

IN TIC INVESTMENTS, “IT’S THE PROPERTY, STUPID!”

Comparing Tenants-in-Common Real Estate Investments by Rena Morris

In 1992 the phrase “It’s the economy, stupid” was widely used to focus attention on the essential issue of the Presidential Campaign. Similarly, with Tenant in Common (TIC) property investments, the importance of understanding the property itself cannot be emphasized enough. That is why I say, “It’s the property, stupid!”

Not all TICs are alike of course, and some are sold with far less disclosure than others. Knowing the *risks* as well as the benefits gives investors crucial information. While investors welcome a high cash-on-cash return, understanding how that return is realized – in other words whether the cash flow comes from property performance rather than the return of the investor’s own capital – is essential.

A BRIEF HISTORY

With a 2002 IRS Revenue Procedure Code (see www.irs.gov) clarifying uncertainties about tax treatment of 1031 Exchanges into TICs, the volume of these transactions has increased dramatically. Specifically, the IRS issued guidelines for TIC co-ownership of real estate, distinguishing it from a partnership; thus, making them eligible for 1031 tax-deferred exchanges. The number of real estate companies called “TIC Sponsors” has increased dramatically as well. TICs provide greater opportunities for investors who sell their appreciated real property and pool their exchange proceeds with a limited number of co-owners to each buy a fractionalized (less than 100%) interest in a better quality property. Previously buyers of these large properties were institutional, such as pension, private equity funds or REITs. “Institutional” properties typically return stabilized, net cash flow to the TIC investor that is superior to that which they received before.

INVESTMENT CONTRACTS

An “investment contract” is an enterprise offered to the public for an investment of money, for a common benefit, sharing in its risks and rewards in reliance on the efforts of others. Because the TIC property is negotiated, placed under contract, underwritten, financed and marketed by real estate organizations (TIC Sponsors), TIC investors substantially rely on others’ efforts in acquiring the interest. A Tenant-in-Common interest is one of the oldest forms of direct co-ownership in real property. Under the circumstances described above, time and time again, the courts have determined that it belongs in the category of a financial instrument that is afforded the full protection of the Federal Securities Laws. That is why most TICs are sold by securities-licensed professionals, who have a responsibility to conduct their sales efforts in compliance with federal securities regulations.

THE SECURITIES ACT OF 1933

The US Supreme Court has taken a broad view of the definition of a security to achieve the legal objective of full disclosure and most TIC sponsors follow the “truth in securities” laws. The Securities Act of 1933 (“truth in securities”) requires that investors receive truthful financial and other significant information from sellers and prohibits fraud, deceit and misrepresentation. In addition the issuer must provide full disclosure to the potential investor. The fact that an investment is treated as a security for purposes of these laws, defining securities broadly to protect investors, is not indicative of the treatment of the interest under the tax revenue laws governing 1031 exchanges.

TICS AND 1031 EXCHANGES

When TIC Sponsors follow the IRS guidelines, the tax revenue laws that govern whether 1031 exchange treatment is applicable are interpreted to mean that the TIC interest is an interest in directly-deeded real estate for the purposes of effecting a 1031 tax deferred exchange. Legal opinions accompany most TIC offerings that describe this position in significant detail.

Some TIC sponsors distinguish that, if the investors choose their own management company, they do not rely on the efforts of others to realize their profitable enterprise: thus, they argue that the “truth in securities” law does not apply. They sell TICs directly to the public using salespeople who are employees. They sell their own inventory, contrary to the variety of sponsor companies’ TICs available to securities-licensees. While the prohibition of committing fraud remains, there is substantial room for omission. Many of these properties advertise a “guarantee” of stated cash on cash returns. But what is often not clear is whether the property is producing the cash flow or whether the cash flow comes from the return of the investors’ own money or from money that is borrowed from other enterprises. The resources behind the guarantee may be, similarly, undisclosed.

SECURITIES LICENSEES

A Securities Broker/Dealer (B/D) and their Registered Representative (RR) have responsibilities under the federal rules to know about the property they sell as well as to know their customer. Their responsibility includes a diligent review of the property offerings to evaluate the risks and to determine whether the property is a good match for the goals, financial condition, and risk tolerance of the investor. B/Ds do not sell their own property inventory. They are part of a selling group, selling TICs from a variety of Sponsor companies.

For example, if a TIC sponsor or securities-licensed registered representative knew but failed to disclose to a buyer that a competing property was going to be built across the street, they would be subject to loss of licensing, fines, damages and possible imprisonment. Recourse would be swift through the regulatory agencies.

However, a TIC sponsor who sold directly to the public through employees is already taking the position that the offering is not subject to the Federal laws, evidenced by the distribution channel of company employees rather than through securities-licensed professionals. They might not view their responsibility to include disclosure of the information. Recourse may be much more difficult. A buyer is given greater protection against fraud, misrepresentation and omission of material information, including risks, when purchasing a TIC interest from a sponsor who follows the Federal “truth in securities” law and sells through securities-licensed representatives. These representatives have the responsibility to diligently review the property, know clients’ goals and interests and to determine suitability of the investment. Clearly, consumer protection was the foundation of the Federal Securities Act of 1933, and buyers should take this into consideration when contemplating from whom they should purchase a Tenant-in-Common property.

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Rena Morris is a Registered Representative with JRW Investments, Inc. and has been investing in real estate in California and in Arizona since 1975, effecting many acquisitions, dispositions and exchanges. Rena provides continuing education seminars focused on 1031 Tenant-in-Common real estate exchanges for estate planning professionals, such as accountants, planning giving officers, tax attorneys & trust officers. She may be reached at (626) 564-1031 or email rmorris@jrwinvestments.com.