

# Parlay a Tenant-in-Common Investment in a 1031 Exchange

by Grisenia Matos, MBA

## Overview

Deferring real estate capital gains taxes by exchanging the appreciated real estate for another “like-kind” property requires lots of planning, consultation with tax advisors, and strict adherence to and understanding of the Internal Revenue Code (I.R.C.) Section 1031 Tax Deferred Exchange<sup>1</sup> (aka Section 1031). Yet a large number of investors never complete one successfully. Though these tax-deferred transactions have been around since 1921<sup>2</sup>, continuous legislative changes, case law, and clarifications by the Internal Revenue Service have left investors confused, and tax and legal advisors scrambling for the most recent interpretations and practicable implementation alternatives.

The confusion became more apparent in a recently released—September 2007—audit report<sup>3</sup> completed by the U. S. Treasury Inspector General on the Internal Revenue Service (IRS). The report noted that in Tax Year 2004 over 338,500 IRS Form 8824<sup>4</sup> were completed representing a doubling of the number of like-kind exchanges reported in 1998. The audit revealed that the IRS had been performing “scant oversight” on these transactions and relying primarily on the taxpayer’s voluntary compliance. In the report, the U. S. Treasury Department recommended and the IRS agreed to the complete the following action items: study the scope of “like-kind” tax-deferred transactions, increase tax payer compliance, and provide guidance.

Today, three of the most common areas of the real estate investor’s frustration and confusion—property suitability, timelines and tax consequence—in completing a “like-kind” capital gains tax-deferred transaction (aka 1031 Exchange or Exchange) may be minimized by simply parlaying a tenant-in-common (TIC) investment as part of an Exchange. It makes sense, therefore, to briefly review the beginnings of the TIC industry, some of the 1031 Exchange fundamentals and the most common Exchange pitfalls prior to discussing the risks and benefits of implementing a TIC strategy in completing an Exchange.

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<sup>1</sup> The 1954 Amendment to the Federal Tax Code changed the Section 112(b)(1) number to Section 1031 of the Internal Revenue Code and adopted the present day definition and description of a tax-deferred like-kind exchange.

<sup>2</sup> Like-Kind Exchanges were authorized by The Revenue Act of 1921 which created Section 202(c) of the Internal Revenue Code.

<sup>3</sup> Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance (Reference number: 2007-30-172), Michael R. Philips, Deputy Inspector General for Audit, September 17, 2007, Washington, DC.

<sup>4</sup> IRS Form 8824 is issued by the IRS for submission by the taxpayer completing a like-kind exchange. The form’s purpose is to report the tax consequence of a capital gains tax-deferred transaction. The form is due no later than the Federal income tax filing date and included with the tax payer’s income tax return. If the taxpayer has requested extending the tax filing date, the form is due with on or before the extension due date.

## TICs in a Nutshell

TIC is a form of ownership that evolved from British common law dating back to 1600s. Today, they are commonly known as an ownership structure where the investor owns an undivided fractional interest in a property and shares proportionately in the property's income stream, tax benefits and appreciation potential.

The TIC industry today has primarily evolved from three separate events: a Supreme Court decision, an amendment to an existing Federal act; and a regulatory clarification made by the IRS.

### *The Decision*

A controversy within the TIC industry professionals has been brewing for decades: Is a TIC sold as an investment a security and offered through securities channel, or a type of real estate property sold through the real estate channel? The controversy came to the forefront with the U. S. Supreme Court's 1946 ruling stemming from the SEC v. Howey<sup>5</sup>. Howey was a farmer from Florida who offered units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to investors.

The investor received two contracts: land sales contract that included warranty deed and a service contract for the operations of the citrus grove. Investors had a choice to participate in the service contract. Ultimately, the appellate court sided with the Securities and Exchange Commission (SEC) and determined that regardless if the respondents to the offering participated in service contract, the offering was a security because all the elements of a profit-seeking venture are present:

- a) an investment for money;
- b) in a common enterprise;
- c) with the expectation of profits; and
- d) derived solely from the efforts of others.

### *The Amendment*

Since 1933, the Securities and Exchange Act has provided for two methods of offering a security either through SEC registration, or if no registration is sought through a private placement exemption. Until 1989, the rules of placing an offering through a private placement were vague. That year, Regulation D was adopted as part of the Securities Act of 1933. Reg. D, as commonly referred to by the securities industry clarified disclosure requirements, limited

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<sup>5</sup> Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293 (1946).

advertising and marketing of private placements, set forth accredited investor criteria, limited the number of participating purchasers, limited purchasing the security for investment purposes as opposed to distribution or resale, and limited compensation to securities registered representatives.

### *The IRS Procedure*

In the mid 1990s, a real estate investor in California found a creative way to kill two birds with one stone. By exchanging his Relinquished Property (the old property owned by the taxpayer prior to completing a 1031 Exchange) into a TIC interest, he would be able to identify the Replacement Property (the newly acquired property in completing a 1031 Exchange) in a timely manner and close within the lawful Exchange time constraints.

Through 2001, investors, for the most part, avoided TIC usage in completing 1031 Exchanges, as the IRS in a wait-and-see ploy made no ruling on validity of their use as qualified property in a 1031 Exchange<sup>6</sup>. Many investors feared the IRS would ultimately disqualify any 1031 Exchange involving a TIC interest, requiring them to pay capital gains taxes and hefty penalties.

In 2002, the IRS released Internal Revenue Procedure 2002-22 (Rev. Proc. 2002-22) that identified 15 guidelines and, if met, would disqualify a Tenant-in-Common (TIC) as a partnership. Rev. Proc. 2002-22 catapulted TICs into the limelight. TICs were now considered “like-kind” property in completing a 1031 Exchange.

For the most part, TICs today are packaged by sponsors (real estate companies that acquire properties and put together the offering in the form of a security), offered through the securities broker/dealer channels, and available to investors through securities Registered Representatives affiliated with a particular broker/dealer. TICs are only available to accredited investors, as defined by Regulation D of the Securities Act of 1933.

Many industry experts are of the opinion that TICs sold through the real estate channel will cease altogether in the near future. One event that has instilled this belief occurred in 4<sup>th</sup> Quarter 2007 when on the urgings of the SEC, Spectrus Real Estate Group, one of the largest and most prolific real estate-based TIC sponsors, issued a press release that “confirmed it will voluntarily not initiate any new offerings of its tenant-in-common income-producing real estate through the real estate channel . . . until it has received further judicial or regulatory clarification.”<sup>7</sup>

For the past three years, the National Association of Realtors and SEC have been meeting to formulate an exemption that will allow Realtors to receive compensation from sponsors when

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<sup>6</sup> Revenue Procedure 2000-46: The U. S. Treasury declines to issue ruling on TICs as partnership interest.

<sup>7</sup> Idaho Real Estate, October 24, 2007.

advising their clients about investing in securitized TIC offerings. In November 2007, the NAR requested that exemption from the SEC. In turn, the SEC provided an unprecedented comment period—the second in its history—ending in December 27, 2007 regarding the exemption. Comments are expected to have an impact on the final version of the actual exemption. The SEC's final decision is anticipated late 2008. Realtor will be required to meet certain parameters, complete required documentation and work closely with the sponsor and broker/dealer community to receive the compensation.

The exemption and Spectrus' cease and desist order are expected to allow increased investor participation, but more importantly, have far reaching consequences for the industry,

### Understanding the Four Elements of a Section 1031 Exchange and Timelines

Of all the impediments a taxpayer—even the most sophisticated and knowledgeable—may encounter in completing a 1031 Exchange, locating suitable replacement property within the required lawful time constraints tops the list. Why?

Section 1031 allows 45 calendar days for an Exchanger (the taxpayer initiating the 1031 Exchange) to identify Replacement Property and 180 calendar days to complete the entire 1031 Exchange.<sup>8</sup> The 180 days includes the 45-day identification period. During these 45 days, the taxpayer must locate, conduct due diligence and properly identify the Replacement Property(ies). Due diligence may include: property inspections (such as Phase I); appraisals; review of financial documents including operating statements; reviewing zoning, property plats and surveys; conducting market and submarket analyses; consulting with tax advisors and attorneys regarding the potential replacement property; talking to lenders; etc. Property not identified by midnight of the 45<sup>th</sup> day ***may not*** be considered for the 1031 Exchange.

TICs save the investor time and upfront due diligence costs in identifying Replacement Property. The reason? They are offered only through private placement memoranda (PPM) that include abstracts regarding completed inspections, appraisals, financials, financing, asset management, property management, legal opinions as to structure, property identification and description, risk assessments, projections, background and prior performance of sponsor, and other relevant market information and documentation necessary for an investor to evaluate the investments and its suitability to the investor's goal. The prepackaging of the TIC investment and offering it by means of a PPM s allows the investor to view multiple properties and select an appropriate investment suitable to their financial needs and investment goals. No longer need the 45-day identification period be as onerous a challenge.

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<sup>8</sup> The Deficit Reduction Act of 1984 amended Section 1031 of the Internal Revenue Code by adopting the 45- and 180-day calendar rules.

By definition, Section 1031 states that “no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment, if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.” Plainly stated, a capital gains tax-deferred transaction has four elements that must be adhered to:

- a) An Exchange must involve a transfer of Real or Personal Property. (For purposes of this paper, only real property will be discussed—examples: apartment complexes or other rental property; shopping centers; industrial property; hotels; vacant land; oil and gas royalties; warehouses; and water rights.) Stocks, bonds, notes, other securities or evidence of indebtedness, or certain other assets are NOT qualified property.
- b) The property must be held for a Qualified Purpose, i.e., either as an investment, or used in a trade or business. Property intended for immediate resale and profit is DISQUALIFIED, i.e., no “flips” or “fixer-uppers” with intent to flip immediately after repairs are completed.
- c) The relinquished property must be “like-kind” with the replacement property. “Like-kind” refers to the type of property being exchanged. An investor can exchange any real estate investment for any other type of real estate investment. For example, vacant land may be exchanged for rental property. In most cases, personal residence is not “like-kind” investment property.
- d) The transaction must be an Exchange as distinguished from a sale with a new purchase. The essence of a sale and purchase of real estate is the receipt of cash for property. The essence of a 1031 Exchange is the transfer of property for property.

Three of the four elements above address the structure and type of properties that qualify as suitable replacement property. The fourth element was addressed when a Qualified Intermediary (QI) was introduced into the tax code in 1991<sup>9</sup>. A Qualified Intermediary is a person or entity that creates a safe harbor for the taxpayer by ensuring that an Exchange as opposed to a sale and purchase of real estate has transpired. The QI may not be related to the taxpayer or have had a financial relationship with them within the two years prior to the close of escrow of the Exchange. The purpose of the QI is to:

- a) control the sales proceeds—directly and indirectly—originating from the sale of the Relinquished Property and, thus, prevent constructive receipt of the proceeds by the Exchanger during the 1031 Exchange;
- b) ensure that the Exchanger adheres to the 45-day and 180-day timelines;
- c) ensure that the Replacement property(ies) have been properly identified; and
- d) complete and submit documentation to the taxpayer and IRS for any proceeds paid.

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<sup>9</sup> The Internal Revenue Code Section 1031(k)1 was modified to include the Qualified Intermediary guidelines necessary to make deferred exchanges work within the restrictions and definitions of the Internal Revenue Code.

Proper identification is crucial. For example, if raw land was identified as Replacement Property, merely identifying a street corner is insufficient. Proper identification should include a full address, ideally including the county and city, as well as a legal description. In the event the taxpayer were identifying a TIC investment, identification would include either the equity amount as well as the debt associated with the investment, or the investor's pro rata share of the entire investment. A QI should provide guidance to the taxpayer on this issue.

### More than Just the 15% Capital Gains Tax Consequence

The tax consequence of an Exchange usually is more than just the 15 percent<sup>10</sup> capital gains taxes associated with the Exchange. Investors should take into account the depreciation and depreciation recapture<sup>11</sup> issues when evaluating the various Replacement Property options available. Depreciation recapture calculations are affected by the initial depreciation methods used, the date the investment property was placed into service, the type of investment property, and the depreciation methods allowed under applicable tax laws and regulations at the time the investment property was placed into service.

Generally speaking, depreciation is recaptured at a rate of 25 percent.<sup>12</sup> Improved properties placed in service between 1981 and prior to 1986 may also be eligible for payment of the *excess* depreciation—if Accelerated Cost Recover System had been utilized by the taxpayer, the excess is the incremental amount of depreciation above the straight line that would have been used— at the ordinary income tax rate of the taxpayer (today may reach up to 35 percent) upon sale of the property.<sup>13</sup>

Additionally, the accelerated treatment of certain structures and improvements to property, such as sidewalks, driveways, fencing, parking, and landscaping, that have been depreciated over 15 years, using 150 percent declining balance method may create *excess* depreciation, which is eligible and taxed at the ordinary income tax rate of the taxpayer (today may reach up to 35 percent) upon sales of the property. Given these depreciation issues, it is not unusual for tax liabilities to range between 25 to 35 percent of the appreciated value of the asset. Depending on the taxpayer's return, the *excess* depreciation may even trip the Alternative Minimum Tax thresholds.

A couple of final comments regarding depreciation—Exchangers interested in replacing improved property with raw land as part of a 1031 Exchange should note that the 25 percent

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<sup>10</sup> Jobs and Growth Tax Relief Reconciliation Act of 2003 changes the capital gains tax rate to 15 percent for assets sold after May 5, 2003.

<sup>11</sup> Depreciation Recapture occurs when taxpayers are required to "take back" the depreciation initially deducted their real estate investment property upon sale of the investment property.

<sup>12</sup> Job and Growth Tax Relief Reconciliation Act of 2003 stated that any capital gain that was linked to depreciation recapture was taxed at a 25 percent rate.

<sup>13</sup> Internal Revenue Code Section 1245.

depreciation recapture tax liability, if any, on the improved property is NOT deferred, but due and paid on the by the tax filing date. Other sections<sup>14</sup> of the IRC affect the taxpayer's depreciation liability and their effects are beyond the scope of this paper, but should be addressed by the Exchanger prior to initiating any 1031 Exchange.

The TIC is structured as a pass-through entity. TICs are not real estate investment trusts, limited partnerships, joint ventures or other real estate programs. The taxpayer does not receive a 1099 or K1 at the end of the tax year, but instead receives an income statement and any other information requested by the taxpayer. Depreciation is calculated independently by each taxpayer. Consequently, the taxpayer may more adequately match the depreciation of the Relinquished and Replacement property, potentially lowering his/her recaptured depreciation tax liability. Keep in mind that TICs, nor any other real estate investment, will offset the *excess* depreciation tax liability, if any, in an Exchange. Ideally, taxpayers should consult their tax advisors prior to listing any property for sale.

Another item of importance is the capital gains tax charged by some States. These additional taxes may increase the tax consequence noted immediately above to up to 45%!

Boot is the receipt of non-like-kind property or money when included as part of the §1031 Exchange transaction. Boot is taxable. Boot may be in the form of cash, mortgage, excess borrowing or personal property. Borrowing more money than is necessary to close on replacement property will not result in the taxpayer receiving tax-free money from the closing. The funds from the loan are first applied toward the purchase. If the addition of exchange funds creates a surplus at the closing, all unused exchange funds will be returned to the QI, presumably to be used to acquire more replacement property. Taxpayers should keep in mind that more Replacement Property may only be purchased if the investor had originally identified the Replacement Property during the 45-day identification period permitted under Section 1031. If no additional Replacement Property had been identified, the excess Exchange funds will be considered Boot.

Cash boot may be identified as net cash received. Examples would be trading down in value of the Replacement Property relative to the Relinquished property. Mortgage boot occurs when the debt of the Replacement Property is less than the Relinquished Property. Personal property boot occurs when the Exchanger receives non-qualified property such as trucks, horses, cattle or other equipment as part of the Exchange.

Ideally, a taxpayer may avoid Boot by trading equal or up in debt and equal or up in equity. However, some taxpayers may only want to defer a portion of the capital gains tax, as they are interested in receiving cash back for other needs. The Exchange rules do not prohibit the cash back to the buyer as long as the capital gains taxes associated with the monies returned to the taxpayer are paid.

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<sup>14</sup> Internal Revenue Code Sections 1245.

TICs are a good alternative investment strategy for Exchangers interested in achieving as much capital gains tax deferral as possible. TIC properties come with pre-packaged financing and pre-determined minimum investment requirements. These afford the investor the opportunity to match their equity and debt requirements potentially avoiding Boot altogether in a 1031 Exchange. For example: an investor with \$1.7M in total Relinquished Property value with a 50% loan-to-value may invest in three TIC interest: one interest equivalent to \$100K in equity and \$300K in debt; another an all equity investment of \$400K; and the third consisting of \$350K in equity and \$550K in debt. The investor has effectively matched his equity and debt ratio, and avoided mortgage and cash Boot while simultaneously diversifying his/her portfolio in to three different properties.

### Identifying Suitable Property

Section 1031 allows the taxpayer three options<sup>15</sup> in indentifying suitable Replacement Properties:

- a) Three property rule—the Exchanger identifies up to three properties of any market value. The Exchanger need not close on all the properties identified. If, however, the Exchanger locates more than three properties, then option (b) below comes into play.
- b) The 200 percent rule—the Exchanger identifies an unlimited number of properties provided the total fair market value of all properties identified does not exceed 200 percent of the *fair market value* of the Relinquished Property. The Exchanger need not close on all the properties identified. If, however, the Exchanger identifies more than 200 percent of the total value then option (c) below comes into play.
- c) 95 percent Rule—if the Exchanger identifies properties in excess of both of the above rules, then the Exchanger must acquire 95 percent of the value of all properties identified. Failure to close on 95 percent of the value of these properties disqualifies the entire Exchange.

The identification rules were designed to allow the taxpayer the opportunity to maximize his capital gains tax deferral by identifying sufficient property in amounts that equal or exceed the equity and debt structure of his/her Relinquished Property. These multiple options allow the investor to have a “back-up” plan in the event he/she encounters difficulty in closing one of the properties identified.

TICs are effective and efficient alternative investments that allow the Exchanger optimum simultaneous use of the identification rules discussed above and the 45-day identification period by:

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<sup>15</sup> Internal Revenue Code Section 1031(k)1.

- a) increasing investment choices;
- b) permitting quicker search and identification of sufficient institutional-grade properties that include completed sponsor and broker/dealer due diligence work;
- c) allowing portfolio diversification by asset type and market; and
- d) meeting the Exchanger's Exchange objectives and financial goals.

### TIC Risks

No investment is without risk; and, TICs are no exception. As with any real estate investment, TICs may be subject to typical real estate risks. For example:

- (a) General real estate risks of investment in a project—performance is contingent upon various variables, such as population trends, local economy, supply and demand that may affect cash flow
- (b) Compliance with Americans with Disabilities Act
- (c) Occupancy levels—the PPMs include projections based on past performance and future expectations. How realistic are the projections?
- (d) Property management company—Investors should note that most TIC properties are professionally managed by regionally or nationally recognized management companies to ensure proper maintenance, reporting, smooth operations, and best possible performance.
- (e) No environmental indemnity—owners are held liable for hazardous material after purchasing the property. The PPMs do include Phase I reviews, which give the investor the opportunity to know the current condition of the property.
- (f) Ability of attracting and retaining tenants—this is a function of the competition and experience of the property manager.
- (g) Titles issues such as condemnation, easements and encroachment—title review reduces the risk of title defects.
- (h) Zoning—third party reports mitigate some of this risk by ensuring correct zoning in place.
- (i) Necessary improvements and repair—The PPMs address immediate repairs and expected repairs over the hold period. Do the reserves projected by the sponsor cover the needs set forth?

TICs are also subject to risks specific to securities investments. These include:

- (a) Tax risk—Sponsors do not guarantee that that a TIC is a 1031 eligible structure. Rev. Proc 2002-22 is not a safe harbor, but guidance, and is subject to interpretation and case law. PPMs include legal opinions as to the probability of the investment meeting the 15 items outlined in the procedure. Most TIC investments include a legal should-meet-the-guidelines opinion letter.

- (b) TIC ownership structure—in an undivided interest all TIC owners must approve major decision and leases. Ways to affect potential conflicts are usually addressed in the PPM in the form of majority vote percentages and call provision percentages. These, however, vary by sponsor.
- (c) The appraised value—the TIC offering price includes lender required reserves and fees associated with the packaging. The appraisals do help in mitigating some of this risk by validating market and acquisition price.
- (d) Risks related to private offering—there is no secondary market as the offering is a private offering.
- (e) Financing risk—leverage risk, ability to refinance at a future date, limited prepayment rights. TICs do help mitigate some of the financing risk through non-recourse loans. The non-recourse loans are subject to “bad boy” carve-outs to protect investors from each other by allowing recourse to the lender in the event of any fraudulent activity. Oftentimes, institutional quality properties coupled with sponsor experience allow for better financing terms than the investor can obtain on their own.
- (f) Potential Boot—there are two types of reserves: lender and equity. Equity reserves are taxable boot. The IRS has not provided clarity on the treatment of lender reserves, though industry professionals are of the opinion that these will not create Boot.
- (g) The project could potentially sell for less than the purchase price.
- (h) Failure to acquire the project—most sponsors have the financial backing to take down the whole project or obtain mezzanine financing in place. The smaller sponsors do not. Consequently, these sponsors may rely on simultaneous closing with the TIC owners to close the subscription. The project may fail to close or may take additional time than anticipated. The additional time may translate to additional costs and/or cause investors with Exchange money to exceed the lawful Exchange time thresholds.

### The Typical TIC Investor

TICs are not for everyone. The average TIC investor is a baby-boomer approaching retirement age; seeking passive income; wants capital preservation of their existing real estate investment; desires to regain the tax benefits (depreciation and interest expense) associated with real estate ownership; wishes to eliminate the day-to-day management burden; wants to improve the quality of the assets in his/her portfolio into an institutional-grade property; can and is willing to let go of day-to-day real estate management control and operations; understands that TICs are long term investments; and understands the risks and benefits associated with owning real estate investments and TICs.

### TIC Trends

Seventy percent of individuals owning commercial real estate as investment properties are over 50 years old and are expected to retire over the next 17 years, according to Del Webb, a company focused on active adult living. Industry experts estimate that fifty-three percent of these individuals are expected to invest in TIC properties as this population will be exploring various passive §1031 Exchange opportunities in order to preserve their wealth, reduce risk through diversification and reduce active management headaches.

As of June 2007:<sup>16</sup>

- a) 13 TIC sponsors were based in the state of Texas
  - a. 10 in Dallas
  - b. 3 in Houston.
- b) 22 TIC sponsors have done Texas deals
- c) 82 properties are located in the state of Texas
- d) Investors have invested \$743 million of equity in Texas deals.

Nationally, 312 TIC programs closed nationally in 2006.<sup>17</sup> The states with the most programs were: Texas, which lead with 55 programs; California with 24; Georgia had 21; Indiana had 18; and Arizona and North Carolina tied with 15 each. Though, the final tally for programs completed in 2007 have yet to be released, the actual number is expected to be lower than 2006. The reduction is not necessarily attributed to lack of interest by the investing public, but to the ripple effect of the 2007 subprime lending problems on the overall credit markets. Financing availability is expected to each by the end of 2<sup>nd</sup> Quarter 2008.

### Summary

Planning the Exchange of any property should NEVER be commenced without at least: (a) securing an estimated tax liability; (b) researching the market conditions, such as supply, demand, value, economic trends, financing and other variables affecting the sale of the Relinquished Property; and (c) searching for potential Replacement Properties. TIC investments mitigate some of the challenges associated with locating suitable Replacement Properties within the lawful timeframes of Section 1031. TIC investments are not without risk. General real estate risk, such as market trends, financing, and liquidity may impact operations and cash flow. TICs are only available to accredited investors. New expected growth in the TIC industry is expected to come from the wave of retiring baby boomer seeking passive income, portfolio diversification and capital preservation. Investors should consult with their tax advisors to ensure that TICs meet their overall financial goals and investment objectives.

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<sup>16</sup> Coast to Coast, TICs are Here So are We., Thompson & Knight, Attorneys and Counselors, June 7, 2006, DCC Breakfast Group.

<sup>17</sup> Omni Research and Consulting, 1<sup>st</sup> Quarter 2007.