TIC funds: Like-kind property exchange gets taxpayer face-lift

By Jonathan Peckham
*Special to Houston Business Journal*

There’s a relatively new kid on the real estate investors’ block. It’s a fancified fund called a tenant-in-common or TIC fund that promotes itself as an alternative to the complex, expensive and often management-intensive prospect of buying and operating replacement real estate in order to defer taxable gain on the sale of a business real estate or commercial investment property.

Although land does not require much management, it often produces no income to pay its property taxes. The TIC fund allows the purchase of a fractional ownership interest in a larger income-producing property that the purchaser could not otherwise afford. One of the claimed benefits is buying into a more diverse or higher class of asset, thus leading to reduced investment risk and related benefits.

The story starts like this: A property owner decides to sell for a handsome profit real estate, perhaps that he used for many years in his business or bought for investment. Maybe the property is obsolete for the owner’s business use or the offer is so above market that the owner feels he just cannot pass it up. Also, the property is not already exempt or mostly exempt from tax because it is not a primary residence.

Knowing the tax man will have his hand out for some of that profit, the owner’s financial adviser may have told him to consider taking advantage of a “like-kind exchange” under Section 1031 of the Internal Revenue Code (1031 exchange). This law allows a person to defer tax on the gain from the sale if, speaking in broad generalities:

- The same person sells one property and buys another.
- It is an exchange of real estate for real estate (though each may have a different use).
- The properties are traded simultaneously (delayed exchanges are allowed within strict time limits).
- He buys property equal in cost to the total sales price of the sold property (to defer 100 percent of the gain).

There are a number of considerations in deciding whether a 1031 exchange is desirable for a given seller. However, the question here is, “What are the pitfalls and risks of

---

1 This article appeared in the Commercial Real Estate Section of the Houston Business Journal, Week of September 16-22, 2005. © 2005 American City Business Journals Inc.
participating in a TIC fund assuming a person has made the basic decision to defer the tax gain?”

**TIC terms**
The TIC fund is promoted as:

- A convenient alternative to owning and managing wholly owned investment property.
- A way of identifying and buying replacement property on a timely basis without overpaying just to beat the deadline (which 1031 exchangers often do to meet IRS deadlines).

IRS rules say clearly that the person involved in the transactions must buy real estate. Proceeds cannot be used, for example, to buy a partnership interest in a partnership that owns real estate.

A tenancy-in-common, however, is nothing like being a tenant of an apartment -- it is actual ownership of an undivided fractional interest in the entire property.

The IRS is not easily fooled by a group of TIC owners creating a partnership “in fact” by entering into a property management and operating agreement that mimics the centralized management and decision-making present in a partnership agreement.

Anyone who has tried to co-own a vacation home knows that many thorny issues arise. These include fair or conflicting use among co-owners, responsibility among co-owners for repairs (and decisions about repair or replacement), one party wanting to sell his interest to someone who others don’t want to share ownership with, financing issues, whether to lease the property, and on and on. Rights of co-owners to partition the property (physically or by forced sale) also give headaches to lenders and prospective renters.

Tenancy-in-common agreements address these issues.

**Risks and complexities**
The IRS has issued regulations and guidelines for how tenancies-in-common agreements could avoid the “partnership in fact” problem, including creating a private letter ruling process.

Because of delays in obtaining letter rulings, and the fact that the rules are complex and subject to varying interpretation, most TIC funds instead rely on opinions from tax lawyers that the agreement “should” stand up to IRS inquiry. Consequently, there is a greater likelihood of having the 1031 exchange status invalidated than in a direct investment scenario and probably no one to blame if that happens.

Some other risks and downsides to the TIC fund alternative (compared to sole ownership) are:
Transactions costs can be quite high, including promoter equity -- potentially lowering returns.

It is tougher to know whether the property is worth what is being paid for it and if a purchaser is truly obtaining a fractional interest that is proportionate to the investment.

Without doing individual due diligence such as environmental checks, the purchaser has to rely on those with more at stake to be covering him. (Just as with sole ownership, the purchaser can be exposed for environmental clean-up costs as a TIC.)

The purchaser has a loss of direct decision-making over leasing, financing, management and other critical operating issues, though the manager is required to allow voting on a number of issues.

Understanding the complexities of the underlying transaction is difficult, and the purchaser may receive a lot of requests to vote on management decisions and not know what to do.

There are other complexities as well, including possible lender requirements for partial guaranties of project debt and creating “bankruptcy remote” ownership of a person’s TIC interest in a limited liability company in order to allow the lender to try and control bankruptcy filing by a TIC.

Although this may appear to be a relatively simple investment option, there are many issues to consider. A TIC buyer should beware and consult legal and financial advisers throughout the entire journey -- or risk being “TIC’d off” at himself later.

Jonathan Peckham is special counsel of transactions and corporate advisory services with Adams and Reese LLP, practicing principally in the area of commercial real estate law.