

Special Report

Tenancy In Common (TIC): A Security or a Real Estate Transaction?

By Dr. Mark Levine

If you're involved in a TIC investment, the issues surrounding TICs as 1031 exchanges are probably on your radar. While the TIC industry is a small part of the 1031 market, it is growing rapidly.

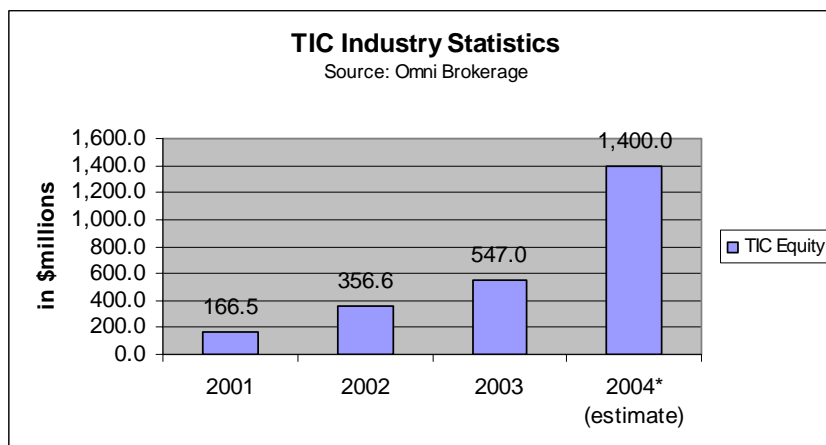
The National Association of Securities Dealers (NASD), the National Association of Realtors (NAR), the Securities Exchange Commission (SEC), the American Bar Association, Tax Section (ABA) and many other groups related to exchange are very concerned that if a TIC is held to be a partnership and/or a security, it will possibly disqualify the use of the TIC under Code Section 1031. The disqualification would require all such TIC transactions/securities to use securities brokers/dealers, not real estate brokers.

What Is The Conflict?

Currently, TICs are brokered as both a securities transaction and a real estate transaction. The "grey zone" between when TIC transactions may be brokered as real estate and when TIC transactions must be brokered as a security is the issue. NAR has member firms that broker TIC deals that are within the grey zone. Those deals typically involve sponsors managing master leases, triple net leases (NNN) or other structures and where a disparate group of investors are expected to play a largely passive role. Those on the securities side believe that these TIC transactions, because the investor is passive and appears to derive income from the efforts of others, must be brokered as securities. When TIC transactions are brokered as securities, due to SEC rules, Realtors® are unable to derive compensation for their role in the transaction. This conflicts with state laws that require the real estate aspects of the transaction to be brokered by a real estate licensee.

Tenancy In Common

Tenancy In Common (TIC) refers to a fractional interest or co-ownership in real estate. The ownership structure, in 2002, qualified as a valid option for 1031 tax deferred exchange purposes. Since 2002, the TIC industry has grown exponentially. Between 2001 and 2004, TIC transaction volume increased 10-fold. Industry sources indicate that Revenue Procedure 2002-22, which established the parameters by which TICs could be done as 1031 exchanges, prompted the rapid growth in the industry.



The use of ownership interests held via what is labeled as tenants in common is not new in the law. Anytime one person owns property with another person, there needs to be an assessment of how the ownership interests on a combined basis are treated. In general, using an entity to hold title, such as through a corporation, partnership, limited liability company or otherwise was and is quite common. However, the issue of whether such a tenancy in common structure constitutes “qualified property” under Internal Revenue Code Section 1031 (i.e., not treated as a security) has not been clearly addressed by the courts, Congress, the Treasury and many other bodies that might impact such transactions.

What Is A Security?

The definition of a "security" is very broad under the Securities Act. One of the terms utilized in the Securities Act is an investment contract. An investment contract has been held to include, in essence, a three-part definition, although some might break this definition apart somewhat differently. Generally, the three parts are:

1. There is an investment of money or other property;
2. The investment in the common enterprise is made with the intent to use the expertise of someone other than the investor; and
3. The intent is to make a profit.

What Does An Exchange of a TIC Involve?

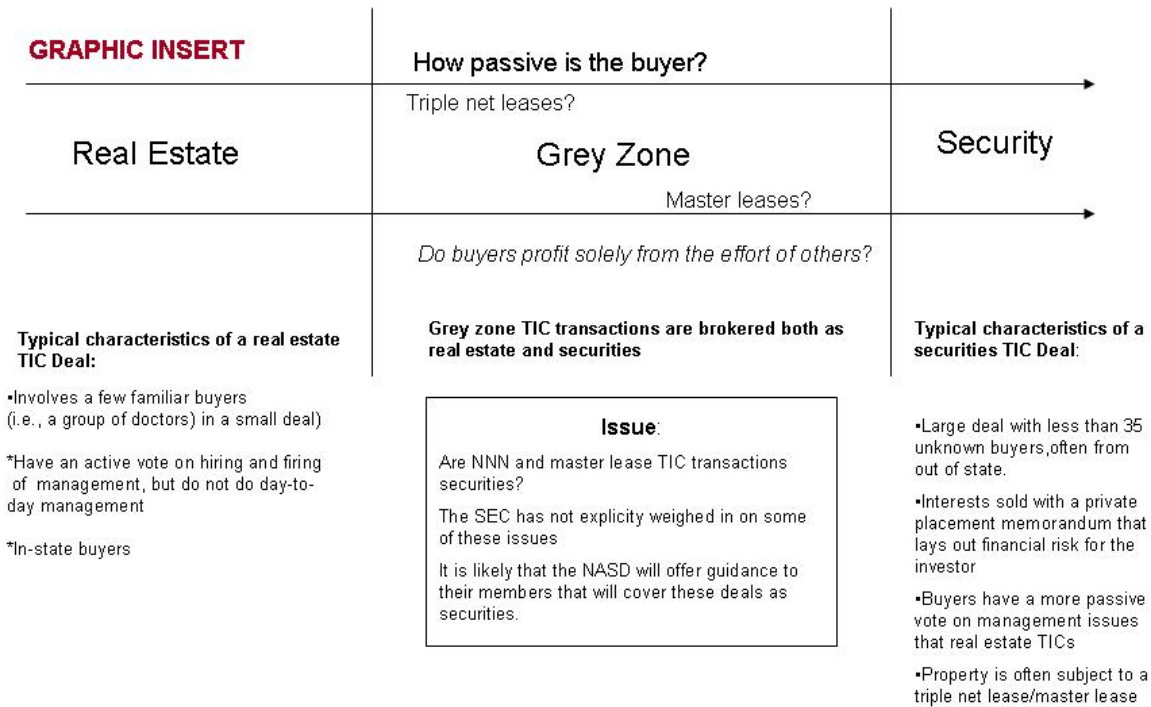
The Federal tax law that provides for deferring gain or loss on exchanges, requires that property given up by the taxpayer (“Relinquished Property”) and the property acquired by the taxpayer (“Replacement Property”) be qualified properties, within the meaning of Code 1031. In that regard, both the relinquished property and the replacement property must be property held for use in a trade or business or held for investment as provided. In addition, such properties must constitute "like-kind" properties. (Generally speaking, “like-kind property” is property which is either real estate exchanged for real estate or qualified personal property exchanged for qualified personal property.) Therefore, in many exchanges, the focal point is on whether the exchange involves any of these disqualified or excepted properties. If the TIC is a security, it is disqualified property for purposes of a tax-deferred exchange. Thus, there is conflict with regard to Code 1031 exchanges, TIC interests and security issues.

Code 1031(a)(2) specifically states that certain types of property cannot be exchanged under Code 1031 to postpone the gain or loss. Property disqualified includes:

- a. Stock in trade or other property held primarily for sale;
- b. Stocks, bonds or notes;
- c. Other securities or evidence of indebtedness or interest;
- d. Interests in a partnership
- e. Certificates of trust or beneficial interest; or
- f. Choses in action (something that can be recovered in a lawsuit)

TIC: When Is It Real Estate? When Is It a Security?

There is lack of clarity of when TIC transactions may be brokered as real estate and when they must be brokered as a security. In order for a TIC transaction to qualify for a 1031 tax deferral, according to the IRS, the investor must have a vote on the overall management of the property, but may not directly manage the property.



Because TIC is a largely un-regulated market, the National Association of Securities Dealers (NASD) has begun to take an active role in evaluating the TIC industry. NASD appears to have a broad interpretation of securities law and would likely view grey zone transactions as securities and include NNN and master lease TIC transactions. As a result, Realtors® may get shut out of these dealings. The NASD works in tandem with the SEC and will likely agree with their interpretation. There are several NAR member firms who broker NNN and master lease TIC transactions as real estate. Their businesses will be directly impacted. Current NASD rules (24-20) prohibit Realtors® from deriving income from the purchase of TIC interests when they are brokered as securities, even though state laws require real estate licensees to convey the real estate components of the transaction.

NASD is evaluating the TIC industry from the following perspectives:

- a. How are these opportunities being solicited to investors?

- b. Does the “Howey” test* impact NNN and Master Lease transactions?
- c. What is the relationship between the investors who purchase shares?

*The United States Supreme Court established in SEC vs. W.J. Howey Co., 328 U.S. 293 (1946), that the test for determining whether a particular scheme is an investment contract is whether the scheme involved an investment of money in a common enterprise with profits to come solely from the efforts of others.

The Securities and Exchange Commission (SEC) is currently evaluating a no-action request from a NAR member firm that, if acted upon, would allow real estate licensees to derive compensation for their role in TIC transactions that are brokered as securities. An SEC no-action letter would allow broker dealers and Realtors® to enter into agreements whereby they would both be able to derive compensation for the unique functions they bring to the transaction. **If the SEC issues a no-action letter, Realtors® benefit. If the SEC and the NASD take a broad securities interpretation of the grey zone, several NAR member firms lose.** However, NAR does have an opportunity to help the SEC better understand the necessary role of Realtors in TIC transactions in the grey zone.

Both the securities side and the real estate side appear to have valid and strong legal grounding for brokering TIC transactions in the grey zone. Currently, approximately 90% of TIC deals are done as securities. Mounting a challenge to the TIC securities business model may likely prompt a sector war between securities and real estate industries. Should NAR take on that legal fight? Based on their brief review of the issue, NAR’s outside counsel views grey zone TIC transactions as securities. They are likely to view this as an uphill fight. What are the ramifications if NAR is not successful? Would NAR still be able to receive favorable consideration on future no-action requests from the SEC? Would NAR bring unwarranted attention to the 1031 loophole that allowed this industry to grow? What protections to the investors do the securities rules offer the investor? Could those rules also help Realtors® manage risk?

The NASD, in March of 2005, issued guidance in its Private Placement of Tenancy In-Common Interests (the "Guidance"). They examined the position of attempting to exchange under Code 1031 a TIC interest that can clearly be defined as a security under state and federal laws. NASD noted:

“Although Code 1031 does not apply to an exchange of investment property for 'interest in a partnership,' 'stocks, bonds, notes,' or 'other securities,' the federal securities law definitions of those terms do not control interpretation of the tax laws. Accordingly, the fact that TIC interests typically are investment contracts under securities laws does not inherently disqualify them as property that may be exchanged under Code 1031 property.”

The NASD and the NAR organizations recognize that there is an overlap as to what is real estate and what is a security. But there is no clear Revenue Ruling, Revenue Procedure, Regulation, Congressional position or other authority that gives proper guidance to this issue. Until the proper treatment is resolved as to this matter of handling TIC interests, it may mean that NASD treat the TIC as a security; NAR can treat the TIC as real estate; and there is uncertainty what the IRS/Treasury and courts will say when this issue is squarely raised.

Marketability

Putting aside the legal and tax issues for the moment, the issue of the marketability of the TIC interest should be addressed. The concern in this area may focus on many factors, such as the “value” of the TIC interest and the market for subsequent dispositions of TIC ownership interests.

The utilization of a TIC for a tax-deferred exchange under Code §1031 is certainly important, especially considering that the volume involving TIC exchanges was over \$4 billion in 2005. If a TIC was not considered a safe vehicle to exchange, this would certainly damage its marketability. There are also general TIC issues regarding the opportunity and marketability of exchanging, or otherwise transferring a TIC. Although an exchange might involve a TIC, many real estate practitioners have raised the issue that it may be very difficult to *subsequently* transfer the TIC interest. Hence, there may be a question of the marketability and liquidity of that TIC interest.

Recent developments – proposed 2006 TIC legislation

REVENUE PROCEDURE 2002-22 Section 4 requires that a taxpayer meet three conditions in order for the IRS to issue a ruling:

1. Each co-owner's percentage interest in each parcel is identical to that of the other co-owner in all of the parcels;
2. Each of the co-owner's percentage interest in the parcels cannot be separated and cannot be dealt with in a trade on a separate basis; and
3. The parcels must be viewed as a single business unit.

REVENUE PROCEDURE 2002-22 Section 6 lists 15 specific conditions that a taxpayer must satisfy to obtain a favorable ruling from the IRS and support the position that the property is not a partnership, and is a TIC. If these requirements are not met, the IRS will probably say that the taxpayer's interests with others are in a partnership. This would mean that the taxpayer could not do a real estate exchange.

These conditions, in summary form, are:

1. Tenancy in common ownership: TIC ownership is necessary, as opposed to an ownership in an entity that is recognized under local law, such as a partnership.
2. Number of co-owners: The number of co-owners is limited to no more than 35 persons.
3. No treatment of co-ownership as an entity: The owners cannot file a partnership, corporate return or other entity tax return.
4. Co-ownership agreement: The co-owners may enter into a limited co-ownership agreement that can run with the land, although what can be allowed under that agreement is restricted.

5. Voting: The co-owners must retain the right to approve the hiring of any manager, the sale of the property, leases of a portion or all of the property, and the creation of blanket liens. Further, where there is a sale, lease or re-lease arrangement, and certain other circumstances, unanimous approval of the co-owners is required. If the issue is outside of these areas, the approval of only greater than 50% of the undivided interests is required.
6. Restrictions on alienation: The co-owners must have the right to transfer, partition and/or encumber their interests without the agreement or approval of any person. Some restrictions limiting the right to transfer, partition or encumber the property may be allowed if it is required by the lender in customary circumstances. There may also be certain first rights of refusal.
7. Sharing proceeds and liability upon sale of property: If the property is disposed of, the debt must be paid, and the proceeds must be distributed among the co-owners.
8. Proportionate share of profits and losses: The co-owners have to share revenue from the property according to their interests in the property.
9. Proportionate share of debt: The co-owners also have to share the debt on a blanket lien.
10. Options: A co-owner may issue an option relative to purchasing the co-owner's interest. However, there are restrictions.
11. No business activities: The activity of co-owners must be limited to those customarily involving maintenance and repair work, in most instances.
12. Management and brokerage agreements: The co-owners may enter into management agreements or brokerage-type agreements, but there are restrictions as to the length of the same and other restrictions.
13. Leasing agreements: Leasing agreements must be bona fide in nature relative to tax considerations and must reflect fair value.
14. Loan agreements: The lender, with respect to debt on the property in question, cannot be a related person to any of the co-owners, the sponsor involved in the property, the manager, or any lessee of the property.
15. Payments to sponsors: Payments to any sponsor involved in helping to put the transaction together, or handling the transaction of the co-ownership interests, are restricted to payments for fees and other interests.

Conclusion

There has been a good deal of concern expressed that investors in real estate that exchange their interests for an interest in a TIC may be acting without proper and reasonable analysis. Much of their decision making seems, often, to be centered on the desire to save

taxes, with an inadequate analysis of the fundamentals of the real estate and interests that are being acquired. That is, often it appears that some TIC owners are entering the TIC with a blind eye to issues that would normally be examined when acquiring real estate. Often the investor is intently focused on avoiding tax and thus reasonably and professionally analyzing the other issues, such as valuation, due diligence, examination of the TIC setting, concern with future issues in owning the TIC and future disposition of the same are not. Saving the current tax dollar often seems to be the only objective!

Title companies, other intermediaries and others in the exchange field also might find themselves burdened with substantial exposure when disgruntled taxpayers are forced to pay tax that they thought was deferred, coupled with possible interest and penalties. Moreover, a conclusion that the TIC interest is a security would almost immediately generate a series of lawsuits against attorneys, CPAs, brokers, title companies, exchange companies and other professionals who structured such exchanges, representing, directly or indirectly, that the exchange met the requirements under Code §1031.

Possibly the SEC and the IRS might address this issue in the near future on some basis that allows taxpayers less heartache and avoids such confrontations.

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Editor's Note: This is an update on current real estate tax developments. With this in mind, readers are cautioned to confirm with their own legal and tax counsel as to the most current position in this field. This article does not give tax and legal advice on which you should rely.

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