

TENANCY IN COMMON LIKE-KIND EXCHANGES

INTRODUCTION

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 a product called "tenant-in-common interest" (TIC) that can qualify as a 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 diversified portfolios, 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 of the issues you'll want to consider.

WHAT IS A TIC?

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 TIC marketplace developed as a response to at least two investor goals: 1) to complete a like-kind exchange and, 2) to own, but not operate or manage real property.



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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, as well as real estate laws. Securitized 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 TIC's that consist only of interests in real estate. However, currently close to 90% of TIC interests sold are structured and sold as securities.

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.



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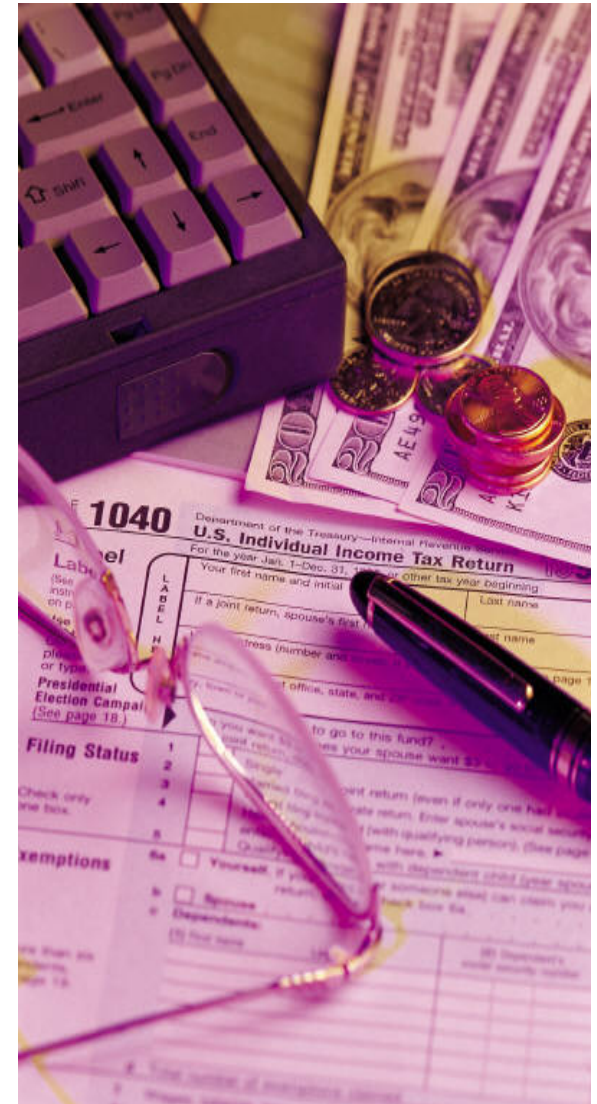
HOW DOES A REAL ESTATE INVESTMENT WITH A DEED TURN INTO A SECURITY?

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 effort 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 (SEC). 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.



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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



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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 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 (NASD) 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 or commission. If the investment is sold as a security, it can still satisfy your client's objectives of finding a replacement property to satisfy the requirements of the like-kind exchange rules if the TIC satisfies IRS requirements in Rev. Proc. 2002-22.

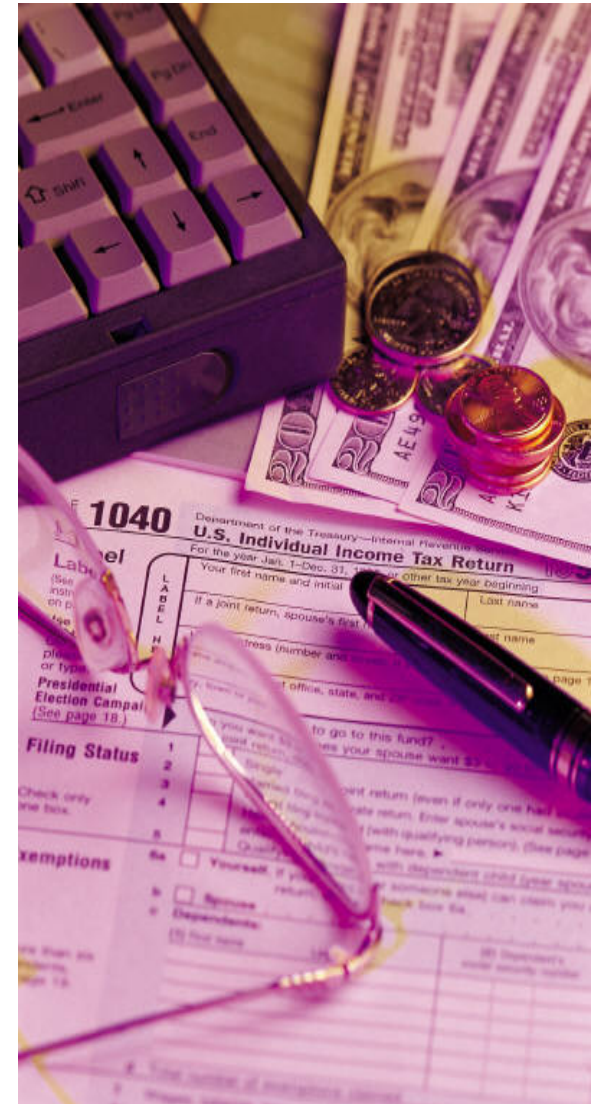


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WHY SHOULD IT MATTER TO INVESTORS WHETHER THE TIC INVESTMENT IS TREATED AS REAL ESTATE OR AS A SECURITY?

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 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.



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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 SEC, the 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 brokers-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 licensees are protected.



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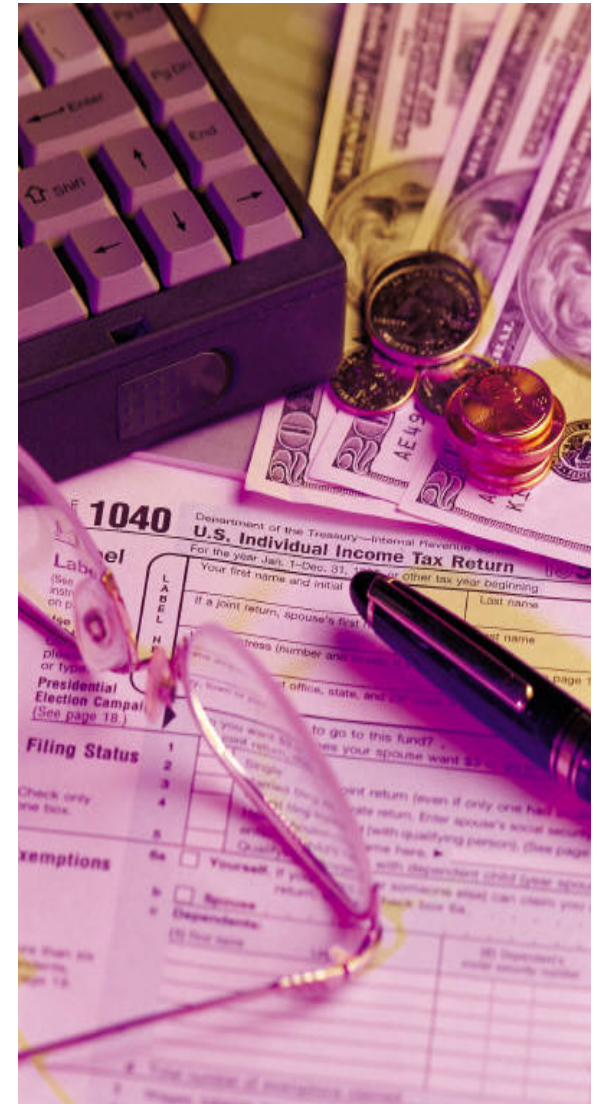
WHAT ETHICAL CONSIDERATIONS APPLY TO A REAL ESTATE LICENSEE WORKING WITH A CLIENT WHO WISHES TO ACQUIRE A TIC INTEREST AS A REPLACEMENT PROPERTY?

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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THE MERITS OF THE UNDERLYING PROPERTY

This is the element of the client's risk evaluation that real estate professionals are best qualified to provide. Commercial real estate professionals 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 the acquisition of property, TIC agreement, financial strength and experience.



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Experienced and qualified commercial real estate professionals 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 professional will need to exercise care to provide advice only on matters within his/her expertise.

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



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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 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?



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DUE DILIGENCE

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 taken.) 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 professional 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.



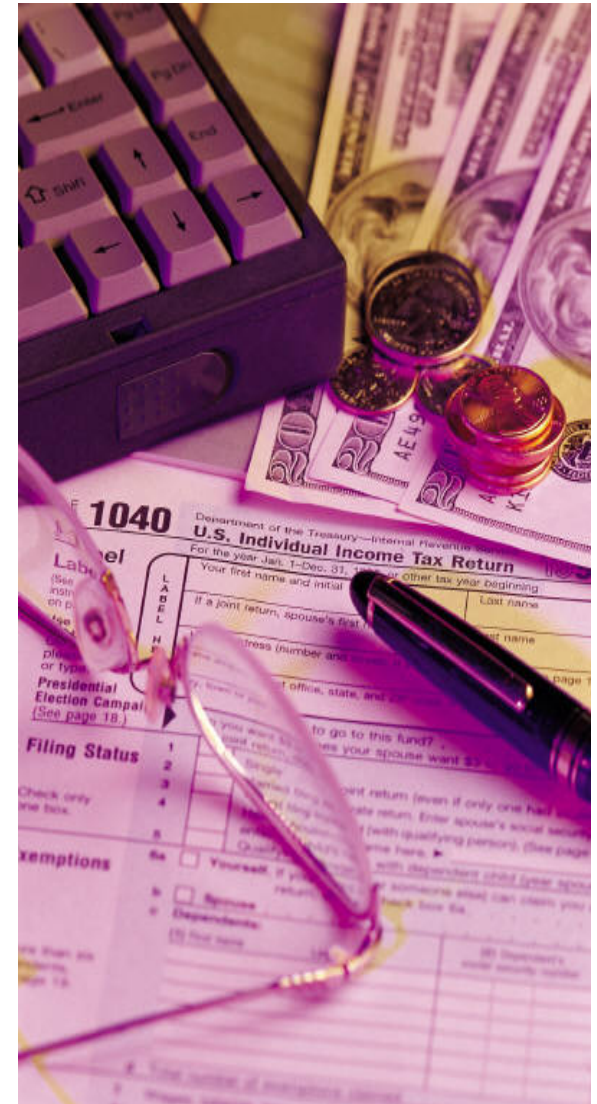
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WHAT ARE SOME OF THE RISKS THAT A REAL ESTATE PROFESSIONAL MIGHT BE EXPOSED TO?

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 laws be violated, then real estate licensees could be exposed to the claims of investors.

WHAT PENALTIES COULD A REAL ESTATE LICENSEE REALIZE WHEN 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.



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TIC GUIDELINES

Property structuring is a critical step in tenancy-in-common transactions. Pursuant to Revenue Procedure 2002-22, the IRS will consider issuing a private-letter ruling to an interested party if the following 15 conditions are met and/or are present in a proposed TIC transaction.

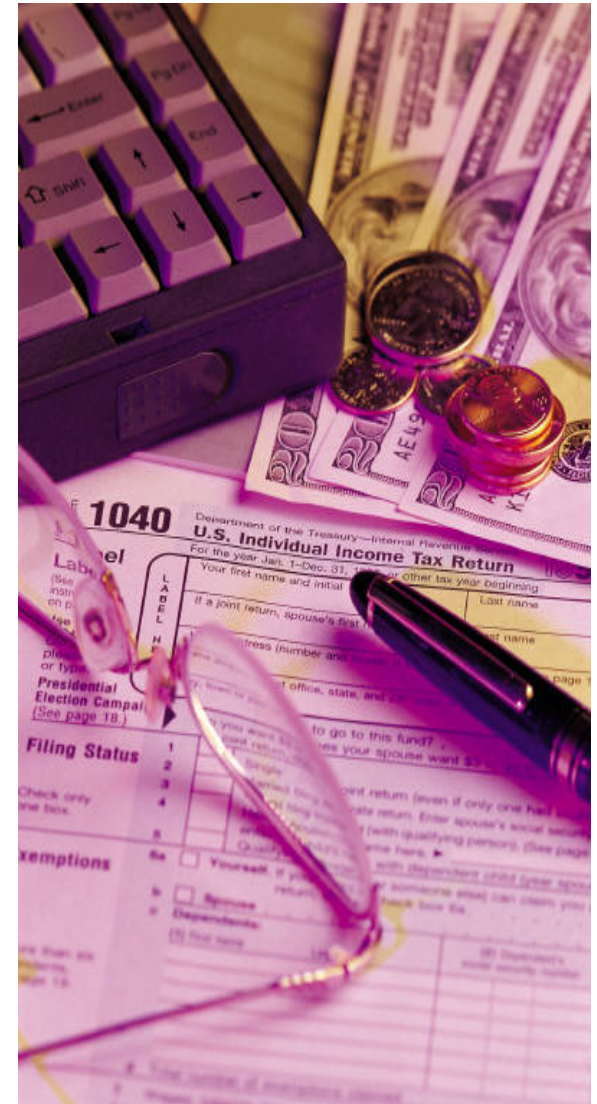
- 1. TIC Ownership:** Each of the co-owners must hold title to the property, either directly or through a disregarded entity, as tenants in common under local law. The title to the property as a whole may not be held by a single entity recognized under local law.
- 2. Number of Co-Owners:** The number of co-owners or investors is limited to no more than 35 persons. For this purpose, a person is defined by Internal Revenue Code 7701(a)(1); however, husbands and wives and all persons who acquire interests from co-owners by inheritance are treated as single persons.
- 3. 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. The individual co-owners similarly may not hold themselves out as partners, shareholders, or members of a business entity.



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4. Voting Conditions: 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 release 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 unanimously approved by co-owners. For all other actions, 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 Rev. Proc. 2002-22 Section 6.05 may provide the manager or other person with a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with an unlimited power of attorney.

5. Restrictions on Alienation: Each co-owner must have the right to transfer, partition, and encumber their own undivided interest in the property without the agreement or approval of any person. 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. Moreover, the co-owners, the sponsor, or the lessee may demand the right of first offer before any co-owner may exercise their right to transfer their 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 before exercising any right to partition.



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6. 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 proceeds must be distributed to the co-owners.

7. 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 with their undivided interest in the property. The other co-owners, sponsor, or manager of the property may advance funds to a co-owner to meet expenses associated with the co-ownership interest unless the advance is recouped to the co-owner and is for a period not to exceed 31 days.

8. Proportionate Sharing of Debt: The co-owners must share in any indebtedness secured by the property by a blanket lien in proportion to their undivided interests.

9. Options: A co-owner may issue an option to purchase its undivided interest, referred to as a call option, provided that the exercise price for the call option reflects fair-market value of the property determined at the time the option is exercised. For this purpose, the fair-market value of an undivided interest 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 an undivided interest, referred to as a put option, to the sponsor, the lessee another co-owner, the lender, or any person related to any of the parties.



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10. No Business Activities: Co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property.

11. Management & Brokerage Agreements: Co-owners may enter into management or brokerage agreements with an agent, which must be renewable at least once a year.

12. 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 and may not depend, in whole or in part, on the income or profits derived by any person from the property leased.

13. Co-ownership Agreement: The co-owners may enter into a limited co-ownership agreement that runs with the land. Such an agreement may provide that a co-owner must offer its interest for sale to the other co-owners, the sponsor, or the lessee at fair-market value before exercising any right to partition.

14. Loan Agreements: The lender may not be a person related to any co-owner, the sponsor, the manager or any lessee of the property for any debt that encumbers the property or any debt incurred to acquire an undivided interest in the property.

15. Payments to Sponsor: Except as otherwise provided, the amount of any payment to a sponsor for the acquisition of the co-ownership interest must reflect the fair-market value of the acquired co-ownership interest and may not depend, in whole or in part, on the income or profits derived by any person from the property.

