“I Quit!” TICs Allow Real Estate Investors to Resign From a Management Role

Charles ‘‘Duke’’ Runnels

This article explains the tax, management, and investment benefits of Tenant-in-Common ownership.

Ten years ago, Andrew inherited a strip mall in Lincoln, Nebraska from his father. Twenty years ago, Linda and Craig began investing in small apartment properties dotting markets in the Northwest. And, eight years ago, Richard invested in a profitable commercial building in the heart of Austin’s booming business metropolis. For years each of these real estate investors have dealt with the ‘‘sweat equity’’ component of being a small owner, dealing primarily with maintenance and repair responsibilities.

Now, as these real estate investors near retirement, they seek a lifestyle of travel, time, and teeing off, rather than the three T’s of management—tenants, trash, and toilets. These individuals are tired of consuming their daily dose of aspirin as a result of the inevitable management headaches from their real estate assets. Sure, they have all made a healthy return on their investments, but they are ready to trade-in their management-intensive properties for a more subdued, hassle-free investment with an equally sound return. However, up until now these four investors have been deterred from selling their property due to one very costly consequence. See, once they sell their real estate asset, they are going to be hit with taxes (recapture, federal and state capital gains tax) that could total 30 percent to 40 percent unless they take immediate action. Thanks to tenant-in-common or TIC investments, not only do these investors defer the capital gains taxes on the sale of their property, but it also allows them to retire from their management role.

Charles ‘‘Duke’’ Runnels is President and CEO of FORT Properties, Inc., a Los Angeles-based provider of Tenant-in-Common (‘‘TIC’’) fractional ownership offerings. Mr. Runnels can be reached at drunnels@fortproperties.com.

Reasons For TIC Growth

Andrew, Linda, Craig, and Richard are part of a growing number of real estate investors who are turning to TIC investments for these reasons. And, they are just a few examples of the investor-types taking advantage of the tax, management, and investment benefits of TIC ownership. But, like these four investors, most TIC investors do possess years of real estate experience.

It is safe to say that the largest sector of investors comes from the pool of 80 million baby boomers, many who head family real estate partnerships/trusts, looking to capitalize on the equity that’s built up in their investment properties. With this investment strategy continuing to gain in popularity, industry sources predict that the total amount of TIC investments for 2005 should top $12 billion.

Why are so many individuals investing in TICs? In short, TIC investors are looking for an investment that provides stable income for retirement years and better cash flow without having to be actively involved in the

@DOMINO/VENUS/PAMPHLET02/ATTORNEY/REFJ/RUNELCPY SESS: 1 COMP: 01/09/06 PG. POS: 1

management of the property. As a TIC owner, an investor owns part of an institutional-grade property (such as a mall or large commercial building) without the day-to-day management obligations. Plus, the investors not only receive a percentage of the rental income from the property, but they take advantage of the depreciation deduction and the potential property appreciation.

One of the most attractive qualities of a TIC investment is that ownership in a TIC does not prohibit individuals from one day returning to sole ownership—it always remains an option. And, TIC ownership is flexible—it can be sold, gifted, bequeathed, or inherited.

What is more, investors do not have to sell a real estate asset to take advantage of the many benefits of TIC investing. Obviously, there are many tax advantages of being a real estate seller/exchanger, but an individual can be a direct investor as well.

Just Say No To Management . . . And Taxes!

TIC investments allows investors to comply with Internal Revenue Code (''IRC'') Section 1031, which offers an exceptional opportunity for real estate sellers to defer capital gains taxes by exchanging property for ''like-kind'' replacement property. Provisions of Section 1031 allow delayed exchanges and state that the capital gains taxes on the sale of a property can be deferred if, within 45 days of closing, a replacement property (or properties) has been identified. Section 1031 also requires that the seller close on the identified property within 180 days of the original sale. These are not guidelines; they are rules. However, in respect to the term ''like-kind'' when referring to real property it is a very broad term. In other words, the old (relinquished property) and new properties (replacement properties) do not have to be the exact same type of real estate. There are certain limits, but an investor could certainly exchange a small apartment property for a large commercial building, vacant land, or a retail center.

In most cases, when Andrew, Craig, Linda, and Richard sell their current real estate assets, they simply will not have the available capital to purchase an entire institutional quality property. However, TIC investments allow these buyers to invest in institutional-quality real estate by owning a percentage of a building or a portfolio of buildings. Generally, the minimum investment in TICs range between $100,000 and $1.5 million, with an average minimum around $500,000. Therefore, if Andrew sells his strip mall in Lincoln, Nebraska for $500,000, he could purchase a five percent interest in a $10 million property via a TIC investment. And, as a result, Andrew would be an individual deed owner with an undivided, fractional interest in a large, institutional quality, commercial property along with other investors/co-owners. Because the investors are simply deed holders of the property, TICs alleviate these individuals of the property management responsibilities. No one individual has to carry around the burden of managing the property again.

In 2004, some experts thought that perhaps the surge of TIC investors would slow due to the federal government lowering the capital gains tax from a property sale from 20 percent to 15 percent. However, when investors really take a look at the other taxes assessed when selling—such as recapture tax and state income tax and phase-out of other deductions—the total tax most pay may be closer to 25 percent to 30 percent. The 5 percent reduction on the capital gains tax is not significant enough to cause people to want to sell now and pay the taxes. Plus, the expanding 1031 exchange market has more than offset any drop-off from those investors who cash out of the market as a result of the lower federal capital gains rate. Additionally, if investors opt to sell and pay the capital gains, they could be facing the Alternative Minimum Tax, and no one can predict the ramifications that will have on the bottom line from a personal tax perspective. Therefore, 1031 exchanges, and specifically, TIC investments as a means to fulfill the 1031 exchange will continue to grow in popularity.

Choosing A TIC Investment Property

While certain properties are definitely hot right now for 1031 exchanges, as always, wise investment decisions must coincide with investors' goals and objectives. If, for example, the investors are mature individuals who have experienced a run up in value of their investments and are looking for investments with secure cash flow and minimal management, they might choose properties with triple net leases and a single or few tenants. Such investments are less management intensive, may have a more stable cash flow, and are often seen as a secure investment option. Investors with more conservative goals are also attracted to industrial/flex or office properties with few tenants for the same reasons—a steady cash flow to supplement retirement or other income.

If, however, the investors are younger and/or more aggressive in their investment approach and willing to take on additional risk, the successful management of that risk may yield them greater growth. Because these investors have a longer investment horizon to create and build wealth, they are more likely to consider properties with higher vacancy rates, or below market leases. They may also be willing to personally take on more of the management of the properties, and might consider apartment buildings or self-storage properties, all focused on wealth creation.

@DOMINO/VENUS/PAMPHLET02/ATTORNEY/REFJ/RUNELCPY SESS: 1 COMP: 01/09/06 PG. POS: 2