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COMMENTARY

Versatility, Speed Make Tenant-in-Common Structures Attractive

By John G. Balboni and Robert J. LeDuc

TENANT-IN-COMMON, OR TIC, STRUCTURES for real estate transactions are one of the hottest products within the real estate industry, causing nothing short of an explosion in new business activity. The driving factor behind this phenomenon is that the TIC structure uniquely serves the needs of many buyers and sellers of real estate. The demand for TIC interests is growing rapidly both nationally and locally and, while such deals are more prevalent on the West Coast, TIC structures are moving east. Fortunately, the barriers to entry with regard to selling this product are not overly burdensome, provided certain tax and securities law guidelines are kept in mind.

The origin of this product is found in the Tax Code. Specifically, in order to complete a tax-free Section 1031 exchange, suitable "replacement property" must be obtained. Recently, the Internal Revenue Service issued guidance that a properly structured TIC interest can serve as such replacement property.

The result of this guidance is that billions of dollars in TIC interests have been sold as "replacement property" to investors looking to defer gains from other real estate in Section 1031 exchanges. This "Section 1031 money" is at the heart of virtually all TIC deals. As described above, Section 1031 of the Tax Code allows a seller of realty to defer gains from the sale by completing a Section 1031 exchange, by (very generally speaking) purchasing a new property with the proceeds from the sale of currently held property.

Time plays a critical role in completing a successful Section 1031 exchange transaction. The "replacement" or new property must generally be identified within 45 days of the disposition of the original asset and, once identified, the "replacement" property must typically be purchased within 180 days of the date of the original sale. Thus, to get the benefit of Section 1031 tax deferral, real estate investors must beat the clock when trying to locate (and close on) replacement assets that make economic sense.

A TIC interest can offer a solution to both the timing challenges to complete the exchange and the need to find a suitable investment. TICs are often sold as part of a pre-packed investment and can be identified and purchased on a much faster timeline than other types of fee ownership. In addition, the value of TIC interests can generally be matched more easily to the amount of gain a seller wishes to shelter in a Section 1031 exchange.

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TIC interests are typically of a higher quality and value than the realty previously owned by the buyer, and without day-to-day management responsibilities. TIC investors, by pooling their funds with other similar investors, typically "buy up" into a better asset class than otherwise obtainable by any one of them alone. In the typical TIC arrangement, sponsors are selling undivided portions of high-quality, triple-net-leased buildings or large-scale retail or office buildings that would have formerly been out of reach to the investor. Finally, TIC interests allow geographic and business segment diversity. For example, a moderately valuable apartment building in Boston could be exchanged for TIC interests in a single-tenant Denver office building, a Los Angeles shopping mall and a Miami storage facility.

Sponsors, or the "sell-side," of such deals are positioning their assets to meet investor demand. This translates into many real estate holdings being restructured to allow for the sale of fractional interests in accordance with current tax rules. TIC sponsors are willing to adjust their traditional thinking on the sale of their assets because sellers obtain benefits in TIC deals as well. For example, TIC sponsors typically realize a higher price for their property than they would have obtained in a straight sale to a third-party buyer. The market also allows sponsors to charge fees for "arranging" the deal and any related debt financing. In appropriate cases, the sponsor will enjoy continuing fees (often related to asset and property management) from the property even though he has little or no ownership thereof, as they retain the active management functions of the asset. Last, where sponsors master-lease the entire asset from the TIC interest holders (and then lease the

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property to subtenants), the sponsor may be able to participate in the long-term income stream from the property (TIC interest holders typically benefit from a master-lease structure in that the master lessee usually guarantees a certain minimum level of rents).

Limitations and Requirements

A properly structured TIC investment (from both the buy-side and the sell-side) must conform to several technical requirements. While a comprehensive discussion regarding structuring issues is well beyond the scope of this article, potential TIC sponsors should keep the following limitations in mind:

• Owners of TIC interests will enter into a tenancy-in-common agreement governing their rights and responsibilities with respect to the property and each other. • Each holder of a TIC interest must generally hold title to the underlying realty either directly or through a "disregarded entity" such as a wholly owned limited liability company.

• There can be no more than 35 TIC interest holders, with certain exceptions for married couples and persons who inherit partial interests.

• Any debt encumbering the property must be borne proportionally by the TIC interest holders, and the profits and losses from the property must be likewise shared proportionally.

• A holder of a TIC interest may grant an option for a third party to purchase the TIC interest, but the option price must be fair-market value at the time of exercise.

• TIC interest holders must limit their activities to those customarily performed in connection with the maintenance and repair of rental real estate; development or other "active business" activities typically cannot be performed by TIC holders.

The prevailing market view is that TIC interests – even though treated for tax purposes as real estate – are a security. Therefore, the sale of TIC interests should comply with (or rely on an exemption from) applicable securities laws. These securities laws requirements include, but are not limited to, selling such interests through a broker-dealer, offering the TIC interests only to accredited investors and providing proper disclosure of the TIC investment's risks.

The TIC product offers major advantages to both property owners and prospective purchasers. While TIC deals must be structured with numerous tax and securities law guidelines in mind, these requirements have not precluded exponential growth in TIC investments and it seems likely this trend to continue, if not accelerate, in the near term. ■