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INSIDERS OUTLOOK

TIC interests: Ideal Section 1031 replacement property

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Tenant-in-common structures (TICS), are currently one of the hottest products in the real estate industry, causing an explosion in new business activity.

Driving this growth is the unique role TICS can serve for buyers and sellers of real estate.

While TIC deals are common on the west coast, TICS are just now moving east.

Fortunately, the barriers to entry in TIC deals are not burdensome, provided tax and securities guidelines are observed.

TICS are tax-driven products, fueled by taxpayers looking to defer capital gains from the sale of realty. Specifically, in order to complete a tax-free Section 1031 exchange, suitable "replacement property" must be obtained.

The IRS recently issued guidance that a properly structured TIC interest can serve as such replacement property, resulting in billions of dollars of TICS being sold.

Time plays a critical role in completing a Section 1031 exchange. 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 original sale.

Thus, to get 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 offers a solution to these timing challenges. TICS are often sold in pre-packaged deals, and can be identified and purchased more quickly than other realty.

TIC investors, by pooling their funds, usually "buy-up" into a better asset class than the property they've just sold.

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.

TICS also allow investment diversity. For example, a small warehouse in Boston could be exchanged for TIC interests in a Denver office, a Dallas mall, and a Miami storage facility.

Sponsors, or the "sell-side", of TIC deals are positioning their assets to meet investor demand. This translates into realty holdings being restructured to allow for the sale of fractional interests.

Sponsors have adjusted their traditional thinking on the sale of realty 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 related debt financing, and sponsors usually enjoy continuing income from the property through management fees.

Last, where sponsors master lease the entire asset from the TIC holders (and in turn lease the property to sub-tenants), the sponsor may be able to participate in a long-term income stream from the property (TIC holders typically benefit from such structures as the master lessee usually guarantees minimum rents).

TIC structures must comply with tax and securities requirements. While a compre-

hensive discussion regarding all structuring issues is beyond the scope of this article, potential TIC sponsors should keep the following in mind.

A tenancy-in-common agreement will govern the TIC holders' rights and responsibilities with respect to the property and each other. Each TIC holder must generally hold title to the realty directly or through a "disregarded entity" such as a wholly-owned LLC. There can generally be no more than 35 TIC holders.

Debt encumbering the property must be borne proportionally by the TIC holders, and the income from the property must also

be shared proportionally. Options may be granted on TIC interests, provided the option price is fair market value at time of exercise.

Last, TIC holders must generally limit their activities to those customarily performed by landlords; development or other "active business" activities cannot usually be performed by TIC holders.

The prevailing 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, such as selling such TIC interests through a broker-dealer, offering TIC interests only to accredited investors, and properly disclosing investment risks.

TICS offer advantages to property owners and purchasers.

While TIC deals must comply with tax and securities laws, these requirements have not stopped the exponential growth in this industry, and this trend will continue if not accelerate in the near term.

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