Avoiding the Traps in 1031 Tenants-in-Common Exchanges

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The 1031 market has grown exponentially in recent years, averaging a 100 percent increase annually since 2000. The Tenant-In-Common (TIC) offering industry is expected to raise $4 billion in equity this year from transactions valued at close to $10 billion, and at the current growth rate, those numbers could well double in the next three years. This is from essentially a standing start in 2002 (Burr [2005]). The continued expansion of this market, combined with the unprecedented run-up in real estate values, indicates investors will have an expanding universe of properties available for 1031 exchanges in coming years. This should also facilitate meeting the 180-day time limitation for purchasing replacement properties.

The TIC structure and the entry of larger sponsors have brought higher-quality, higher-valued properties once reserved for institutional portfolios into play for individual investors. Having an inventory of potential replacement properties available helps ease the pressure on clients and advisors. The inventory also helps alleviate the fear of missing time deadlines should pending deals fall through, sellers renege, properties not be what investors imagined, and so forth.

In this article, we will start with a review of the various mistakes that can befall individuals and prevent them from successfully using this approach. We will then investigate who might benefit from such exchanges, specifically illustrating the proposition that they best serve the needs of investors who are not in the position to find their own properties and complete transactions with their own advisors. We will conclude with a discussion of twenty steps that can serve to enhance the chances of being a successful investor in TIC 1031 exchanges.

MISTAKES

The IRS Revenue Procedure established 15 basic prerequisites to obtain a favorable ruling for a TIC in a 1031 exchange. The most common errors made by advisors typically occur because of misunderstandings regarding:

1. The Qualified Intermediary
2. The Private Placement Memorandum
3. Marketing Miscues
4. Missed Deadlines
5. Mismatched Clients and Vendors.

Advisors who try to shortcut any aspect of the process are inviting problems, including the loss of a commission, the loss of a client, an NASD violation, and/or a lawsuit.

Qualified Intermediary

Most advisors realize a 1031 property exchange requires a qualified, insured third-party intermediary to hold the funds realized

from the sale of a current property until a replacement property is purchased. An area of common confusion, however, is identifying who is a qualified intermediary. According to the IRS, it cannot be any of the advisors directly involved in the transaction, including the client's real estate agent—or the agent representing any of the parties in the exchange. It cannot be the client's financial advisor or CPA if the latter has prepared the client's tax return within the previous two years, or an attorney who has had a relationship with the client during the previous two-year period.

The term *qualified* is actually a misnomer, since the intermediary does not have to be qualified, per se. There is no government guideline, minimum level of expertise, or net worth required. Exchange intermediaries, such as IPX Investment Property Exchange, probably represent the safest alternative for advisors because they are large, experienced, licensed, and bonded for millions of dollars in liability coverage. If one of their employees absconds with funds, the insurance carrier replaces the loss.

There have been numerous cases of IRS disqualification because the wrong person held the money or an attorney inexperienced with 1031 exchanges used improper wording, invalidating the tax-free exchange of the proceeds. Sadly, there have also been cases where intermediaries have absconded with the funds, in one case over two million dollars.

Steven Crawford, a Certified Financial Planner™ and President of The Main Street Group in Glen Allen, Virginia, recalls two investors who bought a commercial lot for approximately $300,000 a few years ago. When it appreciated, the pair borrowed another $800,000 against it. They ultimately sold the lot to a major retailer for $3.8 million. They wanted to do a 1031 exchange but decided to forgo using a financial advisor in favor of their attorney, who assured them of his 1031 expertise. The investors paid the attorney a $40,000 fee for work that likely could have been done by an advisor for a fraction of that amount. After completing the 1031 exchange, the pair bought a motel. Their CPA later discovered the attorney paid off the debt on the original property before completing the exchange, which created a taxable event. The 1031 regulations state that debt on a property being sold must be transferred to a purchased property with an equal or greater amount of debt. By paying off the debt on the original property, the attorney triggered a capital gains tax of $180,000. Added to the attorney's $40,000 fee, the two investors suffered an unnecessary $220,000 loss.

They subsequently sued the attorney and were able to recoup most of the investor loss from the attorney's errors & omissions carrier, but it was a prolonged and stressful experience for the investors and, of course, they could not recover the capital gains tax.

Private Placement Memorandum

Advisors cannot discuss a TIC with an investor before first

1. filling out a broker/dealer investor profile to ensure the investor is accredited and the advisor did not initiate the inquiry
2. filling out a separate investor profile from the property sponsor
3. providing the investor with a private placement memorandum describing the proposed replacement property.

Each property comes with a Private Placement Memorandum (PPM), typically a 75 to 100-page disclosure booklet from the sponsor, to be reviewed in detail with the client. It is a chore going over a hundred or so pages and answering questions, but failure to cover the material fully can have harsh consequences. Advisors should consider a formal checklist with each step initialed by the client as it is completed, acknowledging that area has been discussed. In addition to helping safeguard the advisor's position, the checklist is a sign of professionalism and helps reassure clients.

The PPM describes the property and provides other key information, such as the fees and risks. It is a minefield for potential errors and omissions. There are scads of places for signatures and initials, and disclaimers, in most cases, must be notarized. Make a single error (commission or omission) and the document has to be redone. This may appear to be only a paperwork issue, but if the property sells out during the delay, the investor must identify another property—assuming the 45-day limit has not expired. The closer to the end of the discovery period, the more debilitating errors can become.

Illustrating this point is the case of an investor who, working with her financial advisor, CPA, and attorney, pursued a TIC transaction involving two Midwest buildings, one of which had debt, from a real estate sponsor. In filling out the PPM with her advisors, the client, who evidently was concerned about violating disclosure

requirements, unnecessarily listed a personal bankruptcy discharged 20 years previously. Even though the bankruptcy was no longer on her credit report, the sponsor rejected the application. Again, the client had the option of pursuing a different property with a less-rigid sponsor, but the time clock is always ticking on the 45-day identification and 180-day exchange periods. There is precious little time to waste on misunderstandings or bad judgment.

Marketing Miscues

Regulation D rules restrict the sale of 1031 TIC exchanges exclusively to accredited investors, briefly defined as individuals whose net worth exceeds $1 million, whose annual income exceeds $200,000 in each of the previous two years, or a trust with assets in excess of $5 million.

In addition, advisors cannot solicit the transaction; the client must initiate the contact or be referred by another advisor, such as a CPA or a tax or estate planning attorney. Advisors must be able to document that information on the TIC was requested by the client, not solicited by the advisor.[1]

Missed Deadlines

Investors have 45 days from the sale date of a property to identify potential replacement properties and 180 days to close on a replacement purchase. That sounds simple enough, but it often becomes a race against the clock. Finding a like-kind property of the right size and type within the required time period can be a formidable task. The time pressure can build and become onerous. Writing in *Real Estate Weekly*, Joseph Darby estimates "...over 200,000 real estate transactions are structured, at least initially, to be a like-kind exchange, and estimates are that well over $100 billion of these anticipated exchanges fail because of the inability to find acceptable replacement property" (Darby [2005]).

Given the dire consequences of missing either the 45-day identification or 180-day replacement deadlines, advisors working any 1031 exchange transaction should identify at least one TIC property as a backup should the pending deal blow up. In other words, if a client is exchanging her Wendy's franchise in Chicago for a dude ranch in Montana and a week before the deadline the ranch owner learns there are valuable copper rights under the ground and backs out of the sale, the advisor has a TIC replacement property at hand to save the day. If the dude ranch becomes a reality but $ 300,000 of unused funds that need a home, the TIC once again becomes the safety valve.

That said, only advisors who specialize in 1031 TIC offerings are likely to have a broad array of properties available to fit any need. Writing in the *Journal of Financial Planning*, Clarence Rose, Ph.D., notes that "Perhaps the greatest risk associated with the complexity of the [1031 TIC] transaction, as with any type of like-kind exchange, is that the deal may fall through and prevent an investor from completing the like-kind exchange within the time limitations allowed, thereby subjecting the investor to capital gains taxes and possible penalties" (Rose [2006]).

Sponsors—who live in fear of U.S. Internal Revenue Service (IRS) intervention—rarely deal with part-time TIC advisors. The more TIC transactions an advisor brings to the sponsor, the more that advisor receives first right of refusal on the sponsor's various offerings. The size and mixture of an advisor's TIC inventory are critical to saving clients from the ramifications of missed deadlines.

Mismatched Clients and Sponsors

Not every 1031 that misfires is the result of an IRS disqualification. Clients can lose interest or become discouraged if they are mismatched with property vendors, the benefits are not properly explained, all the options are not presented accurately, or one of the necessary advisors is left out of the process. Clients may decide it is simply less hassle to pay the capital gains tax than to go through the procedural quagmire the 1031 qualification process entails.

Some investors shy away from 1031 exchanges because of illiquidity. While an advisor is required to review the financial qualifications of a potential investor for appropriateness, in many cases the illiquidity issue is not explained properly and the transaction never happens. While TIC illiquidity is a drawback for some investors, retaining a highly-appreciated investment property, or one that no longer generates a satisfactory return, hardly constitutes a liquid position. So although an investor may not improve liquidity with a 1031 TIC exchange, chances are the new position will be no less tenable.

There is a lot to be said for dealing with large sponsors. Only a small percentage of TIC sponsors, about 10 to 15 percent, are large companies with a substantial pool of properties. Larger sponsors have more market leverage

and tend to attract higher value properties because they may do dozens or even hundreds of deals a year versus small sponsors who may do only a single transaction. Better properties, financial arrangements, and the like increase the odds for positive long-term investment results, and the opportunity to do additional transactions with clients. Advisors might benefit from dealing with real estate sponsors who maintain substantial property inventories. They can then make the inventories available to CPAs and other advisors who request the service as backup for their clients doing 1031 transactions.

Currently, there is no sponsor-provided secondary market for TICs. Sponsors report they are seeking ways to create greater liquidity and it is certainly in their interest to do so. The idea to eventually convert TICs into REITs continues to surface and seems a likely development, but sponsor concerns over IRS disqualification understandably slow progress.

As a result, TIC investors are in charge of their own secondary market and there is no guarantee they will be able to sell for a favorable price at a given time in the future. As with any security, market forces dictate prices. However, larger sponsors doing more TIC transactions seem to offer investors a better opportunity to liquidate or exchange their shares for an alternative property as they tend to be market makers with larger investor-client bases. Having multiple properties available also allows investors to purchase a combination of properties to avoid boot capital gains tax liability for portions of sold properties not reinvested.[2]

The more investors a sponsor has, the more likely the sponsor can find an investor to buy shares from someone looking to get out early. Larger sponsors also have a financial interest in getting investors to reinvest, and so would appear to be more flexible in situations where investors want to liquidate or trade their interests. Having multiple properties available also allows investors to purchase a combination of properties to avoid boot capital gains tax liability for portions of sold properties not reinvested. Their experience in doing many transactions should give them a leg up in terms of evaluating properties. They also tend to have excellent due diligence departments, an important consideration for advisors and investors. Since the TIC arena is in its infancy and only a few properties have been held the requisite 1 to 2 years and then sold, commentary on future liquidity is mere speculation.

Each real estate sponsor has a different set of procedures, and it is easy to get snared. One sponsor may accept a client based on certain net-worth requirements or financial ratios; another may not. Advisors must take care to properly match clients with sponsors.

The documentation also varies from sponsor to sponsor, further complicating an already complex process. If a client's initials are missing where requested or a single piece of background information is omitted, the sponsor will kick back the application. The corrections can always be made, of course, but if time factors in, which it usually does, even a minor delay can have severe financial repercussions.

A TIC cannot utilize a REIT; the property or properties must be free-standing buildings owned by 35 investors or less. If the majority of investors decide against selling a property, an individual investor faces a liquidity problem because the only recourse is to sell the share on the secondary market. However, most major real estate management companies have been buying properties for their 1031 inventories with virtually identical specifications as for their REITs. The inevitable trend appears to be that 1031 properties will eventually be moved into REITs, converting investor 1/35th ownerships into corresponding shares of the REITs, which should provide greater liquidity in the future.

CANDIDATES

Tenants-in-common exchanges are not for sophisticated real estate investors or market players; they are likely to find their own properties and complete transactions with their own advisors.

Tenants-in-common candidates include accredited investors with highly appreciated property or property that is no longer generating a satisfactory income. Prospects might be investors who own raw land with inadequate income, perhaps rented for farming or timber purposes. Our firm recently completed a $3.5 million TIC transaction for a client on a family farm. The farm had been generating income sufficient only to pay property taxes. The TIC will generate 6 percent annual income for the client with no further property management concerns, and the investment is no less liquid than was the farm.

Other candidates include investors who no longer want property requiring active management. Retirees, for example, may want to become passive investors and simply collect their checks.

Replacement properties can include residential, commercial, or industrial properties, including office

buildings, shopping centers, manufacturing plants, apartment buildings, restaurants, senior living facilities, and others.

One example involves an offering an advisor received from a real estate sponsor for a stand-alone building occupied by a major pharmacy available in a $1.5 million TIC offering. The sponsor had an existing $2.5 million loan on the property. The appeal to investors was the ability to own their own building with an advantageous 20-year lease. But like investors who become limited partners in a golf course development, celebrity-backed restaurant, or entertainment venue, TIC investors love cocktail party bragging rights about owning prestige properties or those with highly regarded anchor tenants. As an advisor, however, you cannot afford to have stars in your eyes in a TIC transaction. In this case, the downside of the TIC offering was what would happen if the pharmacy broke its lease? What could the investors do with the building? These are not properties than can be easily converted into something else. They are invariably situated on the corner of an intersection where a gas station might logically be located. If the firm vacated, investors would have few options for converting the building into another viable enterprise. Certainly a gas station was not an option. The property was rejected as an option. As the realtors say, "Location, location, location."

Another example of a property that looked appealing at first glance, but paled upon closer examination, was an aircraft factory leased to a defense contractor. It was a beautiful and highly functional facility with a great tenant, but who would lease it if the contractor left? Again, advisors and clients should evaluate a TIC property as an investment first, and a tax strategy second.

Investors who may be better off paying the capital gains tax include those who may need their funds at a predetermined time sooner than the estimated liquidation of the property. There is no guarantee that a property will sell nor is there a vigorous secondary market. In our experience, investors forced to liquidate early typically do no better then 75 cents on the dollar. Investors who otherwise qualify for a TIC but lack sufficient assets outside the TIC to weather potential needs should not participate. If a benefits analysis reveals the numbers are close between paying the taxes and doing the TIC, the more prudent choice may be for the investor to pay the capital gains tax. The TIC should be overwhelmingly supported by the numbers.

SAFEGUARDING INVESTORS

A TIC should move investors into a better position, not merely an alternative position. Sometimes, advisors and clients get so focused on saving taxes they forget that, first and foremost, this is an investment; it must stand on its own. In any TIC transaction, it is advisable to ask if the investor would buy the property if there were no tax issues involved. If not, it is best to look for another property.

Advisors must fully explain the 1031 TIC load to qualified investors, including fees, expenses, and commissions. Typically, the load amounts to 10 to 15 percent of the property value. The client should be advised to consider the alternative of simply paying the 15 percent capital gains tax, and in some cases, this is the prudent action for the client. However, once the taxes are paid, that money is gone and unavailable for investment returns. In a TIC, the money paid for the load can be recouped if the property appreciates. In addition, the client receives an annual return, generally 5 to 7 percent, on the entire value of the property before the load is extracted. So even if the property never appreciates, an unlikely scenario, the client is no worse off than paying the taxes but still receives income on the full value of the property.

Heirs receiving the TIC shares of a deceased investor receive a significant advantage. They pay no capital gains and receive a stepped-up cost basis (the value of the property at the time of the investor's death) for future tax purposes. The benefit would be lost should the TIC shares be gifted to heirs while the investor was alive, because the original cost basis would be passed on to the recipients.

Investors are likely to inquire what, in addition to the 5 to 7 percent annual dividend, they will receive in exchange for the load. Advisors can respond that clients receive critical due diligence on the property, a properly set up limited liability company (LLC) structure, attendant legal work, professional property management, and the reassurance that the transaction will stand up to IRS challenges. In the case of a $1-million property, the 6-percent annual income they will receive on the $150,000 that would have been surrendered to capital gains taxes, amounts to $9,000 a year. If the property is held for 10 years, this equals $90,000 in additional income they would have surrendered by not doing the TIC.

Advisors are warned to beware of TIC offerings with excessive loads, up to 25 percent and even higher, charged by some sponsors. Rarely can fees of that size be justified by any property or terms.

As Clarence Rose notes in the *Journal of Financial Planning*, "An additional risk to consider is the selection of a knowledgeable and experienced financial advisor and TIC sponsor. The complexity of the transaction leaves little room for error."

There is one other element of a TIC transaction that bears mentioning and an option that advisors may wish to consider—visiting the property site with the investor. This is certainly not a revolutionary concept, but having the investor physically inspect the property can alleviate a host of future problems. One advisor was sued for damages by a 1031 investor who did not visit the property, basing the suit on the fact that he did not know the building was on a one-way street with limited access.

Although the cost of flying across country to visit a property or the sponsor's home office with an investor can be substantial, the expense typically represents a minor percentage of the advisory fees. Just as important, the visit may help reassure the client and solidify the transaction, and is a huge due-diligence chip for the advisor. Given the cost of a lost transaction because the client was uncomfortable buying an unseen property, a couple of airline tickets are cheap insurance. Despite the obvious advantage, taking each client on a personal tour of the property is a rare practice among the advisors I spoke to.

TWENTY STEPS TO A SUCCESSFUL EXCHANGE

The following checklist can be used in 1031 TIC exchanges:

1. Record the origination date of your relationship with the prospective exchanger, and also the basis—friendship, financial advisory, or other business.
2. Record the date and circumstances of your first 1031 conversation.
3. Complete a Sponsor Prequalification Questionnaire and notify the sponsor that you are introducing an accredited investor to them.
4. Complete your broker/dealer Investor Profile with the investor, giving the sponsor permission to send details of a current offering to the investor.
5. Obtain the sponsor's Private Placement Memorandum with details of each offering. The document must be read by the investor. Multiple properties each require a separate memorandum.
6. With the investor, review a mathematic comparison of these alternatives:

   a) Paying the taxes and keeping the difference
   b) Exchanging most of the cash, but keeping some
   c) The income stream from a complete exchange
   d) The TIC sponsor loads and fees.

7. Have the investor sign the broker/dealer Investor Representation Form, acknowledging or representing that he/she received the memorandum, reviewed it with their tax advisor, and after careful study, believes a TIC offering is appropriate.
8. Obtain a Qualified Intermediary (QI) and create an investor file.
9. Have the QI contact the investor's closing agent *prior* to closing the first sale so appropriate 1031 language can be included in the closing documents.
10. If all is satisfactory, close the original sale. Have the closing agent send funds directly to the QI. The 45-day Discovery Period begins on the date of closing.
11. Complete the QI's Property Identification Form for each prospective property, keeping in mind the three-property and the 200-percent rules.
12. (Recommended.) Fly the investor and the registered representative to the TIC sponsor's offices to meet with their executives and 1031 team. Next, fly to the location of one or more identified properties and do a physical walk-through.
13. Once the investor has decided on one or more offerings, conference call (with a notary on hand) with the sponsor's 1031 team; sign and complete all necessary forms.
14. Send all signed PPMs to the broker/dealer for compliance approval. Forms are then forwarded to the sponsor.
15. Sponsor runs investor's credit history, reviews financial statements, and completes a sponsor-compliance review. If the property has debt, the lender must also approve the credit worthiness and suitability of the investor.
16. Sponsor's legal department forms a LLC for each property and forwards paperwork to the State Corporation Commission for registration in the state where each property is located.
17. Investor authorizes QI to send funds to sponsor's closing agent.

18. Closing is completed on each property by closing agent.
19. Final ownership paperwork, including Settlement Statement, is sent to the registered representative for delivery to the client. Package includes investor notification of all fees charged and commissions sent to the broker/dealer.
20. Registered representative reviews ownership paperwork with investor and answers all questions.

CONCLUSION

Tenants-in-common investors must have a long-term investment horizon. They should fully understand the fee structure and that they are unlikely to have access to their money until the investment property is sold, typically 5 to 10 years or more. They should know there is no formal secondary market should they wish to liquidate their shares before the property is sold. In addition to administrative and paperwork accuracy, it is equally important to evaluate, case by case, whether the investor's cost of a 1031 TIC is justified by the resulting capital gains tax savings and ancillary benefits.

Although the value of a TIC is based on real estate, and only real estate licensees can broker real estate transactions, only securities broker/dealers can sell TIC shares. This obvious conflict alone should alert financial advisors to the innate dangers of improperly marketing or processing a TIC transaction.

An advisor should follow these basics to successfully add TIC exchanges to his/her product menu:

1. Develop a working relationship with an experienced TIC advisor;
2. Establish contacts among real estate sponsors with comprehensive due diligence procedures and a large and varied inventory of replacement properties;
3. Maintain an inventory of properties from preferred real estate sponsors on hand;
4. Make sure a QI holds the funds;
5. Complete broker/dealer and sponsor/investor profiles before discussing a TIC with an investor;
6. Avoid the temptation to skim over the PPM with investors;
7. Be constantly aware of regulatory deadlines—there is no reprieve;
8. Include all the members of the client's advisory team in the discussion and overall process;
9. Compile a checklist to ensure procedures are followed correctly and investors are fully informed.

Advisors may hesitate to do 1031 exchanges in general—and TIC transactions in particular—because of their complex structure, regulatory requirements, and the ease with which errors can occur. But TICs can provide a significant value-added dimension to an advisor's menu of services, help retain wealthy clients, and provide opportunities for future transactions.

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ENDNOTES

[1]A comprehensive explanation of solicitation and disclosure requirements is available at www.realtor.org under Realtors Commercial Alliance Series: "Hot Topics—Answers to Current Business Issues, Tenants-in-Common Interests."

[2]To the extent that investors do not exchange even, or up, in value and/or exchange even, or up, in equity and debt, they will have received non-qualifying property ('boot") in the exchange. If boot is received, tax is computed on the amount of gain on the sale or the amount of boot received, www.investmenttenantincommon.net.

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