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# TIC FEVER

By Harold D. Hunt

**A new method of syndicating commercial real estate is sweeping the country. This red-hot investment vehicle, known as a tenancy-in-common or TIC, creates an undivided fractional ownership interest in real property. These interests have become particularly attractive to real estate investors in search of properties qualifying for a 1031 tax-deferred exchange.**

Unfortunately, the word syndication conjures up bad memories for many who lived through the 1980s real estate crash. Will this latest variation be "déjà vu all over again," or can TICs become an established, viable real estate investment vehicle? Can real estate licensees benefit from involvement in the purchase and sale of TICs? Will real estate licensees be allowed to receive a commission in some TIC transactions? At this point, there are as many questions as there are answers.

## Small Investors Attracted

TIC transactions were first created in the 1990s by real estate syndicators, now commonly referred to as TIC "sponsors." Sponsors split the ownership of large income-producing properties into undivided shares, which give each investor an interest in the entire property as a tenant in common.

The TIC model offers several advantages. Investors who are financially unable to invest in a sizeable, high-quality commercial property can participate as part of a group. As a result, small investors benefit from professional management and a stable cash flow.

These features are especially attractive to individuals attempting to separate themselves from the day-to-day management of their real estate assets. The purchase of TIC interests also allows for investment diversification by geographic region and property type.

## Ruling Favors 1031 Exchanges

Probably the most important advantage of the TIC investment is that it qualifies for a 1031 exchange. Tax-deferred 1031 real estate exchanges have been recognized under the Internal Revenue Service tax code since 1921. However, whether TIC interests qualify for a 1031 like-kind exchange was unclear until the IRS issued guidelines in 2002 (Rev. Proc. 2002-22). Real estate partnerships do not qualify.

These guidelines fueled a dramatic increase in TIC investments. TIC equity volume exploded to $1.8 billion in 2004 compared with just $167 million in 2001, a 978 percent increase. More than $4 billion in equity will be invested in 2005, based on information presented at the 2004 Tenant-in-Common Association (TICA) Symposium.

Increased availability of TIC properties should take pressure off investors attempting to secure an identically sized replacement property within the 45-day identification and 180-day closing periods mandated by the IRS for a successful 1031 exchange. With the use of a TIC, a sponsor can tailor the size of the undivided interest to meet the specific needs of investors seeking replacement properties.

IRS guidelines establish 15 conditions that should be considered when structuring a TIC interest to qualify as a replacement property for a 1031 exchange. However, the IRS may issue a private letter ruling determining whether a particular TIC agreement qualifies, even if all these conditions are not met. Likewise, an unfavorable ruling is possible even when all 15 conditions are met. In the final analysis, the sponsor's intent when structuring the TIC agreement plays a pivotal role in the determination.

## Real Estate or Security?

For real estate licensees, a key question is whether a TIC is classified as a real estate transaction or a security investment covered by the Securities and Exchange Commission (SEC). The answer determines whether the real estate broker is entitled to a commission.

Although the IRS views TIC transactions as real estate transactions, the SEC views most as securities. Some TIC sponsors obtain legal opinions from attorneys to determine whether TIC transactions are structured as real estate or as a security. However, there are no safe harbors or ironclad rules.

The National Association of Realtors has established a Tenants-in-Common Working Group to educate commercial brokers about real estate and securities issues surrounding TICs. The group concluded that there is "no clear guidance as to when the marketing and sale of TIC interests can be brokered as real estate only and not subject to applicable requirements of federal and state securities laws, when that activity must be treated as the sale of a security, or when persons holding real estate licenses may participate in and be compensated for the sale of TIC interests that constitute the sale of a security."

Presently, a real estate licensee can safely collect a real estate commission when the entire property is sold to a TIC sponsor. When a property interest is later transferred to or from the TIC, whether structured as real estate or not, collecting a commission is questionable.

In a March 2005 notice to its members, the National Association of Securities Dealers (NASD) stated that securities broker-dealers who pay a fee to the real estate agent or split a brokerage commission with the agent in connection with a TIC exchange have violated NASD Rule 2420, which prohibits payment of commissions and fees to entities operating as unregistered broker-dealers. Estimates are about 10 percent of all TICs are being structured as real estate and not securities.

The savings in front-end fees is a primary reason for structuring a TIC as real estate rather than as a security. When securitization fees are added to other costs, such as financing fees, sponsor commissions and due diligence costs, the front end "load" may exceed 25 percent of the investment in some cases. Reduced loads generally equate to higher investor return. Potential TIC investors should compare the load costs against the tax benefits derived from conducting a 1031 exchange.

In return for their fees, sponsors take on the responsibility of creating a viable TIC investment. Potential properties must be identified and either put under contract or purchased outright. All aspects of selling and marketing the TIC interests must be arranged by the sponsor, usually through the services of one or more securities broker-dealers.

Sponsors work with lenders and mortgage brokers, putting together the information necessary to secure financing. Sponsors also are heavily involved in arranging for property management, disbursing payments to the TIC investors and coordinating the eventual sale of the entire property.

## TIC Concerns

TIC investments are not risk free. Investors must consider liquidity and control risks along with market risk, management risk and economic risk. If the TIC interest is sold as a security, the risks will be specified in a Private Placement Memorandum (PPM) required by the SEC. A PPM is not

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required with TICs sold as real estate, although some sponsors choose to issue them anyway.

Liquidity risk (involving divestment of the TIC interest) should be a prime investment concern. A well-conceived exit strategy must consider the sale of both the individual TIC interest and the entire property.

The IRS guideline states that "each co-owner must have the right to transfer, partition and encumber the co-owner's undivided interest in the property without the agreement or approval of any person." Investors wishing to sell an individual TIC interest not as a part of the entire property may encounter problems.

The guideline goes on to say, "restrictions on the right to transfer, partition, or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited." As a result, lenders may include a number of limitations designed to protect their investment when an investor anticipates selling a TIC share. For example:

- Lenders may require their prior approval before an investor transfers a TIC interest.
- Lenders may attempt to restrict a TIC investor's ability to partition the property by demanding prior approval before modifying or terminating the TIC agreement.
- Lenders may mandate a minimum holding period for any large investors, especially in the case of recourse financing, which allows an investor's personal assets to be taken in a loan default.
- Lenders may require that 100 percent of the TIC investors agree to any single investor wishing to sell their interest.
- TIC loans are now being packaged and sold in the commercial mortgage-backed security (CMBS) market. As a result, some lenders may require that a rating agency confirm the creditworthiness of new TIC investors before they are allowed to buy in to reassure CMBS investors.
- All TIC interests sold as securities must be purchased by "accredited" investors as defined by the SEC. TIC interests sold as real estate are not bound by this rule. Even so, lenders may want to ensure the creditworthiness of investors before approving the financing of a TIC property.
- Although the IRS limits the number of TIC co-owners to no more than 35, some lenders may wish to further restrict this number to reduce their underwriting costs.

Even if a TIC investor can secure permission to sell the TIC interest, locating a buyer can be difficult. No secondary market exists for the sale of TIC interests. However, TIC agreements are generally structured to give the other investors in a TIC deal the first opportunity to buy an interest before it is offered to outsiders.

TICs are so new that most investors have owned their interest for only a short time. The relative newness of TICs presents valuation challenges as well. Although an appraisal of the whole property being sold to a TIC sponsor is fairly straightforward, the valuation of an individual TIC interest may be more difficult because of lack of comparable sales data.

A TIC buyer's motivation could be another consideration in the valuation of a TIC interest. Some investors may purchase a TIC interest just to avoid capital gains taxes without adequately considering the strength of the underlying deal structure as an investment. As a result, an argument could be made that some TIC investors may be overpaying. Until more TIC interests are sold, appraisers may be reluctant to value an individual TIC interest.

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In regard to control risk, a tenant-in-common relationship prevents control of the property by any one person. IRS guidelines state that "any sale, lease or re-lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners."

The practical result of this clause is the ability of any single TIC investor to veto major property decisions. Although this represents a loss of control by other individual investors, most TIC agreements employ a call option that allows a majority of TIC investors to buy out the TIC interest of any investors in opposition.

## Opportunity for Consulting Fees

Until the issue of commission payments to real estate licensees for the sale or purchase of TIC interests has been settled, licensees may want to consider acting as consultants to potential TIC investors for a fee. Although sponsors generally conduct their own due diligence on the property, experienced real estate licensees could be hired to prepare an independent due diligence report for interested or unsophisticated investors. For example, some TIC investors may need assistance in examining the financial structure of the underlying deal, the fee structure and fee amounts, the financing documents, the sponsor's track record, the management company's track record and the property appraisal.

Although many important details need to be ironed out before the role of real estate licensees in TIC transactions is set in stone, TICs have already gained tremendous momentum in the marketplace. TICA is expecting to double their annual convention attendance to more than 1,200 in 2006. It is hoped the TIC industry will continue to develop in a way that is beneficial for both real estate investors and real estate licensees.

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