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TIC-TOC FOR TICS?

Is the Tenancy-in-Common Industry Safe for Investors?

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Tenancies-in-Common (TICs) continue to remain popular among real estate investors. A TIC is an undivided fractional interest in property. Investors are attracted to them because of the ability to exchange current real estate investments for a TIC interest on a tax-deferred basis as part of a §1031 exchange. With this backdrop, the TIC industry is flourishing with estimates that the industry will raise more than $40 billion by 2011. If properly structured and with the right people, acquiring a TIC interest can be a very profitable and wise investment.

However, as with all investments, not all TICs are created equal, and taxpayers should invest cautiously. Arguably, it is only a matter of time before the TIC industry undergoes a corrective adjustment from its own wrongdoings. Until then, investors can take comfort in three certainties: (i) the TIC industry is on the rise, (ii) not every TIC deal is safe for purposes of §1031 and (iii) not every TIC deal is a wise investment.

In general, taxpayers who hold real property for use in a trade or business, or for investment, may sell that property without being taxed on the gain so long as, among other requirements, within 180 days they acquire properly identified "like-kind" replacement property. Although not all real property is "like-kind," the requirements are relatively broad. Of grave importance for the TIC industry is that a TIC interest in real property may be "like-kind" to other real property.

Traps & Risks

a) Tax. A poorly structured TIC may be re-characterized by the IRS as a partnership, which would be disastrous for the investor. If re-characterized, the intended §1031 exchange would be treated as:

- a *taxable* sale of the intended "relinquished property," followed by
- an acquisition of a partnership interest.

In such a case, the taxpayer would owe tax on the gain from the sale of the intended relinquished property, plus interest and possibly penalties. More problematic, the taxpayer may be unable to pay the IRS because the cash that would be used to pay the tax may still be invested in the partnership interest.

b) Economics. Taxpayers must determine whether the economics of a TIC investment make sense independent from any intended tax savings. Taxpayers should consider:

- Is the purchase price for the TIC reasonable? Although some mark-up is expected, too much may make the investment undesirable. For example, a sponsor could (i) acquire property for $1 million, (ii) sell a 10 percent TIC interest in the property for $111,111 to nine investors, and (iii) retain a 10 percent TIC interest for itself. As a result of the mark-up the sponsor will have made its money back (9 x $111,111 = $1 million) and retain a 10 percent TIC interest for free. In addition, each investor must now wait for the market to appreciate approximately 11 percent before breaking even on its investment.
- Assuming the project is a commercial rental property, are the lease terms and tenant makeup favorable?
- If leveraged, are the loan provisions reasonable?
- What is the condition of the property and the neighborhood in which it is located?
- Are the financial projections realistic (consider the national and local economy)?
- What types of fees or charges are due to the sponsor (e.g., sponsor fee, broker fee, advisor fee, management fee)?

c) Exit Strategy. Ironically, although an exit strategy is one of the most important factors to consider in any real estate investment, for various reasons many TICs are designed without an easy exit strategy, meaning that a taxpayer may be unable to dispose of its interest when it desires.

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What to Do

Taxpayers should seek advice from counsel who continuously monitor market trends and legal developments in the TIC industry. In addition, instead of investing in a TIC as part of a §1031 exchange, taxpayers should consider cashing out of their investments for the following reasons:

- Certain TICs are aggressively structured when compared to available guidance, thereby inviting IRS scrutiny into the entire industry;
- Certain TICs, even ones that may work for purposes of §1031, are bad investments;
- The federal long-term capital gains rate, at 15 percent, is the lowest it has been in at least 25 years; and
- The real estate market is relatively strong.

An investor who is nevertheless intent on acquiring a TIC interest as part of a §1031 exchange should consider whether:

- The structure of the project is aggressive in light of available guidance;
- The sponsor obtained a tax opinion, and if so, whether the investor's tax counsel is comfortable with it; and
- The investment makes economic sense (including an exit strategy), independent from any intended tax savings.

Although certain TICs may be profitable investments, some advisors believe that it is only a matter of time before the TIC industry undergoes a corrective adjustment. In light of the above, caution may not only be the better side of valor, it may be the only thing that allows a taxpayer to ignore the incessant tic-toc countdown until the inevitable.

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