Evaluating Tenant-In-Common Interests in Real Estate

BY ALEXIS AIKEN, J.D.

ONE OF THE MOST COMMON CONCERNS U.S. INVESTORS AND their professional advisors face when structuring tax-deferred exchange transactions is the difficulty in locating, identifying and acquiring like-kind replacement properties within the unforgiving tax-deferred exchange deadlines. Because many investors wait until the closing of their property sale to start the search for properties, the tax-deferred exchange deadlines already are imminent. Investors are under the gun, and are forced to rush the search for suitable properties and shorten the due-diligence period.

Section 1031 of the Internal Revenue Code places strict time constrictions and rules on designating like-kind replacement properties. Investors typically designate no more than three replacement properties—given the difficulty making a proper identification under the rules—and because of the time limit, they typically evaluate only local or regional properties of the same asset class. Though this manner of identification could meet investors' goals, replacement properties chosen in haste are likely to have the same problems or conditions that originally motivated the investor to sell the relinquished property—inflated sales prices, poor cash flow or intensive property management requirements, for example. Often, investors ultimately face a tough choice: purchasing less-than-ideal properties to complete the tax-deferred exchange or letting the exchange fail and continuing the search for replacement properties that make sense outside 180-calendar-day deadline.

The second practical problem that arises with designating like-kind replacement properties relates to investors' ability to negotiate and close on properties they identify within the 180-calendar-day exchange period. Even where the identification process has been relatively simple—where the investors have no trouble finding properties that make economic sense within the 45-calendar-day identification period—there is no guarantee that the investors will be able to close on the properties in the time remaining.

Real estate transactions fail to close for many reasons: problems discovered during the property inspection, defects in structure, tenant issues, environmental problems and difficult third parties, to name just a few. Though these problems are difficult to redress in the context of a normal real estate closing, they can prove disastrous in the tight time frame of a tax-deferred exchange. Investors who fail to take specific steps to remediate risks to closing their identified properties

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could find themselves in a position where they are unable to close on the property within 180 days and unable to identify any other properties because the 45-day identification period has passed. Their tax-deferred exchange transaction then would be doomed to fail.

To avoid this scenario, investors must reorient themselves to think of identifying replacement properties as a strategic process. Rather than submitting their identification based on a preliminary assessment of potential properties, investors should identify only properties for which they have considered whether they can conduct due diligence in a timely manner, whether the property makes economic sense and whether the transaction has any inherent risks that might prevent closing within the deadline.

These considerations mean investors should start doing due diligence on potential properties very early in the exchange period. Accordingly, investor would have the additional benefit of being able to begin trying to acquire one or more replacement properties during the first 45 days, allowing them to revoke the identification and re-identify additional properties if a contingency were to occur.

LACK OF SUITABLE PROPERTIES LEADS TO TIC INTERESTS

Pursuing a tax-deferred exchange and using a strategic process for identifying replacement property does make one large assumption: that properties meeting investors' particular needs are, in fact, available. However, it is not uncommon for properties on the market to pose a risk to investors in one capacity or another, or to simply not be economically feasible.

In response to this lack of suitable replacement properties, for tax-deferred exchanges and real estate investors in general, an industry has sprung up to develop and offer syndicated property interests as alternative investment vehicles. These fractional ownership arrangements have names such as co-ownership in real estate, or CORE—or more commonly, tenant-in-common, or TIC—interests. Investors should carefully consider and evaluate the merits of these opportunities instead of rushing into an acquisition that does not ultimately make economic sense.

TIC interests in real estate were introduced when real estate entrepreneurs who understood the advantages of owning syndicated property interests in the form of triple-net-leased properties recognized that the size of the properties and the liquidity required to get into triple-net-leased property precluded most investors from participating. So they set out to develop a way to make these interests more marketable. These entrepreneurs began individually arranging financing for and purchasing large properties with triple-net leases to large, credit-worthy tenants and dividing the properties into smaller deeded units, referred to as tenant-in-common interests. These smaller deeded interests are then available for direct purchase to investors through private placement offerings and, since the issuance of revenue procedure 2002-22 in 2002, have been expressly declared valid as like-kind replacement properties for investors in tax-deferred exchange transactions.

Simply stated, TIC interests allow investors to acquire, together with other investors, a percentage or fractional interest of a larger, institutional-quality property that is potentially more stable, secure and profitable than what they otherwise could have acquired alone within the exchange deadlines.

TIC properties—because of how they are packaged, distributed and sold—can provide an alternative to investors struggling with tax-deferred exchange timing requirements. Simply stated, TIC interests allow investors to acquire, together with other investors, a percentage or fractional interest of a larger, institutional-quality property that is potentially more stable, secure and profitable than what they otherwise could have acquired alone within the exchange deadlines.

The interests are, in essence, prepackaged investment properties; the purchase/sale agreement and financing already is negotiated and set in place. In addition, investors can

acquire TIC ownership interests in a number of different properties to improve diversification and investment portfolio quality. TIC interests also allow investors to purchase an interest or value in the exact amount necessary to satisfy tax-deferred exchange requirements.

Investors can work with professionals in the syndicated TIC investment arena to ascertain which opportunities are suitable for them. Syndicators, or TIC sponsors, are responsible for locating, evaluating, financing and acquiring TIC properties. Once arrangements to acquire or actual acquisition of the property occurs, the property is ready to take to market. From that point, TIC brokers market the TIC interests in the same manner as other regulated securities. TIC brokers, who typically work with numerous TIC sponsors, can help investors evaluate various investment options and offer advice as to whether a TIC ownership interest is right for a given portfolio.

TIC STRUCTURES TYPICALLY COMPLY WITH FEDERAL REGULATIONS

Putting together a syndicated TIC offering begins with a sponsor, usually a large real estate investment company, using their commercial contacts across the United States to identify properties likely to have good cash-flow potential and that are priced under market value. After identifying a property, the TIC sponsor's acquisition team begins the due diligence process, verifying the representations and projections and justifying the initial assessment of the property's value. When the acquisition team is satisfied that the project is a good acquisition, the sponsor then purchases the property, arranging the purchase/sale agreement and the financing of the property through an institutional lender.

The syndication of the property into TIC investments begins at this point. The sponsor announces the property's availability to a network of brokers who, in turn, analyze the investment to determine whether it's appropriate for their clients. TIC investments that could be characterized as a security under the Securities Act of 1933 and the Securities Exchange Act of 1934 come to market as what are called Regulation D offerings. This procedure allows an exemption to the registration requirements of the Securities Act of 1933, but also means that only people who meet the accredited investors standard as defined by securities regulations are eligible to invest.

When a prospective investor expresses interest in buying into a particular TIC property, either as a direct purchase or as part of a 1031 tax-deferred exchange, the broker sits down with the investor and his real estate professionals and goes through the private placement memorandum, or PPM, which contains all the information rendered from the sponsor's due diligence process and all disclosures related to the property. The broker and investor decide whether the investment is suitable and, if so, the broker calculates the percentage of the property the investor's purchase money or equity will buy. The investor then acquires that percentage of the property and debt, as outlined in the sponsor's offering.

One of the additional restrictions placed on the sale of many securitized TIC investments by their structure as Regulation D offerings is that the structure brings U.S. Securities and Exchange Commission rules 505 and 506 and 506 into play, which create a prohibition on general solicitation. This restriction is no doubt the most frustrating consequence for many brokers because it prevents them and any person acting on their behalf from announcing the TIC interests in a general solicitation or general advertisement, which includes discussing names and details of specific offerings in publications or at seminars where attendees are invited by general solicitation or advertisement.

A critical factor for determining whether a communication is appropriately limited, so as not to be deemed a general solicitation, is the existence of a substantial pre-existing relationship between the broker and a potential TIC investor. When a broker can substantiate an adequate pre-existing relationship, it is presumed that he will be able to evaluate the investor's level of sophistication and financial circumstances, and make an informed recommendation about whether a TIC investment would be appropriate.

Though Regulation D offerings permit up to 35 investors in any single TIC property transaction, the number of offerings in a particular TIC interest frequently is smaller because the TIC sponsor or lender may want to minimize the number of investors in a particular property to simplify management. In reality, the final decision about the

number of investors suitable for a particular investment lies with the lender.

USE STRATEGY WHEN REVIEWING TIC AGREEMENTS

Individual investors—whatever number have purchased an interest in the particular TIC property—execute and are governed by a Tenant-In-Common Agreement, which enumerates the conditions and management requirements of the TIC property, and the rights and obligations of each individual investor. It is crucial that investors understand the TIC agreement, and can differentiate between what are standard requirements in TIC agreements and what are extraordinary provisions that may later prove problematic.

Special-Purpose, Single-Member Limited Liability Company

Individual investors are required to acquire TIC interests through designated special-purpose entities. These SPEs usually are single-member limited-liability companies, which for tax purposes are disregarded entities. The purpose of maintaining each interest in these special purpose entities is to protect investors from liability that might arise from the conduct of other tenants-in-common or the property itself, and to protect individual TIC investors from each other with regard to bankruptcy filings or other legal issues.

Non-Recourse Debt

In typical TIC investments, the sponsor prearranges financing that is non-recourse to individual investors—a tremendous advantage that TIC properties provide because investors who may experience difficulties qualifying for debt because of earned-income levels can arrange financing that otherwise would be unfeasible. Under the typical financing of TIC properties, investors are liable only for the amount of their investment. In the event of a default on the loan, the lender cannot attach investors' personal assets or other investment properties to satisfy the debt obligation.

Loan Provisions

TIC properties commonly contain carve-outs, referred to as bad-boy provisions, as a means for lenders to protect themselves from the intentional misbehavior of TIC co-owners. Lenders usually draft these restrictions in the loan documentation and commonly include provisions such as prohibitions on the sale of co-owners' special-purpose entities to other investors without lender approval. The restrictions stipulate that any misbehavior on the part of a co-tenant that falls into the bad-boy provisions will result in the debt generated by the behavior being recharacterized as recourse to the offending co-tenant.

Professional Property Management

One of the primary advantages of TIC interests is the significant decrease in active property management responsibilities. When syndicating TIC properties, sponsors use professional in-house property management operations or retain nationally recognized professional commercial property management firms.

Discounts for Estate Tax Purposes

TIC ownership interests are fractional interests and, as such, are not considered liquid investments. The marketability of TIC interests depends significantly on the performance of the subject properties, current market demand and conditions, the characteristics of the particular interests and whether other co-tenants are interested in acquiring them. The only benefit to the lack of liquidity is that when TIC interests comprise part of a decedent's estate, investors can heavily discount the investment to account for restrained marketability.

The ability to apply this fractional discount to TIC interests presents a potential investment and estate-planning strategy for investors who cannot completely shelter various properties under the maximum trust exclusion amounts. By liquidating some or all of their solely owned property interests, using a tax-deferred 1031 exchange and re-investing equity in fractional property, investors can keep either equity invested and generating income and appreciation until death, but simultaneously give their estates the ability to discount the value of fractional property interests, potentially preventing the application of estate tax to equity that otherwise may have fallen outside the applicable exclusion.

Revenue Procedure 2002-22

Early investors showed some hesitation before investing in syndicated TIC interests because the tax implications of the investment were unclear; there was a risk that upon auditing the transactions, the U.S. Internal Revenue Service could recharacterize the investment as a partnership interest and, thus, not a qualified-use property eligible for tax-deferral under section 1031. In

response, the U.S. Department of the Treasury in March 2002 issued revenue procedure 2002-22 to establish guidelines under which the IRS will consider issuing a private-letter ruling on TIC ownership interests acquired as replacement properties within an investor's tax-deferred exchange transaction.

Though revenue procedure 2002-22 does address the specific concerns that arise with syndicated TIC properties, the procedure's guidelines are not specifically limited to TIC investments. It also applies to nonsyndicated TIC interests, such as a single piece of property titled to two investors as tenants-in-common and, arguably, may have more effect in that area because it is much less obvious in that context which particular projects may fall within its scope.

It is also important to note that the guidelines provided by revenue procedure 2002-22 do not offer a safe harbor or guaranteed structure for TIC ownership interests; all the guidelines purport to do is provide guidance about characteristics and factors the IRS will use to determine whether investments constitute true co-tenancy arrangements and, thus, qualify as tax-deferred exchanges.

Issues Involved in TIC Investments

Though revenue procedure 2002-22 established some mainstay components of typical TIC investments, the structure offerings can vary widely. Differences can include terms indicating whether the sponsor might be compensated for later sale of the investment, who will manage the property, whether sponsors retain the ability to refinance properties and other terms. Investors need to know that these differences, in addition to affecting how much control each individual TIC owner retains over certain aspects of the investment, could pose an additional risk that the entity could be recharacterized as a partnership for tax purposes and, thus, jeopardize investors' exchange and tax planning.

15 GUIDELINES FOR TIC PROPERTIES AND SPONSORS

Pursuant to revenue procedure 2002-22, the IRS will consider issuing private-letter rulings to interested parties if the following 15 conditions are met or present in proposed TIC transactions.

1. *TIC ownership*—Each co-owner must hold title to the property, either directly or through a disregarded entity, as tenants-in-common under local law. A single entity as recognized under local law may not hold the title to the property as a whole.
2. *Number of co-owners*—The number of co-owners or investors is limited to 35 people as defined by IRC 7701(a)(1); husband and wife and all persons who acquire interests from co-owners by inheritance are treated as a single person.
3. *No treatment of co-ownership as an entity*—Co-owners may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders or members of a business entity, or otherwise hold itself as a partnership or other form of business entity. Individual co-owners may not hold themselves as partners, shareholders or members of a business entity.
4. *Co-ownership agreement*—Co-owners may enter into a limited co-ownership agreement that runs with the land. Such agreements may require co-owners to offer their interests for sale to other co-owners, sponsors or lessees at fair market value—determined at the time of the offering—before exercising any right to partition (see section 6.06 of revenue procedure 2002-22 for conditions relating to restrictions on alienation). The agreement also could require co-owners holding more than 50 percent of the undivided interests in the property to vote on and approve certain actions taken on behalf of the co-ownership (see section 6.05 of revenue procedure 2002-22 for conditions relating to voting).
5. *Voting*—Co-owners must retain the right to approve the hiring of managers, the sale or other disposition of the property, any leases of a portion or all of the property, or the creation or modification of a blanket lien. Co-owners must unanimously approve any sale, lease or release of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of managers or the negotiation of management contracts (or any extension or renewal of such contracts). Co-owners can agree that a vote of those holding more than 50 percent of the

undivided interests in the property can be binding for all other actions taken on behalf of the co-ownership. Co-owners who consent to actions as outlined in section 6.05 can provide managers or other persons with power of attorney to execute specific documents with respect to those actions, but may not provide managers or other persons with an unlimited power of attorney.

6. *Restrictions on alienation*—Co-owners must have the right to transfer, partition and encumber their own undivided interests in the property without the agreement or approval of any person. Restrictions on the right to transfer, partition or encumber interests—if required by a lender and consistent with customary commercial lending practices—are allowed (see section 6.14 for lender restrictions). Moreover, co-owners, sponsors or lessees may demand the right of first offer—or the first opportunity to offer to purchase co-ownership interests—before any co-owner can exercise the right to transfer his interest in the property. In addition, co-owners can agree to offer co-ownership interests for sale to other co-owners, sponsors or lessees at fair market value before exercising any right to partition.

7. *Sharing proceeds and liabilities upon sale of property*—If the property is sold, any debt secured by a blanket lien must be satisfied and remaining sales proceeds must be distributed among co-owners.

8. *Proportionate sharing of profits and losses*—Co-owners must share in all revenues and costs associated with the property in proportion with their undivided interest in the property. Co-owners, sponsors or property managers are forbidden to advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner—and, where the co-owner is a disregarded entity, the underlying member of the co-owned interest—and is for a period not to exceed 31 days.

9. *Proportionate sharing of debt*—If the property secures a blanket lien, co-owners must share in the indebtedness in proportion to their undivided interests.

10. *Options*—Co-owners may issue options to purchase their undivided interests, referred to as call options, if the exercise price for call options reflects the fair market value. The fair market value of an undivided interest is equal to the co-owner's percentage interest in the property multiplied by the fair market value of the property as a whole. Co-owners may not acquire options to sell undivided interests, called put options, to sponsors, lessees, lenders, other co-owners or any person related to any of the parties.

11. *No business activities*—Co-owners must limit activities to those customarily performed in connection with the maintenance and repair of rental real property, which the IRS calls customary activities.[1] Activities are customary if the amount an organization receives qualifies as rent (see regulations 511(a)(2), 512(b)(3)(A) and associated regulations). To determine what constitutes co-owner activities, the IRS reviews all activities of co-owners, their agents and any persons related to co-owners with respect to the property, regardless of the capacity in which the activities are performed. For example, if the sponsor or a lessee is a co-owner, the IRS will review all property-related activities of the sponsor or lessee—or any person related to the sponsor or lessee—to determine whether the activities are customary. However, the IRS will not review a co-owner or related person's property-related activities, other than in the co-owner's capacity as a co-owner, if the co-owner owns an undivided interest in the property for less than six months.

12. *Management and brokerage agreements*—Co-owners and agents may enter into management or brokerage agreements, which must be renewable at least annually. Agents can be sponsors or co-owners, or any person related to sponsors or co-owners, but not lessees. Management agreements can authorize managers to maintain common bank accounts for the collection and deposit of rents and to offset expenses against any revenues before distributing net revenues among co-owners. Managers must disburse co-owners' shares of net revenues within three months irrespective of circumstances. Further, agreements can authorize managers to prepare revenue and cost statements, obtain or modify property insurance and negotiate modifications of the terms of any lease or any indebtedness encumbering the property, subject to the approval of co-owners (see section 6.05 for conditions on lease and debt modification approvals). Fees that co-owners

pay to managers cannot depend in whole or part on the income or profits derived by any person from the property, and cannot exceed the fair market value of managers' services. Any fee co-owners pay to brokers must be comparable to fees that unrelated parties pay brokers for similar services.

13. *Leasing agreements*—All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by lessees must reflect the fair market value for the use of the property and may not depend, in whole or part, on income or profits from the leased property—other than an amount based on a fixed percentage or percentages of receipts or sales (see section 856(d)(2)(A)). Thus, rent cannot be based on a percentage of net income from the property, cash flow, increases in equity or similar arrangements.

14. *Loan agreements*—Lenders involved with debt that encumbers the property or is incurred to acquire undivided interests in the property cannot be related to any co-owner, sponsor, manager or lessee.

15. *Payments to sponsor*—Except as otherwise provided, the amount of any payment to a sponsor for the acquisition of the co-ownership interest—and the amount of any fees paid to a sponsor for services—must reflect the fair market value of the acquired co-ownership interest and cannot depend, in whole or part, on the income or profits from the property.

TICS SPUR DEBATE ABOUT REGULATORY AND SECURITY REQUIREMENTS

Despite the issuance of revenue procedure 2002-22, the structure and sale of TIC interests continues to elicit professional debate. Much of the current discussion focuses on whether TIC interests in real estate constitute investment contracts as defined by the 1933 and 1934 securities acts, and the ramifications that classification would have on TIC investments and other ancillary fields of law.

To understand the expansive nature of what qualifies as securities under the 1933 and 1934 securities acts, and how TIC investments may be classified as securities, one must understand the need that the U.S. Congress intended to address with the legislation. The securities acts were designed "to prevent further exploitation of the public by the sale of unsound, fraudulent and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion."[2] Because the primary aim of the legislation is consumer protection, courts have interpreted the acts liberally to retain the flexibility necessary to address new and novel investment opportunities that pose risks to consumers and investors. Accordingly, the definition of a security must "embody a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[3]

The case that defines a security according to the Securities Act of 1933 is *Securities and Exchange Commission v. Howey,* 328 U.S. 293 (1946). In *Howey*, the court defined an investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party, it being immaterial whether shares in the enterprise are evidenced by a certificate or by nominal interests in physical assets employed in the enterprise."

The court also held that the determination of whether an investment complies with Securities Act of 1933 regulations, the form of the economic realty of the transaction should be disregarded—an action that widens the definition to encompass potentially any situation where individuals elect to invest money in a common enterprise where profit is derived solely through the effort of a third party, rather than investors' own knowledge and capacity to manage the investment. "Congress' purpose in enacting the securities laws was to regulate 'investments,' in whatever form they are made and by whatever name they are called."[4] To that end, the court enacted a broad definition of security, sufficient "to encompass virtually any instrument that might be sold as an investment."[5]

CASE LAW PROVIDES GUIDELINES FOR TIC INVESTMENTS

Because existing legal precedent supports a broad definition of the idea of investment contracts and because interests sold as TIC investments may, in fact, qualify as a type of investment under current common-law understanding,

identifying whether particular TIC interests may be classified as securities depends predominantly on whether the investment itself is structured so that investors derive their profit from the efforts of others.

In *Securities and Exchange Commission v. Glen Turner Enterprises Inc.,* the 9th U.S. Circuit Court of Appeals ruled that for an investment to not "rely on the efforts of others" and, hence, avoid characterization as a security, investors themselves must be responsible for making key managerial decisions. "Within the definition of 'investment contracts,' which are 'securities' within the federal securities laws as schemes which involve an investment of money in a common enterprise with profits to come solely from the efforts of others, word 'solely' should not be strictly construed; rather the test is whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[6]

In *Williamson v. Tucker*, the 5th U.S. Circuit Court of Appeals held that investors who retain control over the respective investment have not purchased interests in a common venture "premised on the reasonable expectation of profits to be derived from the entrepreneurial and managerial efforts of others." An investment contract exists even if investors have outsourced day-to-day management of the property to an outside vendor.[7] Under *Williamson*, the key in determining reliance on the efforts of others is dependence.

The *Williamson* court established a three-part test to determine investors' dependence on third-party efforts. Investments that meet any of the following criteria may be characterized as a security:

- An agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement distributes power as would a limited partnership.
- The partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers.
- The partner or venturer is so dependent on some unique entrepreneurial or management ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

In all three scenarios, investors have little or no control over the investment, and the profitability or success of the investment relies on the efforts of a third party. Hence, it may be classified and regulated as a security under the securities acts.

The *Williamson* ruling clarifies that in determining whether a particular TIC interest constitutes a security interest, analysis must consider the actions of the sponsoring entity and the co-investors in each individual project. If the sponsoring entity proclaims extraordinary expertise or capacity at managing TIC offerings, or requires investors to use management companies the sponsoring entity is related to or has a pre-existing relationship with, the sponsor likely is violating the third prong under *Williamson* and co-tenants likely are relying on the efforts of others. Alternatively, where co-tenants are so inexperienced and unknowledgeable in business affairs that they may be deemed incapable of intelligently exercising their rights under the project's operating agreement, or co-tenants are so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that they cannot replace the manager of the enterprise or otherwise meaningfully exercise the rights reserved to them under the operating agreement, then again the profitability of the investment relies on the management of a third party, and may be classified as a security.

In addition to elucidating what characteristics are necessary for an investment to be deemed a security, *Howey* and *Williamson* explain circumstances when a TIC investment is not a security. If the sponsoring entity structures a TIC offering so that the operating agreement provides co-tenants with sufficient legal powers to actively participate in the management of the investment, and co-tenants are sophisticated investors capable of understanding the nature of the investment and exercising the rights reserved to them in the investment documents, the sponsor of the project can argue that TIC investors are relying solely on their own expertise to render the project profitable. Thus, the investment contract does not rely on the efforts of others for securities law purposes.

An even stronger case occurs when the sponsor does not participate in the TIC investment after the initial offering

to investors. In that situation, co-tenants must actively participate in all decisions underlying the management of the investment, and will individually be responsible for the ultimate success and profitability of the investment—clearly not relying on the efforts of others.

NATIONAL ASSOCIATION OF SECURITIES DEALERS OFFERS AN OPINION

In March 2005, the National Association of Securities Dealers, or NASD, issued a notice to members titled "Private Placements of Tenants-in-Common Interests" that addresses the consequences of classifying TIC interests sold as securities. The notice explains that when viewed in the light of securities laws and NASD rules, investments sold as TIC investments do qualify as investment contracts for securities law purposes and, therefore, must be sold pursuant to securities regulations.

The NASD's rationale is that when TICs are offered and sold together with other arrangements, including the prepackaged financing and contract for third-party management of the investment, the passive nature and third-party reliance are sufficient to classify the interests as investment contracts, despite the fact that investors are purchasing into real estate and receiving a fractional interest in the underlying property. From the NASD's perspective, TIC investments typically involve the tenants-in-common investing in an undivided fractional interest in the rental real property by pooling their assets and sharing in the risks and benefits of the enterprise. The objective of the investment is sharing in the profits derived predominantly from third party leasing, management and operation of the acquired property as well as the sponsoring company's negotiation of the sale price and the loan.

Opponents to the NASD's characterization point to the fact that investors in a particular TIC program might have authority to terminate a management contract, or maintain or repair the property. But because operating agreements typically do not assign primary responsibility for these activities to tenants-in-common, evidence is lacking that the TIC interests are not investment contracts as defined in securities laws.

The classification of TIC interests as investment contracts gives rise to uncertainty about how these interests should be treated in other areas of law, particularly tax-deferral provisions. If TIC investments are truly investment contracts, section 1031 might not apply to transactions where investors want to reinvest in a TIC property. Section 1031 specifically excludes any exchange of investment property for "interests in a partnership," "stocks, bonds, notes" or "other securities."

Thankfully for investors, brokers and sponsors, though federal securities law definitions are applicable in determining whether TIC investments may be characterized as securities, that characterization does not mean that the same TIC will be treated as a security under federal tax law. This means that the NASD and SEC may declare TIC interests to be investment contracts under securities laws without inherently disqualifying them from being considered real property under tax law.

For most investors' purposes, this dual characterization is the best of both worlds. Because many TIC interests do fall under securities laws, consumer protection mechanisms such as NASD general sales conduct obligations apply to the sale of TIC interests; at the same time, that characterization does not prevent them from being treated as real property for the sake of federal tax law and tax-deferral mechanisms such as section 1031.

THE SECURITIES DEBATE RAGES ON

Despite the NASD's position, the issue of whether TIC interests constitute securities under the Securities Act of 1933 is far from settled. As the number of TIC projects available steadily increases and the structures that TIC sponsors use begin to differ, it is fair to say that some offerings are beginning to blur the line between securities and real estate. Individual investors must carefully evaluate offerings before investing, and consult with legal, tax and financial advisors to determine whether a particular investment is in compliance with securities laws; or if offered as a real estate investment, that its structure falls outside the guidelines established in *Howey* and *Williamson.*

Given the varied nature of tenants-in-common offerings, brokers' required due diligence varies from investment to investment. At a minimum, brokers should:

- Ensure the private placement memorandum does not contain any false or misleading information.
- Conduct a preliminary background check on the sponsoring entity and its principals.

- Review all investment agreements including the purchase and sales agreement, financing agreements, property management agreement and lease agreements.

Real estate professionals should be aware that reviewing lease agreements is crucial in TIC investments. Not all agreements associated with TIC offerings are drafted with due care from a tax perspective, and it is not uncommon for offerings to include language that might not be problematic from an investment perspective, but could be deleterious from a tax perspective. Examples of problematic inclusions can include an option exercisable by some party other than the investor, or provisions for a master lease agreement with a real estate investment trust or its operating partnership or a transaction mandated after the acquisition of the TIC interest. These inclusions could prompt the IRS or state Franchise Tax Board to view the agreement as vitiating investors' intent to hold the TIC interests, and disqualify the investors' tax-deferred exchange.

One of the most intensely debated subjects related to the 0sale of TIC interests is brokers' and sponsors' ability to pay referral fees to third parties for business they refer. If TIC interests qualify as investment contracts under securities laws, such fees are not permissible under NASD rule 2420, which prohibits payment of commissions and fees to entities that operate as unregistered broker-dealers. Section 3(a)(4)(A) of the Securities Act of 1934 defines a broker as a person "engaged in the business of effecting transactions in securities for the account of others," which means that the SEC may be able to characterize payment of a referral fee from a broker-dealer to a real estate agent in connection with the sale of a TIC interest to be the type of activity that would render the real estate agent an unregistered broker-dealer.

As the situation stands now, broker-dealers who consider TIC interests to be investment contracts under securities laws cannot pay real estate agents who are not registered as broker-dealers for referring clients who subsequently purchase TIC interests. Further, broker-dealers cannot evade NASD rule 2420 restrictions through indirect compensation such as reducing normal commissions on TIC investments and requiring the investors to pay the difference to the real estate agent for referring the business to the broker-dealer.

The inability to pay a referral fee to real estate agents often prompts them to view TIC interests as competition to their business and makes them hesitant to refer clients to TIC investments even when they meet investors' objectives. The competition with traditional real estate has to some degree hampered the growth the TIC industry, and is an issue the industry's professional organization is lobbying the SEC to address. However, the restriction preventing referral fee payments is related solely to securities regulations; sponsoring companies may be allowed to pay real estate professionals referral fees in TIC offerings structured so the investment is not a nonconventional investment under securities laws.

EXPECT TO SEE A SURGE IN TIC INVESTMENTS

Despite some uncertainty related to the structure of TIC projects and the evaluation of law regulating the sale of these investments, it is fair to say the field has not yet seen the peak of its growth. After revenue procedure 2002-22 provided the prerequisite assurance that TIC investments are valid replacement property options for tax-deferred like-kind exchanges under section 1031, the market saw a surge in growth.

Investors are taking advantage of TIC investments' prepackaged nature to reduce the anxiety inherent in the tax-deferred exchange deadlines and acquire a percentage or fractional interest of a larger, institutional-quality property that is potentially more stable, secure and profitable than a previously held property. The next wave of growth could very well be driven by future legislation and by educating real estate professionals about the nature and utility of TIC investments. ■

1 Revenue Ruling 75-374, 1975-2 C.B. 261.

2 Senate Committee on Banking and Currency, S.Rep. No. 47, 73d Cong., 1st Sess. 1 (1933).

3 *Securities and Exchange Commission v. Howey,* 328 U.S. 293, 299 (1946).

4 *Reves v. Ernst & Young,* 494 U.S. 56 (1990).

5 *Securities and Exchange Commission v. Edwards,* 540 U.S. 389, 896 (2004).

6 *Securities and Exchange Commission v. Glenn W. Turner Enterprises Inc.,* 474 F.2d 476 (9 Cir. 1973) citing the Securities Act of 1933, section 2(1), 15 U.S.C.A. section 77b(1); Securities Exchange Act of 1934, section 3(a)(10), 15 U.S.C.A. section 78c(a)(10).

7 *Williamson v. Tucker,* 645 F.2d 404 (1981).