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TENANCY IN COMMON FRACTIONAL INTEREST PROGRAMS

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The tenancy in common fractional interest program (TIC Program) is a relatively new and rapidly growing segment of the real estate industry. TIC Programs allow real estate companies to free up significant amounts of equity captured in commercial properties without sacrificing control and ongoing management rights. Smaller 1031 investors once condemned to finding identically-sized replacement properties - - more often than not in a mad dash to beat a 45-day identification and 180-day closing period imposed by IRS regulations - - now have the ability to pool funds and purchase large commercial properties. The TIC Program offers such investors an opportunity to escape the drudgery of day–to-day management of their commercial properties by purchasing a tenant in common interest in larger, professionally managed properties. The broker-dealer community, which is often the conduit between TIC Program sponsors and 1031 investors, also views the TIC Program as an enormous opportunity and has begun to position itself to serve as a clearinghouse for investors in managing their investment portfolios. As with all burgeoning industries, there are tremendous opportunities and risks that accompany the TIC Program. While many practitioners will be reminded of the days of syndicated limited partnerships when evaluating the relative merits and risks of the TIC Program, there is no denying the dramatic and continuing growth of the TIC Program industry across the country.[1]

The TIC Program is premised on a complex ownership arrangement and is therefore typically suited for an institutional grade commercial property. In fact, most TIC Programs usually involve property that is subject to a triple net lease with a single tenant, subject to a master lease with multiple subtenants or may involve multiple leases managed by someone other than the tenants in common pursuant to a management agreement.

Under a typical TIC Program, the sponsor owns or has acquired the right to purchase the subject property and seeks to sell some portion of its equity in the property or to find equity to buy the property. The sponsor sells undivided tenancy in common interests to investors looking for replacement properties pursuant to Section 1031 of the Internal Revenue Code ("Code"). The sale typically occurs through the retail broker-dealer community which receives commissions (often called the "sales load") from the sponsor. Rather than sell partnership or membership interests to investors, the sponsor sells undivided fee interests allowing the investors to claim a deferral of their capital gains tax liability accrued upon sale of the formerly owned properties. The replacement property is owned by multiple tenants in common that pool funds with other similarly situated

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investors to acquire property worth far more than any single investor could acquire by merely reinvesting the proceeds from his or her own relinquished property. The day-to-day responsibility for the commercial property is typically allocated back to the sponsor or its affiliate through a master lease or management agreement. The rights and obligations of the tenants in common are governed by the master lease or a tenancy in common agreement. The lender has a deed of trust on property owned by multiple tenants in common. Although relatively straightforward in theory, negotiating and documenting a TIC Program transaction is quite complicated due to the large number of complex technical issues inherent in TIC Program transactions.

TRADITIONAL CONCERNS WITH A TENANCY IN COMMON

While the tenancy in common ownership structure has existed for some time, it has traditionally been a favorable mechanism for the ownership and operation of commercial real estate; particularly with the advent of the limited liability company structure authorized under RCW 25.15 et seq. and other similar structures. The principal factor in supporting LLC usage over tenancy in common includes consolidation and appointment of a management authority (i.e., an LLC manager), pass-through treatment, liability protection, and taxation. Lenders also prefer limited liability companies over tenancies in common for a myriad of reasons, including ease of foreclosure, limitation of bankruptcy actions by creation of single-purpose "bankruptcy remote" entities, centralization of management, etc.

In contrast, property owned by tenants in common is actually owned by multiple people or entities.[2] Therefore, a tenancy in common is technically not an entity. Rather, each tenant in common owns an undivided interest in the whole property and has a right to possess and enjoy all of the property, subject to the rights of the other tenants in common. Each tenant in common interest is freely alienable and therefore must be subjected to the lien of any deed of trust if a lender seeks to encumber the entire property. Accordingly, a lender must insist that all of the tenants in common execute or otherwise assume the deed of trust. Each tenant in common has the right to seek partition of the property in kind (actual physical division of the property) or by sale, and each tenant in common is fully liable for any liabilities that arise as a result of the ownership of the property, including environmental liabilities.

IRC SECTION 1031

Despite the inherent problems with owning commercial property in a tenant in common structure, TIC Programs are quickly gaining steam due to compelling tax deferment benefits offered under Section 1031 of the Internal Revenue Code. Section 1031 allows an owner of real property to defer gain (and the immediate obligation to pay capital gains tax thereon) by exchanging the real property held for productive use in a trade or business or for investment for "like kind" real property. The exchange allows the investor to defer gain at the time of the exchange even if the property has significantly appreciated in value. For example, an owner of a $2,000,000 multi-family project may exchange the project for a small shopping center of equal or greater value without the immediate obligation to pay capital gains tax. The owner's tax basis in the multi-family project (the "relinquished property") becomes the owner's tax basis in the shopping center (the "replacement property"). The built-in gain is effectively deferred until the sale of the replacement property occurs unless the owner elects to consummate a subsequent exchange pursuant to Section 1031. It is important to note that an interest in a limited liability company, partnership, corporation or similar entity does not qualify as "like kind" property under Section 1031.[3]

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1031 DISADVANTAGES: TIME CONTRAINTS, LIKE PROPERTY ISSUES, REPLACEMENT VALUE

The tax deferment benefits offered by Section 1031 can provide a significant advantage to owners of commercial real estate. However, use of Section 1031 requires compliance with numerous regulations and imposes certain limitations. Most real estate practitioners know, for example, about the 45-day and 180-day requirements.[4] An owner selling real estate and complying with the various Section 1031 requirements (such as making sure that any sales proceeds are held with a "qualified intermediary" so that the owner does not have constructive receipt of the sales proceeds) must additionally identify replacement property within 45 days of the closing of the relinquished property and must close the purchase of the replacement property within 180 days of the relinquished property closing. Many owners find it very difficult to find suitable replacement property within 45 days. Section 1031 offers some flexibility to owners by allowing the owner to identify up to three properties.[5] However, finding an appropriate replacement property that meets the needs of the owner can take a significant amount of time. The 180-day closing period is also problematic. Often times, replacement property transactions don't close as scheduled due to delays in procuring equity and debt financing, due diligence review, environmental problems, etc. Section 1031 provides little to no accommodation for such delays. If the owner does not comply with the 45- and 180-day deadlines, the right to defer gains on the sale of the relinquished property is lost. Generally, the capital gains tax on a non-Section 1031 sale of real property is 15% of the total capital gains realized by the owner. This dynamic has forced many owners into a desperate scramble to find replacement properties.

In addition to the 45-day and 180-day requirements, Section 1031 requires that the replacement property be of equal or greater value. Typically, owners don't sell relinquished properties with the intent of procuring additional cash to buy a replacement property with a significantly greater value. Thus, the Code's allowance for the acquisition of a replacement property with a greater value is not particularly useful for most people. Accordingly, Section 1031 is often used by owners to acquire replacement property with a value approximately equivalent to the relinquished property. However, if the owner is merely acquiring another property with a value equivalent to the property the owner previously owned, the owner might not be gaining much.

TIC - OWNER BENEFITS

TIC Programs offer the chance to mitigate many of the traditional problems associated with Section 1031, as well as address other owner goals, such as elimination of active management, use of deferred gains to further leverage real estate value, and diversification of real portfolios by product mix, location, etc. TIC Program sponsors seek to provide investors with a menu of readily available TIC Program opportunities in order to soften the difficulties presented by the 45-day and 180-day rules and the practical necessity of finding identically-sized replacement properties. TIC Program sponsors view their programs as a way to enable significantly more like-kind exchange transactions that would otherwise occur but for the current limitations under Section 1031. The rapid growth in TIC Programs provides strong evidence that a vast, untapped market might exist for TIC Programs under Section 1031.

If we return to our earlier example of the $2,000,000 multi-family project, it is clear that Section 1031 would allow an exchange for another investment property worth $2,000,000 or more in value. Such a project could not be exchanged outright for a $20,000,000 office building, however, Section

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1031 would allow the owner to (i) exchange the $2,000,000 project for a 10% undivided interest in the $20,000,000 office building, or (ii) exchange the $2,000,000 project for undivided interests in an office building in Atlanta, a shopping center in Cleveland and a warehouse facility in Spokane. Moreover, the exchange might allow the owner to trade a management-intensive multi-family project for an institutional grade property with stable rents and professional management or for multiple properties diversified by product mix (multi-family, industrial, office, retail) or diversified by location (an emerging market in California, a stable market in Boston, etc.). As noted before, the exchange could not occur if the owner was acquiring an interest in the partnership or LLC entity that owned the office building, shopping center or warehouse. Rather, the exchange can occur only if the owner is acquiring a tenant in common interest.

TIC PROGRAM – IS IT A PARTNERSHIP OR NOT?

Until 2002, (see further discussion below), there was very little guidance from the IRS about the viability of the TIC Program. The most obvious risk for any TIC Program investor was a determination by the IRS that the TIC Program transaction constituted a partnership for tax purposes and therefore would fail to qualify for tax deferment under Section 1031. Recent court and IRS guidance notwithstanding, no clear or objective standard has yet been established to describe when a joint participation or arrangement, in particular a tenancy in common will not be classified as a partnership for federal income tax purposes. Therefore, such determination must be evaluated on a case-by-case basis pursuant to the facts and circumstances of each case.

A partnership is defined as "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and is not a corporation, trust or estate".[6] The regulations provide in relevant part:

> A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits there from. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent… However, the joint undertaking merely to share expenses is not a partnership… [M]ere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.[7]

In Commissioner v. Culbertson,[8] the Supreme Court indicated that a partnership exists when:

> considering all the facts - the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent - the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.[9]

Since Culbertson, the parties' intent has been the key factor in determining whether a particular arrangement constitutes a partnership for tax purposes. The relevant inquiry post-Culbertson is not whether there is evidence of intent to be treated as a partnership for state law or tax purposes, but rather, whether there is evidence of intent to carry on a business or venture for joint economic gain.

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Thus, a partnership may be found to exist for income tax purposes even where there is an expressed intention not to form a partnership.[10]

The IRS previously considered the treatment of tenant in common interest in Rev. Rul. 75-374. In this Ruling, the IRS concluded that a two-person co-ownership of an apartment building rented to tenants did not constitute a federal tax partnership. The co-owners employed an agent to manage the apartments. The agent collected rents; paid property taxes, insurance premiums, and repair and maintenance expenses; and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The IRS further concluded that the agent's activities were not sufficiently extensive to cause the co-ownership to be characterized as a partnership for federal income tax purposes.

The conclusion reached by the IRS in Rev. Rul. 75-374 is in contrast with several court decisions in which a co-ownership arrangement was found to be a tax partnership. For example, in Bergford, 12 F.3d 166 (1993), 78 investors purchased "co-ownership" interests in computer equipment. The equipment was subject to a seven-year net lease. The investors authorized the manager to arrange financing, collect rents, purchase and lease the equipment, apply rents to notes used to finance the equipment and advance funds to participants on an interest-free basis. The agreement allowed the investors to decide by majority vote whether to sell or lease the equipment at the end of the initial lease term. An investor could assign his or her interest in the property subject to a number of conditions, including obtaining the manager's consent.

The Bergford court held that the co-ownership arrangement was a partnership for tax purposes. In reaching this conclusion, the court emphasized the limitations on each investor's ability to sell, lease, or encumber either his or her interest or the underlying property, as well as the manager's effective participation in both profits (through a remarketing fee of 10% of the equipment resale price) and losses (through advances). In Madison Gas & Electric Company, 633 F.2d 512 (1980), the court held that a co-generation operation conducted by three utilities as tenants in common was a partnership for tax purposes because the parties shared expenses and divided the jointly produced property among themselves. Two other courts reached similar conclusions where a promoter/manager maintained a significant economic interest in the property that was sold to co-owning investors.[11]

REV. PROC. 2002-22: GUIDANCE FOR THE TIC PROGRAM

Despite the case law and IRS guidance to-date addressing the partnership/real estate issue, there has been little meaningful direction or guidance with regard to whether an investor's acquisition of a tenancy in common interest (pursuant to a TIC Program) qualified as "like kind" property. In fact, the distinction between a partnership and a tenancy-in-common remains unclear. For example, both structures have co-ownership of property and a division of the income generated from the property. A co-tenancy exists where the owners' activities are limited, for example, to maintaining the property, renting the property, etc. A partnership exists when the investors join together capital or services with the intent of conducting a business or enterprise and sharing the profits and losses. As seen in partnerships, there often will be situations in which one of the partners acts on behalf of the other partners. In a co-tenancy, each co-owner can act on behalf of and bind only himself or herself. A partnership frequently will engage in business operations, whereas a co-tenancy in real estate usually involves the mere passive ownership of property in which the co-owners benefit from rent and appreciation in the value of the property. As a result, the distinction between a partnership and a tenancy-in-common remains unclear.

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In 2002, the IRS provided further direction with the issuance of Revenue Procedure 2002-22 (Rev. Proc. 2002-22). Rev. Proc. 2002-22 created legitimacy in the TIC Program industry and ignited the dramatic growth over the past 3 years. Rev. Proc. 2002-22 outlines the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity, within the meaning of §301.7701-2(a) of the Treasury Regulations.

With the publication of Rev. Proc. 2002-22, the IRS has established guidelines and conditions under which it issues rulings to taxpayers. This revenue procedure applies to co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common.

Rev. Proc. 2002-22 provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the IRS in issuing advance ruling letters as promptly as practicable. The guidelines set forth in Rev. Proc. 2002-22 are not intended to be substantive rules and not to be used for audit purposes. The guidelines and conditions set forth in Rev. Proc. 2002-22 do not establish any particular "law" or "rule" for the treatment of TIC ownership arrangements; rather they merely set forth the circumstances under which the IRS is prepared to rule favorably when presented with a particular case. Cases that do not meet all the requirements and conditions of Rev. Proc. 2002-22 may nonetheless qualify as proper TICs for tax purposes under their particular facts and circumstances.

<u>Guidelines</u>. Section 4 of Rev. Proc. 2002-22 sets forth three "guidelines" for submitting ruling requests; if these guidelines are not met, the IRS will generally not consider the request.

<u>Guidelines</u>
1. each co-owner's interest in each parcel is identical to that co-owner's interest in every other parcel
2. each co-owner's percentage interests in the parcels cannot be separated and traded independently
3. the parcels of property are properly viewed as a single business unit. For this purpose, contiguous parcels are treated as a single business unit.

<u>Conditions for Obtaining Rulings</u>. In addition to the Guidelines set forth in Section 4 of Rev. Proc. 2002-22, the IRS will not ordinarily consider a ruling request unless the fifteen conditions described in Section 6 are satisfied. Nevertheless, the IRS may grant favorable requests even when the Conditions are not satisfied if the facts and circumstances clearly warrant a favorable ruling.

Condition
.01 *Tenancy in Common Ownership*. Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

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Condition
.02 *Number of Co-Owners*. The number of co-owners must be limited to no more than 35 persons. For this purpose, “person” is defined as in §7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.
.03 *No Treatment of Co-Ownership as an Entity*. The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under the revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.
.04 *Co-Ownership Agreement*. The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, 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 (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of the revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).
.05 *Voting*. The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with Section 6.05 of the revenue procedure may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.
.06 *Restrictions on Alienation*. In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner’s undivided interest in the Property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See section 6.14 of the revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner’s exercise of the right to transfer the co-ownership interest in the Property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

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Condition
.07 *Sharing Proceeds and Liabilities upon Sale of Property*. If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.
.08 *Proportionate Sharing of Profits and Losses*. Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.
.09 *Proportionate Sharing of Debt*. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.
.10 *Options*. A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.
.11 *No Business Activities*. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in §511(a)(2) from qualifying as rent under §512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.
.12 *Management and Brokerage Agreements*. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue

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Condition
and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.
.13 *Leasing Agreements*. All leasing arrangements 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. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.
.14 *Loan Agreements*. The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.
.15 *Payments to Sponsor*. Except as otherwise provided in the revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-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.

An extensive discussion of Rev. Proc. 2002-22 and its applicability to typical TIC Programs that are currently in the marketplace is beyond the scope of this article. Some practitioners dismiss Rev. Proc. 2002-22 as nothing more than mere guidelines for letter ruling requests. Other practitioners note that some of the specific guidelines relating to certain aspects of TIC Programs are not relevant to the fundamental partnership/co-ownership issue or practical given the operational requirements of commercial properties. The IRS specifically stated that Rev. Proc. 2002-22 does not establish law or rules for the treatment of tenant in common ownership arrangements; however, it is likely that the guidelines in Rev. Proc. 2002-22 have become and will remain a "safe harbor" for the proper structuring of TIC Programs.

SECURITIES LAWS: THEIR APPLICATION TO THE TIC PROGRAM

TIC Programs are complicated enough given the tax issues posed by current law and Rev. Proc. 2002-22. However, there are other complicated issues including the application of federal and state securities laws. Because of the pooling nature of the TIC Program, properties are typically subject to management agreements or master leases that address the leasing, management, and operations of the property. A critical issue in the TIC Program industry is the effect of laws that govern the scope of the disclosure obligations to investors and laws that govern the registration, licensing and compensation of individuals who are compensated in connection with TIC Program transactions. Under federal securities law, an investment is considered a security if it is an "investment contract."

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The United States Supreme Court has held that an investment contract is an investment of money in a common enterprise, with profits derived solely from the efforts of others. SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

In two different no-action letters in 1999 and 2000, the SEC noted that TIC interests in § 1031 real estate, subject to a master lease agreement, are securities. (See 2000 SEC No-Act. LEXIS 824 (Aug. 23, 2000)(Corporation Finance) and 1999 SEC No-Act. LEXIS 83 (Jan. 19, 1999)(Market Regulation).) In the no-action letter requested from the Division of Corporation Finance in 2000, the proposed activity was specifically described as selling replacement property to owners of real estate held for investment, or for trade or business purposes, in a 1031 TIC Program structure. The SEC did not argue that the activity only involved real estate investments and not securities, and so it could not offer that individual the no-action ruling.

The offering of undivided interests in real estate, together with a management contract or subject to a master lease, is likely an offering of securities in the nature of investment contracts, where the circumstances indicate that the purchasers will acquire the property with the expectation of realizing profits from the efforts of other persons, or where the purchasers enter into a management agreement for the operation of the properties and the sharing of profits.

Some people have argued that because a 1031 TIC Program includes an interest in real estate for 1031 exchange purposes, it cannot be a security for federal or state securities law purposes. While it is theoretically possible to construct a 1031 TIC Exchange that is not a security under federal or state securities laws, such an example is extremely limited in scope. The typical 1031 TIC Program structure involves passive investment with profits generated from the efforts of third parties, such as a master lease or management contract of the property. The critical issue, as the United States Supreme Court has observed, is whether the success of the enterprise is dependent upon third-party efforts. If it is, then it is a security for federal and state securities law purposes. Thus, a 1031 TIC Program would likely not be a security only if the tenants in common undertake every activity necessary for the investment to generate a profit and do not delegate or contract to any third party any of the activities necessary to generate a profit.

The U.S. Supreme Court appeared to resolve this issue recently in SEC v. Edwards, No-02-1196 (540 U.S. ______) (2004). This case involved a payphone sale-leaseback scheme in which 10,000 people invested $300 million. The sponsors sold payphones to the public and leased them back with a site lease, management agreement and guaranteed return promise. The SEC brought an enforcement action claiming that the investment scheme was an "investment contract" that required compliance with registration requirements. The Supreme Court agreed with the SEC's position and many people in the TIC Program industry believe that Edwards confirms that TIC Programs constitute the sale of securities.

Given that the SEC will likely insist that TIC Programs are subject to federal securities laws, it is prudent for any sponsor to comply with registration exemption and disclosure obligations. Generally, sponsors today will only sell TIC Program interests to accredited investors and rely on Regulation D to avoid registration of the TIC Program.

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TIC PROGRAM: REQUIRING LICENSED PROFESSIONALS

Since TIC Programs are considered securities, there are significant federal and state securities law compliance issues to be considered. First, any firm involved in recommending, offering or selling such investments must be a licensed broker-dealer with the NASD and state securities regulators in every state in which the firm operates or the client resides. Second, any individual who recommends, offers or sells these investments in return for a commission must be licensed as a securities professional - - a registered representative - - with the SEC, the NASD and the states, and must be associated with a licensed broker-dealer. Any unlicensed individual or firm involved in recommending, offering or selling these investments is likely in violation of federal and state securities laws.

Some have argued that a person who receives compensation for referring investors who ultimately invest in a 1031 TIC Program need not be a registered representative because that person is an agent of the issuer. Under certain very limited circumstances, there is an exemption from registration as a securities professional for a person who acts solely as the agent of the issuer. Rule 3a4-1 under the Securities Exchange Act states that an associated person of an issuer of securities is not deemed a broker as long as all the requirements set forth in that rule are kept, and the securities are sold in a certain way. One core requirement demands that the person in question "is not compensated in connection with his participation by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities."

Broker-dealers and their registered representatives are extensively regulated. Securities regulators impose detailed rules and regulations regarding record-keeping, the suitability obligations of the registered representative and the parallel supervisory obligation of the firm, and the duty to disclose all material information to investors relating to compensation paid arising out of the recommended investments, as well as any other conflict of interest.

James Dawson, the regional head of the National Association of Securities Dealers (NASD) in Seattle has expressed the NASD's strong interest in developing the TIC Program industry and maintains that TIC Programs involve the sale of securities and can only be sold by licensed brokers-dealers. There is, however, a clear conflict between the SEC's and the NASD's position about TIC Programs and general state law requirements that stipulate anyone selling "real estate" must have a real estate license issued by the relevant state.[12] It is unclear how this conflict will be resolved. Some say that anyone selling TIC Programs must have both a broker-dealer license and a real estate license. Recently, the Tenant-in-Common Association, a national industry group, has approached the SEC staff to resolve the apparent conflict but has not yet received any response. It is likely that this issue will remain unresolved in the short-term.

FINANCING COMPLEXITIES AND LENDER REQUIREMENTS

The need for TIC Program financing is growing. Many lenders are dealing with the inherent complexity of TIC Programs and struggling to address multiple ownership issues, management issues, partition rights and other issues inherent to TIC Programs. Many lenders today originate loans for ultimate pooling and sale to the secondary market as commercial mortgaged back securities ("CMBS"). Lenders are quite concerned about whether their loans can be sold on the secondary market and CMBS lenders are working closely with the secondary market rating agencies to develop TIC Program underwriting standards. DUS lenders, such as Fannie Mae and Freddie Mac, have

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refused to process TIC Program loans citing the need to develop appropriate underwriting standards. Some portfolio lenders, such as life insurance companies, are exploring the viability of TIC Program loans.

The financeability of TIC Program properties is one of the most significant challenges facing the TIC Program industry. There are few projects that can be financed solely with equity dollars. Most owners believe that effective use of leverage is an important ingredient to long-term asset value. TIC Programs will be forced to find market rate financing that is competitive with financing available to other institutional owners of commercial real estate. Otherwise, TIC Program properties will be burdened by a higher debt load and affect the owners' ability to offer market lease rates and generate the best possible returns. The most competitively priced loans are generally offered today through the conduit (CMBS) or DUS lending markets. Some portfolio lenders are available but the inherent limitations imposed on any one portfolio lender make it difficult for any one portfolio lender to service the debt financing needs for multiple TIC Programs. Since the DUS lenders have pulled back from TIC Programs, TIC Programs must generally be able to satisfy CMBS secondary market requirements to obtain necessary debt financing. A few of the lending issues and solutions for TIC Programs are described below.

(i) **Borrowing Entities**

Lenders who make loans to TIC Programs must address the multiple ownership issue. As mentioned earlier, each tenant in common has an undivided interest in the property. A lender will require that each tenant in common to execute the loan documents including the deed of trust or assumption agreement to effectively encumber the entirety of the property. The lender cannot be in a position where less than all of the tenants in common are in default or where the lender can only foreclose on a portion of the undivided interests in the property rather than the whole property. Lenders will require that each tenant in common be jointly and severally liable for all of the obligations under the loan documents although most CMBS loans will be non-recourse loans, subject to certain carve-out guaranties. Lenders will impose single purpose entity requirements on each tenant in common and insist on the creation of a limited liability company ("SPE") that will take title to the property and own nothing else other than its tenancy in common interest in the property. A tenant in common's joint and several liability should not adversely affect the actual investor since the SPE will be the entity executing the loan documents and the SPE owns nothing more than the tenant in common interest in the property. Moreover, most CMBS loans will be non-recourse.

In response to sponsors' concern over a 1031 investor acquiring an interest in an SPE rather than actual fee title, the IRS has provided guidance indicating that an SPE is a disregarded entity for purposes of satisfying the "like kind" requirements of Section 1031.[13]

Most CMBS lenders will impose other SPE requirements on TIC Programs depending on the size of the loan and the leverage ratios. Some lenders will require each SPE to be a Delaware limited liability company. Other lenders will require, for loans in excess of $20,000,000, a bankruptcy-remote corporate manager for each SPE, which corporate manager must have an independent director in an attempt to avoid bankruptcy filings. Current law allows the trustee for the bankruptcy estate for any one tenant in common to sell the entire property and divide the proceeds among the tenants in common in accordance with their respective percentage interests. In addition, the bankruptcy of any one tenant in common can stay the foreclosure action by the lender against the property. The bankruptcy risk is multiplied by the number of tenants in common. The overall bankruptcy risks

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facing a lender force the lender to require that each tenant in common satisfy all of the rating agency requirements to the same extent as if it were the single borrower. As a result, TIC Programs will have to structure investor participation in accordance with all applicable SPE requirements.

(ii) **Underwriting**

Lenders making loans for TIC Programs will typically underwrite each tenant in common. However, standards will vary dependent upon the overall leverage ratio, the size of the loan, the size of individual percentage interests for tenants in common, etc. Most sponsors will negotiate the underwriting standards with lenders to limit the impact on prospective investors since most CMBS loans will be non-recourse. Minimum underwriting standards require litigation, lien and bankruptcy searches for investors. Lenders are primarily concerned about the ability of individual tenants in common to contest a foreclosure action, file a bankruptcy proceeding or take other actions which obstructs a lender from pursuing its remedies. As a result, lenders are quite concerned about an investor's prior credit or litigation history. Some lenders will impose additional underwriting standards and also require a review of financial statements and tax returns. Prudent sponsors will try to limit underwriting of investors and require time limits from lenders to accommodate the strict Section 1031 time periods applicable to investors.

(iii) **Guaranties**

Most lenders who provide non-recourse financing insist on non-recourse carve-out guaranties that impose personal liability in the event of fraud, environmental liabilities, misappropriation of insurance proceeds, rents or reserve funds, voluntary bankruptcy, partition actions and violations of due on transfer provisions. Some sponsors will request that only its principals be required to execute the guaranties. Other sponsors try to avoid guaranties that would apply to actions solely within the control of the individual tenants in common, i.e., violation of due on transfer provisions, violation of SPE requirements, voluntary bankruptcy and partition actions, etc. Lenders will often want guaranties from the individual investor that owns the SPE to control an investor's possible bad behavior. Some lenders seek to require any tenant in common to waive its inherent right to partition the property. Unfortunately, this waiver is in direct conflict with Rev. Proc. 2002-22. As a result, most lenders will make the partition action an event of default which is permissible under the Rev. Proc. as a "customary lending practice" or otherwise trigger conversion of the loan from non-recourse to recourse under the carve-out guaranties. Prudent sponsors will also address the partition right by creative call options or similar tactics.

(iv) **Centralized Management**

Lenders do not want to deal with multiple tenants in common. The lender typically has no relationship with the individual investors. Moreover, the lender is quite concerned about the effective functioning of a property that is left to the hands of a disparate group of investors who have no prior relationship or any other connection. Accordingly, lenders are highly motivated to make sure that a master lease or management agreement stays in place to centralize management functions with the original sponsor or its affiliate. Other lenders require lockbox arrangements to ensure that property rentals are applied first to debt service, taxes, insurance and required maintenance reserves. Most lenders require centralized notice provisions for all tenants in common.

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There are a multitude of other issues affecting TIC Program loans, including concerns about the number of investors, the obligations of investors to make "capital calls" or otherwise feed a project when necessary, requisite legal opinions, such as non-consolidation, Delaware non-dissolution, bankruptcy and enforceability, accredited versus non-accredited investors, and investor transfer rights. Lenders, sponsors and investors will continue to work through the issues in an attempt to standardize TIC Program loan requirements in the future.

CONCLUSION

The introduction of TIC Programs is a rather new development in the commercial real estate industry. TIC Programs offer many advantages to owners of commercial real estate that seek to pull out equity in projects without losing management control. TIC Programs also offer investors the opportunity to convert management-intensive properties for larger properties that are professionally managed, to diversify real estate holdings and to avoid some of the customary limitations of Section 1031. There are significant issues involved in the structuring of TIC Programs, as described in this article. Moreover, the industry faces many of the problems that affected the syndication business, including unscrupulous sponsors more interested in fees than investors, heavy "sales load" problems, tax risks for an improperly structured program, and poor disclosure about the asset performance, (including financial health of project tenants, competition, financing risks, etc.). The number of TIC Programs, sponsors and investors is growing and practitioners have another interesting challenge before them in addressing and resolving many of the issues facing the industry.

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ENDNOTES

[1] According to the Tenant-in-Common Association (TICA), which is a new national industry group of TIC Program sponsors, broker-dealers and lenders, TIC Programs accounted for approximately $167 million in raised equity transactions in 2001. In 2004, TICA expects more than $2 billion in raised equity transactions for the year. Although these figures are a small portion of the overall real estate industry, the sheer growth in the TIC Program, coupled with its inherent advantages, may foretell a significant change in the way commercial real estate is held in the future.

[2] For an excellent discussion of the tenancy in common, please see (i) § 1.28 and § 1.31 of Professor William B. Stoebuck's Real Estate Property Law (1995) and (ii) Chapter 9 of The Washington Real Property Deskbook written by Professor John W. Weaver.

[3] I.R.C. § 1031(a)(2)(D).

[4] Treas. Reg. § 1.1031(k)-1.

[5] Id.

[6] I.R.C. § 761(a); § 7701(a)(2).

[7] Treas. Reg. § 301.7701-1(a)(2).

[8] 337 U.S. 733 (1949); see also, Commissioner v. Tower, 32 U.S. 280 (1946).

[9] Id. at 742.

[10] See Wheeler v. Commissioner, 37 T.C.M. 883 (1978); Luna v. Commissioner, 42 T.C. 1067 (1964); G.C.M. 36436 (Sept. 25, 1975).

[11] Bussing, 88 TC 449 (1987); Alhouse, TCM 1991-652.

[12] See, for example, RCW 18.85 and 18.86 et seq. and WAC 308-124

[13] Rev. Proc. 2002-22 and 2002-69.

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