FROM THE BULLPEN – THE EMERGENCE OF FINANCING TENANT IN COMMON (“TIC”) INTERESTS IN 1031 PROPERTY ACQUISITIONS

I. §1031 EXCHANGE – A REVIEW.

A. “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 a like kind which is to be held either for productive use in a trade or business or for investment.”[1] In plain English, you can exchange certain property for other “like-kind” property and, if done properly, you can defer the recognition of gain on the sale of one in exchange for another property of “like-kind.”

B. General Statutory Requirements.

1. Property surrendered and property received must be held either for productive use in a trade or business or for investment.

a. While the definition of what is “like-kind” for real property is broad, the definition of “like-kind” for personal property is more restrictive.

i. Improved real property can be exchanged for vacant real property.

ii. A car cannot be exchanged for a truck.

---

[1] I.R.C. §1031(a)(1)

2. As a general rule, all real property is generally like-kind to other real property. Examples:

a. A commercial building in exchange for acquisition and development subdivision lots.

b. A fee simple interest in a farmland in exchange for a leasehold interest (an interest with at least 30 or more years to run) in an improved office building.

c. A tenant-in common ("TIC") interest in real estate in exchange for an absolute fee simple interest in real estate and vice versa.

3. Not all property can qualify for non-recognition treatment under §1031.

a. Stock in trade or other property held primarily for sale (dealer property).

i. The issue of whether or not property is held as dealer property or for trade or business is a question of fact.

ii. Property that is not stock in trade may be excluded from non-recognition treatment if it is held primarily for sale even though not to customers in the ordinary course of business.

b. Stocks, bonds or notes.

c. Other securities or evidence of indebtedness or interest.

d. Interests in a partnership.

e. Certificates of trust, real estate investment trusts ("REIT") or other beneficial interests.

f. Choses in action (the contractual right to recover cash or property from another).

C. Identification of Replacement Property. There is a built in delay between the disposition of taxpayer's relinquished property and the taxpayer's acquisition of replacement property. The 45 calendar day identification period and the 180 calendar day completion period are not extended by weekends or holidays, and §1031 does not grant the IRS with the authority to extend these time limits. There are a limited number of exceptions under which the time periods may be extended.[2] The time limits are hard and fast, and if a taxpayer fails to adhere to the strict time requirements, and does not otherwise qualify for any of the exceptions described, the opportunity to be availed of the ability to defer recognition on the sale of the relinquished property will be lost.

a. The 45 day identification period.

i. A limited number of properties (not more than three) must be designated as the property to be received in the exchange within 45 days from the date the taxpayer surrenders control of the relinquished property.

---

[2] The IRS issued Rev. Proc. 2002-71 which provides for the postponement of the identification periods for taxpayers affected by a disaster (declared by the President), terrorist activity or military action. The postponement is also applicable to individuals serving in the Armed Forces or serving in support of the Armed Forces in a combat zone.

b. The 180 day completion period.

i. Replacement property must be received within 180 days of the date that the taxpayer surrenders control of the relinquished property or the date the taxpayer's income tax return is due for the year in which the relinquished property is surrendered, whichever comes first.[3]

ii. For calendar year taxpayers, any exchanges which occur on or after October 17 in any year, the filing date of the taxpayer's income tax return (April 15) would need to be extended in order to take full advantage of the 180 day replacement property period.[4]

D. Avoiding Constructive Receipt of Money or Other Property as a Result of the Deferred Exchange.

a. If a closing agent disburses the sale proceeds of the relinquished property to the taxpayer or one of its agents (which

---

[3] §7503 of the Internal Revenue Code extends the time of performance when the last day for performance falls on a Saturday, Sunday or a legal holiday. Proposed Regulations to §1031; [Prop. Reg §1.1031(a)-3(b)] state that §7503 does not apply to the dates the 45 day or 180 day periods end. The Tax Court has taken a contrary position and that in consideration of fairness and convenience, the statutory periods should be extended under those circumstances.

[4] Without the benefit of filing an extension for the filing of an individual taxpayer's Form 1040, if the relinquished property is disposed of on December 30 of any given year, the taxpayer would have only 106 days (April 15 of the following year) within which to complete the tax free exchange. A taxpayer must file Form 4868 (for individuals) on or before the normal due date of the return to obtain the automatic extension for filing. If the form is not timely or properly filed, the exchange period ends on the normal due date of the return and any replacement property obtained after the normal tax return due date will not qualify for the exchange.

include but are not limited to real estate agents, accountants and attorneys) receives possession of the sales proceeds, the sale may fail to qualify as a deferred exchange, as the taxpayer may be deemed to be in constructive receipt of the sales proceeds.

b. It is necessary to have an agreement tying the sale of the relinquished property and the acquisition of the replacement property together; such as an exchange agreement with a qualified intermediary[5] or a three party agreement between the taxpayer, buyer and seller.[6]

E. Use of Safe Harbors. The regulations regarding §1031 deferred exchanges, as promulgated by the IRS, establish four "safe harbors," and if any of the safe harbors are used, it will result in the determination that the taxpayer is not in actual or constructive receipt of the sale proceeds.[7]

a. Security or guaranty arrangements. Such arrangements are not often used when a qualified intermediary is involved in the exchange process.

b. Qualified escrow accounts[8] and qualified trusts.[9]

---

[5] This outline will generally focus on the use of a qualified intermediary for purposes of facilitating the §1031 deferred exchange.

[6] This is commonly referred to as the "Three Corner Exchange."

[7] Reg §1.1031(k)-1(g)(1).

[8] A qualified escrow account is one where the holder of the escrow is neither the taxpayer nor a disqualified person, and under which the escrow agreement establishing the account contains express limitations to the taxpayer's ability to receive, borrow, pledge or otherwise obtain the benefits of the cash held in the escrow account.

c. The use of a qualified intermediary.[10]

i. Using a qualified intermediary looks much like a standard sale transaction.[11]

ii. The intermediary must enter into the exchange agreement with the taxpayer with the required language described in the regulations.

iii. The intermediary must be assigned the transfer agreements for the relinquished property and replacement property, with written notice of the assignment to all parties to those agreements.

iv. The intermediary must hold the net sale proceeds in its account or by utilizing a qualified escrow or trust.

d. Direct deeding.

II. TENANT IN COMMON ("TIC") OWNERSHIP.

A. Real estate investors seeking to maximize returns, with the help of a qualified intermediary would dispose of relinquished property and be faced

---

[9] A qualified trust is one where the trustee is neither the taxpayer nor a disqualified person and under which the trust agreement between the taxpayer and trustee expressly limits the taxpayer's ability to receive, borrow, pledge or otherwise obtain the benefits of the cash held under trust.

[10] Utilizing the services of a qualified intermediary is the most popular safe harbor in use today for facilitating a §1031 deferred exchange.

[11] The intermediary may act as agent of the taxpayer and sign documents as an agent. Typically, the taxpayer executes all the closing documents and the deed, and the intermediary typically executes the closing statement as well as escrow closing instructions.

with the absolute need to identify suitable replacement property within the 45 calendar day identification period.

1. TIC market was originally developed as a hedge for taxpayers who had a difficult time in identifying suitable replacement property.[12]

2. TIC ownership, though once a stop-gap alternative, is evolving into a more regularly recognized investment alternative.

3. The need and desire for diversification (both geographically and by property type) of a taxpayer's real estate portfolio.

4. TIC investors can achieve relief from property management responsibilities.

B. TIC Replacement Property Offerings.

1. Institutional grade properties.

2. Properties which have a value larger than individual investors can acquire on their own.

3. Due to the high quality of the real estate and rent roll of the real estate being offered by TIC promoters, many promoters are able to secure non-recourse financing.[13]

4. The TIC promoter offers fractional TIC interests for sale to taxpayers desiring to obtain suitable replacement property. Not all of the fractional interests need be equal.[14]

---

[12] TIC promoters and sponsors have historically maintained inventories of suitable replacement property. As a result, TICs have been used as a fall-back or fail safe position by taxpayers who fear that some of the property that they may have identified as replacement property may be acquired by a third party, or may be found to be undesirable during the due diligence period.

[13] The loan to value ratio in a "typical" TIC loan is less than that one would find in a typical income producing property acquisition loan (in the range of 50% - 65%).

5. If acquiring a TIC interest as replacement property, the taxpayer should identify, in its property identification statement provided to the qualified intermediary (within the 45 calendar day identification period) the exact percentage interest to be acquired.[15]

C. Risks Related to the Acquisition of TIC Interests.

1. Non-exclusive ownership to any portion of the replacement property. Each TIC acquires an undivided tenant in common interest in the replacement property. Accordingly, TICs may experience management, operations or financing difficulties as a result of this form of ownership, and such difficulties may increase the possibility of defaults arising under the agreements binding the TICs and the replacement property.

2. TIC's are responsible for their pro rata share of future cash needed. To the extent not reserved in the lease payments received from tenants, TICs are responsible for funding their pro rata share of capital expenses and capital improvements for the replacement property.[16]

3. Certain actions by the tenants require unanimous consent. All TICs must be afforded, at a minimum, the right to approve:

a. All leases and amendments thereof;

---

[14] The growth of the TIC deferred exchange market is evidenced by the following: $355 Million was placed into TIC investments in 2002; $756 Million was invested in 2003; $1.94 Billion was invested in 2004; and for 2005 more than $4 Billion of equity is expected to be invested. Source: Glass, Gabrielle, *The Improving Stock of TICS,* Heartland Real Estate Business, Vol. 3, Issue 9, May, 2005.

[15] Failure to provide the exact percentage could result in a faulty identification.

[16] The prudent lender will require a capital improvement escrow as part of the loan relationship.

b. All financing and refinancing of the replacement property; and

c. The sale of the replacement property.

4. A TIC can be required to sell its interest against its will at a price that may be less than the value of the TIC's pro rata share of the replacement property.[17]

5. Defaults by one TIC can adversely affect the interests of other TICs.

6. TICS may be required to make additional cash contributions to cover any shortfall by a defaulting TIC.

7. Bankruptcy of or partition by a TIC may adversely affect the other TICs.

III. <u>THE TENANTS IN COMMON AGREEMENT</u>

A. As a means of acquiring and financing TIC replacement property, both the TIC promoter and the lender providing the acquisition financing will require the TICs to enter into a Tenants in Common Agreement (the "TIC Agreement"). The rights and obligations of the promoter and the TICs are governed by the TIC Agreement.

---

[17] To avoid the inequities that may arise if a TIC refuses to consent to a sale or refinance of the replacement property, or to take action to prevent or cure an event of default under secured loan documents, TICs typically enter into a "Call Agreement," and under such an agreement, when TICs owning a supermajority of the replacement property consent to a sale or refinancing or to take action to prevent or cure an event of default, the consenting TICs have the right, but not the obligation, to purchase the TIC interests of the dissenting tenants in common. The amount realized on the sale of an undivided interest in the replacement property will likely be less than the sale of the replacement property as a whole.

1. The term of the TIC Agreement is typically for a term of years (an average of 20-25 years).

2. Most TIC Agreements require the use of either a Master Lease or a Management Agreement in the use and/or operation of the replacement property.[18]

3. The TIC Agreement requires each TIC to contribute its pro rata share of all funds needed for capital expenses. Also, if there is a casualty to the replacement property and the available insurance proceeds are inadequate, the TICs are obligated to fund the cost of the capital expenses (for example, costs of roof, structure and parking lot repairs and replacements). As a result, a TIC may be required to fund more than its pro rata share of such expenses to protect its investment and, in extreme cases, could lose its entire investment in the property if the remaining TICs do not satisfy their obligations to fund such capital expenses and operating deficiencies. If any TIC fails to pay any required cash contribution, one or more of the other TICs may loan such amounts to the nonpaying TICs, in which event the nonpaying tenants in common shall be liable on a fully recourse basis to repay the amount of such loan plus interest thereon. In addition, the master lessee (under a Mater Lease) or property manager (under a Management Agreement) is authorized and directed to use future rent or cash from sale or refinancing of the replacement property or other distributions due the nonpaying TICs to pay future expenses associated with the ownership, operations and management of the replacement property and to pay the TICs entitled to be repaid the sums loaned. The remedies against a nonpaying TIC are in addition to any other remedies that may otherwise be available, including, by

[18] In nearly all instances, an affiliate of the promoter will be the master lessee under a Master Lease and the designated manager under a Management Agreement.

way of illustration but not limitation, the right to obtain a lien against the ownership interests of the nonpaying TIC to the extent allowed by law.

4. The TICs must unanimously approve the following: (i) all leases and amendments thereof; (ii) all financing and refinancing of any acquisition loan; and (iii) sale of the replacement property. All other decisions can be made by a simple majority of the TICs.

5. Acquisition of TIC interests is subject to restrictions on transferability and resale, and they may not be transferred or resold except as permitted under the Securities Act of 1933 and applicable state securities laws. In addition, any acquisition loan documents may restrict a TIC's ability to transfer its TIC interest. Subject to the securities laws and any restrictions on transfer imposed by the acquisition loan documents, generally each TIC may sell, transfer, convey, pledge, encumber or hypothecate its undivided interest in the replacement property, provided that any transferee shall take such interest subject to the TIC Agreement and the Master Lease or Management Agreement (as the case may be). Each TIC is responsible for compliance with applicable securities laws with respect to any sale of its interest in the replacement property.

6. Subject to the rights of the Master Lessee (if a Master lease is used), each TIC will be entitled, based on their respective pro rata ownership interests, to all income, expense, loss, liabilities and cash flow from the replacement property, and all cash proceeds from any sale, exchange or refinancing of the replacement property. Additionally, each TIC bears all liabilities secured by the property based on their respective interests, including, but not limited to, any amounts due from the landlord pursuant to the terms of the Master Lease (if so used) and additional amounts due subsequent to the

expiration or termination of the Master Lease related to the ownership, operation and maintenance of the Property.

7. The TICs have no right to possession of the replacement property. However, a TIC will generally have the right to file an action for partition with respect to the replacement property subject to the right of the other TICs to purchase the TIC's undivided interest at fair market value. Notwithstanding the general right of a TIC to file an action for partition, the lender's loan documents likely provide for a remedy in the event partition action is commenced.[19]

8. If any TIC files for bankruptcy, makes a transfer for the benefit of creditors or other similar action, then the other TICs have the option to purchase the bankrupt TIC's undivided interests at fair market value.[20]

9. The TIC Agreement also provides that each TIC elects to be excluded from the partnership tax provisions of the Internal Revenue Code, as it relates to the ownership of the replacement property.

B. The Call Agreement.

1. A Call Agreement provides that if a TIC does not consent to a sale or refinancing of the replacement property or to take action to prevent or cure an event of default under secured loan documents

---

[19] It is this writer's experience that certain lenders do not *per se* prohibit a TIC from filing a partition proceeding. A lender will provide in its loan documents that if a partition proceeding is commenced, and the interest of the moving TIC is not purchased within the prescribed time, or the partition proceeding is not otherwise dismissed, that the acquisition loan becomes fully recourse and all TICs then become jointly and severally liable for repayment of 100% of what was previously classified as non-recourse debt.

[20] In most circumstances, the filing of the bankruptcy action is also likely to constitute an event of default under the acquisition loan documents.

relating to the replacement property (a "Dissenting TIC"), and TICs owning a super-majority of the replacement property do consent to such a sale or refinancing or to take action to prevent or cure an event of default under secured loan documents relating to the replacement property ("Consenting TICs"), the Consenting TICs have the right, but not the obligation, to purchase any ownership interests of the TIC who does not so consent (the "Call Rights").

IV. FINANCING TIC OWNED PROPERTY.

A. Property management and control.

B. Joint and several liability of the obligation to lender.

C. Exceptions to non-recourse liability

D. Lender risks associated TIC ownership structure.

1. TIC files partition action.

2. TIC files bankruptcy to prevent foreclosure.

3. TIC owner files for bankruptcy.

4. Property management and control.

5. Unanimous approval required for a sale or re-finance of the property.

E. Taking steps to eliminate right of partition.

F. Use of management agreement

G. Use of master lease

V. FEDERAL INCOME TAX CONSEQUENCES OF TIC OWNERSHIP.

A. Status as TICs.

1. Acquisition and financing.

2. Partition right.

3. Master Lease or Management Agreement arrangement.

4. TIC Agreement.

B. Avoid identification of the TIC as the acquisition of a partnership interest.

1. Whether or not co-owners of property constitute a partnership for tax purposes depends on the facts and circumstances surrounding the arrangement and no bright-line test is available. For tax purposes, a partnership is created when persons join together their money, goods, labor or skill in order to carry on a trade or business and there is a community of interest in the profits and losses.

2. Holding oneself out as a partnership by the use of a partnership name, a joint bank account or (most importantly) the filing of a partnership tax return can, without more, cause co-owners to be characterized as a partnership for tax purposes. Such activity can be considered determinative of an intent to be a partnership. To avoid such an "intentional partnership," under a typical TIC Agreement each TIC agrees not to file a partnership income tax return or hold himself out in any manner as a partner or agent of the other TICs.

3. The §1031 Regulations provide that (in the absence of an intentional partnership described above), mere co-ownership and leasing of property do not, of themselves, constitute a partnership. According to the Regulations, whether a partnership results from a lease by co-owners depends in part on the amount of business activity conducted by the co-owners, either together or through an agent.[21]

[21] In Revenue Ruling 75-374, 1975-2, C.B. 261, two co-owners, who each owned a 50% tenant in common interest in an apartment complex, employed an agent to manage the apartments on their behalf. The agent, on behalf of the co-owners, negotiated leases, collected rent, paid property taxes,

Revenue Procedure 2002-22[22] sets forth those factors that will be considered in determining whether TICs will be treated as partners in a partnership for federal income tax purposes.

4. Even without an intentional partnership and without substantial business activity, an arrangement may be characterized as a partnership for tax purposes if co-owners give up their rights to deal separately with their undivided interests in their co-owned property.

C. Securities. §1031 expressly prohibits tax-free exchange treatment for a security. Thus, if the IRS were to classify acquired membership interests as "securities" for federal income tax purposes, they would not qualify as like-kind interests in real property and would be ineligible replacement property to complete a like-kind exchange.[23]

---

insurance premiums, repair and maintenance expenses, and provided heat, air conditioning, trash removal, unattended parking and maintenance of public areas. The IRS ruled that services rendered by the agent on behalf of the co-owners would be considered to be rendered by the co-owners themselves. Despite that, the IRS ruled that no partnership existed between the co-owners because the services that they furnished through the agent were only those that are customarily furnished in such a leasing activity.

[22] Section 6.11 of Revenue Procedure 2002-22, citing Revenue Ruling 75-374, states more specifically that the activities of co-owners, their agents or any persons related to the co-owners, with respect to rental real property must be limited to those activities "customarily performed in connection with the maintenance and repair of rental real property." If the activities of the co-owners would not result in amounts received by an organization described in Section 511(a)(2) being excluded from rent under Internal Revenue Code Section 512(b)(3)(A) and Treasury Regulations Section 1.512(b)-1(c)(5), then those activities will be treated as customary.

[23] The term "security" is not defined in §1031 or the Regulations promulgated thereunder. In addition, the term is defined differently under different sections of the Internal Revenue Code and, therefore, has a different meaning in §475 than it has in §731, §1236, or §6323(h)(4). A TIC interest in real property is not included within the definition of a security in any provision of the Internal Revenue Code. In G.C.M. 38206, the IRS concluded that warrants and calls were securities for

D. Advance Ruling Requirements. In Revenue Procedure 2002-22, the IRS issued prerequisites for obtaining an advance ruling letter that an undivided tenant in common interest will be considered a direct interest in real property.[24]

---

purposes of the like-kind exchange rules of §1031 because they were included within the definition of "security" under certain other provisions of the Internal Revenue Code. The fact that a tenant in common interest in real property is not listed as a security in any other provision of the Internal Revenue Code that defines a security suggests that the Interests would not be considered securities for purposes of the like-kind exchange rules.

[24] The prerequisites are not intended to be substantive rules and are not to be used for audit purposes but provide meaningful guidance about the IRS's reasoning in this area: (a) Tenants In Common Ownership. Each co-owner must hold title to property (directly or through a disregarded entity) as a tenant in common under local law. (b) Number of Co-Owners. The number of co-owners may not exceed 35 persons; (c) No Entity. The co-owners may not file a partnership tax return or otherwise hold themselves out as a partnership or other form of entity; (d) Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. This agreement may provide that a co-owner must offer the interest for sale to the other co-owners or the sponsor at fair market value before exercising any right of partition; (e) Voting. The co-owners must have certain voting rights. Unanimous approval of co-owners must be required for any sale, lease or re-lease of property for any negotiation or re-negotiation of indebtedness secured by the property, for the hiring of any manager, or the negotiation, extension and renewal of any management contract. Approval of more than 50% of the co-owners is sufficient for taking any other coordinated action by the co-owners; (f) Restrictions on Alienation. Each co-owner must have the right to transfer, partition, and encumber his interest in the property without the agreement or approval of any person except that restrictions required by a mortgage lender that are consistent with customary commercial lending practices are not prohibited. A co-owner who plans to exercise a partition right may be subject to a mandatory obligation to sell his interest for fair market value to the sponsor or the other co-owners before exercising such right. This right to partition, however, shall be subject to any lender restrictions, which may include a prohibition on the right to partition during the term of the loan; (g) Sharing Proceeds and Liabilities Upon Sale of Property. If the property is sold, any debt secured by the property must be satisfied and the remaining proceeds distributed to the co-owners; (h) Proportionate Sharing of Profits and Losses. Each co-owner must share in all revenue generated by the property and all costs associated with the property in proportion to his interest in the property.

VI. CONCLUSION.

A. If a TIC program complies with Revenue Procedure 2002-22, the TIC ownership of the real estate will be respected for federal income tax purposes.

B. The sale and marketing of TIC interests have passed the scrutiny of the Internal revenue Service and are no longer considered an option of last resort.

C. TIC investors may now own a portion of institutional grade real estate which would otherwise be unavailable to a taxpayer, and to participate in its appreciation without purchasing the entire parcel.

D. Due to the growing popularity of the availability of TIC interests more and more lenders are willing to structure loans to accommodate the financing of same.

Neither the other co-owners, the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the property, unless the advance is recourse and is not for a period exceeding 31 days; (i) Proportionate Sharing of Debt. The co-owners must share in any indebtedness secured by the property in proportion to their undivided interests in the property; (j) Options. A co-owner may grant the promoter or the other co-owners an option to purchase his interest provided the exercise price equals the interest's fair market value when exercised. A co-owner may not have a right to require the sponsor, a tenant, another co-owner or the lender or any person related to such parties to purchase his interest.