New Twists of Tenancy-in-Common Property Ownership

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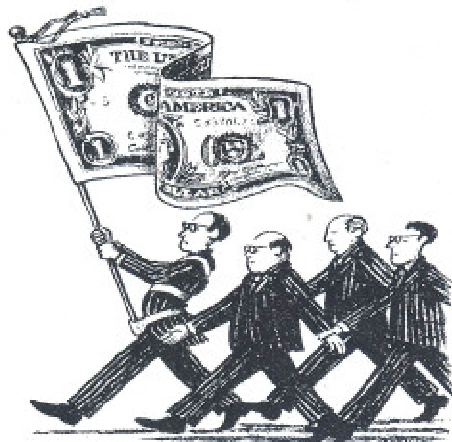
In today's investment marketplace, tenancy in common has become a popular investment vehicle, allowing groups of investors to acquire fractional interests in large commercial properties. TICs permit co-tenants to reap the benefits of real estate ownership without participating in nuances of day-to-day property management. However, TICs present many practical and legal issues that individual investors must consider before entering into a TIC arrangement.

The disadvantages of TIC arrangements begin with the property being subject to a partition lawsuit by one TIC owner to force the sale of the property. A partition action is essentially a complaint stating that the tenants in common cannot agree on how to manage the property and that the property should be split into parts or sold.

Although modern law supports the notion that property ownership should be protected, under the laws of most states, including California, a tenant in common may end the TIC by bringing an action for partition to force the sale of the property and distribute the proceeds. A mere desire of one of the tenants is sufficient to authorize a court to dissolve the TIC.

Unlike other forms of joint ownership, it has no right of survivorship that transfers a co-tenant's interest to the other co-tenants upon death. Thus, when one co-tenant dies, there must be a court-supervised administration of the estate of the dead co-tenant to transfer the TIC interest. This can subject the surviving co-tenants to probate court costs and delays.

Also, a TIC share is not immune to being targeted by creditors. A creditor who wins a judgment against a TIC owner can satisfy a claim by acquiring title through a levy on a TIC share. In such a situation, a judgment creditor becomes a tenant in common with the debtor-tenant's co-tenants.



Like-Kind Exchanges and TICs

On the plus side, with the increased cost of real estate, it has become financially difficult for individuals to own quality commercial properties. TICs provide an opportunity for individuals to organize under a TIC structure and acquire, for a relatively modest sum, a fractional interest in a large, institutional-grade investment property.

Moreover, TIC investments offer significant advantages over interests in real estate partnerships. In contrast with a partnership in which the investor merely owns an interest in a legal entity, a TIC investor owns the underlying real property related to his or her interest. Thus, a TIC investor can transfer or divide his or her interest in the property freely.

The TIC investor also can enjoy tax benefits in an exchange of a property interest. Section 1031 of the Internal Revenue Code enables taxpayers to postpone the recognition of gain upon the sale of certain properties held for trade, business or investment. The basic requirement of Section 1031 is that the property sold must be exchanged for a "like-kind" property that constitutes a direct interest in real property. The term "like-kind" relates only to the nature of the property; therefore, virtually all real property will qualify for treatment as "like-kind." But the person or entity who sells the relinquished property must be the same person or entity who purchases the replacement property.

Section 1031 does not view entity interests, such as partnership interests, to be "like" real estate. Therefore, an interest in real property exchanged for an interest in an entity does not qualify as a like-kind exchange under 1031.

To avoid TIC arrangements being characterized as a partnership or other entity, a well-drafted tenancy-in-common agreement is important. The TIC agreement sets forth the rights and obligations among the tenants in common and serves many of the same purposes that a partnership agreement would serve. The IRS scrutinizes TIC agreements to determine whether the arrangement will be re-characterized as a partnership for the purposes of 1031. In Revenue Procedure 2002-22, the IRS sets forth 15 conditions that a TIC arrangement should contain for the IRS to treat it as a TIC rather than a partnership for federal income tax purposes. Although Revenue Procedure 2002-22 is not a *de facto* litmus test to determine whether a relationship is a TIC, it has clarified the steps TIC investors should take in drafting TIC agreements to avoid partnership treatment.

Though partition, probate and management problems led some investors to own commercial property through a partnership, the benefits of 1031 have caused many investors holding real property interests in general partnership to convert such interest to TICs to facilitate tax-free exchanges. Moreover, by using the TIC structure, investors maintain the flexibility of deciding individually, rather than as a group, whether they want to pursue tax-free exchanges.

Cottage Industry for TICs

Since the 1990s, a cottage industry of syndicators or "sponsor" companies has developed to meet the demand for TIC interests as replacement properties in 1031 exchanges. Under such arrangements, commercial real estate projects are fractionalized into TIC interests, which are in turn exchanged with investors seeking replacement properties. Sponsors often facilitate, structure and arrange financing, as well as handle the property management for commercial real estate projects.

For example, if a TIC owner sells his interest to obtain the benefits of 1031, he has only 45 days to identify a suitable replacement property. Alternatively, a TIC owner may contact a sponsor company and purchase a TIC interest in another property, receive income from that property and reap the benefits of 1031 quickly and conveniently.

If the relinquished property is held by an entity, such as a partnership or a limited-liability company, such entities may restructure into a TIC in order to effectuate a 1031 exchange. The question in such a transaction is whether the relinquished property was "held for productive use in a trade or business or for investment" as required by 1031 requirements.

Although a partnership may choose to wait until close of escrow before transferring the property out to the partners as tenants in common, if the IRS scrutinizes pre-exchange transfers to determine whether an entity held the property prior to holding it in TIC ownership, the IRS may challenge the exchange. Thus, many tax practitioners suggest spinning the property out of partnership and holding it as a tenant in common for at least one tax-return reporting period to avoid characterization as a sham transaction by the IRS. The best policy: Be certain that the TIC agreement is structured from the outset in accordance with IRS guidelines.

As with any real property investment, tax issues are only one factor among many to consider when structuring a TIC transaction. As an example, though TIC arrangements consist of real estate interests, an investor must consider whether the sale of a TIC interest constitutes the sale of a security subject to federal and state securities laws.

If the TIC interest is characterized as security interest, it must be registered under applicable securities laws, documented as a security sale, offered for sale and sold by a licensed securities broker.

Despite the complexity and risks involved in TIC transactions, TICs are a practical and efficient means for real estate investors to defer capital gains tax through the use of a 1031 exchange. TIC investments can offer huge advantages to individual investors seeking to invest in substantial properties through a tax-free exchange. Investors must consider carefully the separate aspects of such transactions, especially the examination of legal issues involved in managing these properties under TIC agreements.

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