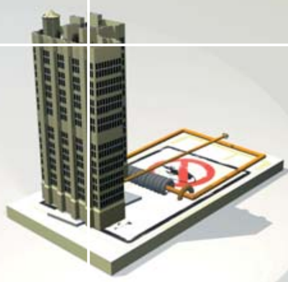

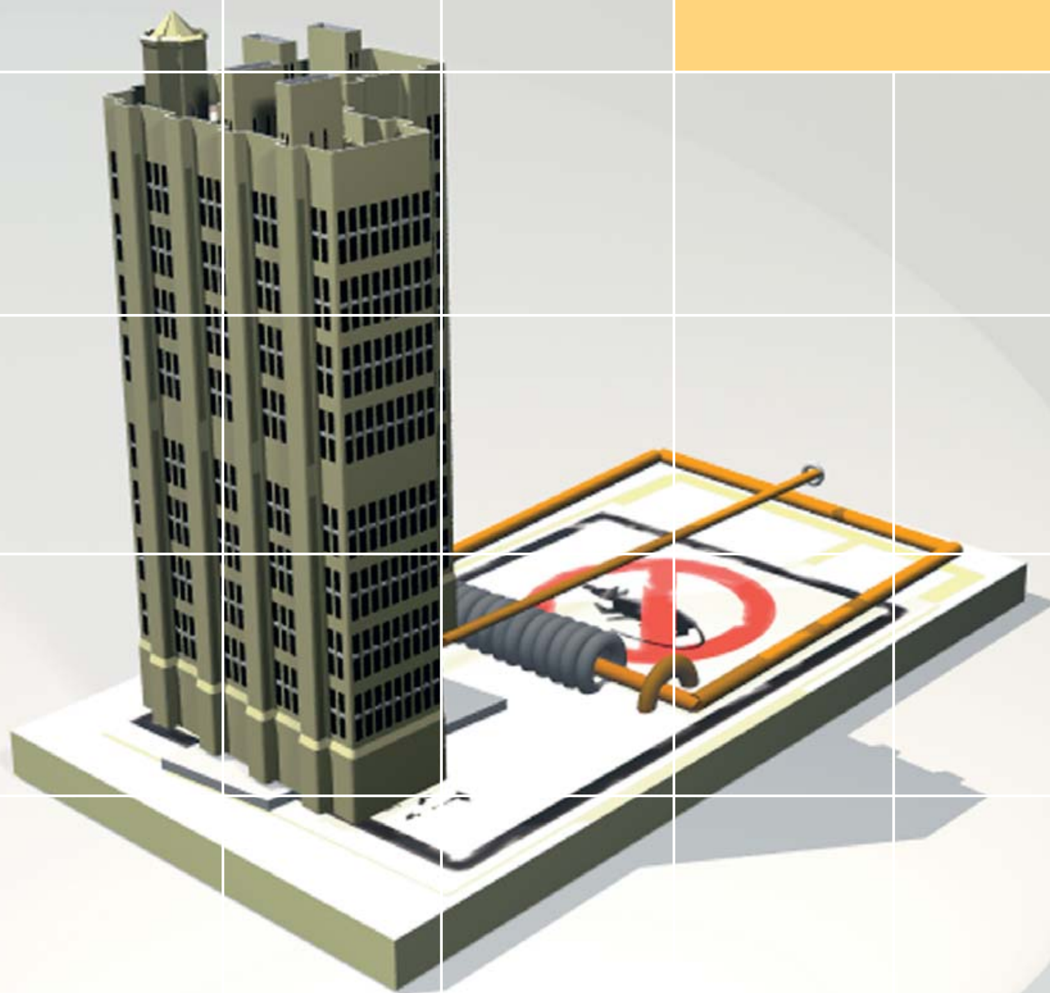

Syndicated Tenancy-in-Common Arrangements

How Tax-Motivated Real Estate Transactions Raise Serious Nontax Issues

By Bradley T. Borden and W. Richey Wyatt

Some real estate syndicators have added tenancy-in-common (TIC) interests to their traditional offerings of limited partnership interests. A TIC interest allows an investor to acquire an undivided interest in the underlying property instead of buying an interest in an entity that owns the property. The primary driving force behind this trend is property owners' need for replacement property to complete tax-free exchanges under Code § 1031. Syndicators, however, are finding that investors will invest cash, other than Code § 1031 exchange proceeds, in TIC arrangements. They do so because syndicators promise higher rates of return than investors have recently been able to find in the stock and bond markets. Nonetheless, because TIC arrangements almost always involve Code § 1031 exchange proceeds, technical requirements must be satisfied to obtain the tax results required by the Code § 1031 investors. Also, because these arrangements involve the ownership of real estate by multiple owners, they raise many nontax issues that must be considered along with the tax issues.

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Typical Syndicated TIC Arrangements

Syndicators either acquire property directly or through a controlled entity and then sell TIC interests to investors, or they contract to acquire property and assign the right to acquire the property to TIC investors who simultaneously close into the property. Once the TIC investors acquire the property, it is generally held in one of the following three arrangements:

1. *A lease with a single tenant*—The lease likely would be a triple-net lease and require minimal, if any, management by the owners.
2. *Multiple tenants subject to a single master lease*—Under this type of arrangement, the master lessee, who generally is a syndicator or manager, would sublease the property to the tenants.
3. *Several leases entered into with several tenants but managed by a person other than the owners.*

Each of these types of arrangements frees the owners from the management function. The particular type of arrangement used may determine the type of taxpayer who would be interested in acquiring the TIC interest.

Syndicators generally emphasize the following points when marketing TIC interests:

- The ease of identifying a TIC interest as replacement property within the 45-day identification period and closing on it within the 180-day exchange period to complete a Code § 1031 exchange.
- The return on the taxpayer's investment that a TIC interest will provide. This projected return is often based on two factors: (1) the individual co-owner's share of rental income and (2) an estimated selling price to be received when the property is later sold.

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- The lack of management responsibility associated with TIC interests. This feature is often attractive to people who have sold real property specifically to rid themselves of the hassles of managing the property and who wish to invest in something that provides a steady flow of "mailbox" income. Based on this factor, it is not surprising that TIC interests appeal to older taxpayers who no longer wish to be bothered with managing property.
- The convenience of using a TIC interest as an investment alternative to a fee interest in real property. TIC interests are appealing in part because they enable a person with a relatively small investment to acquire an interest in property leased to a credit tenant.

Investor Considerations

In advising an investor on whether to purchase a TIC interest, advisors must consider both tax and nontax issues related to the investment.

Tax Issues

Because exchanges of interests in partnerships and other business entities are not eligible for Code § 1031 treatment, investors wishing to complete a Code § 1031 exchange must ensure that the TIC interest will be treated as an interest in the underlying property and not as an interest in an entity. In a revenue procedure issued in 2002, which applies only to rental real property, the IRS listed 15 conditions that generally must be satisfied for a taxpayer to receive an advanced ruling on whether a TIC arrangement will escape partnership treatment for federal income tax purposes. Rev. Proc. 2002–22, 2002–1 C.B. 733. The cited procedure technically is not a safe harbor, but is often treated as such. Thus, many tax attorneys are willing to issue opinions that an interest in an arrangement satisfying all (and in certain circumstances, almost all) of the conditions in the procedure will be treated as an interest in the underlying property. Although the conditions specified in the procedure help establish the federal income tax nature of an interest, they raise many nontax issues.

Condition 1: Tenancy-in-Common Ownership. Each co-owner must hold title to the underlying property directly, or indirectly through an entity disregarded for federal income tax purposes, and must be a tenant in common under local law. For asset protection purposes, some TIC arrangements require that each TIC interest be owned in a single-asset entity.

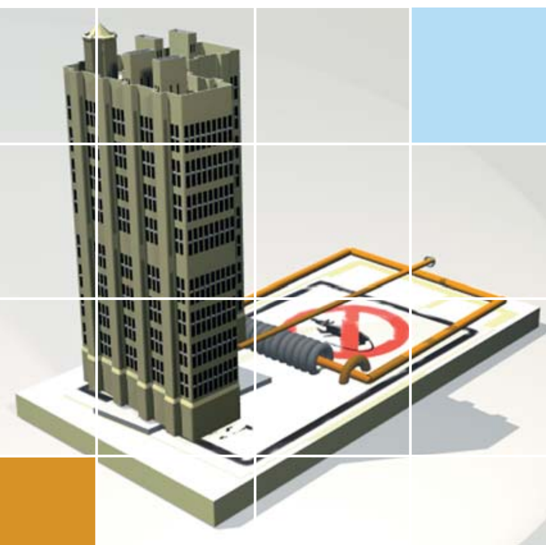
Condition 2: Limited Number of Co-owners. Apparently as an offshoot of state and federal securities laws, the number of co-owners per TIC arrangement is limited to no more than 35 persons. The definition of "person" found in Code § 7701(a)(1) is used for this purpose, except that husband and wife are treated as a single person and all persons who acquire an interest from a co-owner by inheritance are treated as a single person.

Condition 3: Co-ownership Not an Entity. The co-ownership may not (1) file a partnership or corporate tax return, (2) conduct business under a common name, (3) execute an agreement identifying any or all of the co-

owners as partners, shareholders, or members of a business entity, or (4) otherwise hold itself out as a partnership or other form of business entity. Finally, the IRS generally will not issue a ruling under the procedure if the co-owners held interests in the property through a partnership or a corporation immediately before the formation of the co-ownership arrangement.

Condition 3 raises two significant issues: First, many parcels of real property have a common name. The requirement appears to apply to co-owners *conducting* business under a common name, not simply *using* a common name. For example, the IRS would probably consider it inappropriate if any person were able to sign for the owners as a manager or an officer of an arrangement doing business under a common name, but referring to the property by its common name should be appropriate.

Second, the IRS's disapproval of a co-ownership that immediately follows ownership by a separate entity reflects the IRS's interpretation of the law, which has not been supported by courts. In *Bolker v. Commissioner,* 760 F.2d 1039 (9th Cir. 1985), the Ninth Circuit allowed Code § 1031 treatment of a transaction involving the exchange of property immediately following a distribution of the property from a corporation. The IRS failed to argue in the lower court that the transaction should be treated as a sale of corporate stock, which would not qualify for Code § 1031 treatment. Thus, the court did not address that issue, but by ruling that the transaction satisfied Code § 1031, the court implied that the transaction was a transfer of the underlying property (not an interest in an entity) by the former shareholder (not the corporation). Subsequently, in *Mason v. Commissioner*, 55 T.C.M. (CCH) 1134 (1988), the Tax Court addressed the issue directly, holding that former partners who exchanged real property interests immediately following a distribution of the property from a partnership exchanged interests in the underlying property, not partnership interests. Because courts have respected the form of ownership immediately following a distribution of property, the IRS's blanket disregard of such arrangements is inappropriate.



Condition 4: Co-ownership Agreement. The co-owners may enter into a co-ownership agreement that runs with the land. Because a co-ownership agreement will serve many of the same purposes that a partnership agreement serves in a traditional syndication, it is difficult to imagine a TIC arrangement that does not have such a co-ownership agreement. Under the procedure, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value before exercising a right to partition or transferring his or her interest to a third party (see Condition 6). Furthermore, a co-ownership agreement will typically address the co-owners' agreement regarding voting on actions affecting the property (see Condition 5).

Condition 5: Voting. The co-owners must unanimously approve (1) the hiring of any manager, (2) the sale or other disposition of the property, (3) leases of any portion or all of the property, or (4) the creation or modification of a blanket lien. Under Condition 10, however, the co-owners may agree to grant call options to any other person, including a co-owner. This agreement allows the holder of a call option to force others to sell their interests. Without careful drafting, a call option may vest a minority interest owner with the power to force the sale of the property by exercising the option to acquire all other interests in the property and then selling the property to a third party. A properly drafted call option provision can vest the power to dispose of the property in a fraction of the total ownership (preferably a majority or some higher-percentage threshold of owners), apparently rendering meaningless the unanimous consent requirement in connection with selling the property.

Condition 5 also provides that for all actions on behalf of the co-owners, other than those requiring unanimous consent, the co-owners may agree to be bound by the vote of those holding more than 50% (or some higher percentage) of the undivided interests in the property. In a private letter ruling, the IRS ruled that consent was received if a co-owner did not object to an action within a specified period after notice was sent to the co-owner. PLR 200327003 (Mar. 7, 2003). The co-owners may not, however, provide the manager or another person with a global power of attorney or proxy to make decisions for them.

Condition 6: Right to Alienate. Each co-owner generally must have the right (which may be subject to a right of first offer granted to another co-owner, the sponsor, or the lessee) to transfer, partition, or encumber the co-owner's interest in the property without agreement or approval of any other person. Condition 4 and Condition 6 appear to distinguish between a right of first refusal before partitioning and a right of first offer before transferring or encumbering the property, respectively. In practice, although it is often difficult to distinguish between a right of first offer and of first refusal when drafting co-ownership agreements, these rights, along with other allowed options may be used to accomplish the same

goal as a buy-sell agreement in the partnership or corporate context. The procedure also allows the co-owners to place certain restrictions on the right to transfer, partition, or encumber an interest in the property, if such restrictions are required by a lender and are consistent with customary commercial lending practices.

Condition 7: Split on Property Sale. If the property is sold, any debts secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners. This condition prohibits arrangements between co-owners that are designed to have perpetual existence following the disposition of the property, perpetual existence being an indication of a partnership.

Condition 8: Proportionate Sharing of Profits and Losses. Each co-owner must share in all revenues generated by the property and in all costs associated with the property in proportion to the owner's undivided interest in the property. Any advances to a co-owner by another co-owner, the sponsor (as defined in the procedure, the word "sponsor" includes a "syndicator"), or the manager to meet expenses associated with the co-ownership interest must be recourse to the co-owner receiving such advance and cannot exceed a 31-day period. If the co-owner is a disregarded entity, the advance must be recourse to the owner of the disregarded entity.

Condition 9: Proportionate Sharing of Certain Debt. The co-owners must share in any debt secured by a blanket lien in proportion to their undivided interests. To be a blanket lien, the lien must be recorded against the property as a whole. Thus, this condition does not apply if each co-owner obtains financing separately and liens are recorded against the separate interests. Condition 9 may make TIC arrangements involving a blanket lien unattractive to some cash-only investors.

Condition 10: Options. As discussed under Condition 5, a co-owner may issue a call option for a TIC interest. The procedure requires that the exercise price for a call option reflect the fair market value of the property determined at the time the option is exercised. For this purpose, 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 whole property, precluding minority discounts. The procedure prohibits an owner from acquiring a put option to sell the property to the sponsor, the lessee, another co-owner, the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender. This prohibition against the acquisition of a put option from the sponsor or another co-owner makes TIC interests unattractive to investors who wish to acquire a TIC interest to extend the 180-day exchange period. Such investors will be disinclined to acquire TIC interests because they have no guaranteed exit strategy.

Condition 11: No Business Activities. The procedure limits the activities in which a co-owner may participate to those customarily performed in connection with the maintenance of rental property. The procedure cites Rev. Rul. 75–374, 1975 C.B. 261, in defining those customary activities, which include heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning public areas. The procedure further provides that activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in Code § 511(a)(2) from qualifying as rent under Section 512(b)(3)(A) and the regulations thereunder. The activities of a co-owner's agent or any person related to the taxpayer will be taken into account in determining whether prohibited activities are being performed by the co-owners. This condition limits a taxpayer's ability to manage certain types of property.

Condition 12: Management and Brokerage Agreements. The co-owners may enter into management or

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brokerage agreements with an agent, but the activities of an agent, sponsor, or co-owner, acting as manager, may not exceed the activities allowed under Condition 11. A management or brokerage agreement must be renewable no less frequently than annually, and even though the sponsor or a co-owner may fill such capacity, a lessee may not. The procedure allows co-owners to agree to authorize the manager to perform nominal accounting and clerical functions, such as (1) maintaining a bank account before dispersing each co-owner's share of net revenues, (2) preparing profit/loss statements for the co-owners, (3) obtaining or modifying insurance on the property, subject to the approval of the co-owners, and (4) negotiating modifications of the terms of any lease or any debt encumbering the property, subject to the approval of the co-owners. The procedure requires the manager to disburse to the co-owners their shares of net revenues within three months from the date of receipt of those revenues. For this reason, the TIC arrangement probably cannot accumulate earnings to maintain a maintenance or other type of reserve.

Any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived from the property and may not exceed the fair

market value of the manager's services. This condition prevents the manager from sharing in net profits with the co-owners (sharing in net profits typically indicates a partnership). Furthermore, any fee paid by the co-ownership to a broker must be comparable to fees paid by an unrelated person to a broker for similar services.

Condition 13: Leasing Agreements. All leasing agreements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the property, which means that the determination of the amount of rent must not depend, in whole or in part, on income or profits derived by any person from the leased property (other than an amount based on fixed percentages of receipts or sales). This condition prevents the co-owners from sharing in the net profits with the tenant.

Condition 14: Loan Agreements. The procedure prohibits any person related to any co-owner, the sponsor, the manager, or any lessee of the property from being a lender for any debt that encumbers the property or for any debt incurred to acquire an undivided interest in the property.

Condition 15: Payments to Sponsor. Except as otherwise provided in the procedure, any payment to the sponsor for the acquisition of the co-ownership interest (and the fees paid to the sponsor for services) must reflect the fair market value of the acquired ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property. Thus, the sponsor is prohibited from sharing in the net profits derived from the property.

Nontax Issues

Securities and Real Estate Laws. Investors should consider whether a TIC interest comes within the definition of a "security" under state and federal securities laws. The TIC industry appears to have concluded that TIC arrangements that satisfy the requirements of the procedure generally do fall within such a definition under state or federal securities laws. Indeed, most promoters sell TIC interests as securities. Although a real estate broker also may be required to be involved in a TIC syndication (because a TIC interest is still an interest in real estate), promoters typically hire broker/dealers licensed under appropriate securities laws to sell TIC interests. Investors should understand the implications of acquiring a real property interest that is treated as a security. For example, they must understand that state and federal securities laws may limit their ability to later dispose of the interest. Also, even if a TIC interest is not marketed as a security, it may still be a security under applicable law.

Although a TIC interest offered in a syndication is arguably a security under state and/or federal securities laws, the interest is most likely still real estate under state real estate law. The two characterizations are not mutually exclusive. A promoter who does not own the property that is being sold as a TIC investment should, under the real estate licensing laws of most states, hire a real estate broker to handle the sale of the interests in addition to hiring a broker/dealer licensed under appropriate securities laws. Unless relevant exemptions or exceptions are applicable in a particular syndication, the failure to have both a broker/dealer and a real estate broker involved in a syndicated TIC transaction may subject the promoter to significant liability exposure and may result in criminal prosecution of a party (including the promoter) marketing the TIC interest without the appropriate license. Promoters should also be mindful of applicable rules against the sharing of commissions under both applicable real estate and securities laws.

The above-referenced licensing requirements and the classification of a TIC interest as a security are intended to protect investors. Investors and promoters should understand that to the extent that a particular offering of TIC interests constitutes a sale of securities, either (1) the securities must be registered with the appropriate securities regulator or regulators or (2) the offering must fall under a relevant exemption from registration under the applicable securities laws. Failure to comply with these requirements may afford an investor the right to rescind his or her investment, a result that would not be welcome to a promoter if the investment goes sour.

Financial Aspects. Investors interested in acquiring a TIC interest must examine the financial aspects of the TIC arrangement. In many TIC arrangements, the value of the interest will depend on the rental income from the property. If value is based on rental income, the TIC interest will function much like a bond—as interest rates go up, the resale value of the interest will go down (unless the rental revenues are proportionately increased). Furthermore, the financial health of the tenant will affect the value of the projected lease payments, including rent escalators. In addition, leasing to a single tenant versus multiple tenants may affect the value of a TIC interest because some investors believe a single tenant adds risk to the investment. The projected resale value of a TIC interest may also be considered in arriving at the value of the TIC interest.

Asset Protection Planning. Investors must consider the security of their investment. With multiple owners involved, each owner must be cognizant of potential exposure to claims arising from actions of other co-owners. For example, if a claim arises against a single co-owner, the claimant may be able to secure a judgment lien against the TIC interest of that co-owner, which would attach to the property. Such a lien could, and likely would, adversely affect the marketability of the property as a whole. Requiring that each co-owner acquire the property in a single-purpose entity may provide some protection against claims brought against individual owners,

but the potential for reverse-piercing such entities, as was accomplished in *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003), should be a concern of all co-owners. Further, as with any interest in real estate, the investor should be mindful of liabilities (such as environmental risk or slip-and-fall liabilities) that could arise from owning the real property, which is another reason for owning a TIC interest through a single-purpose entity.

Exit Strategies. Investors must also consider exit strategies and the possibility and limitations of reselling the interest on a secondary market. Because the interest will most likely be a security under securities laws, investors should be aware of limitations or restrictions on reselling the interest as a security. Furthermore, an undivided interest in real estate may be difficult to market because of an individual co-owner's lack of control. As with other interests in real estate, because the value of the interest is determined in large part by projected rental income, as a return on investment, fluctuations in interest rates will most likely affect the value of the interest. In addition, the termination of a key tenant's lease may reduce the value of the TIC interest.

Real estate investors who desire the flexibility to make the deal to acquire property would be more interested in TIC interests if they had a guaranteed exit strategy. Such a guarantee would allow dealmakers to acquire a TIC interest and later retrieve the investment by selling the TIC interest and exchanging into another property. Doing this, however, would require that the investor have some guaranteed exit strategy that would allow the investor to obtain the exchange proceeds on demand. It is difficult to find TIC arrangements that have guaranteed exit strategies. One reason is the restriction against certain put options in the procedure. Unless there is a suitable strategy for selling the property as a whole, an investor would have to sell its TIC interest on the open market, if possible, and hope to be able to recover its entire investment, with no guarantee of doing so.

Conclusion

The Code § 1031 industry continues to evolve, most recently resulting in the creation of syndicated TIC arrangements as an investment alternative to help simplify the exchange process. Although the syndicated TIC industry grew out of a tax need, TIC arrangements involve complicated real estate, commercial, and securities issues. Such arrangements should be offered and invested in only after the numerous tax and nontax issues are carefully considered. Failure to do so may cause the investor to lose the desired tax treatment or obtain a worthless investment interest and may expose syndicators, and others who market the interest, to civil liabilities and criminal prosecution. Any of those consequences could be a high price to pay for the tax savings under Code § 1031. ■