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Tenancy-in-common offers investment benefits

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Investments in tenancy-in-common interests in real estate have been exploding. While TIC investments provide significant benefits, including preserving the ability to dispose of or acquire such properties as part of a Section 1031 tax-free exchange, they also present many practical and legal issues that a TIC investor must consider before signing on the dotted line.

A typical TIC investment in real estate involves a number of individuals, generally unknown to each other, who each own an undivided tenancy-in-common interest in real property. The advantages of such an investment are significant.

Ownership of a TIC allows the investor to own, for a relatively modest sum, a fractional interest in a large, institutional-grade investment property. Such properties are typically professionally managed. Thus, instead of owning separate rental houses and dealing with emergencies and late-night tenant phone calls, a TIC investor might simply own an interest in an apartment complex whose maintenance and rent issues are handled professionally.

Another advantage is the potential for tax-free exchange treatment.

Although TIC interests in real estate have been around for years, interest in them has dramatically increased since 2002, when the Internal Revenue Service provided guidance in the area. The IRS issued a revenue procedure that year which indicated that a taxpayer can use a TIC investment, if properly structured, as either relinquished property or replacement property in a qualifying tax-free exchange. Thus, an investment in a TIC has a significant advantage over an investment in a real estate partnership. Sales or purchases of partnership interests cannot, without risky structuring, qualify for tax-free exchange treatment. The real estate industry perceived the new revenue procedure as the IRS' stamp of approval, triggering a TIC rush that has continued ever since.

In recent years promoters have developed and marketed TIC investments, which are usually sold through traditional real estate brokers. Depending on the structure, TIC interests might be deemed a security, like a stock or a bond, under federal and state securities laws. If so, the TIC interests must be registered under applicable securities laws (unless an exemption from registration is available), documented as a sale of a security, and offered for sale and sold by a licensed securities broker.

In contrast with a partnership, a TIC investor actually owns the underlying real property. In a partnership, the investor merely owns an interest in a legal entity -- the partnership -- which in turn owns the real estate. The relationship among TIC owners of a property is generally controlled by a tenancy-in-common agreement. A TIC agreement is analogous in many ways to a partnership agreement. In fact, if a TIC agreement is not carefully structured, the IRS may recharacterize it as creating a partnership for tax purposes, effectively destroying the ability to exchange on a tax-free basis. In making such a recharacterization, the IRS looks at factors such as whether the TIC agreement permits voting among the owners to make major management decisions, which would point to characterization as a partnership. The IRS also considers whether profits are distributed among the TIC owners in proportion to their ownership interest in the property, which again points to partnership status. The 2002 revenue procedure sets out a list of provisions for a TIC agreement that would avoid recharacterization.

Clearly, an investor should engage tax counsel to review a TIC agreement to see whether it will be treated as a partnership for tax purposes.

As with any real property investment, tax issues are only one factor among many to consider. An investors must also obtain and examine due-diligence information about the property. Such materials would include property inspection reports, environmental reports, title reports, a property survey and a financial analysis of the prior operation of the property.

Investors must also consider the ability to resell their interest in the TIC. It is possible, for example, that a TIC interest in 10 percent of a property, if sold separately, could sell at a discount to 10 percent of the current value of the entire property.

Another significant consideration is the management of the property. Decisions to sell, borrow funds, lease or hire a property manager are controlled by the TIC agreement. The IRS has clearly signaled that it will treat voting on major decisions in a TIC agreement as a basis to treat the TIC as a partnership. If unanimous approval for such decisions is required, one recalcitrant TIC owner could block the will of the other owners.

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Careful drafting of the TIC agreement can at least partially solve this problem by allowing TIC owners to purchase the interest of a single owner who is thwarting the will of the others.

Finally, investors must realize that each owner in a TIC can force a sale of the property by filing a partition action. A partition action is essentially a complaint to a court stating that the owners cannot agree on how to manage the property and that the property should be either split into parts (which is not possible for most improved properties) or sold. Waiving the right to partition in the TIC agreement, however, may cause the IRS to treat the TIC as a partnership for tax purposes. One solution that most TIC agreements utilize is to give the other owners a right of first refusal to purchase the interest of an owner before he or she can file a partition action.

In summary, TIC investments offer huge advantages by allowing investors to invest in substantial properties through a tax-free exchange. After examining the soundness of such transactions as real estate investments, however, investors must also consider the practical issues involved in managing these properties and must ensure that the TIC will not be treated as a partnership for tax purposes.

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