TIC now have no protection against fraud," he says.

### Break from the past

The potential for fraud is stirring a good deal of concern among property experts, who suggest that unscrupulous sponsors will buy dubious properties and then flip them to TICs for a quick profit. A Reg. D offering best protects investors from those situations, says Charles "Duke" Runnels,

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president and CEO of Fort Properties, a sponsor based in Los Angeles.

The conventional wisdom is that ultimately some TICs will fail, especially as rising interest rates create desperate sponsors. "When a sponsor's next transaction is what keeps him in business, it starts to introduce the kind of peril that permeated the syndications of the late 1970s and early 1980s," says Runnels, who's firm sells TICs as securities. "The temptation to put together deals that don't make sense for investors but that generate fees for sponsors is very great."

Sponsors are familiar with the comparisons to the failed syndications some 20 years ago, but most downplay the chances that history will repeat itself. Back then, investors didn't have the same operating control of properties that TIC investors enjoy today, says Omni Brokerage's Beynon. He adds that the lion's share of TIC investors already have some real estate expertise, unlike members of syndicates years ago, and that lenders are much more disciplined

## A primer on TICs

**T**he tenant-in-common (TIC) structure remains a mystery to many potential investors, despite the industry's phenomenal growth in the last couple of years. Sponsors essentially divide properties into equal shares and sell the shares to investors. Some sponsors acquire the property outright and then sell it to a TIC, while others contract to buy an asset and then form a TIC to raise equity to help finance the deal.

TIC investors typically set up single-member limited liability companies as the vehicle that buys into the co-ownership structure. In most cases, investors receive a deed of trust that reflects their fractional ownership of the property. The focus in any TIC investment should first be on the sponsor, says Douglas Johnston, Jr., CEO of SCI Real Estate Investments in Los Angeles.

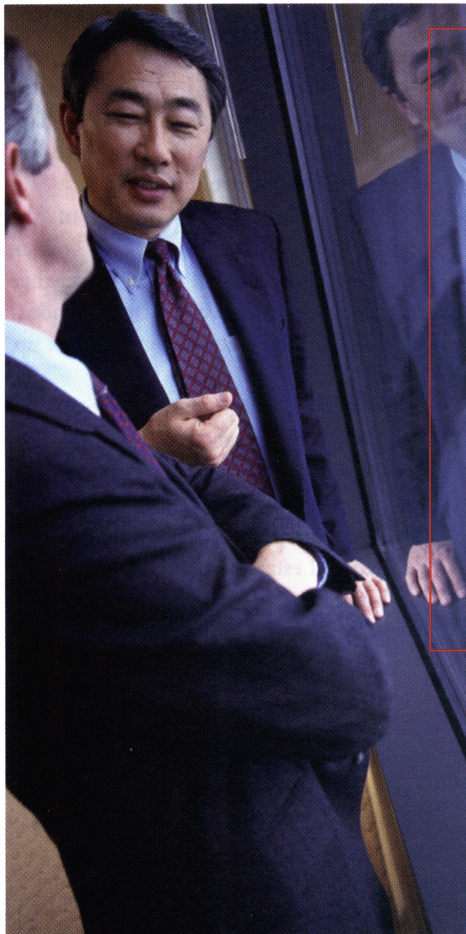
"The industry has only been around about three years, but as an investor I'd want to make sure the sponsor knows what he's doing and has a track record," says Johnston, whose firm has closed more than 40 TIC transactions since 2000.

The tipping point occurred in March 2002, when the Internal Revenue Service issued Revenue Procedure 2002-22. The procedure gave sponsors and investors assurances that TICs wouldn't be considered partnerships for tax purposes and listed 15 guidelines for TICs to follow: TICs can number up to 35 members, for example, and members vote on major property decisions regarding capital improvements, leases, rents, and property and asset managers, among other issues.

Rev. Proc. 2002-22 also ruled that TIC shares were considered property, creating a voracious appetite for co-ownership among 1031 exchange buyers.

Late last year, however, the IRS ruled that TICs could be structured as a Delaware Statutory Trust (DST), which adds more nuance to co-ownership groups. DSTs streamline the process to establish TICs, but they also take away many of the decision-making duties from co-owners that are required under a conventional TIC structure. Additionally, unlike a conventional TIC, in which each investor receives a deed to the property, DSTs hold the real estate deed and DST co-owners possess a beneficial ownership in the trust.

— Joe Gose



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# INVESTMENT

today than in the past.

Additionally, TICs are still a drop in the bucket in terms of the commercial real estate universe, accounting for only 1% of all transaction dollar volume last year, experts say. But SCI's Johnston suggests that over the next three to five years, TICs could account for 5% to 10% of all commercial real estate dollar volume. SCI, in

fact, is pushing to broaden its pool of TIC investors. Currently, the average age of its investor base is 60.

"We think it's reasonable to figure that fewer than 5% of all Americans have ever heard of a TIC," Johnston says. "We're looking to educate a younger crowd and tell them that they can take advantage of TICs, too."

## Raising equity is a cinch

The TIC phenomenon certainly hasn't waned even without younger blood. It's estimated that TICs could acquire \$15 billion in commercial properties this year. According to Omni Brokerage, 51 reporting sponsors raised some \$620 million in equity in the first quarter of 2005, which was an increase of 121% over equity raised in the first quarter of 2004. The firm also reports that co-ownership structures acquired \$1.5 billion in assets in this year's first quarter.

Sponsors expect their volume to keep doubling, and new sponsors keep popping up. SCI's Johnston predicts his firm will sponsor some \$700 million in TIC deals this year, more than double last year's production.

Most recently, a TIC sponsored by SCI acquired the 340,000 sq. ft. Cobb Place Shopping Center in Kennesaw, Ga., in March for nearly \$64 million. The acquisition, which was completed at a capitalization rate of 6.9%, featured about \$24 million in equity. SCI projects an annual average cash flow yield of 7.8% over five years, and tenants include Bed Bath & Beyond, Thomasville Furniture and Cost Plus World Market.

Meanwhile, 1031 Exchange Options in Walnut Creek, Calif., a 1031 financial consultant to TIC buyers, represented investors who acquired some \$600 million in real estate via TICs in 2004, which was almost double the volume in 2003.

"Nothing surprises me about the growth of TICs," says Cary Losson, founder and president of 1031 Exchange Options. "Quarter over quarter, the industry's growth has been close to straight up, if not straight up."

At some point, that trajectory will fall off, TIC proponents admit. But for now, they fail to see many obstacles to continued growth — as long as boomers and other small property owners want to shield real estate gains from taxes, diversify and become passive property owners.

"Most people have bought a house in their lifetime," says Argus Realty's Snodgrass, "but how many have bought a \$50 million building? Now you can, and it's certainly new, and it certainly solves a problem."

Joe Gose is a Kansas City-based writer



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