Considerations Within Sponsored Tenants-In-Common Like-Kind Exchange Programs

by James F. Hopson, J.D., CPA, and Patricia D. Hopson, CPA

Executive Summary

- While like-kind real estate exchanges under Internal Revenue Code Section 1031 have been around since 1921, the use of the tenants-in-common (TIC) technique for these exchanges was just approved in April 2002. This article provides guidance in selecting a TIC sponsor, but also alerts advisors and investors to problems within the industry.
- To successfully defer taxes using a like-kind exchange, the seller must identify and close on replacement property within 180 days of the sale. The seller has three options for identifying replacement property. The TIC technique makes the task of finding suitable replacement property easier.
- The tenants-in-common technique allows taxpayers to qualify for like-kind exchanges through co-ownership of property or even multiple properties. The co-ownership is typically handled through a TIC sponsor.
- Advantages of TICs include the ability to invest in institutional grade property, flexibility to invest the exact amount needed, and the ability to diversify more easily. Disadvantages include additional fees in acquiring and selling the TIC property, lack of independent control, and often restrictive financing terms.
- TIC owners usually use either a property management company or lease to the TIC sponsor under a master lease structure. Under a master lease, however, the investor's ability to recover their investment in an economic downturn is limited.
- Because of the risks involved in relying on a third party in TIC transactions, Standard & Poor's has established a ranking service of TIC sponsors.

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Since 1921, Internal Revenue Code Section 1031 and its predecessors have allowed sellers of real or personal property to reinvest their sales proceeds in like-kind property and defer the taxes on their sale. An estimated $200 billion dollars of property is exchanged each year using Section 1031 deferred techniques. But the use of the tenants-in-common (TIC) technique for real estate like-kind exchanges was just approved in April 2002 when the Internal Revenue Service issued Revenue Procedure 2002-22.

TICs create a new opportunity for investors and a new product for their financial advisors. This article provides guidance for the financial planner in helping clients select a TIC sponsor. It also suggests cautions about problems within the industry. Advantages and disadvantages of tenants-in-common ownership are presented in two sidebars. The article also discusses the role of and current issues with the use of a qualified intermediary to accommodate Section 1031 exchanges; different management structures of tenants-in-common properties; the new Standard & Poor's ranking criteria of sponsor risk; investment risk, including the risk of an undercapitalized master lessee; and how demographic variables play a role in real estate investment risk.

Section 1031 Rules

For those who are unaware of the rules to qualify under Section 1031 and the recent IRS guidelines on tenants in common, see “Using the New Tenancy-in-Common Interests in Section 1031 Real Estate Exchanges” previously published in this journal.[1] In brief, a 1031 transaction allows the seller to defer taxes on the sale of the asset if the sales proceeds are held by a qualified intermediary (see sidebar “The Qualified Intermediary Role”), replacement property is identified within 45 days of the sale, and the replacement property is closed within 180 days of the sale.

There are three options in identifying replacement property:

1. **Three-property rule.** The client may identify up to three properties as possible replacement property for the property sold without regard to their value.
2. **200 percent rule.** The client may identify an unlimited number of properties as possible replacements, so long as the combined fair market value of all properties identified does not exceed 200 percent of the value of the relinquished property.
3. **95 percent exemption.** The client can identify an unlimited number of properties as possible replacements, so long as the purchases are at least 95 percent of the aggregate value of all the properties identified.

Many clients are unaware of the benefits Section 1031 provides, but reinvesting all of their proceeds in income-producing property with before-tax dollars can significantly increase their cash flow. In the case of TIC property, sponsors are typically paying investors, depending on risk, an annual 7–10 percent cash distribution on cash invested. As additional compensation to investors on the leveraged amount invested, TIC sponsors are making the mortgage payment and paying the property taxes and the insurance premium. (Sponsors of like-kind exchange programs are paying investment advisors 8 percent commission on cash raised but not on the total investment, which may be leveraged as high as 90 percent to 95 percent.)

As many financial planners know, helping investors qualify for 1031 treatment is a challenge because locating similarly valued property and negotiating the terms of the exchange of quality investment-grade replacement property within the time restraints imposed by Section 1031 is difficult. This is where the tenants-in-common technique comes in. TIC sponsors have created a niche market to satisfy this artificial demand created by the Internal Revenue Code’s 45-day identification requirement and requirement to close the transaction within 180 days.

IRS Procedures Provide a New Like-Kind Exchange Opportunity

In April 2002, the IRS issued Revenue Procedure 2002-22 (RP 2002-22), which created a new opportunity for investors and a new product for their financial advisors. The revenue procedure allows taxpayers to qualify for like-kind exchanges by replacing the property they sold with property held as tenants-in-common. The TIC form of ownership has been around for centuries, but for most investors and financial planners the concept is new. A TIC is nothing more than co-ownership of property in which each owner is issued a deed for an undivided interest in the real property. The interests do not have to be equal, so TIC ownership provides flexibility to taxpayers looking for like-kind exchange replacement property.

Since the passage of RP 2002-22, a proliferation of TIC sponsors have emerged offering TIC interests to investors looking for quality replacement property. If the sponsor is selling property through investment advisors within the securities industry, the sponsor packages properties as securities and issues a private placement memorandum (PPM), which describes the property and addresses RP 2002-22 guidelines and discloses most aspects about the investment. Some sponsors bypass this procedure and expense, however, claiming the transaction is not a security but a real estate transaction. And some sponsors rely on the fact that many investors don’t preview the property before buying, and the property and location are subpar.

Quality sponsors provide investors a unique opportunity that was once available only to institutional investors—to buy with a minimum investment a portion of institutional-quality, investment-grade real estate (class A office buildings, apartments, retail shopping centers, or hotels). RP 2002-22 allows up to 35 TIC owners (a husband and wife are treated as one owner) in any one property, so minimum purchase requirements can be as low as $100,000 in equity. Furthermore, although the PPM may call for a higher investment, the sponsor may waive the minimum if another investor has bought a very large portion of the property. Investors also may diversify their real estate investment through multiple TIC holdings.

TIC ownership is just like any other real estate investment: investors enjoy the appreciation (or depreciation), cash flow, and annual depreciation benefits, and the property can pass to their heirs in the event of death. The properties can vary from poor investment opportunities to large institutional-quality properties, with either single or multiple tenants. The mortgages on TIC properties may be recourse or non-recourse, depending on what the sponsor has negotiated with the lender. As with any real estate investment, investors should insist that adequate liability and property insurance be carried on the property.

In addition to locating the properties, the sponsor typically negotiates the purchase of the properties and the financing, performs comprehensive due diligence on the property (including a Phase I Environmental Site Assessment) and its tenants, and usually manages or leases back the property post-closing (discussed in more detail later). As a consequence, investors spend little if any time managing their real estate holdings and more time concentrating on their business or enjoying retirement.

TIC Ownership Advantages and Disadvantages

In any investment opportunity, there are advantages and disadvantages; tenants-in-common investments are no different. There are many features to owning property as tenants in common that attract the real estate buyer, but available benefits and issues vary depending on how the particular sponsor structures its offerings. The sidebar “Advantages of TIC Ownership” lists 14 advantages of TIC ownership, while the sidebar “Disadvantages of TIC Ownership” lists 7 disadvantages investors should consider when buying TIC property.

Although financial advisors need to understand the advantages discussed in the sidebar, it is also important to give considerable weight to the disadvantages so as to not mislead the client on the risk involved in TIC offerings. Advisors should fully review the private placement memorandum so they can give their clients a full explanation of the advantages and disadvantages of the TIC investment. Financial advisors must also gain a level of comfort with the risk involved with the sponsor, the management company, and the investment and the liability issues that affect the investment, as discussed later.

Management of TIC Property

Many tenants-in-common investors are retired individuals who want to minimize their involvement in the management of income-producing real estate. There are two ways to accomplish this:

1. TIC owners use a property management company
2. TIC owners lease to the sponsor under a master lease structure

Under the property management approach, the sponsor is under contract to manage the property, usually for a fixed percentage of income, and the TIC owners are provided the benefits and risk of market fluctuations.

With the master lease structure, the lessee (typically an entity owned by the sponsor) leases the entire property under a triple-net lease from the TIC owners and is therefore responsible for the management of the property. The TIC owners are provided a fixed level of income, and some sponsors provide an escalation clause in the lease that increases the rent in later years. The lessee takes on the risk and the benefits from the market; thus, if rental rates increase, the lessee benefits—not the TIC owner. But in a down market, the lessee—not the TIC owner—suffers the loss. But investors must understand the sponsor's obligation to make lease payments is only as secure as the lease. Investors should not rely on the sponsor's financial statement unless the sponsor has guaranteed the lease payment. If the sponsor has not guaranteed the lease payment, the investor should examine the lessee's financial statement very carefully.

The triple-net master lease typically requires the lessee to pay all expenses including taxes, insurance, and maintenance and repair on the property. Some sponsors write the lease to exclude from their obligation some or all responsibility for any necessary capital expenditures, such as air conditioners, foundation, roof, and structural repairs. Financial planners should have a good understanding of all lease terms and explain the terms in detail to their client.

Where the lessee is required to totally maintain the property, there is a risk that the property will not be properly maintained and capital improvements will not be performed; therefore, some monitoring and enforcement procedures should be included in the lease. One solution is to require a monthly amount to be placed in escrow with the lender that only releases funds to pay invoices for capital repairs or improvements. Many lenders require property reserves be escrowed for vacancy, capital expenses, taxes, and insurance. The exception to this lack-of-maintenance rule is major hotel property. Major brand hotels routinely inspect the property and require scheduled property improvement programs.

Management fees need to be examined to determine if they are reasonable. This is true even if the property is master leased, because when it is time to sell, the value of the property will usually be determined on the net operating income the property produces. Excessive management fees may reduce the value of the property.

Sponsor Risk

As with any investment, there is a risk when you are relying on a third party to not only invest your money, but manage your investment. To bring some standardization to the TIC market and its sponsors, Standard & Poor's has established a procedure to evaluate sponsors and help enhance the transparency in the securitized TIC market.[2] Standard & Poor's ranks the sponsor's ability "to carry out its property and asset management and financial reporting responsibilities." The rankings are (1) very strong, (2) strong, (3) good, (4) marginal, and (5) weak. These are valid for one year and are updated semi-annually. The S&P evaluation is a three-phase process:

1. It analyzes the TIC sponsor's documentation and information.
2. It reviews the TIC sponsor's asset and property management processes and procedures.
3. It visits the sponsor's offices.

In phase one, Standard & Poor's examines not only the resumes of the sponsor's principals and key employees and the private placement memorandum, but also proformas, budgets, operating statements, monthly and quarterly property reports, and where applicable, the master lease, and compares them with expected performance.

In phase two, Standard & Poor's tries to determine the sponsor's "ability to monitor the financial status of a property and its ability to handle any unforeseen events that may arise, in order for a property to maintain or improve its cash flow." It also assesses "the regional property manager's capability to manage a property on-site or a nearby property manager, as well as the on-site or nearby property manager's capability to manage a property's day-to-day operations."

Phase three is an expected three-day visit to clarify and verify information and documentation.

Based on a scoring of the three phases, Standard & Poor's will then rank the sponsor. TIC sponsor evaluations are posted on the S&P Web site[3] in PDF format. Sponsor experience represents 50 percent of the ranking, property and asset management represents 30 percent of the ranking, and reporting and investor relations represent the last 20 percent of the ranking.

Investment Risk and Risk of Undercapitalized Master Lessee

Typically, the master lessee is a newly created LLC owned by the TIC sponsor. This provides protection to the sponsor in an economic downturn and protection to lenders if a liability issue occurs at another property leased or managed by the sponsor; but this arrangement could limit investors' ability to recover their investment. Financial advisors and investors should carefully examine the master lessee and how it is capitalized. Did the owners of the lessee contribute cash or a letter of credit or simply a promissory note that may be worthless? Does the sponsor have liability if the master lessee fails to meet its obligations under the lease? Does the sponsor have adequate financial strength to meet the lessee's obligation and protect the investor?

Investors and financial advisors need to evaluate the risk of any TIC investment, just as they would any other real estate investment, based on the qualities of the property and tenants. Items that need to be reviewed include

- Master lease terms
- Existing terms and length of underlying leases
- Quality of the tenants
- Type of construction
- Condition and age of the building and other improvements
- Past and (with caution) projected profit and loss statements
- Growth potential for the area

Finally, as with all real estate, the most important item is location, location, location, because when all is said and done, the investor owns a piece of real estate with the risk commonly associated with real estate ownership.

Demographics and Real Estate Risk

As current trends in the housing market illustrate, the value of real estate is affected by supply and demand. Demographic variables—age, race, education, and income and job market of an area—affect not only the current value and demand, but help forecast future demand. Florida is a good example of demographic change creating demand for an asset class that is in short supply. As retirees continue to move into the state, the value of real estate continues to escalate, as does the demand for adult communities and assisted living facilities.

Demand can also be created by barrier to entry into a market. For example, consider an area where all the major hotels have existing facilities for each of their flags (brands). Very seldom will they authorize any new construction of hotels carrying their brand; therefore, you have a barrier to entry of a new product in that hotel market. Also, in some areas the current cost of raw land and construction, compared with the room rate that a new hotel can charge, may create a barrier because the end product cannot create a positive cash flow.

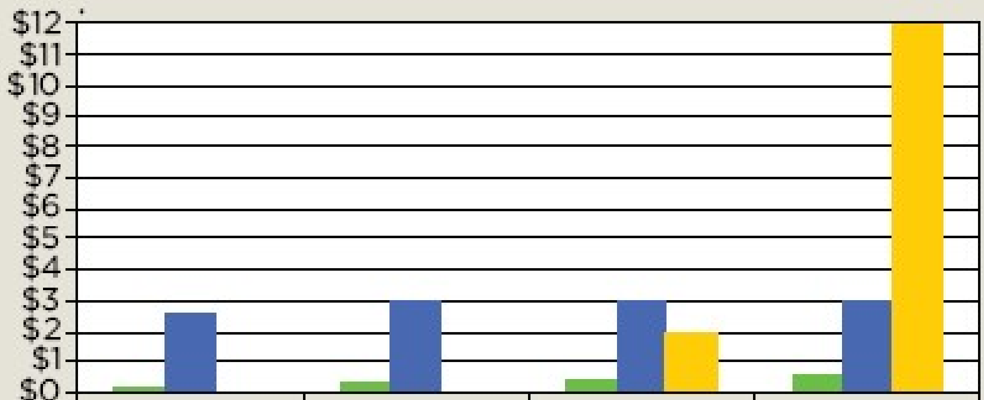
Demand is also affected by how current economic conditions affect local industry. Housing prices, office rents, and building values decline if the principal industry in the area is experiencing hard times and laying off employees. This decline in values can be softened if the area has a broad-base diversity of industries and businesses supporting the economic engine, instead of depending on one particular type of business.

Is a 1031 Transaction for Your Client?

Let's say your 66-year-old client wants to eliminate management headaches from her life and sell her existing hotel, which is making her $360,000 a year. She wants to invest in a larger property, with different demographics and geographic area. For her, a 1031 transaction may be an option. A 1031 transaction also provides an opportunity to increase her leverage while increasing her income. For example, she sells the hotel she owns and manages for $5 million, and nets $3 million. She has four options (see Figure 1):

1. An after-tax investment of $2,550,000
2. A $3 million pre-tax investment with no leverage and 10 percent earnings of $300,000
3. A 1031 exchange for a property valued at $5 million with $2 million financed
4. A 1031 exchange for a TIC interest in 15 professionally managed Marriott and Hilton hotels located in 15 different cities in 8
 different states, valued at $15 million, with $12 million financed

Figure 1: Options for Client Using a 1031 Transition



	Option 1	Option 2	Option 3	Option 4
Annual Return	$255,000	$300,000	$360,000	$660,000
Cash Investment	$2,550,000	$3,000,000	$3,000,000	$3,000,000
Leverage Amount	$0	$0	$2,000,000	$12,000,000

The cash investment yields 10 percent and all properties can be bought at a 10 percent cap rate. She can finance properties in options three and four with a 7 percent non-recourse loan. With option one, she would earn $255,000. With option two, she would earn $300,000. Using option three, she would earn 10 percent on her $3 million down payment ($300,000) and 3 percent (10 percent cap rate minus the 7 percent interest rate) on the $2 million leveraged amount ($60,000), for a total $360,000 return. Going with option four, she would earn 10 percent on her $3 million down payment ($300,000) and 3 percent (10 percent cap rate minus the 7 percent interest rate) on the $12 million leveraged amount ($360,000), for a total $660,000 return. Property values are expected to increase an average of 5 percent; therefore, she is also earning 5 percent appreciation on her leveraged investment on options three and four.

Conclusion

The like-kind exchange program offered by tenants-in-common sponsors can be more than a unique opportunity for your clients who would like to invest before-tax dollars in other income-producing properties. It also can provide investors with properties offering an excellent cash distribution and appreciation on their investment.

Consider exploring this program with clients who are planning to sell real estate in the near future, because the cash flow on pre-tax investments will generally exceed the cash flow on post-tax investments by up to 35 percent (the top federal income tax rate). In addition, TIC investments allow investors not only to diversify their real estate investment in class A office buildings, apartments, retail shopping centers, or hotels with a minimum investment, but also to diversify the locations of their real estate holdings throughout the country. Further, investors may also diversify their real estate investment in several TIC holdings, thus spreading their risk.

Endnotes

1. Clarence Rose and Douglas Brinckman, "Using the New Tenancy-in-Common Interests in Section 1031 Real Estate Exchanges," *Journal of Financial Planning* 19, 5 (May 2006): 70–80.
2. Standard & Poor's announced its "Tenant-In-Common (TIC) Sponsor Evaluation" program during the first half of 2007.
3. The sponsor evaluations can be found at Standard & Poor's Web site: http://www.standardandpoors.com. From the home page, select "Products & Services," then "Products & Services A–Z," and then "Tenant-in-Common (TIC) Sponsor Evaluation."

Sidebar:

The Qualified Intermediary Role

The qualified intermediary is an individual or entity that holds the proceeds from the sale to facilitate a 1031 exchange and provides a safe harbor under Section 1031. The Federation of Exchange Accommodators (FEA) is the only national trade organization formed to represent qualified intermediaries.[1]

There is a risk in choosing a qualified intermediary. Qualified intermediaries are not licensed by any government agency, though the state of Nevada has some regulations on qualified intermediaries, and other states are considering legislation. Because they are basically independent and unregulated, with no restrictions by the Internal Revenue Service (they use the money they hold) investors should use caution in selecting an intermediary.[2] In their written agreement with the intermediary, investors should restrict the use of the funds and where the funds can be deposited.

Currently there are two large lawsuits against qualified intermediaries—one in the amount of $95 million for misappropriation of funds from more than 130 clients, and one against a qualified intermediary who has filed for bankruptcy protection from more than 300 clients who trusted the intermediary with over $150 million.[3]

One solution to the problem is to use qualified intermediaries working for banks, title companies, and regulated publicly traded companies, and restrict their use of the funds.

Endnotes

1. The Federation of Exchange Accommodators (FEA) has over 330 members and is located in Philadelphia, Pennsylvania. If investment advisors are looking for a qualified intermediary, the FEA Web site is http://www.1031.org/member Locator/index.asp. It provides a list of qualified intermediaries by state.
2. Although limited, the FEA performs a background check on all companies except those that are subsidiaries of publicly traded companies.
3. Peter Lattman and Kemba Dunham, "Tax Strategy for Real Estate Hits Rocky Turf; 'QI' Ploy Draws Focus as Middlemen Develop Financial Difficulties," *Wall Street Journal* May 26, 2007: B.1.

Sidebar:

Advantages of TIC Ownership

1. The option to buy either newly developed property or income-stabilized property.
2. The opportunity to own part of an institutional-grade, high-value property with credit tenants located in a highly desirable location, with a minimum investment.
3. The option to participate in property that is master leased by the sponsor under a triple-net lease or property that is only managed by the sponsor.
4. The option to participate in property that is leased by tenants who are national credit tenants.
5. Investments where investors can spread their risk by diversifying by location across a wide geographical area and by property types (hotels, retail shopping centers, single or multi-tenant office buildings, and multi-family apartments), instead of buying only one replacement property in a single location.
6. Investments where the sponsor locates the property through its acquisition teams, which include experienced negotiators.
7. The option where the sponsor arranges the financing, performs due diligence and usually a Phase I Environmental Site Assessment (the sponsor's due diligence package should be examined for client suitability).
8. The flexibility to invest the exact amount of money an investor needs to reinvest.
9. Many investments are non-recourse financing with very competitive interest rates.
10. Ease in identifying replacement property, the high certainty of closing within the 180 days required under Section 1031, and the simplified closing process.
11. Professional management of the property or the master tenant has the responsibility of overseeing the property; consequently, most of the investor's management responsibility is eliminated.
12. Owners receive steady monthly revenue and the depreciation and appreciation on their percent of ownership.
13. Ownership as evidenced by a recorded deed.
14. With sponsor deals, there is a high degree of certainty that the transaction will close and the gain will be deferred.

Sidebar:

Disadvantages of TIC Ownership

1. Lack of liquidity.
2. Additional fees in acquiring real property may be 5 to 7 percent and will include marketing and due diligence, formation fees and organizational costs, and additional legal fees. (If the property is offered through a private placement memorandum, these fees are usually disclosed in "Sources and Uses of Funds" and "Compensation of Sponsor and Its Affiliates.") The difference between what a single investor could pay for the property and what all of the TIC investors are paying is a measure of the sponsor's efficiency.
3. The holding period must be long enough to cover the additional fees just to break even.
4. When exiting, the fees and cost of transferring an undivided (fractional) interest in property and assuming any existing debt may be high.
5. Financing terms may restrict investors, and the loan-to-value ratio may be very high.
6. Lack of independent control and the ability to make unilateral decisions (control is usually dictated by a co-ownership agreement).
7. Typically the property is located a substantial distance from the investor, so routine property inspection is inconvenient.