

## Tenant-in-common deals exceed private REITs

Investors are clamoring for Tenant-in-Common 1031 exchange private placement deals. Part of the demand is being driven by retiring baby boomers unloading headaches associated with investment real estate and seeking to defer capital gains taxes, sponsors say.

As of May 1, "TICs," as these private placement deals are known, purchased more property this year than private Real Estate Investment Trusts (REITs)—\$1.64 billion vs. \$1.49 billion—according to Real Capital Analytics in New York. For all of 2005, TICs purchased \$6.7 billion in property. However, some observers indicate TIC purchases may be leveling off. The \$1.64 billion in purchases as of May 1 this year compares with \$1.68 billion for the same period in 2005.

Don't confuse tenant-in-common deals with REITs. Tenant-in-Common 1031 exchanges provide a way for a real estate investor to defer capital gains taxes on the sale of investment property by joining with other investors. He or she gets a deeded interest and title in the replacement property. Among IRS requirements for a 1031 exchange: An investor's replacement property must be of equal or greater value than the one sold; a seller must identify a potential exchange property within 45 days of the closing of the sale and complete the exchange for one or more properties within 180 days of that closing; and an independent third party "qualified intermediary" must prepare legal documents for the exchange and hold the money. Investors may do their own tenant-in-common 1031 exchanges. But that generally would not eliminate the headaches involved with managing an investment property.

On the other hand, by signing onto a private placement deal, a client can join with others seeking to exchange real estate and purchase a fractional interest in a potentially larger property. The sponsor does all the work.

Louis J. Rogers, president of what may be the nation's largest TIC sponsor, Triple Net Properties in Santa Ana, Calif., wonders why so many financial advisors are shunning them. While the hefty commissions often associated with these transactions might remind some advisors of the limited partnership era, there are ways to avoid them.

"It's possible for investment advisors to sell TICs net of load," Rogers notes. Not only does this present a more cost-effective deal for a client, he says, but a registered investment advisor can hold the security as a fee-generating asset under management.

"As real estate investments become more complicated, real estate investors are turning to their financial advisors," says Charles

"Duke" Runnels, president of another of the leading TIC sponsors, FORT Properties Inc. in Los Angeles. "I would suggest that 30% of our business originates through some sort of financial advisor, compared with 10% a year ago."

The tenant-in-common 1031 exchange evolved into an investment contract largely via IRS Revenue Procedure 2002-22. In March 2002, the IRS rule set 15 conditions, including a limit of 35 participants, that many believe allowed investors to buy fractional interests in a 1031 exchange. A number of companies, many already involved in real estate, immediately began sponsoring TIC private placement deals. Investors now can sell investment properties to whomever they want and buy into a private placement deal. The sponsor arranges the new purchase, and often the subsequent management, of the replacement property.

But not all advisors see TICs as trouble-free. Ed Santos, a CFP and an enrolled agent in Davie, Fla., says TICs are significantly less liquid than traditional real estate. You often need permission of others to buy and sell. Buyers of a TIC, if deemed an investment contract, generally must meet regulatory standards of "accredited investors," limiting the market of potential buyers.

Also, NASD Member Notice 05-18 reiterates that most TICs are subject to a prohibition on general solicitations. "They (potential buyers of TICs) need to have the same goals you had when you originally purchased this, which is limiting the numbers of people dramatically," Santos says.

Other major issues concerning TICs: These deals are new, so few programs have matured, and performance is questionable.

There are a number of grey regulatory areas. Chief among these: Whether a TIC is a real estate transaction or a securities deal. A National Association of Realtors publication says it largely depends on how active investors are in managing the property and the extent to which the sponsor retains an interest.

The NASD says "TIC interests are generally investment contracts." According to the 350-member Tenant-in-Common Association in Sacramento, Calif., 90% to 95% are structured as securities deals. The NASD warns that if they're securities, those who sell them must have at least a Series 7 or Series 22 license. Also, members must comply with NASD rules on suitability, due diligence, splitting of commissions with unregistered individuals or firms, supervision and recordkeeping. Advisors selling them may also need state real estate licenses.

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In April, the NASD said it fined Rance King Securities Corp., in Long Beach, Calif., \$10,000 in conjunction with \$294,000 in commissions paid in tenant-in-common transactions to real estate brokers not registered with NASD.

TICs also come with major tax questions. Gary Gorman, a qualified intermediary whose company, 1031 Exchange Experts LLC, in Greenwood Village, Colo., advises on 1031 exchanges, cites a scary rumor. The IRS, he says, may take another look at TICs due to their growth. Meanwhile, he says, it's possible that only a couple of sponsors bothered to obtain the IRS' blessing for them.

IRS spokesman Michael L. Dobzinski confirms that Revenue Procedure 2002-22 "does not address specifically whether a transaction qualifies as a 1031 exchange." It "specifies the conditions under which the (IRS) will consider a request for a ruling that an undivided fractional interest in rental real estate property ... is not an interest in a business entity."

Dobzinski also says, "Only two private letter rulings issued under Revenue Procedure 2002-22 have been made public so far. The rulings don't specifically "sanction" any TIC section 1031 exchanges, he says. Rather, they rule that the subject TIC interests "are not interests in an entity" that would be "ineligible" for a 1031 exchange."

"We continue to keep an eye on the practices of sponsors of TIC interests in real property," Dobzinski says.

"In the TIC industry, there are "big dogs," those who do high-visibility TIC transactions and have a lot to lose if they screw up," Gorman says. They likely are a significantly safer bet for clients who do one deal. "Those, he says, are companies like Triple Net Properties LLC; FORT Properties; FOR 1031, part of Spectrus Real Estate Group in Boise, Idaho; and SCI Real Estate Investments in Los Angeles."

Yet Gorman estimates "the little people" are doing 70% to 80% of the individual transactions. He suggests that advisors be wary of their representations, including rates of return or appreciation rates.

One TIC Gorman says he examined for a client involved an office building fully occupied with cream-of-the-crop government tenants. It promoted extremely attractive returns. "But this project was coming out in 2004, and the longest lease expired in 2007 or 2008. So the sponsor was making all these projections based on the fact that the tenants would renew, and they would renew at increased rental rates, when the market didn't support that. The fact that you're going to have a whole building potentially empty in just a few years to me was a high risk."

Today, he says, he is hearing from commercial real estate agents nationwide that "there's no good product out there to sell," Gorman says. "I hear that complaint everywhere I go in the United States, and then I turn around and every TIC sponsor I turn to has property that is totally pristine—with no warts. If a property is such a good deal, why hasn't some Warren Buffett type scarfed it up?"

Gorman says he knows of no deal yet that has imploded or is ugly. But he suggests that financial advisors question due diligence and do their own investigation on behalf of clients. He suggests examining the engineer's reports about the structure of the building; determining whether it has been maintained by the previous owner; whether it needs a new roof; how long tenants have been leasing and whether they pay their rent on time. Also, examine the area's crime rate and whether a property is well-lit, he suggests.

"There's no body of law that deals with TIC syndications," acknowledges Tim Egan, executive director for the Tenant-in-Common Association, "except for the (IRS) revenue procedure. No action letters (concerning commission splits for real estate brokers) have been submitted to the SEC to request guidance." No response from the SEC, as of this writing.

Egan, who had just talked with an angry investor whose advisor failed to prequalify him for a TIC deal, says TIC approvals may be required not only by the sponsor but also by the lender. Any delays, he warns, may jeopardize a client's ability to do a 1031 exchange due to the IRS' 45-day/180-day ticking clock.

Steven Crawford, a fee-based advisor and president of The Main Street Group in Richmond, Va., learned a hard lesson from a client who refused to let him get involved in a 1031 exchange. Instead, the client hired an expensive lawyer as a qualified intermediary. Bad move! For one thing, lawyers often can't be qualified intermediaries.

"The client's attorney can't serve as a QI (qualified intermediary) if there's been an attorney-client relationship over the preceding two years, nor can the client's CPA if he or she has prepared the client's tax return within the last two years," says the National Association of Realtors. "A real estate licensee representing any party in the exchange is also excluded because of the agency relationship. To further confuse matters, there are no statutory requirements as to what constitutes a QI or the qualifications for becoming one."

Plus, Crawford says, the investor made the fatal mistake of taking a loan against equity to buy something else and then paying that debt off. The payoff violated IRS rules surrounding the exchanging of "like-kind" property. The ultimate cost to the investor: \$180,000 in capital gains taxes.

"For those it is right for, it's phenomenal," Crawford says of tenant-in-common 1031 exchanges. They've helped his clients earn income from land or property that otherwise would be doing nothing. They also have proven very attractive for clients who no longer wanted the traditional day-to-day hassle of owning real estate.

Crawford adds it benefits CPAs he works with to have at least one TIC identified as a fail-safe option in the event another property targeted by a client for a 1031 exchange falls through.

Without backup, a 1031 exchange deal blow-up could trigger capital gains taxes. Commissions are necessary, Crawford believes, because of the amount of work involved. Even though his broker-dealer, Linsco/Private Ledger of San Diego, handles due diligence and picks the TIC deals, he has had to go so far as to fly a client to see the property. The good news: Although a client's \$1-million investment may be worth just \$875,000, due to his commission, the investor gets a rate of return on the whole \$1 million. "The IRS isn't going to pay you 6% on the tax!"

"This is not like selling a mutual fund," Crawford says, after having done some 20 TIC deals within the last two years. "If an investment doesn't do as good as you had hoped, you can go somewhere else. When you have one of these, you're in the game. You can't get out for a long time because it takes a majority of owners to vote to sell the property."

*Gail Liberman, who has Florida real estate and mortgage broker licenses, is coauthor of several books, including Rags to Retirement (Alpha Books).*

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