



REALTORS® Commercial Alliance Series

HOT TOPICS—

ANSWERS TO CURRENT BUSINESS ISSUES

TENANTS-IN-COMMON INTERESTS



NATIONAL ASSOCIATION OF REALTORS®

The Voice for Real Estate®

Real Strength.
Real Advantages.

TENANTS-IN-COMMON

The Parties, the Risks, the Rewards

What Real Estate Licensees Need to Know

Your client has just sold an investment property with the intent of completing a tax deferred like-kind exchange. The proceeds have been placed with a reliable accommodator. You want to continue to work with this client to find a suitable replacement property. Good properties are in short supply, but you've heard of product called a "tenant-in-common interest" (TIC) that can qualify as replacement property. Should you enter that marketplace? Is it the right product for your client?

The answer to these questions is: "Maybe." TICs can be valuable assets in a diversified portfolio, but you and your client need to carefully evaluate several issues before either of you decides whether a TIC investment makes sense. Here are some issues you'll want to consider.

What is a TIC?

A tenancy in common is a form of ownership for holding title to real estate with more than one party. In today's marketplace, the reference is generally to an investment vehicle that permits participants to enjoy the risks and rewards of real estate ownership without participating in the ongoing management of a property. Today's TIC marketplace is comprised of sponsors who facilitate the sale of tenant-in-common interests in which unrelated investors each own undivided interests in a property. The best TIC sponsors assemble projects that are top-quality, institutional-grade investments. While a TIC investment is a form of shared ownership, the TIC interest is not the same as a partnership interest in its economic, tax or legal characteristics. A TIC interest is simply an undivided interest in real estate.

TIC interests always consist of real estate interests, but depending on how the sponsor organizes the transaction they may also be securities. It is important to note, that securitized TIC interests are subject to both federal and state securities laws and state real estate laws. Securitized

TIC interests are brokered by securities broker dealers, who, at this time are prohibited from compensating, directly or indirectly, real estate professionals for the provision of real estate services in connection with the sale of TIC interests. No such limitations apply to TICs that consist only of interests in real estate. However, currently close to 90% of TIC interests sold are structured and sold as securities.

The TIC marketplace developed as a response to at least two investor goals: to complete a like-kind exchange and to own, but not operate or manage, real property. An investor might have only one of these goals or may have others, but these two objectives drive the market.

Why isn't a TIC investment just business as usual?

A TIC investment *can be* business as usual. You, as a real estate licensee, might have a small group of familiar investors who want, for example, to own the property where a national chain has a store in their community. The investors own the property and the chain or other professional property managers operate the property and the activity on it. There's no solicitation for other investors and the investors agree that since they want to keep their investment group intact, owning as tenants in common makes the most sense.

Such transactions are not common in what is generally called the TIC marketplace. What makes the TIC marketplace different than this simple transaction is the solicitation of investors who are unknown to one another into a common enterprise of real estate ownership with an expectation of limited management responsibilities.

How does a real estate investment with a deed turn into a security?

Sponsored programs that are promoted to investors and that solicit funds for investment move TIC investments away from the business-as-usual deal. A real estate investment can become a security when a sponsor seeks capital from individuals who will be engaged in a common enterprise with an expectation of profit based on the efforts of others.

The 1946 Supreme Court case *SEC vs. Howey* laid out the criteria for investments that are subject to federal law and regulation by the Securities and Exchange Commission. An investment is a security when there is (1) an investment of money (2) in a common enterprise (3) with the expectation of profits (4) derived solely from the efforts of others.

The last point is key to the securitization of TIC interests. The more investors rely on others, such as the sponsor, to operate the investment property, the more likely the investment is to be considered a security.

The crucial factor that causes a TIC program to constitute a security is that the investors depend on the labor of other, unrelated persons to generate income and secure profit from the investment.

Does a TIC investment ever retain its character solely as real estate?

Yes. A few sponsors have successfully offered TIC products that they believe are not treated as securities. You and your client, however, should ascertain whether a program is a security or real estate. Sponsors should be able to make specific, documented representations to clarify when a program is sold as a security and when it can be characterized solely as real estate.

CHARACTERISTICS OF SECURITIZED TICs

- Interests are generally sold with a private placement memorandum.
- The underlying property may be held in a trust.
- Sponsor retains an interest in the property.
- Co-owners are completely passive, except for some management decisions that must be made unanimously.
- Property may be subject to triple net lease or master lease.

CHARACTERISTICS OF REAL ESTATE TICs

- Private placement memorandum not required, but investors should ask for disclosures about property and terms of investment.
- Sponsor usually exits the management and operation of the property, but may retain an interest along with co-owners.
- Co-owners have an active vote in the hiring and firing of management, but are not engaged in day to day management.
- Property is generally not subject to a master lease that includes other properties.

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Why should it matter to real estate licensees whether the TIC investment is treated solely as real estate, or also as a security?

Treatment as a security would mean that federal and state securities laws would apply to the sale of the TIC interest. In addition, the rules of the National Association of Securities Dealers explicitly state that the **real estate licensee may not be compensated** by the sponsor or a broker-dealer for participation in the marketing and sale of TICs, either by means of a fee or commission. If the investment is sold as a security, it can still satisfy your client's objective of finding a replacement property to satisfy the requirements of the like-kind exchange rules if the TIC satisfies IRS requirements specified in Rev. Proc. 2002-22.

NAR is working with the SEC to develop a means by which real estate licensees may participate in and derive compensation from the brokerage of securitized TIC interests. As of October 15, 2005, the SEC had made no determination providing guidance for licensees.

In working with the SEC, NAR has emphasized that real estate licensees are uniquely qualified to advise clients on the real estate aspects of a securitized TIC investment and therefore serve the customer's best interest. NAR noted that real estate licensees work with clients to identify the most suitable property, of which a TIC interest may be an option. Because of this relationship, real estate professionals should not be precluded from advising on the real estate aspects of a securitized TIC interest. Furthermore, state laws require the participation of real estate licensees in connection with the brokerage and sale of real estate, including TICs. NAR is seeking guidance from the SEC to resolve the apparent conflict between federal and state laws on these brokerage questions.

Why should it matter to investors whether the TIC investment is treated as real estate or as a security?

From an investor's perspective, any TIC investment can qualify as replacement property in a like-kind exchange, so long as the TIC itself satisfies all the IRS requirements. Nonetheless, investors should be advised to consider not only the tax aspects of a TIC program, but the economics as well, including the strength of the secondary market available to both securitized and non-securitized TIC interests. Any project should be evaluated on its own merits in the same manner that any direct investment in real estate would be considered. A primary distinction between a securitized TIC interest and a non-securitized TIC interest is that, in many cases, the sponsor of a TIC sold as a security retains a role in the management of the project's operations.

The sponsor of a non-securitized TIC interest often relinquishes all operational aspects of the project, although the sponsor may be included among the co-owner tenants in common. The sponsor may leave a property and asset management structure in place, though the TIC investors may vote to change that structure at anytime. You and your client will want to identify any risks that you might perceive with properties in which a sponsor may or may not remain engaged in the project's operation.

How can a securities broker-dealer sell real estate?

All states require that anyone engaged in marketing and brokering real estate for compensation must have a real estate license. Common sense would also dictate that when an investor evaluates real estate, a real estate licensee should be involved.

While all TIC interests are real estate transactions, all *securitized* TIC interests are *also* subject to the rules and regulations of the Securities and Exchange Commission, the National Association of Securities Dealers (NASD) and, in most cases, the securities rules of the state where the TIC interests are being sold. Thus, both federal and state securities laws **and** state real estate laws apply to the brokerage of securitized TIC interests.

Moreover, the March 2005 ruling of the NASD specifically bars securities broker-dealers from compensating real estate licensees for their role in TIC transactions, either directly or indirectly. Yet, the ruling also advises NASD members to be cognizant of state real estate laws. Thus, real estate licensees are often cut out of securitized TIC transactions, contrary to the requirements of state real estate laws. The Association of Real Estate License Law Officials (ARELLO) has formed a task force to identify ways to assure that the interests of consumers and real estate licenses are protected.

What ethical considerations apply to a real estate licensee working with a client who wishes to acquire a TIC interest as a replacement property?

Real estate licensees must familiarize themselves with and understand the TIC marketplace before referring clients into a TIC investment, whether it is securitized or not. TICs are usually complex investments, and there is never a guarantee that a TIC sponsor will safeguard the client's best interest.

Because there is often a very fine line between a securitized TIC interest and a non-securitized TIC interest, licensees should take care not to market TIC investments without careful attention to compliance with securities and real estate laws and regulations. Doing so may trigger enforcement action by the appropriate state regulatory enforcement entities.

Know the risks of the TIC marketplace and be sure to call upon a more experienced colleague when in doubt. From the National Association of REALTORS® code of ethics:

REALTORS® shall not undertake to provide specialized professional services concerning a type of property or service that is outside their field of competence unless they engage the assistance of one who is competent on such types of property or service, or unless the facts are fully disclosed to the client. Any persons engaged to provide such assistance shall be so identified to the client and their contribution to the assignment should be set forth. (Article 11)

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Shouldn't an investor seeking a replacement property be advised about the merits and income potential of the underlying property?

Yes. That's an element of the client's risk evaluation that real estate licensees are best qualified to provide. Real estate licensees who choose to advise clients about TIC investments might tell the client to, at a minimum, identify the following:

- **The Property:** Location and date of construction/improvements, leases and/or subleases, environmental challenges, title encumbrances (if any), tenant financials and operating history, rent rolls, financing documents, current appraisal, property tax records.
- **The Asset/Property Managers:** Existing manager, recommended asset/property managers, relationship of managers to TIC sponsor, relationship of TIC sponsor and tenant(s), copies of any existing management agreements.
- **The Market:** Demographics, market conditions for property class, land use/zoning classification.
- **The Sponsor:** Its background, potential conflicts of interest, civil suits, bankruptcy, use of investor proceeds, real estate broker of record for acquisition of property, TIC agreement, financial strength and experience.

Can a real estate licensee provide any of this advice?

Experienced and qualified real estate licensees are uniquely positioned to help the client evaluate elements of the TIC investment such as the existing or planned leases, condition of the title, comparables for the type of property and its location and the financing terms of the property. Beyond these fundamental matters, the real estate licensee will need to exercise care to provide advice only on matters within his expertise. *In securitized TIC*

transactions, the real estate licensee and the client will need to agree upon a compensation arrangement for this advice, as the real estate licensee cannot be directly or indirectly compensated by the broker-dealer or TIC sponsor for the client's purchase of a securitized TIC interest.

What else does the client need to think about?

As with any investment, the client needs to identify his own wants and needs. Some of the factors the client may want to consider include:

- Is the property correctly valued?
- Am I willing to be a co-owner rather than the sole fee owner?
- Am I willing to invest with co-owners who are unknown to me?
- Am I willing to participate in an investment that requires unanimity for such basic decisions as asset/property managers, financing and leasing?
- Will this investment enable me to diversify my real estate holdings?
- If I should die, what happens to my TIC interest?
- How long am I willing to remain invested in this project?

TIC investments appear to require significant due diligence on the part of the sponsor and the investor. Do these due diligence requirements spill over to the real estate licensee who brings a client to the TIC marketplace?

Yes and no. Any time a securitized TIC interest is sold, the promoter is required by both state and federal law to provide substantial disclosures and to determine whether the investor meets the so-called "qualified investor" rules of the securities laws. This is generally accomplished by providing a private placement memorandum and other disclosures. (These rules are intended to give the promoter some confidence that the investor is able to evaluate risk

and that the investor can “afford” the risks undertaken.) If a real estate professional has engaged a client in a securitized TIC transaction, the professional should take care not to provide advice on the securitized aspects of the transaction.

Securities rules do not apply to real estate licensees who participate in the brokerage of non-securitized TICs, or the sponsors who promote them. Nonetheless, any real estate licensee involved in the sale of TIC interests will need to provide competent real estate brokerage services related to TICs, including providing all relevant property disclosures, and may assist the client in determining whether the TIC investment is a proper choice.

What are some of the risks that a real estate licensee might be exposed to?

Risks can arise and liabilities can attach when there is a mismatch between (1) the expectations of an investor and the performance of the investment and/or (2) failures, errors or omissions on the part of any promoter, advisor or other party involved in the investment process. Should any of these mismatches occur, or should state or federal securities law be violated, then real estate licensees could be exposed to the claims of investors.

What are the penalties that could attach to the real estate licensee when the securities laws have been violated?

Penalties that may be imposed for securities law violations by real estate licensees include civil or criminal penalties and fines. The harshest civil penalty under the securities law is known as the right of rescission. When rescission is successfully invoked, sponsors and promoters are required to pay back to the investor all the funds that the investor has put into the program. Securities litigation is complex and costly for all parties. Real estate licensees should note that errors and omissions insurance generally

will not cover them in rescission actions related to securities matters.

The preceding discussion has been about the investment process and the characterization of an investment as either real estate or securities. I thought the TIC interest was rooted in tax law.

It’s true that the TIC marketplace arose to satisfy the need to provide diverse investment opportunities for purchasers who seek replacement properties for their like-kind exchanges. The tax rules themselves are quite straightforward. They are readily ascertainable and are found in IRS guidance Revenue Procedure 2002-22. A TIC will either satisfy those tax rules or it won’t. Assuring conformity with the tax requirements is the responsibility of the program sponsor. A TIC investor should be counseled to seek competent legal and financial advice regarding the specific investment and its tax implications. *The marketing, acquisition and operation of a TIC interest, however, are completely outside the tax system. Accordingly, real estate licensees assisting clients in their efforts to find replacement properties need to become well informed about the complexity and opportunities the TIC market presents.*

The information contained in this Hot Topic document is not intended as and does not constitute legal advice, and provides general information only. Before engaging in transactions of the nature described herein, real estate professionals and their clients and customers should consult with legal counsel familiar and experienced with state and federal securities and real estate law.

To contact NAR Commercial Real Estate staff: 888-648-8321. To find an online version of this publication go to, REALTOR.org/RCA. For a complete listing of NAR legislative and regulatory initiatives, go to http://www.realtor.org/government_affairs



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