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A prudent and practical approach to protecting the 1031 exchange client in TIC investments

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The explosive growth of the relatively new Tenant in Common (TIC) industry has raised concerns about investor protection, as all investments, securitized sponsors and non-securitized promoters are not created equal. This article is intended to provide the reader with a basic understanding about the issues facing the investor, and to offer suggestions to the advisor with an investor client.

In 2002, the fledgling TIC industry was legitimized by IRS Rev. Proc. 2002-22 and fueled by the desire of 1031 exchange investors to defer capital gains tax and remove themselves from the hassles of day-to-day property management. A TIC interest is a means for several investors to simultaneously own a fractional interest in the same piece of real estate, professionally managed by others. Each owner receives a deed and owns a proportionate share of the benefits and burdens of that given piece of property, including income, expense, gain, loss and deductions.

A TIC real estate investment can be a good choice for a passive 1031 investor, assuming that he has the ability to qualitatively discern between 70 TIC offerors and up to 60 properties that may be available at any given time. Just like any other industry, there are high and low quality products, suppliers, and salespeople. The people who package TIC deals are called sponsors (securitized regulation D offerings) or promoters (non-securitized offerings). Some were previously in the syndication, property management or development business and entered the "public" TIC marketplace as a way to leverage their expertise. In their TIC offerings, they market an opportunity for an investor to receive projected cash flows through a turnkey investment product. Primary property types include Office, Retail, Industrial and multifamily. Other property types that are offered as TICs are interests in hotels, student housing, senior housing, oil & gas, marinas and golf courses. These investments offer projected first-year equity yields of between 5% and 8%.

In addition to the non-traditional property types, the investor also has the ability to diversify by investing in several asset types in different geographic regions. TIC investments are frequently financed with 50% to 75% "non-recourse" debt which allows the investor to deploy all of his equity while partially sheltering potential future cash flow through depreciation and interest expense. However, the risks of these investments are illiquidity, that the fees or mark-up could outweigh the tax deferral benefits, that the tax laws could change, and the projected returns are not guaranteed.

The 1031 replacement property buying process is unique in that it is accelerated by the ticking 45-day identification clock and the tax deferral need of the investor. The sophistication and skill sets of the investors and their advisors may make meaningful due diligence and appropriate decision-making somewhat challenging within such a short timeframe. How does a farmer, real estate broker or registered representative in Sioux Falls, South Dakota analyze the risks and rewards of an apartment building in Atlanta, Georgia? Real estate investing or brokerage experience does not necessarily transfer geographically and/or across different property types. Managing ten

apartments around the corner is not going to support an investor in understanding the variables of a shopping mall five states away. This is a nationwide industry with the majority of investments being made across state lines. In 2006, approximately \$4.3 billion of equity was invested in TICs, with total property value of approximately \$11 billion. Approximately 85% were securitized TICs and approximately 15% were so-called non-securitized TICs.

The typical investor doesn't have a full national view of the property choices, nor the capacity to understand all of the variables relating to the sponsor/non-securitized promoter, the markets, property types, financing, legal issues and management. The TIC offering packages, in and of themselves, can be overwhelming to the uninitiated investor. In addition, the investor or his advisors would need to have all of the skills to analyze the financial projections, the underlying assumptions, the quality of management systems, the quality of the property management personnel and asset management personnel.

The investor or his advisors would also need access to unbiased third party real estate market data on a national basis as well as a copy of the appraisal for each potential property in order to understand the risks and returns of these TIC investments.

It would also help if they understood the competition in the planning stages, the barriers to entry and the projects under construction that may impact the supply/demand relationship for a given product type in a given market. This is a due diligence intensive undertaking for the prudent investor and hopefully for their respective broker-dealer, registered representative, real estate salesperson and allied professional advisors.

The challenge for the investor is to become educated enough to make an intelligent decision before his 45-day 1031 replacement property identification period expires. With so many variables and so many choices, the 1031 investor can be easily confused by the technical aspects (1031 regulations, TIC structures, accreditation, securities regulations, and loan documents) of the proposed transaction. This confusion can cloud the focus on the material financial information and the economic risks that may ultimately determine the after-tax amount of the projected monthly check.

The following are some of the areas of concern and must be carefully reviewed and analyzed by the potential investor and his advisors in order to minimize risk: Is the Sponsor or non-securitized Promoter transparent in offering meaningful user-friendly information about its past performance in all of its previous offerings? The investor must know about the character of the Sponsor or non-securitized Promoter, and transparency is an indicator. If the Sponsor's or non-securitized Promoter's track record is not provided, the assumption must be that something is being hidden and it would be foolhardy to invest. Track record means actual equity yield earned (not just distributed) as compared to the projections provided in the investment offering memorandum. A Sponsor or non-securitized Promoter who pays out a distribution higher than what is actually earned by the property is just paying an investor back with their own money; this is a red flag to be investigated and explained. In the case of properties that are master leased (lease on the whole property is put in place by the Sponsor or non-securitized Promoter), the actual Net Operating Income (NOI) must be compared to the lease payment made, across the whole portfolio. If a substantial portion of the properties are not performing, it wouldn't be prudent to invest as the future value of the asset will be determined by that

future NOI and present performance can be an indicator of underwriting, management, and future value.

Beware of the Sponsor or non-securitized Promoter who highlights the number of properties sold at a profit ("full-cycle properties"). The resultant Internal Rate of Return generated is not necessarily a meaningful metric of past performance, as declining interest rates and declining capitalization rates play such a large role in increased valuations.

The cause and effect in many recent real estate valuations may be more about good fortune than about quality deal sourcing, conservative underwriting and effective management. These are the functions of the Sponsor or non-securitized Promoter and one of the reasons the investor is willing to pay a premium over the original purchase price. Touting returns on full-cycle deals and not providing real NOI information is misleading and alerts the analyst that the Sponsor or non-securitized Promoter is distorting the data as a marketing and selling tool. If Sponsors or non-securitized Promoters insist on advertising their full cycle deals, they must provide data on how their actual monthly distribution yield compared to their original projection, exclusive of the profitable sale. Sponsors or non-securitized Promoters should be forthright about their underperforming properties. Nobody wants to tell prospective investors about properties that are not performing. However, the honest Sponsor, non-securitized Promoter, Real Estate Salesperson, Broker, Registered Representative and Broker-Dealer will identify underperforming properties and explain specifically what has occurred and what plan of action is being undertaken to correct the problems.

Are the underlying financial assumptions prudent, based on available market data? This data is available from appraisers, data services (Real Capital Analytics, Costar, Loopnet, Torto Wheaton, REIS) real estate brokerage firms and tax assessors. If the assumptions are overly optimistic, the projections may be unattainable. Quality, conservative assumptions are grounded in reality and supported by unbiased third party providers.

Who will manage the property? Did the actual property manager on the ground at the property work with the Sponsor or non-securitized Promoter in formulating the pro-forma? If not, does the property manager agree with the underlying assumptions and the projections? Are the asset manager's and the property manager's interests aligned with the investor? Will the property manager be accessible and accountable to the investor? Under-managing is an ongoing concern and must be monitored.

Is a publicly offered real estate TIC investment always a security? Are you buying from a Sponsor or a non-securitized Promoter? Why does it matter? A problem in the TIC marketplace for the investor and the industry is the competitive cross-selling between securitized and non-securitized TICs. They are different investments that are sold on different platforms. The typical 1031 TIC investor has plenty to process in learning about 1031 and Tenant in Common property offerings, and they are not well served by the added confusion of salespeople saying the non-securitized Promoters are breaking the securities laws, or that the fees and costs of a securitized TIC offering are too high. It does not appear that any state or federal regulator has taken action against these so-called non-securitized TIC Promoters. Each side uses their argument to sell against the other.

The Salesperson, the Sponsor, the non-securitized Promoter lose credibility with the investor in engaging in such sales jargon.

A securitized TIC generally has to pass through the following six levels of outside disclosure and due diligence and:

1. be approved by the Sponsor's acquisitions department and investment committee
2. pass Regulation D securities disclosure requirements
3. be approved by the securities law firm preparing the Private Placement Memorandum
4. be approved by the independent due diligence law firm hired by the Broker-Dealer
5. be approved by the Broker-Dealer Due Diligence & Investment Committee and
6. though not a legal requirement, hopefully be approved internally by the selling Registered Representative before it is recommended to the client.

It is tough for poorly underwritten transactions to make it through five levels of outside due diligence. On the other hand, a non-securitized Promoter does not have any disclosure obligation or any responsibility to obtain outside due diligence review.

The real estate salesperson representing the investor (buyer's representative) in a non-securitized investment may be the only person looking out for the non-securitized TIC investor. Their national expertise may be limited unless they do national investment property analysis for a living across many property types and asset classes. In addition, the choice of non-securitized property possibilities (inventory) may be limited due to a shortage of non-securitized Promoters, who represent about 10% of the overall national TIC marketplace.

A securitized TIC sponsor stays in the transaction, handles the management and supports the investors. They have an embedded interest in having a successful venture as they earn fees for ongoing management and a profitable sale, and the Sponsor wants the Broker-Dealer, the Registered Reps and their investors to be happy. This way they will be inclined to offer their next transaction to their potential clients. Hence, there is a level of accountability and leverage that can be brought to bear by Broker-Dealers and Registered Representatives if there is an error in underwriting or management. The investor remedy for a problem offering in a security transaction is a FINRA (previously NASD) arbitration with the Broker-Dealer or Registered Representative, or a complaint to the SEC, and then a lawsuit if the issue can't be resolved.

On the other hand, non-securitized Promoters are unable to have a continuing Promoter role in the transaction, can't earn any fees, and are not accountable to the real estate salesperson, broker or investor. They cannot and do not sponsor anything. The remedy for poor underwriting in a non-securitized transaction is a lawsuit for rescission claiming the investment is a security under the investment contract definition in the 1946 case of SEC v. Howey, or some claim for fraud or misrepresentation under contract law. Lawsuits can be a financial and emotional burden on the investor.

One advantage of a non-securitized TIC property is that it may be resold easier than a securitized property. While securitized TIC resales do occur, the market may be smaller and the regulations may be cumbersome. Most TIC buyers are giving up liquidity for some period of time (typically at least ten years) so that they can earn a cash flow return on the tax liability that they have deferred.

They must enter any TIC transaction understanding that the investment is illiquid; anyone who tells you differently is living in a hypothetical world and may be stretching reality a bit.

If the investor studies a Sponsor's portfolio and focuses on the real estate fundamentals, the comparison of projected vs. actual net operating income in past deals, and the likelihood of future appreciation, the quality sponsors will rise to the top. Then, a thorough analysis of the underwriting of present offerings will allow the investor to determine which offerings are the best for their given risk/reward ratio.

In every industry there are varying levels of sophistication, competence and honesty amongst suppliers, salespeople and customers. The prudent investor understands this variance and shops around accordingly to find the most competent Advisor, Sponsor, non-securitized Promoter, Broker-Dealer and/or Real Estate Brokerage firm. At one leading TIC Broker-Dealer, the due diligence team and investment committee reject approximately 30% of the properties presented by Sponsors. The registered representatives at that firm can then review the remaining approved offerings and determine which are suitable for their given investing clients. Conversely, no third parties reject properties offered by non-securitized Promoters before they come to market.

The wise 1031 investor will do his homework when buying a TIC property and stand firm in asking for meaningful answers from Sponsors, non-securitized Promoters and Salespeople. A telling inquiry to make is about the worst three performing properties they have ever brought to market, the names and phone numbers for the investors in those properties and an explanation of what occurred and why. This will ground the sales talk in reality and focus the investor on the downside possibilities.

Sometimes it is smarter to pay the capital gains taxes and pass on the exchange if the replacement property, the Sponsor/non-securitized Promoter and the Salesperson are unable to make the investor and their advisors feel comfortable with the quality of the investment. Risk and reward go together, even in inefficient markets. The correlation between risk and reward may sometimes be inaccurate and unmeasurable in the TIC marketplace which makes judicious decision-making somewhat challenging.