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TICs offer investors way to defer taxes on real estate gains

By Burl Gilyard/F&C Real Estate Writer
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Michael Houge, principal with the Minneapolis-based Upland Real Estate Group, has spent the last decade of his real estate brokerage career specializing in net-leased properties — generally buildings fully occupied by a single, high-visibility, brand-name retail tenant with a long-term lease.

But in recent years, Houge found that the demand for quality net-leased properties was outpacing the supply in the market. “We were really seeking another product to offer the same kind of investors,” recalled Houge. After surveying the market, Houge was reborn as an evangelist for tenancy-in-common (TIC) real estate investments.

The principals of Upland founded Safe Harbor Properties Exchange in 2003 as a promoter of TIC’s — also known as 1031 exchanges — which essentially offer investors a way to defer capital gains taxes on real estate sales.

Last December, Safe Harbor offered TIC investments in the Valley Business Center I in Apple Valley. For the deal, the property was valued at $4.75 million, including the stake retained by the original owner. Today the building has nine tenant in common owners, including Safe Harbor. Not counting the larger stake retained by the owner, new investors made investments ranging from $100,000 to $500,000 in the property.

The 62,000-square-foot suburban building on a 6.3 acre site is fully leased. Among its eight tenants are a distribution center for the St. Paul Pioneer Press and a staging display facility for Wal-Mart. The facility at 14898 Energy Park in Apple Valley was built in 1999.

“You never see any of our properties on the market,” said Houge. “There’s no sign on the building — it’s not for sale.”

Section 1031 of the IRS code sets the ground rules for these exchanges. The general concept of a TIC exchange is that a seller can defer capital gains taxes on the sale of real property, provided that he reinvests the sale proceeds in a similar property. For tax purposes, the deal is treated as an exchange rather than a sale. In theory, the mechanism allows investors a way to defer capital gains taxes in perpetuity — provided that they can satisfy a series of complex conditions outlined by the IRS. Investors must identify the new exchange properties within 45 days of the sale — and close within 180 days.

There’s nothing new about such tax-free, or like-kind, exchanges. But within the last few years the previously arcane realm of TICs has become something of a real estate investment fad. The business has particularly taken off in the wake of the issuance of IRS Revenue Procedure 2002-22 — or “Rev. Proc. 2002-22” in TIC shorthand — which details 15 guidelines for TIC deals.

In TIC deals, the co-owners must scrupulously avoid the appearance that they are operating a partnership. Per the Revenue Procedure: "The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity)."

If a TIC group acts too much like a partnership, the IRS could disallow the tax deferral.

The guidelines also note that any decisions about sale, leasing and hiring a property manager demand the approval of all of the co-owners. The maximum number of co-owners for a property is 35.

Firms like Safe Harbor arguably help investors navigate through the complex regulations. "We aren't trying to do deals that I would consider shaky or risky," said Houge. "They have to be based on the fundamentals." Still, Houge notes that there is risk in any deal: "Real estate has risk. You're not buying a government bond."

Safe Harbor prefers newer properties, generally less than five years old. Typically, in the deals offered by Safe Harbor, the original owner signs onto the deal. "All of our deals include the developer staying in the deal," said Houge, whose firm bills these investors as "specialty partners."

Keith Sturm, principal with both Upland and Safe Harbor, stresses that the principals of Upland and Safe Harbor invest — and stay invested — in every TIC deal that the firm shops. "These are cash-flow properties," said Sturm.

Houge and Sturm partnered with Duane Lund, managing partner of The Geneva Organization, to create Safe Harbor. Lund brought an expertise in finance to the table; his firm packages real estate deals for investors. "I call myself a real estate retailer," said Lund. "There's just a flood of capital that's looking for a home in real estate. I think it [TIC] will be a $4-5 billion market in the next 12 months." (Lund is an owner of Safe Harbor; Upland and Geneva, however, have no common ownership interest.)

To date, Safe Harbor has sold $60 million in TIC investments. Safe Harbor is currently offering nine different TIC properties with a total of $156 million in investments available. Properties include a building that houses an Ashley Furniture Home Store in Milwaukee; a building occupied by a Barnes & Noble and a PetCo in Fargo, North Dakota; an assisted living complex in Waupaca, Wisconsin; and a collection of office/warehouse buildings in Maple Grove.

While investors can get into some deals for as little as $100,000, minimum required stakes of $250,000 or $500,000 are more common. And — obviously — if an investor is looking to cash out with a real estate sale, a TIC exchange isn't an option. In a 1031 exchange, IRS guidelines require that the sale proceeds be held and then distributed by a qualified intermediary — a third party not otherwise involved in the transaction.

Growth in the TIC market has been explosive. A May 2003, article in Business Week estimated that TIC investors would acquire $3 billion in real estate in 2003 — triple the number from 2002.

An April 2004 industry estimate from OMNI Brokerage, a TIC sponsor/promoter, put actual TIC sales at roughly $750 million in 2003, with nearly $2 billion in projected sales for 2004.

Tom Dunck, midwest regional manager for Investment Property Exchange Services (or IPX), points to the climbing annual attendance of a national TIC symposium as one bellwether of the industry's rising popularity. Dunck's firm serves as a qualified intermediary for transactions.

"The first March there were about 50 people that showed up. The second year, there were about 200 there. This past year, there were over 500," said Dunck, referring to this year's event in Salt Lake City. "That is really indicative of not only the interest, but the growth that's happening. It's becoming a very, very attractive product for many investors."

Dunck is based in Chicago, but notes that his firm is close to reopening an office in the Twin Cities. "It's a dynamite area. I certainly believe it's going to gain in popularity," said Dunck, who characterizes TIC growth as "dramatic."

Yet as the TIC market grows, some industry observers are preaching caution for potential investors. Gary Gorman serves as managing partner of The 1031 Exchange Experts, a Denver-based firm that serves as a qualified intermediary for 1031 transactions.

"The whole TIC industry smells a lot like the tax-shelter stuff of the 1970s and 1980s," said Gorman. "You get a bunch of slick promoters that are trying to sell junk that doesn't have any real economic merit to it."

Gorman bluntly dismisses 70 percent of all deals promoted under the TIC umbrella as "junk." He recalls seeing one building that was only worth $13 million being sold to TIC investors for $18 million. "These poor investors will never get out of this property," said Gorman.

Houge knows that there are many who still view TICs warily. "It's the same thing that happened with the REITs," said Houge, who recalls that many investors were initially wary of real estate investment trusts.

Another risk for investors is that deals could be disallowed by the IRS, if not appropriately structured. "We think that there's going to be a fair amount of that kind of thing happening in the future," said Gorman, who notes another issue for the industry is insuring that deals are structured as real estate transactions — as opposed to a transaction requiring a securities license.

Despite his *caveat emptor* view of the market, Gorman does see some positive trends. "The thing that I'm seeing that's attractive is about 30 percent of the market seems to be non-1031 money," said Gorman, which represents new investment money, rather than money being rolled over from a sale into an exchange. "There are some good promoters out there that have good product that really fill a need."

But he notes that this is hardly a game for the investor who just inherited a few thousand dollars from a late aunt and wants to play the real estate game. "On the good properties, it seems like the minimum investments run $500,000," said Gorman. "You need to get up to the bigger bucks to get some of the nicer stuff."

There are other challenges. "Not only is there a challenge finding good desirable property, but property with the right value," said Dunck. If an investor has just sold a property for $500,000, he must find a home for the full amount. "Maybe you find a wonderful piece of property that you like, but it's only $350,000," said Dunck.

Houge and Sturm acknowledge that TIC players will come and TIC players will go as the market intensifies. But they believe that they are positioned for the long haul. "I think in any transaction, a prudent buyer needs to do their due diligence to make sure they're comfortable with the real estate investment," said Sturm. "It's just like everything else. You've got to do your homework and do your due diligence to know who you're doing business with. We're going to be that long-term player."

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