

ONLINE ARTICLE

# Tenant-in-common exchanges pose risks

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**U**nless structured properly, the sale or exchange of certain property can trigger an unwanted taxable event. That's why it's important to understand the tenant-in-common exchange. While not without risks, the TIC exchange can be beneficial to the real estate investor.

Many investors that sell a property want to acquire a different real estate investment instead. Perhaps the investor wants to acquire a larger parcel that produces a better cash flow, or wants to convert non-income-producing property into income-producing property. Or maybe the offer received for the property is simply too good to refuse.

Whatever the motivation, the sale of the disposed property can trigger a taxable event. The investor must pay tax on the difference between the investor's tax basis in the property sold and the net sales price received. The payment of the tax leaves the investor with less money to invest in a new or replacement property and may make the transaction economically unattractive.

However, under Section 1031 of the Internal Revenue Code, a properly structured exchange will result in the deferral of tax on the sale of the disposed property, leaving the investor with more money to buy a replacement property. In such a transaction, the investor will not pay any tax until the replacement property is sold for cash or other cash-equivalent consideration. But to qualify for the tax deferral, the investor must satisfy a number of Section 1031 requirements.

First, the disposed property must be investment property exchanged for other investment real property. Second, while the exchange need not occur simultaneously with the initial sale, a 1031 exchange requires the replacement property be identified within 45 days of closing of the disposed property. Further, the closing of the replacement property must occur within 180 days of the closing of the disposed property.

Third, at no time may the investor have access to the cash proceeds from the initial sale; instead the cash must be held by an unrelated third-party accommodator until the replacement property is acquired.

Last, the investor must acquire a replacement property that has a value equal to or greater than

the total of the cash proceeds from the initial sale and the debt the investor was relieved of when the property was sold.

Simultaneous exchanges are rare because it is difficult for all parties to close on each of the exchange parcels at exactly the same time.

Deferred exchanges are far more common. However, even then, many investors have trouble finding replacement property that meets their requirements. The replacement property must not only make economic sense, but must be affordable and match or exceed the cash-plus-debt values.

As a result, many investors have turned to jointly investing in real properties as tenants-in-common with other investors.

The TIC investment generally begins with a sponsor who has identified an income producing real property to acquire and who will bring in multiple TIC investors. The TIC investor can invest the precise amount of cash and assume the precise amount of debt to defer any gain without the difficulty of finding the perfect replacement property.

Further, the acquisition of a TIC interest generally is a passive investment where the day-to-day management of the property is handled by a professional property manager.

Finally, many TIC arrangements allow the investors to acquire higher-value properties occupied by solid credit tenants with triple net leases. These are properties the investors could not buy individually, thus making the overall investment less risky.

But the TIC investment is not without risk. Day-to-day management is given up by the investor, leaving less control over the investment. In addition, any joint investment creates the possibility of disagreements among the investors, or may require wading through the bankruptcy or other litigation of a co-owner.

Also, because TIC investments are a relatively new concept, it is not clear if there is a sufficient secondary market for TIC interests where an investor can sell his or her interest without requiring that all other co-owners also sell.

And there are legal risks associated in investing the proceeds of a 1031 exchange in a TIC transaction. For example, Section 1031 specifically prohibits the exchange of partnership interests. A partnership generally is defined as two or

more persons carrying on a business enterprise sharing the profits generated thereby. Clearly, a TIC arrangement involves two or more persons owning a parcel of real estate with the intent of generating some cash flow during the period of ownership and some gain on the liquidation of the investment. In this regard, the TIC may have the appearance of a partnership.

Because it is a question of fact whether the parties intend to carry on a venture to share profits and losses, there is not 100 percent certainty that a court, asked to review the TIC arrangement with the benefit of hindsight, might not conclude that the TIC relationship is really that of partners and not of true tenants in common.

Fortunately, the IRS provided some guidance in 2002 when it issued Revenue Procedure 2002-22. That procedure set forth 15 guidelines for structuring TIC arrangements in order to earn a favorable revenue ruling. Unfortunately, the IRS has not made the guidelines a safe harbor, so compliance with all 15 guidelines in a TIC arrangement will not necessarily assure the taxpayer of an audit-free investment.

A 1031 exchange may be the most effective way to obtain the best return for real estate investors that want to sell a property yet keep an investment in real estate. Exchanges present challenges, such as short time frames to find and purchase a replacement property, and the difficulty of securing a perfect match for the investor's exchange and financial needs.

Although not without risk, a properly structured TIC arrangement may solve many of those problems. Experienced counsel can help guide the investor through that structure.

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