TICs and 1031 Exchanges– The Basics

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By Kevin L. Kete, SIOR

Tenants-in-common (TIC) offers investors in general and exchangers in particular, the opportunity to obtain an undivided fractional interest in a larger, institutional-grade property that is typically too big for an individual investor and that, under ordinary circumstances he or she might not be able to afford. Under this arrangement, an investor obtains an undivided fractional interest in that property. The explosive growth of the TIC industry is the result of two factors: (1) an investment market that believes real estate is becoming the investment of choice and (2) IRS Revenue Procedure 2002-22.

Notwithstanding the attractiveness of TICs as an investment, we must not ignore the process and fundamentals of executing a successful tax deferred exchange with a TIC as the replacement property(ies). It is important for investors and the commercial brokerage community to know and understand the rules and regulations for "safe harboring," a delayed tax deferred exchange.

Let's start with determining whether a TIC is "like kind" real estate. The answer is "yes." The 2002-22 Revenue Procedure established 15 guidelines, and if they are adhered to, the IRS will rule favorably, allowing the exchange into a TIC. Note that this ruling does not provide a "safe harbor." But for practical purposes it is "like kind" because the major players who sponsor TICs adhere strictly to the 15 guidelines and will provide a legal opinion to that effect. The strongest legal opinion is a should letter, i.e., the legal opinion saying in effect that the IRS should give that particular deal its okay in the event of an audit.

As a commercial broker providing professional services on behalf of your client, you should remember that one of the many requirements for a successful exchange is that there must be continuity of the taxpayer. The taxpayer selling the relinquished property must be the same taxpayer on the title of the replacement property. (Note: Partnerships may exchange but partner interests may not. Qualify your client, customer, or prospect.)

Requirements for a Complete Tax Deferral

To achieve a complete tax deferral of the replacement properties whether land, buildings, a build-to-suit, or a TIC, the taxpayer must satisfy three requirements:

1. All the net proceeds from the sale of the "old" property, held by the qualified intermediary, must be used in the purchase of the replacement property.
2. The price of the replacement property must be equal to or greater than the net price received from the sale of the relinquished property. Typically this is not an issue because the TIC sponsorship universe offers hundreds of properties, all with different "share prices."
3. The debt on the replacement property must be equal to or greater than the debt that was on the relinquished property.

The last point is a challenge because a TIC is set up with an in-place fixed equity and debt ratio. Some TICs are for equity investments only and don't offer assumption of debt. There is little or no leeway to match both within the same offering. In fact, it is prohibited by one of the guidelines set out in Rev. Proc. 2002-22, designed to ensure that a partnership relationship isn't created among the investors within a particular TIC. How do you resolve this? Shop around among all the offerings to find a match.

Coping with the Timing/Identification Scramble

Arguably, the most critical aspect of any kind of deferred exchange is wrestling with the timing parameters of the Identification Period (45 days) and of the Exchange Period (180 days). Incidentally, of the reported exchanges audited by the IRS (three to five percent), most of the failures are because of dating errors. Another requirement that must be met during the Identification Period is "unambiguously" identify the property(ies) being designated as replacement(s). For example, "an office high rise building in downtown Chicago" is unacceptable, but "500 W. Madison, Chicago, Illinois" is.

Why is this relevant and how do you assist your client? First, according to TIC presenters on an Association of Industrial Real Estate Brokers panel in February 2007, TICs are no longer backups to an exchanger's designation notice. Indeed, some of these offerings fly off the market. Second, the purchase of an undivided fractional interest, i.e., being a tenant-in-common with others, clearly requires that the identification be specific as to what fractional interest is to be acquired: 10 percent or five percent or 2.417 percent of the Brooklyn Bridge Colonnades Plaza, New York City, New York.

What if the percentage identified isn't what is delivered to you by the sponsor? There is an IRS regulation that says, in part, "…taxpayer…acquires substantially what was identified." The IRS allows for up to a 25 percent variance.

Although it is not desirable to wait until the last moment to identify a replacement property or properties, the market today often forces exchangers into near-desperate choices. However, the Identification Period ends at midnight of the 45th day after closing on the sale of the relinquished property; one can add, subtract, revoke, or in any other manner change the designations as long as notice arrives in writing, signed by the exchanger, at the office of the qualified intermediary up to the last second before midnight.

TICs Can Be Good Backups

So, is it true that TICs are no longer considered backups? That would be true if the exchanger has focused on a TIC as the optimum replacement opportunity meeting his/her objectives. However, TICs are still a viable option when the exchanger acquires identified property but for less than the total amount in the exchange account. Monies left over in an exchange account following a replacement purchase (assuming that other identified properties are still available but not wanted) must remain in the account until after the Exchange Period (180 days) expires.

Further, those remaining funds will be subject to tax, and not necessarily on a pro rata basis. For example, a user/owner of an industrial building in Elk Grove Village puts three industrial buildings on his designation notice. He ultimately chooses to exchange into the one he deems best suits his needs or the one that is the best of the lot but not ideal. In any event, he has $1 million in his exchange account with the qualified intermediary, yet his purchase costs him $750,000. Should he leave the other $250,000 in the account until the end of the 180 days and then be taxed or should he "back up" with a TIC that offers $250,000 worth of shares. Because he will now have a tenant-in-common ownership, it can be exchanged later for something more attractive.

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More Tools: Reverse Exchange and Multiple Property Exchange

Suppose, for example, a TIC sponsor sends out an attractive offering that won't last very long. It could be a trophy quality structure located at Main and Main with a world-class tenant roster and an acceptable return. You want to grab like yesterday. You also need or want to pay for it by disposing of another property or properties. You need or want to keep all the equity built up in it/them, i.e., defer all the taxes. How do you accomplish this? One way is to do a reverse exchange. The challenge is to get the TIC lender to participate. This can sometimes be accomplished by a reverse exchange for the TIC interest or, if necessary, facilitating a reverse exchange for the exchanger's relinquished property allowing the exchanger to trade into the TIC on a timely basis.

Finally, one of the many reasons for doing tax deferred exchanges is to diversify one's portfolio, such as selling some of the multifamily properties and acquiring a strip center or releasing several multitenant industrial buildings and acquiring an office building. The same idea applies to exchanging into a TIC. Rather than investing $5 million in a single TIC—say, a retail center in Phoenix—it might make more sense to invest that money in three TICs, such as an office building in Schaumburg, an industrial building in Indianapolis, and an apartment complex in Atlanta. This would be a multiple property exchange. It might occur if the exchanger were selling several properties to exchange into one or more TICs. Be sure to consult legal and tax counsel on how to structure that transaction to optimize the outcome of the exchange on behalf of the exchanger.

Since 2002, TICs have increased dramatically in the volume of exchange replacement properties, and we hope and expect that this will continue. But we must be aware that no matter how attractive a TIC or any other replacement property may be, it won't matter unless the exchange is safe harbored by adhering to all the Section 1031 rules and regulations.

Note: This article is not meant to provide legal advice. Always consult your attorney, accountant, or other professionals before entering into any financial agreement.