



Breaking News in the Real Estate Industry

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Capital Constraints Affect TICs

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For the first time since 2002, the tenant-in-common (TIC) industry did not reach the anticipated all time highs by year-end 2007. The industry ended the year raising \$2.7 billion in equity compared to \$3.7 billion raised in 2006.

Two factors weighed heavily: (1) inability of sponsors (i.e., TIC syndicators) to obtain favorable financing in completing acquisitions; and (2) inability of the potential TIC investor to complete a 1031 exchange (i.e., complete a capital gains tax deferred transaction) on the relinquished property—many of which are tied to the residential market in the form of rental property, and therefore subject to the volatility of the residential mortgage interest rates and perceived economic instability of the country—and invest in a TIC investment. Many sponsors sat on the sidelines as their financing continued to be re-traded time after time. At the same time, the commercial mortgage backed securities market virtually dried up overnight. A number of sponsors looked and found alternative financing sources through Fannie Mae. But, Fannie Mae restricts the number of slots in a TIC investment to ten, thus, reducing the potential number of suitable investors and increasing the minimum investment requirements.

On the positive side, participation in the apartment, hospitality and industrial TIC markets increased by 5%, 16% and 455%, respectively. Two hundred forty-seven programs closed in 2007. Texas lead with the most programs closed at 44, followed by 18 in Georgia, 14 in Ohio, 11 in California, and 10 each in Arizona, Indiana and Florida.² The TIC industry has never been restricted in growth potential due to the investors; the Baby Boomer generation is the largest, fastest maturing and wealthiest demographic in the country. These demographics, as well as the pending request from the National Association of Realtors to the Securities and Exchange Commission to allow Realtor compensation for their ability to opine on the real estate merits of TIC transactions to their clients, have increased interest from larger regional broker/dealers looking to provide TIC products to their investors.

¹Tenant-in-Common is a structure of property ownership where multiple investors pool their funds to purchase and own larger properties. A TIC owner has an undivided fractional interest in the property and share in their portion of the net income and appreciation..

²Source: TIC Talk, 1st Quarter 2008.

More than Just the Yield

TIC investments are more than the location of their real estate, the type and quality of the structure, the tenants and the quality of the income, market strength, the terms of the buy and the yields. The success of the TIC investments hinges also on the management of the investment. This is more than just the property management. It includes the financial strength and the commitment of the sponsor from the acquisition of the property through the sale of the investment to the TIC investors, and ultimately to the disposition of the investment for the TIC investors at the end of the investment cycle.

In completing their own due diligence, investors should scrutinize: the stability of the sponsor; their managerial experience; prior performance history; the company structure; their ability to address and resolve current concerns, and discover and address new issues; their transparency in conducting business; and their management of investor relations and expectations. Investors should consider visiting sponsors prior to investing as a good way to determine if the sponsor has these characteristics.

1031 Exchange Tips

Investment Considerations when Exchanging in Today's Economy

By and large, the commercial real estate market has not suffered the dramatic declines seen in the residential market and still remains a viable diversification strategy in light of today's economic trends and declining stock market. However, fear of a pending change in the political arena is motivating many investors to sell outright their long-held investment property and pay the capital gains taxes associated with the sale of these investments, than to utilize the benefits of Section 1031 of the Internal Revenue Code, which allows deferral of capital gains and recaptured depreciation taxes in like-kind exchanges.

The investment decision falls prey to a series of emotional and short-term decisions rather than analytical forethought. If investors are considering selling rather than completing a 1031 Exchange, after determining the true tax consequence but **prior to** listing and selling their investment property, investors should evaluate the following: (1) What kind of investments are available that will allow me to regain and replace the equity I would lose in paying taxes? (2) How long will it take me to recoup what I have paid in taxes? (3) What type of before- and after-tax returns must I achieve to replace what I have paid in taxes? (4) What kind of potential income have I lost by paying the taxes?

There are two components of return that most rational investors consider: capital appreciation and income. For simplicity, the discussion below focuses solely on income. Also, the goal of this discussion is to: (1) compare different investment options—pay taxes and reinvest versus conducting a 1031 Exchange utilizing a TIC investment as replacement property; and (2) highlight that portion of the income received in real estate and TICs that is sheltered from taxes in the form of depreciation, which is not available in other more traditional investments such as stocks, bonds, and mutual funds.

Let us assume Mr. John Smartinvest owns an apartment building originally purchased at \$1,000,000 and now valued at \$2,000,000. John owes \$500,000 on the apartment building, and has taken depreciation expense of \$500,000. John has been a responsible owner and has made \$25,000 of capital improvements. Upon the sale, John expects to pay \$60,000 in commissions. In this example, assume a 15% capital gains tax and a 25% recapture depreciation tax.

Based on this example, John would have a capital gain of \$1,415,000 and total taxes due of \$395,260—this includes both capital gains taxes and recaptured depreciation. If John opts to sell and pay the taxes, he would have only \$1,044,740 to reinvest, not the \$1,440,000 of gross equity (note: this includes commissions and old loan balance) available to him in a 1031 Exchange.

There is a fundamental flaw with this analysis. It attempts to compare the taxes owed versus the incremental cost of the investment above the standard purchase price. It fails to look at the risk/return tradeoff of the old investment relative to other investments that are available, for example: (1) the ability to locate a larger replacement property with better cash flows; (2) the expected cash flow of the new replacement property; and (3) the tax-sheltered cash flow from the new depreciation schedule of the replacement property.

Let's go a step further and assume that John opts to complete a 1031 Exchange and keep the same percentage leverage of 50%. He purchases a commercial TIC investment with a projected before-tax cash-on-cash return of 7%, and he falls in a 35% ordinary income tax rate.

In this scenario, John will have \$1,440,000 of gross equity after completing a 1031 Exchange to invest into a TIC investment, resulting in: (1) a before-tax cash flow of \$100,800, of which \$48,308 will be sheltered through allowable annual depreciation expense; and (2) an after-tax cash flow of \$82,428. Nice! This translates to a 5.72% **after-tax yield**.

Now let's examine if John had **NOT** completed a 1031 Exchange and paid his capital gains and recapture depreciation taxes. In this scenario, he would have \$1,044,740 to re-invest. To achieve the **same after-tax** return and cash flow on his investment as noted above, he would have to locate an investment that paid him a 7.89% after-tax yield. Or, if calculated on a **pre-tax basis**, the investment would have to provide a cash flow of \$111,277 or 10.65%. Very difficult to achieve in today's economic environment.

This analysis is useful, but remember, it does not take into consideration: (1) any capital appreciation; (2) It assumes that both TIC and non-TIC investments will meet their projected annual returns; (3) It does not take into consideration another viable option for many investors, which is a combination of the two strategies mentioned above—paying taxes on a portion of the original sales proceeds and exchanging a portion of the original sales proceeds. All investors should consult with their tax and financial advisors.

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Source: Casey Frazier, CFA, Welton Street Investments, LLC Member FINRA & SIPC

1031 Advanced Realty Exchange Services

- ⇒ One-one-one consultation with investors and their attorneys or certified public accountants regarding the 1031 Exchange process
- ⇒ Access to a team of core professionals to assist the real estate investor with their exit strategies from appreciated
- ⇒ Locate a qualified intermediary
- ⇒ Access to quality institutional-grade properties and programs nationwide
- ⇒ Work within the 1031 Exchange time limit constraints
- ⇒ Locate Replacement property to complete the 1031 Exchange
- ⇒ Obtain essential information on potential replacement properties and programs, their benefits and risks and their respective sponsors
- ⇒ Evaluate the properties' and programs' private placement memorandum (PPM) with respect to financial projections, market conditions, tenants, leases, financing, legal structure and exit strategy
- ⇒ Analyze your investment goals and the property's suitability to your financial objectives
- ⇒ Follow-up and follow through the entire direct investment or 1031 Exchange process and in arranging the necessary paperwork to complete the process

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