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Federal guidelines for tenants-in-common property interests widen the gate for individuals looking to defer taxes while exchanging real estate investments

Gayle Ronan



WHEN CLIENTS OWN appreciated real estate that no longer meets their investment needs, advisers often suggest they swap the old property for more suitable real estate through a Section 1031 exchange. This allows for the deferral of taxes on any gains that are rolled into the new property.

Unfortunately, the 1031 exchange—named for the section of the tax code that permits it—doesn't serve every client's needs. Sec. 1031 imposes tight deadlines for identifying and buying replacement property, making it difficult for some investors to find a suitable substitution in time. This can lead them into a less-than-optimal purchase in order to meet the deadline.

Furthermore, Sec. 1031 requires that exchanges be made for like-kind property, and investors must exchange for real estate of equal or greater value to take full advantage of the potential tax deferral. This severely limits the options for investors looking to make a one-for-one swap—say one rental home for another. One solution, say real estate experts, is making exchanges for partial interests in properties through tenants-in-common (TIC) ownership structures.

A tenants-in-common structure is a form of joint property ownership whereby two or more individuals each own an undivided interest in the property. Tenants-in-common shares are not required to be of equal size or value, and—unlike partnership interests—they may be bought, sold, and left to heirs independently of the approval of other owners. And, also differing from partnership interests, they

are tax-advantaged to boot.

TIC structures have been used for years, but they existed in a gray area of tax law before the Internal Revenue Service issued guidelines for them in March 2002 (Revenue Procedure 2002-22). The guidelines don't provide a safe harbor

ensuring the qualification of all such programs for use in a 1031 exchange, but they do establish 15 conditions under which the IRS will consider issuing a private-letter ruling (see "A Framework for Building TIC Deals," on page 18). "The revenue procedure's true impact was legitimizing the TIC structure by acknowledging there is a proper way of structuring one," says Kevin Fitzgerald, president of U.S. Advisor, a sponsor of these investments in Napa, Calif.

With the IRS guidelines in place, tenants-in-common structures are increasingly being packaged for advisers' consumption on behalf of their clients. Though they are used for other purposes as well, about 95 percent of the arrangements function within a 1031 exchange, estimates Julianna A. Clementi, vice president with Cole Taylor Deferred Exchange, a qualified exchange intermediary affiliated with Cole Taylor Bank in Chicago. One reason they're popular for 1031 exchanges is that they come in various sizes—some as small as \$50,000 or \$100,000 increments—so investors have greater flexibility in finding appropriately valued replacement property within Sec. 1031 deadlines. To qualify for tax deferral, investors must identify replacement property within 45 days of the original sale and complete its purchase within 180 days of the

sale date. Finding a single property at the right price in a hot real estate market can be very difficult. But as more and more TIC ownership interests become available, program sponsors say, advisers and their clients will be better able to identify suitable exchange candidates, as well as backups, within the allotted time frames. Equity invested in commercial real estate using tenants-in-common is expected to exceed \$2 billion this year, double the amount invested in 2003.

The flexibility to swap a single property for a number of partial interests of various increments also makes it easier for investors to get full tax deferral. "TIC programs accommodate investors who want to match up their dollars more precisely," says Gary Ralston, retired president of Commercial Net Lease Realty in Orlando, Fla.



Liquidity in the TIC market is destined to improve with the entry of large, national property managers

Moreover, incremental shares enable your clients of moderate wealth to diversify their real estate holdings and buy shares of investment-grade properties they couldn't afford to buy outright, according to David Marcus, recently retired chief executive officer of J.P. Morgan Property Exchange in Hanover, Mass., a qualified intermediary and subsidiary of J.P. Morgan Chase. For example, a client who owns a rental home could exchange it for tenants-in-common interests in shopping centers with high-grade tenants, such as Wal-Mart Stores and Walgreens. The co-ownership may also appeal to rental property investors who have grown tired of being landlords—but not of rental income.

Granted, TICs have their drawbacks. For one thing, they're expensive. It is not uncommon for 20 to 40 percent of an investor's equity to be used to pay sponsor markups and fees, transaction costs, and broker-dealer fees. Among the conditions set forth in the IRS guidelines is that in order to qualify for tax deferral, the program cannot function as a partnership or other business entity. As a result, its operations can't be centralized. "No one sends out a K-1," says Ralston. If there are 35 TIC interests in a property, "35 people have to prepare 35 statements on the year's income and expenses." To minimize costs, as well as confusion,

Ralston advises investors to look for deals with as few moving parts as possible. In other words, keep the operations simple, and avoid multitenant leases.

Because transaction costs can punish returns, "it is important to look at the spread between the promoters' purchase price for a property and the price the investor group is paying, as well as the fees to broker-dealers," warns Michael J. Tuchman, senior partner in the tax and real estate group at Levenfeld Pearlstein, a law firm in Chicago that helps structure tenants-in-common programs. In fact, because they're so expensive, Marcus doesn't believe TIC interests are an appropriate option for investors with more than \$3 million for allocation to real estate, who can invest directly and still get diversification.

At present, investors also face a liquidity problem, muting one of these vehicles' potential advantages—tradability. Reselling activity does exist among TIC program providers and real estate professionals. "Mainly when something hot is involved, like a downtown parking garage, interests are readily resalable," says Clementi. But a secondary market has yet to fully develop.

By all accounts, however, liquidity is destined to improve. After all, the IRS issued its guidelines fairly recently,

notes Richard Lipton, a partner with the law firm of Baker & McKenzie in Chicago and a specialist in real estate taxation. And the significant increase in TIC activity has occurred since then.

The entry into the market of large, national property managers like CB Richard Ellis Investors in Los Angeles should further diminish the liquidity problem. Their programs are expected to bring greater uniformity in structure to future offerings and greater awareness to the market.

Still another disadvantage: Neither the programs nor their providers are subject to regulatory scrutiny. Experts widely agree that TICs should be regarded as securities for Securities and Exchange Commission purposes yet still qualify as real estate for tax purposes, but the question of what organization should provide oversight remains open to debate. Also, unlike real estate investment trusts, tenants-in-common interests are not analyzed by any rating agencies or tracked by research firms, notes Ralston. More recent deals are being financed through securitized and agency-rated loans, according to Tuchman, so the lenders and the agencies that rate them are conducting some analysis. "But reliance on this alone would be misplaced," Tuchman warns. After all, if the investment fails,

the lender stands ahead of investors.

That leaves the responsibility of due diligence to you, the adviser. "In the past, financial advisers really didn't have an opportunity to bring their analytical expertise to bear in the investment real estate area," says Fitzgerald. He suggests any analysis start with an assessment of the assumptions used by the program sponsor as well as consideration of the underlying expenses and fees. There's no sense in deferring taxes if the deal makes no economic sense, he adds.

Before advising any client to invest in one of these deals, make sure you have a clearly defined exit strategy. Because there is not yet an active secondary market, and because many of the deals involve long-term leases, notes Randy Blankstein, president of the Boulder Group, a TIC sponsor in Northbrook, Ill., it's crucial that you understand where the program is headed, as well as how to get out.

In addition to analyzing the investments, make sure you look for experienced, reputable sponsors, says Fitzgerald. The nascent TIC industry is fragmented and contains many novice sponsors attracted by the fees. If either the provider or the product causes you to pause, he recommends walking away. "There are just too many well-structured deals out there to take chances," he says.

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A FRAMEWORK FOR BUILDING TIC DEALS

WITH REVENUE PROCEDURE 2002-22, THE Internal Revenue Service set forth 15 guidelines under which a tenants-in-common arrangement may qualify for a private-letter ruling. Some structures that do not satisfy all 15 points will still qualify for tax deferral within a Section 1031 exchange, but a critical element of meeting the guidelines is ensuring that the TIC arrangement cannot be regarded as a partnership, according to Richard Lipton, a partner with the law firm of Baker & McKenzie in Chicago, and the individual many people credit with spurring the IRS to release its guidelines. Here are the directives as outlined by Michael J. Tuchman, senior partner at Levenfeld Pearlstein, a law firm in Chicago:

1. Co-owners must hold legal title directly. No entities, such as trusts or limited liability companies, with more than one owner are permitted.

2. All of the major decisions require unanimity.

3. Co-owners must share in all revenues and expenses in proportion to their interests.

4. Fees paid to sponsors must reflect the fair market value of the co-ownership interest and cannot be tied to income or profits generated by the property.

5. The TIC may not hold itself out as a business entity nor engage in entity-like activities, such as filing a partnership or corporate tax return.

6. The number of co-owners cannot exceed 35.

7. Co-owners may enter into a limited co-ownership agreement.

8. Each co-owner has the right to transfer, partition, or mortgage his or her undivided interest without approval of any other co-owner.

9. When a property is sold, any pro-

ceeds after debt is repaid must be distributed proportionate to the owners' interests.

10. Mortgage debt must be allocated according to owners' interests.

11. Co-owners may issue options to buy their interest (calls) at fair market value. They may not, however, acquire options to sell their interest (puts) to the program sponsor, another co-owner, lessee, lender, or other related person.

12. Co-owners must remain passive with respect to the real estate investment.

13. Any property-management and brokerage agreements must be renewed annually.

14. Leases must be true leases, with the rents reflecting the property's fair market value.

15. Mortgage lenders may not be related to any co-owner, program sponsor, lessee, or manager of the property. —GR

Make sure you also investigate any of the tenants in commercial rental property deals. Although rating agencies do not assess the individual programs, they do grade the tenants involved in the triple-net leases that are typically used in TIC deals and that require the tenants to pay all insurance, taxes, and maintenance on the property.

Perhaps most important, make sure you carefully review the legal opinion that accompanies the majority of tenants-in-common arrangements. These opinions are a professional assessment of how closely a program's structure meets the 15 guidelines established by the IRS. In the opinion, the issuing attorney states the likelihood that a program will meet with a favorable private-letter ruling, were one to be requested. "The further away from the guidelines a program is, the higher the risks, and therefore the returns, and the more cautious a buyer needs to be," says Clementi.

Because the legal opinion forms the basis of a TIC investment, the reputation of the firm issuing it is also critical. "You are buying someone's credibility," Fitzgerald says. Marcus is more blunt: "Not only do you want to see an attorney's opinion, you want to see one from a large law firm with deep pockets, since these are essentially insurance policies against an unexpected tax liability."

The opinion letter is so crucial because few sponsors

ask for a private-letter ruling—only one party has done so since the IRS released its guidelines. Asking for a ruling is a costly, time-consuming process. However, Tuchman, who helps TIC sponsors structure deals, says most follow the guidelines closely.

Keep in mind, however, that the IRS guidelines are for obtaining permission to ask for a ruling, not for ensuring a favorable one. If an opinion doesn't reflect a high likelihood of success, Lipton suggests that your client pass up the deal. Because so many programs have opinion letters predicting a low level of tax risk, investing only in higher-quality programs shouldn't be a problem, he adds.

Lastly, make sure your client is not participating in one of these deals solely for the tax breaks. "Too often, investors don't look closely at the economic returns," cautions Tuchman. He suggests you advise clients to consider all the alternatives available to them, including buying individual properties, and prepare a comparison on an after-tax basis. Advisers who do so may offer the greatest service to their clients. Remember that TICs aren't the only game in town. But given the right circumstances, they can be quite advantageous to clients seeking to shelter real estate gains.

Gayle Ronan, a private investment manager, writes frequently about financial-planning issues.