

An alternate ownership structure grows in appeal

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The increase in shifting capital between commercial real estate investments in a surging market has many investors thinking one thing: taxes.

An ever-broadening array of investors have bought into commercial real estate market, and thus are looking for ways to shield sales profits from capital gains taxes. Traditionally, 1031 tax-deferred exchanges, so named for section 1031 of the IRS code, have provided

protection, but a new breed of smaller investors is increasing the popularity of tenancy-in-common exchanges, also known as TICs.

A TIC is simply a way for groups to own property while retaining individual deeds to the property. Typically, TIC investments include apartments, office buildings or industrial facilities at a value of \$10 million or higher.

TICs comprise about 2 percent to 3 percent of 1031 exchanges, according to the **National Association of Realtors**,

but have increased drastically, from \$166 million in equity in 2002 to \$6 billion in 2005.

While the rise of TICs partly results from the flight of investors to real estate since the stock market faltered, an IRS ruling on TIC exchanges in 2002 gave investors the guidance and confidence to more aggressively pursue them. Generally, they allow smaller investors to own high-quality assets.

With a TIC, investors with limited funds can pool together to buy proper-

ties or better diversify their purchases. For example, if an investor wanted to sell a property for \$750,000 with a gain of \$250,000, there are limited properties to reinvest the sum and avoid a capital gains tax. But several investors with that amount could buy a better property or several properties in diversified locations.

What makes TICs tick?

Traditionally, real estate investors have been able to protect their gains through a 1031 exchange. By the rules of the 1031, an investor can sell property at a profit and then reinvest the capital in other real estate within a given time period (45 days to identify the property and 180 days to close the sale) and defer tax payments, which are about 15 percent of the gain.

But, when groups invest in properties, the rules change.

If a group of people go in together to buy real estate as a partnership or LLC and then sell the property, individuals in the entity can't take their money and leave the partnership without being liable for taxes on the capital gains. The reason is that the 1031 exchange does not cover the group disbursement in a partnership or LLC like it does an individual entity in commercial real estate. With the partnership or LLC, it becomes an all-or-nothing thing.

However, a TIC allows for this by creating, in effect, separate deeds to the property for all parties. Each member owns a share of the property, so individuals can buy in or sell off as separate entities, thereby taking advantage of 1031 exchange rules.

"It's a very attractive vehicle that offers the flexibility you don't have as a single entity," said **Alfred Adams**, a partner at **Womble Carlyle**, a North Carolina law firm. "This represents a significant market to provide that flexibility."

Essentially, there are three types of TICs. The most common is the simple TIC where investors go in together to buy a property and then have a firm manage it.

The securitized TIC involves unrelated investors buying shares of a property (but they hold a deed and title) from a broker. These "co-owners" become passive managers of the actual property with the sponsor retaining a role in management operations. Though sold as a security, this kind of TIC still satisfies 1031 requirements.

The **Securities & Exchange Commission** has raised questions about these types of TICs, questioning whether brokerage of these deals should be overseen by both SEC and state real estate regulations.

In a complex TIC, a seller will attract various investors and then exit the deal. This type of arrangement has also raised questions with regulatory boards, because it involves security-like transactions.

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