

Tenant-in-Common Capital in Value Added Transactions

by

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Submitted to the Department of Architecture  
in Partial Fulfillment of the Requirements for the Degree of Master of  
Science in Real Estate Development

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## **Abstract**

Billions of dollars of equity is flowing into the emerging tenant-in-common (TIC) market, forcing demand for such investments to outweigh the current supply of TIC offerings. Investors seeking deferral of capital gains are enticed by the flexibility of passive ownership, the access to institutional quality assets, and the comfort of professional third-party management. In attempt to tap into this growing source of equity, a feasibility study was conducted to determine whether TIC capital could finance development and/or redevelopment (value added) transactions that are initially non- or low-income producing assets.

Tenant-in-common investments, regulated by various IRS guidelines and potentially security laws, are very complex. If structured incorrectly, a TIC investment could lose its tax deferral status and could even open the door to security law violations. Therefore, a thorough review of the industry is prerequisite to introducing such capital into riskier value added transactions.

No organization has ventured to use TIC capital in value added deals. If a legal structure is determined to appease all regulations and still offer a marketable return to investors, then it is a win-win scenario; TIC investors gain access to higher yielding assets and developers gain access to a valuable new source of capital.

TIC investors have historically been relatively risk-averse. However, it is believed that a certain segment of TIC investors would react favorably to value added deals and allocate a portion of their investment to higher risk-adjusted returns. After a thorough analysis, five types of hypothetical transactions were formulated with structures that legally fulfill all requirements while still offering a competitive yield to investors, granting evidence that it is feasible to finance value added transactions with tenant-in-common capital.

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## **Biographical Note**

Jared Smith's professional background is in real estate development and acquisitions. Before coming to MIT, Jared developed retail shopping centers in the Midwest. He focused his time on finding new development opportunities and procuring entitlement approvals from municipalities. He gained acquisition experience in the private equity field working for Starwood Capital Group in Greenwich, Connecticut, where he participated in over a billion dollars of acquisitions.

Jared is a candidate for the Master of Science in Real Estate Development from Massachusetts Institute of Technology in September 2005. He received his Bachelor of Science in Economics with a concentration in Finance from the Wharton School of the University of Pennsylvania in 2001, graduating magna cum laude. He also worked as an intern in the Real Estate Investment Banking Division of Salomon Smith Barney in New York City and for Grosvenor USA Limited in Washington, D.C.

Before completing college, Jared took a two-year sabbatical to Italy where he served as a humanitarian volunteer. He enjoys traveling, snow and water skiing, and hiking. He has been married for six years and has two wonderful young daughters.

## TIC Introduction

One of the fundamental driving forces behind real estate investments is the inherent tax benefit to investors. Real estate investors not only enjoy depreciation expense, which lowers taxable income, but they also benefit by deferring capital gains tax through like-kind exchanges utilizing Section 1031 of the Internal Revenue Code (IRC) of 1986.<sup>1</sup> Since 1986, like-kind exchanges have played a substantial role in the real estate industry with \$210 billion in 1031 transactions in 2003 alone.<sup>2</sup>

Historically, most investors of like-kind exchanges own real estate individually or through a partnership. A partnership that participates in a like-kind exchange has limited flexibility since the same entity that sells the old property must be the same entity that acquires the new property. Therefore, a partnership can participate in an exchange but only as the partnership entity, individuals within the partnership cannot separately exchange in and out of their partnership interests. All partners must therefore collectively agree to participate in the exchange and upon which replacement property to purchase. This can be a dilemma, especially when partners face differing financial needs and goals. Over the last few years an ownership structure, known as tenant-in-common or “TIC”, has gained recognition and helps remedy the partnership dilemma by offering increased flexibility to like-kind exchanges. Under a tenant-in-common ownership structure, individuals and/or entities are able to come together and each separately own a proportionate interest in real estate and upon sale of the asset each individual or entity can decide whether to “cash out” of real estate or exchange into another asset, without being obligated by the decisions of the other co-owners or being forced to remain with any of the co-owners in the future. Tenant-in-common is simply an umbrella ownership structure under which multiply individuals or entities join together to own real estate, while still abiding by IRC Section 1031 rules.

TIC investments offer multiple benefits. A TIC investor purchases an undivided fractional interest in real estate, usually by exchanging into the asset from another like-kind investment. As

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<sup>1</sup> United States. Internal Revenue Code, Section 1031. Office of the Law Revision Counsel, U.S. House of Representatives.

<sup>2</sup> Janet Novack and Matthew Swibel, “Trading Places,” *Forbes* (4 July 2005), p. 1.

multiple TIC investors join together as co-owners, they are able to compete with institutional capital that has historically controlled larger scale, higher quality real estate transactions. Therefore, in addition to deferring capital gains, TIC investors gain access to better investments, professional third-party management, and the benefit of diversifying ownership in real estate among various asset classes and geographic locations. TIC investors also benefit from the freedom of exchanging their individual undivided interest at any time (subject to lender approval) instead of waiting for the disposition of the asset, something not permissible to partnership interests.

The following example illustrates how the TIC structure allows small investors the benefit of owning properties occupied by nationally accredited tenants and diversified among various asset classes. A farmer that sells his land for \$5 million could parcel his exchange funds into TIC interests in multiple different assets – a portion of a Kohl’s Department store, a multi-family apartment building, an office tower tenanted by major law firms, and a hotel operated by Marriott. The farmer can defer his capital gains and exchange the funds from his farm into various diversified assets spread across the country and enjoy a stabilized income with professional third party managers overseeing all administrative affairs.

Tenant-in-common transactions fall into two very different camps with regard to how interests are classified – securities and real estate. Sponsors, who believe that the selling and marketing of TIC interests should adhere to security laws, structure their transactions as securities. Those who believe tenant-in-common ownership is similar to typical syndicated real estate deals with slight variations, structure their transactions as real estate. The market data and numbers listed below in the following figures are for security based TIC transactions only as the author is not aware of any source currently tracking aggregate TIC real estate marketed transactions.

The industry has grown aggressively since 2002, when the IRS released Revenue Procedure 2002-22 that granted further guidance on undivided tenant-in-common ownership of property under IRC Section 1031 and offered validity to the industry. Figure 1 on the following page depicts the total dollar value of TIC acquisitions and Figure 2 shows the total amount of TIC equity placed. In 2004, \$1.7 billion in equity was placed in approximately \$3.5 billion of acquisitions. Annual equity invested through

tenant-in-common ownership is projected to reach \$4 billion in 2005, a 135% increase over 2004 numbers. This growth in TIC investments has been a small, but contributing factor to the overall increase in demand for commercial real estate.

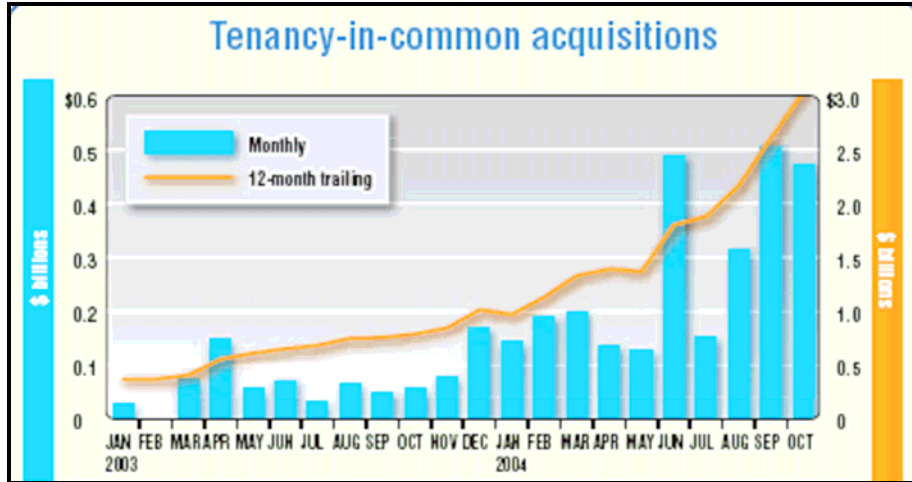


FIGURE 1 Tenant-in-Common Acquisitions as Securities<sup>3</sup>

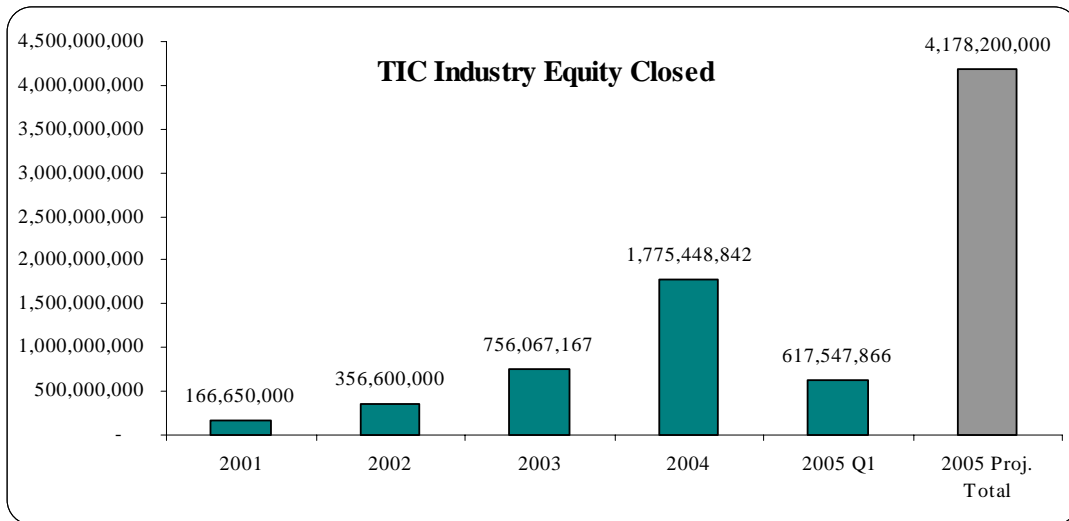


FIGURE 2 TIC Industry Securities Equity Closed<sup>4</sup>

The increased demand for real estate – fueled by historically low interest rates and an overall investor bias toward safer more stable assets such as real estate – has resulted in more investors chasing a limited amount of product. “There’s just been a flood of capital that’s come into the [real estate] market in the last two years”, says Dan Fasulo, director of market analysis for Real Capital Analytics, a New

<sup>3</sup> Donna Mitchell, “The Bottom Line,” *Shopping Centers Today* (February 2005), p. 1.

<sup>4</sup> OMNI Brokerage, Inc. “1<sup>st</sup> Quarter 2005 Numbers,” *TIC TALK* (OMNI Brokerage, Inc. April 2005), p. 3.

York firm that tracks commercial property values.<sup>5</sup> According to Direct Investments Spectrum, an industry newsletter, “From every vantage point, the amount of investor capital flowing into TIC programs for the purpose of facilitating 1031 exchanges appears on the verge of exploding”.<sup>6</sup> Tim Snodgrass, president of Argus Realty Investors, a major TIC sponsor, and chairman of the Tenant-In-Common Association, said “that despite the phenomenal growth experienced in the last two years, this investment sector [TIC] is only in the first inning”.<sup>7</sup> This excess demand has pushed TIC sponsors, the groups that procure and usually manage the assets on behalf of the TIC investors, to find alternative types of transactions. The area of study for this thesis is the feasibility of using tenant-in-common capital in development and redevelopment transactions or “value added” investments, i.e. investments where more is required than solely traditional asset and property management to harvest income from a property. The term “value added” for purposes of this thesis is not intended to be synonymous with the real estate industry’s classification of investment strategies such as core, core-plus, value-added, and opportunistic. As used in this feasibility study, the term value added is meant to cast a wider net and encompass all types of transactions in which the income of the property is not already stabilized and is dependent upon development or redevelopment efforts.

In order to answer the feasibility question of TIC capital in value added transactions, a thorough analysis of the TIC industry must be established starting with the fundamental rules governing IRC Section 1031. Next, an examination of tenant-in-common ownership according to the guidelines of Revenue Procedure 2002-22 will introduce the debate over whether TIC transactions should be treated as securities or as traditional real estate for sales and marketing purposes. Each type of structure has varying risks and benefits which must be clearly understood. Finally, an analysis of potential transactions will illustrate structures that successfully utilize TIC capital in value added deals.

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<sup>5</sup> Jay Hancock. “90’s Real-Estate Crash Unlikely in Today’s Market,” *The Baltimore Sun Company*, July 17, 2005, p. 1D.

<sup>6</sup> Spencer Jeffries, “Ready or Not, Here Come the TICs,” *Direct Investments Spectrum* (Jan/Feb 2005), p. 4.

<sup>7</sup> *Ibid.*, p. 2.



TIC investors have typically acquired stable, income producing real estate that offers a conservative yield with slight appreciation. Interestingly, the demographic of the typical TIC investor has also changed. Manuel Nogales, director of business development for OMNI Brokerage, Inc., a managing broker-dealer, retail broker-dealer, and industry consultant, recently discussed the changing face of the typical TIC investor. “To date, the majority of exchangers have been comprised of Post Baby Boomers whose primary objective was the preservation of capital and a conservative income stream. The TIC marketplace is now seeing the emergence of lead edge Baby Boomers. This segment represents 78 million or 27% of the total [U.S.] population. This group is concerned with preservation of capital but is also looking for higher levels of appreciation and yield on their equity investment.”<sup>8</sup> TIC investors are looking for stable, non-management intensive investments that accommodate tax deferral needs. Therefore asset preservation is essential; however, many TIC investors are willing to venture into slightly riskier transactions in hope of receiving a higher total return. This segment of the population is the target investor of potential value added TIC transactions.

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<sup>8</sup> Manuel Nogales, Omni Brokerage, Inc. “1<sup>st</sup> Quarter Industry Review,” *TIC TALK* (OMNI Brokerage, Inc. April 2005), p. 2.

## IRC Section 1031

Section 1031 of the Internal Revenue Code allows a property owner to trade one property for another without paying current capital gains tax on the transaction.<sup>9</sup> Using Section 1031, taxable gains are not recognized and are deferred until some time in the future, usually when the party sells the new property and “cashes out” of real estate. If real estate investors were assessed taxes upon every sale, investors would have to liquidate other assets to pay taxes or settle for a replacement property of lower value in order to cover the tax burden. Instead investors, who perform exchanges correctly, keep the earning power of deferred tax dollars working for them in new investments. In a way, it is an interest free loan from the IRS on the deferred taxed portion of the gain.

A person seeking to participate in an exchange hopes to trade the relinquished property with a new replacement property. Because it is rare to find two property owners who want to swap one property for the other, a qualified intermediary is used to facilitate a three-party exchange. A qualified intermediary is a party that ensures the exchange is done properly and that the taxpayer is never in “constructive receipt” of the funds, meaning that the taxpayer never receives the proceeds from the disposition of the relinquished property, as such would invalidate the exchange and create a taxable event.<sup>10</sup> Qualified intermediaries also aid in delayed exchanges, as most transactions do not close simultaneously. Logistically, the investor of the replacement property carries forward the original tax basis from the relinquished property plus any increase in value between the two properties. This forms the new basis for the replacement property, from which depreciation expense is deducted going forward and upon which taxable gain is assessed upon future sale.

As an example, assume an exchangor has a property worth \$1 million with 50% leverage that he is considering to sell (Appendix 1 shows an illustrative depiction of a typical exchange). Before the sale of the relinquished property, the exchangor meets with a qualified intermediary to prepare for the potential exchange. Upon sale, if the exchangor has already identified a replacement property then it is

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<sup>9</sup> John K. Kimball, Timothy G. Halligan, and Oliver J. Ford, *Trade Secrets of Exchanging*, p. 3.

<sup>10</sup> *Ibid.*, p. 14.

automatically purchased. If the replacement property is not already identified, then upon sale the qualified intermediary receives and holds the cash payment for the relinquished property, i.e. the exchangor never receives the sale proceeds. The exchangor now must identify a replacement property, which is found for \$1 million. The exchangor informs the qualified intermediary to use the proceeds from the relinquished property to purchase the replacement property (maintaining 50% leverage). The exchangor now owns a new property and has deferred all current capital gains. However, the exchangor's basis in the new property remains the same as in the relinquished property.

The IRS has stipulated two initial requirements for determining whether a property qualifies for an exchange. "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment."<sup>11</sup> Therefore the property must be "like-kind" and must be held for "productive use".

"Like-kind" means that real property should be exchanged for real property, even among various asset classes. "All real property is like-kind, regardless of whether it is improved or unimproved and regardless of the type of improvement or interest. Therefore, raw land is like-kind to a duplex. A tenancy-in-common interest is like-kind to a fee simple interest. One property is like-kind to more than one property. A shopping center is like-kind to a single family house. A residential apartment building is like-kind to a storage facility."<sup>12</sup> However, real property is not like-kind to personal property, i.e. a boat could not be exchanged for ownership in real estate.

"Productive use" regulates that both the relinquished and replacement property must be for investment or business purposes.<sup>13</sup> The properties cannot be part of a primary or secondary residence as such would be deemed personal use not productive. Though unwritten, a third guideline stipulates that

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<sup>11</sup> United States. IRC 1031. *op. cit.*, (a)(1).

<sup>12</sup> Kimball, Halligan, and Ford, *op. cit.*, p. 12.

<sup>13</sup> Robert L. Nessen, *Real Estate Finance and Taxation* (New York: Wiley Law Publications, 1990), p. 157.

the properties be held for at least one year to avoid being viewed as “dealer property” that is acquired for resale, which cannot qualify for tax deferral.<sup>14</sup>

After qualifying the property, there are various logistical requirements that must be followed in order to qualify the exchange. First, the replacement property must be of equal or greater value than the relinquished property. Second, all the net proceeds (equity) from the relinquished property must be spent on the replacement property. Any realized proceeds from the sale of the relinquished property are defined as “boot” and become taxable.<sup>15</sup> Third, if it is a delayed exchange, the taxpayer has 45 days from sale of the relinquished property to identify the replacement property and 180 days (or, if earlier, the due date for filing the tax return for the tax year of the sale) to close on the replacement property.<sup>16</sup>

In addition, the following three rules regulate the number of replacement properties that can be identified before the close of the 45-day identification period:<sup>17</sup>

1. **3 Property Rule:** May identify up to three properties, regardless of their fair market value, or
2. **200% Rule:** May identify more than three properties, as long as the total fair market value of all properties at the end of the 45-day identification period is less than or equal to 200% of the total fair market value of all the properties relinquished.
3. **95% Rule:** If the taxpayer does not meet either the three property rule or the 200% rule then the taxpayer must acquire 95% of all property identified. If the taxpayer then subsequently fails to adhere to the 95% rule then all property acquired in exchange will be deemed not like-kind and the full taxable gain will be recognized.

As mentioned, a tenant-in-common interest is like-kind to a fee simple interest. The important distinction that allows TIC ownership to participate in like-kind exchanges is that each owner of a tenant-in-common interest holds title to an undivided fractional ownership of the property. A TIC interest is not

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<sup>14</sup> Kimball, Halligan, and Ford, *op. cit.*, p. 13.

<sup>15</sup> 1031 Corporation Exchange Professionals, “Everything You Ever Wanted to Know About 1031 Exchanges,” 28 July 2005 <<http://1031cpas.com/1031%20literature.htm>>, p. 10.

<sup>16</sup> Nessen, *op.cit.*, p. 159.

<sup>17</sup> 1031 Corporation Exchange Professionals. *op cit.*, p. 5.

a partnership, as the IRS does not allow owners to exchange in and out of partnership interests.<sup>18</sup> The same entity that holds ownership to a relinquished property must take ownership of the replacement property in order for the exchange to qualify.

For example, a three-member limited liability company (LLC) can exchange a property only if the same three-member LLC owns the replacement property, i.e. one party cannot cash his interest out of the deal. However, a TIC ownership structure grants additional flexibility as three separate limited liability companies (each single member owned) may own a property as tenants-in-common and upon exchange of the relinquished property the three separate LLC owners may exchange their proportionate share into three separate replacement properties. Since the TIC ownership structure is not deemed a partnership, the three separate LLCs in this example are not forced to remain together. This added flexibility allows TIC investors to come together for individual deals without the concern of doing business with the other corresponding TIC investors in the future.

Participants of tenant-in-common investments are able to exchange in and out TIC interests at anytime, without being forced to wait for asset disposition. However, many believe the creation of a stable secondary market would add significant liquidity and grant TIC investors even more sale flexibility. Greg Paul, president of OMNI Brokerage, Inc., a managing broker-dealer, retail broker-dealer, and industry consultant, has alluded to the possible creation of a secondary market for TIC interests. “In real estate there are many non-property and non-performance related events that force investors to sell, such as divorce, a death in the family, or other lifestyle changes. A secondary market would greatly benefit such an investor. Efforts are going forward to discover how to mechanically accomplish such an endeavor.”<sup>19</sup>

Contrast this flexibility with a typical partnership structure. As an example, three people come together and enjoy a number of years owning real estate together under a limited partnership (LP) structure. Imagine the disarray if one partner were to choose to never do business with the other two in

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<sup>18</sup> U.S. IRC 1031. *op. cit.*, (a)(2)(D).

<sup>19</sup> Greg Paul, Omni Brokerage, Inc., Personal Interview, 12 July 2005.

the future, what options does the disillusioned partner have and how are the other two partners affected by her actions? The other partners could try and buyout the third member's ownership portion. However, such a buyout could not be accomplished with exchange funds according to Section 1031. This would force the two partners to use after-taxed money to fund the buyout and compel the parting member to face a potentially significant tax burden. Unfortunately, all assets owned under the partnership are in a sense locked together.

If the same members held their properties under tenant-in-common ownership, then the exiting party could exchange out of the assets without affecting the tax position of the other members. Most importantly, under the TIC structure all members have the opportunity to defer their capital gains tax, allowing their pre-taxed dollars to continue working for them. Even if the three partners enjoy working together, but one member is concerned that multifamily apartment buildings will lag the performance of other asset classes, under a TIC structure that member could choose to exchange her undivided interest in apartments for another TIC interest in an office building. Best of all, the apartment complex nor the office building would have to be sold as the TIC interest would simply be exchanged for another. The tenants leasing both properties and the other TIC co-owners would be able to enjoy business as usual without interruption. Revenue Procedure 2002-22 offers further guidance on how to correctly structure TIC interests as to qualify for exchanges under IRC Section 1031.

## IRS Guidance

The issuance of Revenue Procedure 2002-22 (RevProc) by the IRS on March 19, 2002 represents a major milestone within the TIC industry as it gives guidance on how TIC interests should be structured to accommodate an exchange under IRC Section 1031. Although a few sponsors were structuring tenant-in-common programs as long ago as the early 1990's, since the release of RevProc the TIC industry has made exponential strides in terms of equity invested, the number of new sponsors, and the diversity of TIC structures within the industry (a sponsor is defined by the IRS as "any person [or entity] who divides a single interest in the property into multiple co-ownership interests for the purpose of offering those interests for sale"<sup>20</sup>). For example, in 2001, one year prior to the release of RevProc, there were approximately nine sponsors in the industry representing a total equity investment for the year of approximately \$167 million.<sup>21</sup> In 2004, just three years later, there were 46 sponsors that had closed at least one transaction and the total equity invested for that year was approximately \$1.78 billion.<sup>22</sup> Needless to say, gaining a better understanding of this revenue procedure will provide insight into the explosive growth of the industry and will offer valuable information regarding IRS guidelines and conditions for structuring TIC programs.

RevProc was intended by the IRS to repeal the former Revenue Procedure 2000-46, in which the IRS had specifically stated that it would no longer issue advance rulings stipulating whether TIC investments were interests eligible for tax-deferred exchanges under IRC Section 1031.<sup>23</sup> The IRS wanted to clarify the taxpayer's erred assumption that certain structures of TIC investments were interests in partnerships as opposed to undivided interests in real property, as the former does not qualify under Section 1031.

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<sup>20</sup> United States. Internal Revenue Service. Revenue Procedure 2002-22, Section 4, Par. 3.

<sup>21</sup> Data regarding number of sponsors and equity raised is based on transactions marketed and sold as securities.

<sup>22</sup> Spencer Jeffries, Directs Investment Spectrum, "Optimism, Concerns at TICA Symposium," *TIC TALK* (OMNI Brokerage April 2005), p. 9.

<sup>23</sup> Louis J. Rogers, Hirschler Fleischer, Letter to Clients and Friends of the Firm, 19 Mar. 2002. p. 6.

Technically, RevProc “specifies the conditions under which the IRS will consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity (i.e. – partnership)”<sup>24</sup> but it does not provide a “safe harbor” for specific TIC structures, as was expected by the industry at the time.

In practice, RevProc has become a set of guidelines for sponsors to follow in structuring TIC investments in a way that co-owners (defined by the IRS as “any person that owns an interest in [a] property as a tenant-in-common”<sup>25</sup>) are able to defer capital gains through like-kind exchanges. Industry perception is that RevProc is general guidance for deal structuring, as opposed to narrow conditions for “advance ruling”. This is because in order to receive a ruling, RevProc requires information to be submitted that is generally never known until the very end of a transaction. For example, Section 5.02 of RevProc requires a sponsor to submit, as part of the request for ruling, the percentage of fractional interest in a property for each co-owner. Since this information is not available until the last days of a transaction, it is very “unlikely that many sponsors will be able to keep a deal open long enough to obtain a ruling”.<sup>26</sup>

Furthermore, one of the statements of RevProc clearly demonstrates a “guidance-type” nature, as opposed to specific “safe harbor” language, by stating “the guidelines set forth [herein] are not intended to be substantive rules and are not to be used for audit purposes.”<sup>27</sup> A safe harbor means that if a sponsor were to fulfill all requirements then the IRS would guarantee compliance with Section 1031. Unfortunately, the RevProc stops short of a safe harbor and offers only guidance on how the IRS would probably rule if a TIC structure appeased all RevProc guidelines, but even then there is no absolute guarantee how the IRS will rule. Basically, the issuance of RevProc allowed the IRS to defer the more difficult questions regarding appropriateness of TIC programs until individual sponsors made requests for rulings on specific transactions.

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<sup>24</sup> U.S. RevProc. *op. cit.*, Section 1, Par. 1.

<sup>25</sup> *Ibid.*, Section 4, Par. 3.

<sup>26</sup> Rogers. Letter to Clients and Friends of the Firm, *op. cit.*, pp. 2-3.

<sup>27</sup> U.S. RevProc. *op. cit.*, Section 3, Par 3.



Aside from some of the vagaries mentioned above, the RevProc has established the fundamental criteria for structuring TIC interests and has become the benchmark for the industry. Sections four and five provide answers to basic questions regarding the information that is to be submitted to the IRS as part of a ruling request, which are not central to this discussion but can be found in Appendix 2.

Section six of RevProc is the most scrutinized within the industry and contains the fifteen points which are viewed as standard conditions to be met in order to “safely” structure a TIC offering. Again, although complying with these conditions does not create a safe harbor, they signify in what manner the IRS would generally issue a favorable ruling on a specific TIC structure. Below is a summary of these conditions together with additional detail relating to specific structuring concerns for those points that are less concise:<sup>28</sup>

### **1. Tenancy-in-Common Ownership**

*Summary:* Each co-owner must hold title to the property as a tenant-in-common under local law.

Title of the property as a whole may not be held collectively as an entity.

*Additional Detail:* Generally, standard transactions consist of creating a separate single-member LLC for each individual/entity interest.

### **2. Number of Co-owners**

*Summary:* Limited to no more than 35 persons (husband and wife are treated as one person).

*Additional Detail:* In creating the limitation of 35 investors, which has no direct substantive legal basis, “the IRS was concerned in [RevProc] about whether a co-ownership arrangement was so large that there ‘must’ be some type of business entity present in a situation where one was not legally formed.”<sup>29</sup> Additionally, if two people (not a husband and wife) form an LLC and own one TIC interest in full, their entity would count as two investors toward the 35 total persons allowed.

### **3. No Treatment of Co-ownership as an Entity**

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<sup>28</sup> *Ibid.*, Section 6. *Note: All 15 points are referenced to RevProc Section 6, unless additional author citation is provided elsewhere.*

<sup>29</sup> Richard Lipton, Todd Golub, and Arnold Harrison, “The Intersection of Delaware Statutory Trusts and Tenancies-in-Common,” *Real Estate Taxation* (1<sup>st</sup> Quarter 2005), p. 80.

Summary: The co-ownership may not file a partnership or corporate tax return or otherwise conduct business as a partnership or other form of business entity.

#### **4. Co-ownership Agreement**

Summary: The co-owners may enter into a limited co-ownership agreement that may run with the land. This agreement may provide that a co-owner must 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.

#### **5. Voting**

Summary: Certain issues require unanimous voting, including the right to approve the hiring of any manager, the negotiation of a management contract, 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. Less pertinent decisions require a simple majority vote.

Additional Detail: “RevProc provides maximum decision-making authority to each of the co-owners to avoid partnership status.”<sup>30</sup> Logistically, most voting rights are structured as implied or negative consent. If a response is not received from a co-owner within a specific period of time after notice is given, the consent is deemed implied. This allows the sponsor to respond quickly to time sensitive decisions that may arise with a tenant or lender (i.e. – easements, landlord waivers for tenant financings, brokerage agreements, leasing, etc...).<sup>31</sup> As will be discussed further in Section 6.11 below, sponsors are generally discouraged from taking a long-term ownership interest in transactions (though the Geneva Group recently received an IRS private letter ruling that allows significant sponsor ownership).<sup>32</sup> In addition, sponsor ownership can create potential conflicts of interest that may arise through unanimous voting considerations. Since co-owners must have the right to approve major property management decisions through unanimous consent, a sponsor who owns a TIC interest in full, could theoretically vote to block any of the major decisions associated with the property, even the removal of the sponsor as manager.

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<sup>30</sup> *Ibid.*, p. 81.

<sup>31</sup> Jim Shaw, Cap Harbor, Personal Interview, 12 July 2005.

<sup>32</sup> Mark Anderson, “IRS Ruling Helps Put Geneva in Expansion Mode,” *Finance and Commerce*, (31 Mar. 2005).

## **6. Restrictions on Alienation**

*Summary:* Each co-owner must have the right to transfer, partition, and encumber the co-owner's undivided interest in the property without the agreement or approval of any person. However, 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.

*Additional Detail:* These restrictions provide further evidence that individual co-owners are, in fact, owners of real property that is not dependent on decisions of related investors as is the case in partnerships.

## **7. Sharing Proceeds and Liabilities upon Sale of Property**

*Summary:* If the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

## **8. Proportionate Sharing of Profits and Losses**

*Summary:* Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner and is not for a period exceeding 31 days.

*Additional Detail:* The inability to lend funds for the long-term prevents a co-owner from being "bailed out" of negative cash situations, which brings TIC ownership more in line with traditional ownership of real estate as opposed to a partnership.

## **9. Proportionate Sharing of Debt**

*Summary:* The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

*Additional Detail:* In most transactions the mortgage will be non-recourse, but each co-owner is responsible for the recourse carve outs, such as fraud. This is further demonstration of true property ownership as opposed to partnership pooling.

## **10. Options**

*Summary:* A co-owner may issue a “call” option to purchase the co-owner’s undivided interest, provided that the exercise price reflects the fair market value of the property determined at the time the option is exercised. A co-owner may not acquire a “put” option to sell the co-owner’s undivided interest to any party related to the transaction.

*Additional Detail:* The inability to use put options prevents financial engineering in a transaction, which could be used to reduce standard risk that is part of real estate ownership. As discussed in 6.6, each co-owner has the right to transfer and/or partition its interest, though such an agreement cannot be predetermined as a put option, as no co-owner can force another co-owner to purchase its interest.

## **11. No Business Activities**

*Summary:* The co-owners’ activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property. If the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee with respect to the property will be taken into account in determining whether the co-owners’ activities are customary activities. However, activities of a co-owner or a related person with respect to the property will not be taken into account if the co-owner owns an undivided interest in the property for less than six months.

*Additional Detail:* The six month ownership limit is generally intended to allow a sponsor, which may own a property outright before selling off TIC interests, sufficient time to complete the final sale so as to not require that their actions be taken into consideration as a co-owner as presented above. Despite the intention of the IRS to discourage a sponsor from taking ownership in transactions, many sponsors have found ways to technically abide by the guidance, but in practice retain some ownership. For example, many sponsors keep a minority interest, up to 49%, in a multimember LLC that in turn owns one TIC interest.<sup>33</sup> This structure is effective as the sponsor does not technically own the TIC interest; however, a 49% interest will generally be the largest ownership position therein and therefore in theory allowing the sponsor to maintain control. Additionally, some lenders may require some permanent

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<sup>33</sup> Shaw, *op. cit.*

ownership by the sponsor, which is at odds with this RevProc requirement. The IRS, though, has been lenient regarding this point when the sponsor's ownership is required as part of customary commercial lending practices. As lenders have gained more confidence and experience in lending to TIC-sponsored properties, sponsor ownership requirements have decreased and even disappeared in some cases. Those lenders who still require sponsor ownership, generally require anywhere between one to three percent ownership of total equity invested.<sup>34</sup>

## **12. Management and Brokerage Agreements**

*Summary:* The co-owners may enter into management or brokerage agreements, which must be renewable at least annually, with an agent, who may be the sponsor or a co-owner, but who may not be a lessee. The management agreement may authorize the manager to do the following: 1) Maintain a common bank account to collect rent and offset expenses before disbursing each co-owner's share of net revenues (must be disbursed to co-owners within three months from the date of receipt); 2) Prepare statements for the co-owners showing their share of revenues and costs from the property; and 3) Obtain or modify insurance on the property and negotiate modifications of the terms of any lease or any indebtedness encumbering the property, subject to the approval of the co-owners. Fees paid by co-owners to the manager must not exceed fair market value of standard management fees and all fees must not depend upon the income and profit derived by any person. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

*Additional Detail:* A sponsor is the person or entity that instigates the transaction by dividing a single interest in real estate into multiple co-ownership interests. The sponsor usually remains involved in the property as the manager after the acquisition. The manager is defined as the person or entity that oversees the administrative affairs of the property (similar to a partnership manager). All investor questions and concerns are addressed to the manager. The manager may however choose to outsource the actual property management of the asset to a third party professional management company such as Jones Lang LaSalle or CB Richard Ellis. It is always at the discretion of the co-owners to hire or fire the manager.

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<sup>34</sup> Shaw, *op. cit.*

Since the majority of sponsors become the managers of the property after acquisition, many references in the thesis will refer to the sponsor/manager as one person or entity. However, it should be understood that this is not a requirement of RevProc.

### **13. Leasing Agreements**

*Summary:* All leasing arrangements must be bona fide leases for federal tax purposes and reflect the fair market value for the use of the property.

### **14. Loan Agreements**

*Summary:* The lender may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the property.

### **15. Payments to Sponsor**

*Summary:* Except as otherwise provided in the RevProc, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property.

*Additional Detail:* This provision is an attempt of the IRS to disallow profit sharing, waterfall, and/or preferred return structures that are prevalent in partnerships.

## **TIC Structure: Real Estate vs. Securities**

Though Revenue Procedure 2002-22 establishes some basic structural requirements for TIC interests, it is not intended to give guidance on whether TIC deals should be structured and sold as real estate or securities. This question has significantly divided the industry and each side believes to be adhering to sound principals. The answer is typically found in the degree of managerial control held by the investor. As investors take on a more passive role and rely upon the merits of others, the investment begins to resemble a security. However, most experts acknowledge that TIC transactions can be structured and sold as either securities or real estate.<sup>35</sup> The debate will continue until the Securities and Exchange Commission (SEC) offers more formal guidance. An analysis of both viewpoints will be explored in order to determine the best structure for value added TIC transactions.

### ***Real Estate***

As examined earlier, the Revenue Procedure 2002-22 stipulates various property decisions that require unanimous approval of co-owners. This point seems to give strength to those who favor a traditional real estate structure for TIC ownership. The manager, the person or entity that oversees the affairs of the property and coordinates the property management of the asset, cannot enter into any major decision relating to the asset without the consent of each co-owner. Therefore, future results are dependent upon the co-owners' decisions, meaning the fate of the investment is not solely based upon the efforts of the manager. Logistically, the credence to an investor buying a TIC interest in real estate is "buyer-beware" as there is no stipulated requirement for full and fair disclosure. Obviously, the managers should not be involved in fraudulent behavior, however, each owner is responsible for her own separate due diligence and is under no security law protection.

Al Mansell, president of the National Association of Realtors and Utah State Senator "argues that 1031 exchanges were pioneered by the real estate industry. And investors in real estate-only deals

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<sup>35</sup> Michelle Napoli, "Top Story: Securities vs. Real Estate Issue Heats up TICA Conference," *Net Lease Forum* (5 Oct 2004), Vol. 02, No. 15, p. 1.

typically have more control over management. While president of the Utah State Senate last year, he spearheaded recently adopted legislation that permits tenant-in-common 1031 deals to be either real estate or securities transactions in that state. ‘Investment property owners, looking to invest in a tenant-in-common 1031 exchange,’ he maintains, ‘should have a choice.’<sup>36</sup> Thomas V. “Var” Reeves, former president of FOR 1031 LLC, a sponsor that sells TIC interests as real estate, stated the following during an interview on June 15, 2004: “all it [IRS Revenue Procedure 2002-22] says is why something is not a limited partnership. A limited partnership is a security, so it’s interesting when all these guys get together and say, ‘Well, it’s a security for securities purposes, but it’s real estate for tax purposes.’ Yet we’re still dealing with the same federal government which inherently is responsible for interpreting things the same way no matter what department things are in. Clearly the law of the [IRS] code says you cannot [transact a 1031] exchange for stocks, bonds, indebtedness and other securities.”<sup>37</sup>

## ***Securities***

Securities advocates warn if investments sold as real estate really are securities, those not following SEC laws and regulations may find themselves facing criminal charges. Security laws present the stark reality of potentially devastating risks as the fallout of an unsuccessful deal can result not only the loss of investor money, but potentially the criminal conviction of a sponsor, manager, and/or broker. Mr. Michael Hines, director of enforcement for Utah’s securities division, speaking about a TIC investment in the fall of 2004 said, “I can envision this transaction being sold as real estate, but the way I see it [being] sold, it’s a security...The securities industry does not have an open mind if you are violating the law...If you are the example the state takes, your freedom is in jeopardy.”<sup>38</sup> According to Cary Losson, a TIC consultant and president of 1031 Exchange Options in Walnut Creek, California, “it’s

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<sup>36</sup> Gail Liberman, “Understanding Real Estate Exchange Deals,” *Financial Advisor Magazine* (May 2005), p. 1.

<sup>37</sup> “Insider: For 1031’s Thomas Reeve,” *Net Lease Forum* (15 June 2004), Vol. 04, No. 0617.

<sup>38</sup> Napoli, *op. cit.*, p. 1.



absolute insanity to offer these [TIC investments] to the general public and not structure them as a security”.<sup>39,40</sup>

Internal to the debate over classification of TIC investments as securities or real estate, is the pressing question of who can receive compensation. Security law violations can loom over the heads of those who receive compensation for referring or placing clients in TIC security deals, but do not have security licenses. At the Tenant-in-Common Association’s (TICA) annual meeting in the fall of 2004, Rob Hannah, president and CEO of TSG Real Estate LLC and TICA board member said to members of the conference, “Someone is breaking the law one way or another. If someone doesn’t go and get guidance, people in this room are going to start going to jail.”<sup>41</sup>

So what depicts a security? A share in a Real Estate Investment Trust (REIT) is a security and the purchase of a single family home is a pure real estate transaction, the difficulty is defining those investments that fall in-between these points on the real estate spectrum. Why would an undivided fractional ownership in real estate be classified as a security? It is not a stock, bond, or any other instrument specifically listed as a security by the Federal Securities Statutes.<sup>42</sup> The answer comes from SEC v. W. J. Howey, a U.S. Supreme Court case that established the test for determining whether something is an “investment contract” and therefore a security. Generally, all four of the following four parts of the “Howey Test” must be met for the scheme to be deemed an “investment contract”: 1) the “scheme involves an investment of money, 2) in a common enterprise, 3) with [the expectation of] profits, 4) to come solely from the efforts of others.”<sup>43</sup> If one of the points is missing then the investment is not a security.

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<sup>39</sup> Joe Gose, “An Up-TIC in Realty Swaps,” *Barron’s Online* July 18, 2005, p. 2.

<sup>40</sup> Though many groups voice strong opposition to those structuring TIC transactions as real estate, the SEC to date has given no formal guidance prohibiting such structures. There is no accurate way to predict what percentage of TIC deals are done as real estate, (as the author is not aware of any agency tracking such data) however, it should be noted that a significant portion of TIC deals are structured as real estate.

<sup>41</sup> Napoli, *op. cit.*, p. 1.

<sup>42</sup> Elena Marty-Nelson, “When is a Real Estate Interest a Security?” *The Practical Real Estate Lawyer* (May 2001), p. 8.

<sup>43</sup> United States. Securities and Exchange Commission. SEC v. Edwards, 124 S.Ct. 892,(2004), par. 2.

Early after the *Howey* case, the language of requirement four, which states that “profits come solely from the efforts of others”, was being abused by promoters of schemes in various lines of business, who were finding ways to avoid the test by requiring ministerial efforts on the part of investors. In response, the courts have deemed the requirement met “if the efforts of the promoters are the undeniably significant ones – those essential managerial efforts that affect the failure or success of the enterprise”.<sup>44</sup>

Likewise, the debate in the tenant-in-common industry is over requirement four of the *Howey* Test. Revenue Procedure 2002-22 mandates that co-owners must approve major decisions, which many believe removes the possibility that profits are coming “solely from the efforts of others”. The catch is that many sponsors today are structuring management agreements that grant implied consent by owners if negative consent is not voiced. Similarly, many sponsors are master leasing the properties purchased by the TIC investors. Steps such as these place co-owners in a more passive role in which profits are coming almost solely from the efforts of others, i.e. the investment begins to more closely resemble an “investment contract”, or a security. In order to determine who is correct, the following question must be asked: Are the efforts of the managers the dominant ones, and are the efforts of the investors minor in comparison? If the response is answered in the affirmative then there is a definite possibility that the *Howey* Test holds, meaning the investment is a security. And if an investment is treated as a security then all security laws apply.

## **Securities Law**

After the Stock Market crash of 1929 the U.S. Congress passed federal securities laws and created the Securities and Exchange Commission (SEC). The Securities Act of 1933 and the Securities Exchange Act of 1934 are the two main federal laws that regulate a company that wants to sell its securities to the public. The former law mandates “full disclosure of all material facts” and registration with the SEC, the later requires periodic disclosure of financial information.<sup>45</sup> The registration process

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<sup>44</sup> Marty-Nelson, *op. cit.*, pp. 10-11.

<sup>45</sup> United States. Securities and Exchange Commission, “Q&A: Small Business and the SEC,” 23 June 2005 <<http://www.sec.gov/info/smallbus/qasbsec.htm>>.

with the SEC can cost hundreds of thousands of dollars and is very time consuming. Therefore, for smaller transactions, such as TIC transactions, it makes little economic sense to file a registration with the SEC. However, “private” offerings to sell securities can be made without filing a registration with the SEC, as long as an exemption is filed and all the qualifications are met. The most common exemption used for TIC investments is Regulation D.

## **Regulation D<sup>46</sup>**

All Regulation D exemptions are still subject to antifraud provisions of federal security laws, i.e. a company selling securities will be responsible for false or misleading statements, whether oral or written, and any omissions. The three exemptions from Securities Act registration under Regulation D are listed below:

- 1) **Rule 504:** Exemption for the offer and sale of up to \$1,000,000 of securities in a twelve month period.
- 2) **Rule 505:** Exemption for the offer and sale of up to \$5,000,000 of securities in a twelve month period.
- 3) **Rule 506:** Exemption for the offer and sale of an unlimited amount of capital.

Rule 506 is a “safe harbor” for the private offering exemption, meaning a company can be assured of its Regulation D exemption if all the stipulations are followed.<sup>47</sup> It has several standards that must be met in order to assure exemption, but only a few are discussed here (for a complete list see Appendix 3). Rule 506 allows a company to sell securities to an unlimited number of accredited investors and up to 35 sophisticated investors. The term accredited investor is a buzz word in the TIC industry and can legally represent various types of entities (for a complete list of accredited investor descriptions see Appendix 3). Most applicable, an accredited investor is someone that has a net worth of \$1 million or earned \$200,000 (\$300,000 joint income) the last two years and reasonably believes to earn at least that

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<sup>46</sup> United States. Securities and Exchange Commission. Regulation D.

<sup>47</sup> A sponsor following Rule 506 of Reg D will not receive direct feedback from the SEC stating that full compliance is in order. The assurance of Reg D exemption is simply implied when all requirements of Rule 506 are followed.

amount this year. A sophisticated investor is not tested by net worth or income, but whether the investor has adequate knowledge and experience in financial and business matters to be capable of evaluating the merits/risks of an investment. If a sponsor chooses to sell TIC interests as securities, they must be sold by registered representatives that are licensed to sell securities. For this reason, and the fact that investors must be screened to be deemed accredited or sophisticated investors, sponsors are not allowed to engage in any form of general solicitation of their transactions. Even registered representatives must avoid general solicitation, as to prevent a situation in which more than 35 non-accredited investors receive marketing information about the transaction.

### ***Decision***

Risk and flexibility are the two main criteria for determining whether value added transactions should be structured as securities or real estate. As the sponsor/manager takes on a more aggressive role, transactions begin to lend themselves more fully to securities, especially as investors rely upon the efforts of others. Value added deals are inherently more risky and require more flexibility than traditional TIC transactions, due to the demands of any development or redevelopment opportunity. After a thorough analysis, it is the author's opinion that the most optimal way to reduce the risk and grant the necessary flexibility in value added deals is to follow a securities structure under Regulation D exemption. This increases the initial complexity of the deal and fee structure, but reduces the overall risk as all parties are assured that security laws are being followed. In addition, investors should be more content with securities as full and fair disclosure is required, which guarantees investors a more thorough due diligence review and increased accessibility to property information.

Increased risk can potentially correlate to increased liability for the sponsor. Any time an investment falls into financial trouble, there is potential for legal action. Such risk is significantly compounded when sponsoring a transaction on behalf of other investors, as is the case in traditional TIC investments. After adding in the additional layer of development/redevelopment risk found in most value

added TIC transactions, it is apparent that a sponsor of such investments will require as much protection as possible.

Structuring a deal as a security does not automatically shield a sponsor from liability; in fact it can be the opposite. Those who sponsor deals as securities must abide by security laws and disclose all information. In addition, “any material misstatements or omission could result in liability under securities antifraud provisions”.<sup>48</sup> However, a sponsor who abides by all security laws has a degree of comfort in that if a transaction fails, he is protected as long as all risks were clearly delineated and he has not participated in any fraudulent act. The real concern is for the sponsor who sells a TIC transaction as real estate, which is later deemed to be a security. The sponsor has now violated security laws and could face criminal charges. Due to this potential risk of having a transaction reclassified as a security, it is far less risky to abide by securities laws initially and structure all value added deals as such. In addition, investors of TIC securities are screened to verify that they are financially qualified to experience the potential risks of participating in private investment offerings, i.e. accredited investors. This leaves less potential for investing on behalf of individuals who may be financially devastated through the economic loss of a transaction.

Flexibility in value added transactions is fundamental, as decisions must be made quickly, without delay. Many believe security transactions actually add complexity, cost, and therefore reduce flexibility to the sponsor/manager. In truth, the initial deal structure is more complex and costly as licensed security representatives must sell the offering and all security compliance issues must be addressed. However once in place, a security offering grants the manager the necessary freedoms to actively develop or redevelop the project. For example, sponsors of value added deals will more than likely adhere to a ground lease, master lease, or purchase option structure with the TIC investors in order to maintain control and flexibility. Each of these develops a structure that closely adheres to requirement four of the Howey Test, as investors are basing their profits more fully on the efforts of others (the manager). This said, once the Howey Test is passed, the structure resembles an investment contract,

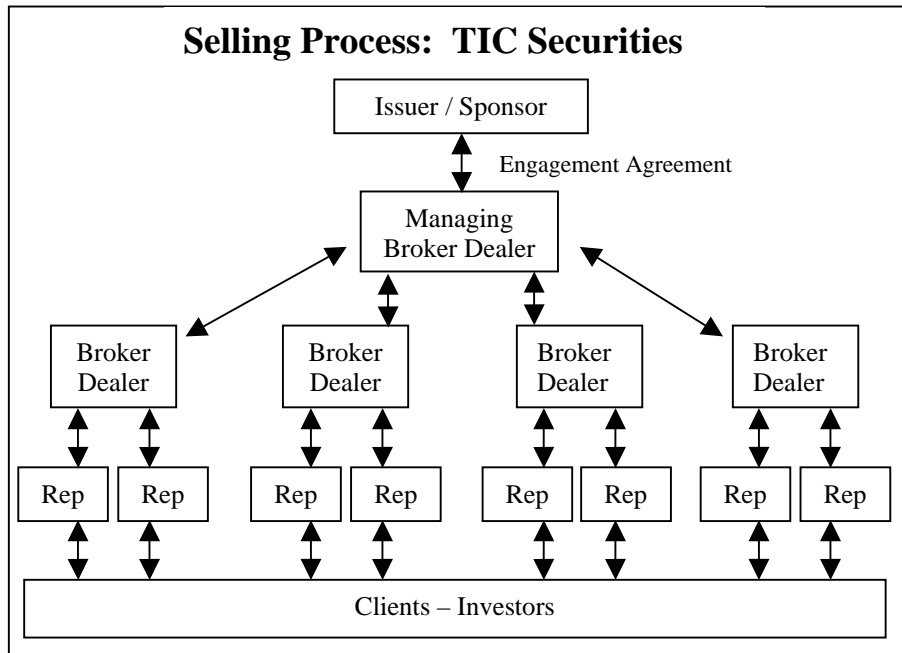
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<sup>48</sup> Marty-Nelson, *op. cit.*, p. 8.

which is a security. Therefore, in the opinion of the author, once structures such as ground leases, master leases, and purchase options are established to control much of the decision making power of the asset (something essential to development and redevelopment) the structure has become a security.

## Logistics of a Deal

The logistical aspect of selling a tenant-in-common interest as a security is fairly complex. Since only those representatives holding the proper security licenses are authorized to sell securities, sponsors of TIC securities turn to such representatives to sell and market their transactions.



**FIGURE 3** TIC Securities<sup>49</sup>

As seen in Figure 3 above, the sponsor enters into an engagement agreement with a managing broker-dealer to oversee the marketing, distribution, and sale of the TIC interests. The sponsor will later sign selling agreements with the retail broker-dealer groups, known collectively as the selling group. Once the selling agreements are signed, the numerous registered representatives, working under the affiliation of the broker-dealer organizations, are at liberty to sell the TIC securities to investors. It is the broker-dealers' responsibility to control and distribute the information to their registered representatives. All registered representative must be licensed security professionals that are associated with a broker-dealer that furnishes them with an approved list of product to sell.

<sup>49</sup> Kevin Bradburn, Omni Brokerage, Inc., Personal Interview, 12 July 2005.

The following is a hypothetical illustrative example of the process. Sponsor LLC signs an engagement agreement with Managing Broker-Dealer Co. Managing Broker-Dealer Co. helps Sponsor LLC prepare marketing materials and identify other broker-dealers to include in the selling group. Sponsor LLC signs selling agreements with a few of these broker-dealers. The registered representatives, under the affiliation of their broker-dealer organizations, begin selling the product to their clients all around the nation.

Following Regulation D exemption, the TIC securities are sold through a private investment offering. In order to grant investors full and fair disclosure, a sponsor will prepare a private placement memorandum (PPM) to distribute to potential investors through the described broker-dealer network. The PPM will list all significant facts relating to the property, the terms of the deal structure, and a description of potential risks. It will be the key document upon which registered representatives will rely to market and explain the transaction to investors.

	<b>Forms of Communication that a Sponsor is allowed to provide to each party at certain times</b>		
	<b>Before PPM Available from Sponsor</b>	<b>After PPM available, but before Selling Agreement Signed</b>	<b>After Selling Agreement Signed</b>
<b>Broker-Dealer</b>	All Forms okay	All Forms okay	All Forms okay
<b>Registered Rep</b>	Verbal Communication Tombstones	1. Verbal Communications 2. Tombstones 3. Executive Summaries/Website Notices (#3 Only with permission from the B/D)	1. Verbal Communications 2. Tombstones 3. Executive Summaries/Website Notices 4. PPMs 5. Other info on property
<b>Client</b>	No Property or Offering-Specific Communication	No Property or Offering-Specific Communication	1. Verbal Communications 2. Tombstones 3. Executive Summaries/Website Notices 4. PPMs 5. Other info on property

**FIGURE 4** Sponsor Communication<sup>50</sup>

Figure 4 above is an industry standard table that lists the preferred timing of communication of property specific information by sponsors, as one of the largest concerns regarding the sale of TIC interests is pre-marketing. Pre-marketing is when a sponsor prematurely begins communicating with registered representatives or possible clients about a specific deal before a selling agreement is signed by

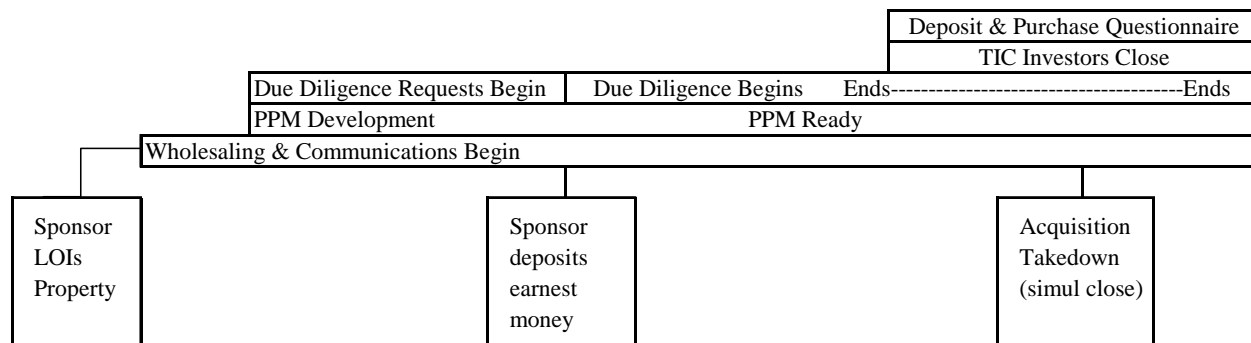
<sup>50</sup> Broker Dealer Best Practices. Memorandum. Omni Brokerage, Inc. 15 Sept. 2003. p. 3. Note: with slight adaptation.



the broker-dealer.<sup>51</sup> Such actions could be deemed as general solicitation, violating stipulated guidelines of Regulation D. In addition, if clients begin showing indications of interest prematurely it could create like-kind exchange identification problems as clients inaccurately rely upon transactions that may not close within the required time frame or never come to fruition at all.

As seen, all correspondence between the sponsor and broker-dealer is allowed at anytime. However, no specific written materials should pass from sponsor to registered representative until the selling agreement is signed, though verbal discussions are always permitted. Most importantly, the sponsor should not relay any property or offering specific information to the clients until after the selling agreement is signed and even then it should be distributed through the broker-dealer network as listed in Figure 4.

***Timeline***



**FIGURE 5** Timeline<sup>52</sup>

Figure 5 above illustrates the process and typical timeline of selling a TIC security. The sponsor initiates the transaction by entering into a letter-of-intent with the selling property owner. The sponsor then begins to review the property through early stage due diligence and enters into communications with a managing broker-dealer. Once the sponsor believes the asset is sound and has real potential, a purchase-and-sale agreement is signed with the seller and earnest money is deposited in order to commence the formal due diligence phase. The sponsor has consecutively been working to develop the private placement memorandum.

<sup>51</sup> *Ibid.*, p. 2.

<sup>52</sup> *Ibid.*, p. 4.

Now that the property is under control, the sponsor works closely with the managing broker-dealer and industry attorneys to refine the PPM. At this point, the managing broker-dealer, retail broker-dealers, and third-party due diligence consultants all initiate a thorough due diligence review. The broker-dealer community relies heavily upon the report produced by the due diligence consultants. As previously discussed in Figure 4, the sponsor and the registered representatives should avoid entering into any pre-marketing as all transaction information is still preliminary. Once the PPM, engagement agreement, and selling agreements are formalized then the equity raising stage officially begins. A couple weeks are spent disbursing and explaining the PPM and other due diligence materials to the broker-dealers, registered representatives, and finally to the clients. TIC investors, through their registered representatives, begin submitting deposits, executed documents, and questionnaires that validate their status as accredited investors. Soon the formal due diligence period ends and the sponsor enters the closing phase of the agreement. A smaller sponsor will prepare all the deposits of the TIC investors to coincide with the close of the property, therefore conducting a simultaneous close and avoiding the need to fund the take-down of the asset before selling it off to the TIC investors.

It should also be noted, that thorough due diligence is also performed on the sponsor group. Broker-dealers have a fiduciary responsibility to their clients to independently verify not only the stability of the property, but that of the sponsor as well.<sup>53</sup> The last thing the industry wants are sponsors who, after taking their upfront fee, exit the industry and abandon the TIC investors and their broker-dealers. Therefore, broker-dealers will hire (at the expense of the sponsor) third-party due diligence groups to independently review a sponsor's accounting and asset management systems, perform background checks, verify capitalization of the company, and generally validate that all necessary infrastructure is in place to professionally manage real estate assets and the needs of TIC investors.<sup>54</sup>

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<sup>53</sup> *Ibid.*, *op. cit.*, p. 3.

<sup>54</sup> *Shaw*, *op. cit.*

## Fee Structure

<b>TIC Securities Fee Structure</b>
9.0% Total Above the Line Fees (Mkting and Sales)
1.0% Managing Broker-Dealer
1.0% Broker-Dealer
7.0% Registered Representatives
2-4% Organization & Offering
8.0% Sponsor Fee
1.0% Loan Costs
1.0% Possible Miscellaneous
<b>21-23% Avg. Total Load (as % of Equity Raised)</b>

**FIGURE 6** Fee Structure<sup>55</sup>

Loads charged on the equity of tenant-in-common transactions are fairly expensive and can vary significantly. However, on average, and as seen in Figure 6, total loads currently range around 21-23% of equity raised. The total “above the line fees”, those fees paid to licensed security

brokers-dealers and their registered representatives to sell and market the offering , average around 9% of equity, although can reach as high as 13%. Organization and Offering is generally a non-accountable expense that covers the cost of preparing the PPM, legal fees, and due diligence costs. On average, the sponsor takes an 8% fee, while an additional 2% is needed to cover the cost of loan and miscellaneous fees. Unlike profit sharing in a partnership structure where a real estate manager’s compensation is generally tied to the success of the property, a sponsor in a TIC transaction receives the entire 8% fee upon acquisition. A sponsor will typically continue to manage the property and collect a market asset management fee, and those sponsors who are real estate brokers may also receive a selling commission for the asset upon disposition years later. Revenue Procedure 2002-22 depicts the criteria for structuring TIC interests so as not to resemble partnership interests, as the IRS does not allow investors to exchange in and out of partnership interests. The dilemma this creates is that the sponsor’s compensation is now almost entirely front-end loaded in variance with traditional real estate partnership ideals that managers should only be compensated when or after investors realize a healthy return on their investment. This is a negative aspect of tenant-in-common ownership, as the IRS fails to align the economic interests of sponsors and co-owners, and in the opinion of the author is a poor decision by the IRS. A sponsor’s

<sup>55</sup> Bradburn, *op. cit.* Note: All information in this section that references Figure 6 is credited to Kevin Bradburn.

reputation is really the only check-and-balance to guarantee that sponsors will market and sell reputable real estate transactions.

<b>Typical Deal Load</b>			
<u>Initial Asset Valuation</u>		<u>TIC Asset Valuation</u>	
Rent	1,000,000	Cash-on-Cash Yield to TIC Investors	7.0%
Sponsor Purchase Cap Rate	8.20%	(pre-tax and w/o depreciation)	
Sponsor Purchase Price	12,195,122	TIC Equity Raised	4,677,196
LTV	70%	Debt Amount	8,536,585
Debt Amount	8,536,585	LTV	65%
Equity Amount	3,658,537	TIC Purchase Price	13,213,781
		TIC Cap Rate	7.57%
Rent	1,000,000	Excess Equity Raised	1,018,659
Debt Payment	(672,596)	<b>Load</b>	<b>21.8%</b>
Cash Flow	327,404		

**FIGURE 7** TIC Example

Traditional TIC investments are currently yielding on average around a 7% cash-on-cash return (6-8% range), with a slight increase in total return due to appreciation of the asset and the benefit of depreciation as a tax shield.<sup>56</sup> Since most TIC investments are only a few years old and every investor's depreciable basis is different, it is difficult to accurately estimate their total return. However, on average a 50-150 bps spread above their cash-on-cash return is an accurate estimate. Listed above in Figure 7 are the basic financials to a typical tenant-in-common transaction. In this example, a sponsor buys a property for an 8.2% capitalization (cap) rate.<sup>57</sup> The sponsor then sells the asset to the TIC investors at a 7.57% cap rate, or an initial 7% cash-on-cash return on an asset that is 65% leveraged. This spread in cap rates produces an additional \$1,018,659 of equity, which is the increase in cost that TIC investors are paying over the initial asset valuation. This amount divided by the total amount of equity raised (\$4.67 million) gives an equity load of 21.8%. At the investor level, leverage drops from 70% to 65% due to this increase in equity to cover the transaction fees. The cash-on-cash return is initially the most important number to investors. It is derived by dividing a leveraged cash flow by the amount of equity raised; therefore the quality and quantity of leverage plays a fundamental role in TIC transactions.

<sup>56</sup> Shaw, *op. cit.*

<sup>57</sup> Larger sponsors purchase the asset and then resell it to investors a few weeks later. Smaller investors, strapped for capital, will coincide the raising of TIC capital with the purchase of the asset, so as to never own the property themselves.

At first glance, the high load on tenant-in-common equity may scare away investors. The purchase price to the TIC investors in Figure 7 is 8.4% higher than the initial purchase price. Is the asset worth that much more to TIC investors? Investors initially flock to tenant-in-common investments for tax reasons, but then realize the strength of co-investing with others. Each TIC investor must determine if the added benefits of access to institutional quality real estate, real estate diversification among multiple assets and markets, sale flexibility, and professional third-party management are worth the added cost. For TIC investors, as is the case for investors of commercial mortgage-backed securities (CMBS), the sum of the parts is worth more than the whole. However, the answer to whether a TIC investment is worth the cost will vary according to the value investors place on the additional TIC benefits. Comparing an investor's alternative options is the best way to determine whether TIC benefits are worth the added cost.

Upon real estate disposition, some investors may choose to pay their capital gains tax owed and invest elsewhere, where fees are not as high. Especially in light of the recent Jobs and Growth Tax Relief Reconciliation Act of 2003 in which the federal capital gains tax rate was reduced from 20% to 15%.<sup>58</sup> However, the tax burden may not be as low as first assumed, especially since all depreciation claimed on the property is taxed at a recapture rate of 25%, not to mention any state-level capital gains tax.<sup>59</sup>

Figure 8 below walks through a simplified example of a hypothetical transaction and its corresponding tax burden after 15 years of ownership. An investor purchases a commercial real estate property 15 years ago for \$1 million. Assuming 90% of the value is depreciable over a straight line base-term of 39 years and a sale price of \$1.49 million in 15 years (grown annually at a conservative 2.7%, the CPI growth from 1990-2005)<sup>60</sup>, the total tax burden upon sale is \$160,000. Assuming 50% leverage upon sale, the tax burden accounts for 21.5%<sup>61</sup> of the total equity value, not much different than a 21-23% average TIC equity load. The difference is that the TIC investor is already reinvested in a new transaction

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<sup>58</sup> United States. Internal Revenue Code, Job and Growth Tax Relief Reconciliation of 2003, Section 301.

<sup>59</sup> Donna Mitchell, "1031's Still Hot, Players Say," *Shopping Centers Today* (October 2003), p. 1.

<sup>60</sup> United States Department of Labor. Bureau of Labor Statistics, CPI Data 1990-2005, 29 July 2005, <<http://data.bls.gov/cgi-bin/surveymost>>.

<sup>61</sup> A conservative estimate, as state-level capital gains are omitted for simplicity.

while the investor who chose to cash out is not. The investor that chose to pay her taxes would still need to pay any necessary transaction costs to enter into a new investment.

<i>Capital Gains Tax Analysis</i>			
Initial Purchase Price	1,000,000	Total Gain on Sale	836,154
Land allocation at purchase	100,000	Gain Attributed to Depreciation	346,154
Initial Depreciable Basis	900,000	Depreciation Tax Recapture Rate	25%
Annual Depreciation Expense	23,077	Total Tax on Depreciation	86,500
Years Held	15	Capital Gain	490,000
Total Depreciation Claimed	346,154	Capital Gains Tax Rate	15.0%
Ending Land Basis	100,000	Capital Gains Tax	73,500
Ending Building Basis	553,846	<b>Total Tax</b>	<b>160,000</b>
Total Ending Basis	653,846	Tax as % of Sale Value	10.7%
Total Sale Value	1,490,000	Leverage	50%
Ending Basis	653,846	Equity Upon Sale	745,000
Total Gain on Sale	836,154	<b>Tax as % of Equity Value</b>	<b>21.5%</b>

**FIGURE 8** Capital Gains Tax Analysis

An alternative approach is to compare TIC loads to other types of investments. If an investor has substantial holdings in real estate he may be able to attract a major public REIT to purchase his assets in return for operating partnership units in an UPREIT that would be redeemable for stock.<sup>62</sup> This would allow the investor to defer capital gains taxes until he chooses to trigger the taxable event by redeeming the partnership units for stock. However, this option would only be available to significant holders of real estate. To the average small investor, another option is to invest in a private REIT. Again if the private REIT were to purchase the investor's relinquished property a similar type of like-kind exchange would allow the investor to exchange into operating partnership units in an UPREIT structure. The probability that the private REIT will want to purchase the investor's exact asset is low. However, the investor could always pay the tax due and invest in a private REIT. However, private REITs also carry heavy loads of 10-15% of the total acquisition price.<sup>63</sup> It is important to remember that REIT loads are classified on total deal cost, while TIC loads are classified only on equity raised.

<sup>62</sup> Atlantic Exchange Company, LLC., "Transfer to an UPREIT," 29 July 2005, <<http://www.aec1031.com/upreit.html>>

<sup>63</sup> Christopher Ostrowski, "The REIT Wars," *Real Estate Forum* (May 2004) 29 July 2005 <<http://www.inlandgroup.com/news/PressClips/REITS%20INLAND%20REPRINT.PDF>>.

As seen in Figure 9, a 50% leveraged \$2 million acquisition in a private REIT with a 10% total deal load would equate to a 20% equity load, almost the same load level of a TIC transaction. Also, as previously mentioned, private REIT's can carry deal loads as high as 15% which would greatly outpace a TIC's 22% equity load. After considering the tax burden and the cost of other investments such as private REITs the load burden on TIC investments does not seem as excessive.

***Transaction Loads***

<b>Tenant-in-Common</b>		<b>Private REIT</b>	
Total Investment	\$2,000,000	\$2,000,000	Total Investment
Leverage	50%	50%	Leverage
Equity	\$1,000,000	\$1,000,000	Equity
TIC Equity Load	22.0%	20.0%	Private REIT Equity Deal Load
TIC Total Deal Load	11.0%	10.0%	Private REIT Total Deal Load
Total Load	\$220,000	\$200,000	Total Load

**FIGURE 9** Loads

If an investor chooses to defer capital gains and participate in an exchange, there are three possible options. First, an investor could exchange into an UPREIT structure as defined earlier, however it is unlikely that the REIT would purchase the investor's asset. Second, the investor could exchange into a replacement property through the same ownership structure under which she held ownership in the relinquished property. If the investor owned the property alone, she could exchange into a replacement property alone. If the investor owned a property under a limited partnership, that same partnership could exchange into a replacement property. However, without using the tenant-in-common structure the investor could not sell the property that she individually owned and then partner with other investors to purchase a new property. Nor could the investor under any partnership structure take her portion of the proceeds and exchange into a property alone. In addition, without using a TIC ownership structure the partnership that sells the relinquished asset could not join with another group of investors to exchange into a replacement property. The third option is to invest into a TIC structure.

An investor trying to avoid the high tenant-in-common equity loads by participating in a like-kind exchange alone or as part of partnership will reduce costs, but also benefits. For example, outside of a TIC investment the investor is forced to find, review, and decide upon which replacement property to

buy. That could mean traveling to various markets, paying for appraisals and environmental reports, negotiating purchase-and-sale agreements, and obtaining loan financing commitments. TIC investments are prepackaged with complete due diligence reviews and there is no concern about being forced to remain with any co-owners in the future, which is a major disadvantage of partnership investing. Partnerships restrict the sale flexibility of the investor, as it is prohibited to exchange in and out of partnership interests according to Section 1031 guidelines. Owning an asset alone grants complete control, but with that control comes the requirement of active participation, which can be very time intensive. TICs are more passive in nature freeing the co-owners from the daily administrative affairs. In addition, when an investor owns a property alone she assumes all the downside risk, in a sense placing all of her real estate eggs in one basket. The fees will be lower to exchange into an asset alone or through a partnership, however, such a choice may not grant all the benefits desired and will demand much more effort on behalf of the exchangor than investing in TIC transactions. The investor must therefore personally weigh the cost increase against the corresponding increase in benefits and determine whether such is justified.

### ***Alternative Structures***

While co-ownership of property as tenants-in-common is the most common way in which to own an undivided fractional interest in real property and defer capital gains per IRC Section 1031, another is through ownership of a Delaware Statutory Trust (DST). Also, the combination of a master lease with a TIC or DST presents additional ownership structures.

### **Delaware Statutory Trust**

It is first important to note that while considered part of the “TIC Industry” the DST is a completely separate structure from TIC ownership with separate rules governing its use. Despite the confusion of some players in the industry regarding the relationship between DSTs and TICs, an article written by three prominent TIC industry attorneys, specifically in regard to the difference between the two structures, states that they “have little in common except that an interest in either may constitute an



interest in property for purposes of Section 1031 and that the DST Ruling does not indicate that the requirements of both must be satisfied when an interest in a DST is acquired.”<sup>64</sup>

In 2004, the IRS gave guidance regarding the use of DSTs through Revenue Ruling 2004-86, the purpose of which addressed whether a trust would be treated as either a trust or a business entity under Treasury Regulations 1.7701-4 and 1.7701-3 respectively.<sup>65</sup> In order to qualify for Section 1031 treatment the trust must not only be treated as a trust for Reg. 1.7701-4 purposes, but must also satisfy the requirements of a grantor trust under Section 671 and seven other main points now commonly referred to as the “seven deadly sins” of DSTs. The “seven deadly sins” are very restrictive, as trustees of the trust are not allowed any involvement in the operation or management of the trust (See Appendix 4 for a complete list).

It is clear after reviewing these prohibitions that the DST, as compared to a TIC, is a very limited property ownership vehicle for purposes of deferring capital gains. The beneficiaries/shareholders of the trust have absolutely no ability to participate in management or decisions regarding the property being held by the DST. The activities of the trustee are also extremely limited to passive roles such as rent collection and disbursement to beneficiaries and are not permitted to perform any of the more general activities that are allowed by a sponsor of a TIC structure.

Despite the obvious DST limitations, this structure also has various perceived benefits, which is the reason for exploration into its use in the first place and to what culminated in the IRS granting additional guidance in 2004. Probably the most attractive aspect of the DST is the simplicity and economic benefit that it brings to property debt financing. One of the largest challenges in standard TIC transactions is the difficulty that lenders have in understanding how to allow a blanket loan/mortgage on a property to be divided among up to 35 individual investors who each are separate and distinct borrowers. “Lenders are hesitant to lend to numerous co-owners because in the event of a bankruptcy, foreclosure, or

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<sup>64</sup> Lipton, Golub, and Harrison, *op. cit.*, p. 76.

<sup>65</sup> Although beyond the scope of this study, Treasury Regulation 1.7701-3 sets forth the tax treatment of partnerships and corporations while Reg. 1.7701-4 sets forth the tax treatment of trusts (see Lipton, Golub, and Harrison for more detail).

other legal proceedings involving the property, the lender will be forced to work with all the co-owners, each with separate counsel and each making claims and demands, some of which may be inconsistent with those made by the other co-owners.”<sup>66</sup>

A DST, however, greatly simplifies this process by having the trust as the only borrower, and in the case of a potential bankruptcy of a beneficiary the trust and its assets will not be affected. This added simplicity through the DST structure also provides economic benefit for beneficiaries through better financing terms and rates and much lower initial structuring costs as compared to a TIC, which usually requires the creation of a single member LLC for each co-owner.

DSTs have potential structural benefits over TICs in that DSTs have no limit on the number of beneficiaries, the number of assets held by the trust, buy-sell provisions, or other restrictions dealing with “association vs. partnership” analysis. DST’s may also provide a good structure for sale-leaseback transactions done within the TIC industry because of the absolute triple-net or “bondable” nature of such leases (i.e. – tenant has responsibility for all conceivable property related issues including all expenses, maintenance and repair, condemnation, structural, and environmental). Tenants under a sale-leaseback transaction may also prefer the DST structure for many of the same reasons that they are attractive to lenders, which were previously mentioned. Whereas when structuring a TIC transaction there can be no existing lien on a property due to logistical concerns with a lender, a DST can more easily assume financing because of its single-entity nature.

In trying to capture the benefits of a DST while dealing with its extremely passive nature, the only logical potential uses of this structure include properties that require minimal or no owner attention, such as absolute triple-net leased buildings, ground leases, or master leased properties. However, even within these types of assets or ownership structures there could potentially be situations, such as a lease renegotiation or refinancing, that a trustee would not be allowed to perform. It is for this reason that there are very few, if any transactions, currently in the marketplace that have been successfully structured using

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<sup>66</sup> Ronald Shellan, Miller Nash LLP, “Can A Delaware Statutory Trust Solve a TIC Loan Structuring Problem?” Tax-Free Exchange Advisor (Fall 2004), <<http://www.millernash.com/showarticles.asp?Show=377>>, p. 1.

a DST. As sponsors continue to push the limit of risk in using this structure or as additional guidance is provided by the IRS, time will tell what the future of DSTs will hold.

## **Master Lease**

In traditional TIC transactions, co-owners receive their rental income from tenants that are leasing the improvements on the co-owners' property. For various reasons, some sponsors have opted to sell TIC interests subject to a master lease arrangement between the co-owners and an affiliate of the sponsor/manager. Speaking of his company's reason for its use of the master lease structure, John Mayeron, a principal at DBSI, a large sponsor that aggressively uses the master lease structure said "while several of our investments returned two, three, four, or more times the original projections, DBSI did not share in those successes. Because of this inequitable balance we elected not to get involved in the 1031 market. Enter the Master Lease. Now we have an opportunity to share in the property's success while protecting the investor's downside."<sup>67</sup> For example, in a master lease structure a property is leased to a single entity known as the master lessee. The master lessee, which is usually an affiliate of the sponsor and not the sponsor itself, generally signs a long-term triple-net lease with the co-owners that requires the master lessee to make set rental payments, despite the occupancy or net operating income of the property, and to pay for all standard triple-net property expenses (i.e. – taxes, insurance, repair expenses, leasing expenses, etc...). As is the case with any triple-net lease, the co-owner's do not have the concern for, or the responsibility of, potentially escalating property expenses, but nor will they receive the benefit of lower expenses that often come with expert property management.

Additionally, the master lessee generally has the right to sublease the property without the landlord's (i.e. – co-owners') consent. As part of this right, the master lessee benefits in situations where the rent paid by a subtenant is greater than its own rental requirement, but takes the downside risk in the event that the subtenant rental receipts are less than its own obligations. The fact that the master lessee actively manages the property, through property subleasing, places the TIC investors in an extremely

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<sup>67</sup> John Mayeron, DBSI Group, "Master Lease from the Sponsor's Perspective," (DBSI July 2004 Publication), pp. 3-4.

passive role. Some industry participants believe that this extreme passivity of co-owners not approving all leases and lease amendments, which is a requirement of RevProc, puts the investment at risk of being labeled a partnership by the IRS and losing its 1031 status. Bryan Mick, an independent due diligence officer and attorney refutes this argument and says that it “is a misplaced analysis, and construing the Rev. Proc. to require approval of subleases would necessarily conclude that a master lease is not a valid or recognized legal document. It would be unwelcome news to various state and federal government agencies, international hotel and restaurant franchisee operators, and the commercial real estate industry in general.”<sup>68</sup> Louis Rogers, a prominent attorney within the TIC industry, and now president of Triple Net Properties, another large TIC sponsor, further defended the merits of the master lease by inferring that the co-owners do, indeed, approve all leases associated with the property because “there is only one lease – the master lease – which is approved by each TIC when they make the [initial] investment.”<sup>69</sup>

Regarding DSTs, not only is the use of the master lease within this structure very similar to that of TICs, it is absolutely essential for any property that is not either an absolute triple-net leased property or a ground lease due to the passive nature of the DST. Furthermore, the master lease and DST are potentially good fits as they both cater to investors looking for a very hands-off approach to fractional real estate ownership.

In general the master lease can be a very effective tool for diligent sponsors with a strong sense of fiduciary responsibility, but can also be an opportunity for unscrupulous sponsors to take advantage of investors. For transactions involving multi-tenant or residential properties where there is constant lease rollover and other management responsibilities, the master lease does, indeed, provide a more convenient structure so that co-owners looking to be passive are not burdened by continuous voting responsibilities. However, there is also a tendency by some to unnecessarily use a master lease in a single tenant triple-net leased property to “skim off” rental proceeds and provide lower returns to co-owners. Additionally, it is

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<sup>68</sup> Bryan S. Mick, Croker Huck LLP, “DBSI Master Lease as Seen From an Independent Due Diligence Officer’s Perspective,” (DBSI July 2004 Publication), p. 2.

<sup>69</sup> Louis J. Rogers, Hirschler Fleischer, “Master Lease Preferred Structure Under 2001 Revenue Procedure,” (DBSI July 2004 Publication), p. 1.

important that a sponsor using this structure have sufficient assets to provide some sort of credit behind the master lessee. Otherwise, the master lessee is a shell entity that takes upside away from co-owners, but provides no downside protection in return.

Tenant-in-common investments are logistically complex. In addition to abiding by IRC Section 1031, Revenue Procedure 2002-22, and security laws with dictated fee structures, sponsors and investors must weigh the pros and cons of alternative ownership structures such as the Delaware Statutory Trust and the master lease. The next section will apply the legal and structural complexities of TIC investments to hypothetical but practical value added transactions.

## Value Added Transactions

Value added TIC transactions offer higher yields than those of typical TIC deals. The opportunity to incorporate a riskier, yet higher-yielding TIC investment into an overall tenant-in-common portfolio offers investors the ability to diversify their individual expected property returns and therefore maintain a better balanced portfolio with the potential of a higher total portfolio level expected return.<sup>70</sup> For example, an investor with \$5 million of real estate to exchange may choose to place a small portion, such as \$250,000, into a higher risk, yet higher yielding value added TIC investment. If the remainder of the money is disbursed among various less risky assets, it makes sense from a diversification aspect to allocate some funds where there is a greater chance of achieving substantial appreciation.

The largest obstacle facing tenant-in-common capital in value added transactions is the inherent need for additional equity beyond that raised through tax-deferred like-kind exchanges. Following IRC Section 1031, an investor that exchanges a property sold for \$10 million into a property worth \$8 million would be forced to pay tax on the additional \$2 million not exchanged (assuming the same percentage of debt on each deal). Likewise the same investor could not exchange the \$10 million into an \$8 million property and use the excess \$2 million to renovate the project without facing the tax apportioned to the \$2 million. All \$10 million must be exchanged, i.e. all exchanged funds must be absorbed in the purchase price. Any amount of money held for future development or renovation would be considered "boot", not "like-kind" to the relinquished property, according to IRC Section 1031 and would not qualify for tax deferment status.<sup>71</sup> Since one of the largest benefits to TIC investors is tax deferment, any additional capital needed for development or renovation must come from after-taxed funds. However, investors of after-taxed equity may not be eager to participate in a TIC transaction that carries on average a 21-23% equity load, especially without the benefit of tax deferment. Therefore how can TIC capital be used in value added transactions without raising additional after-taxed equity?

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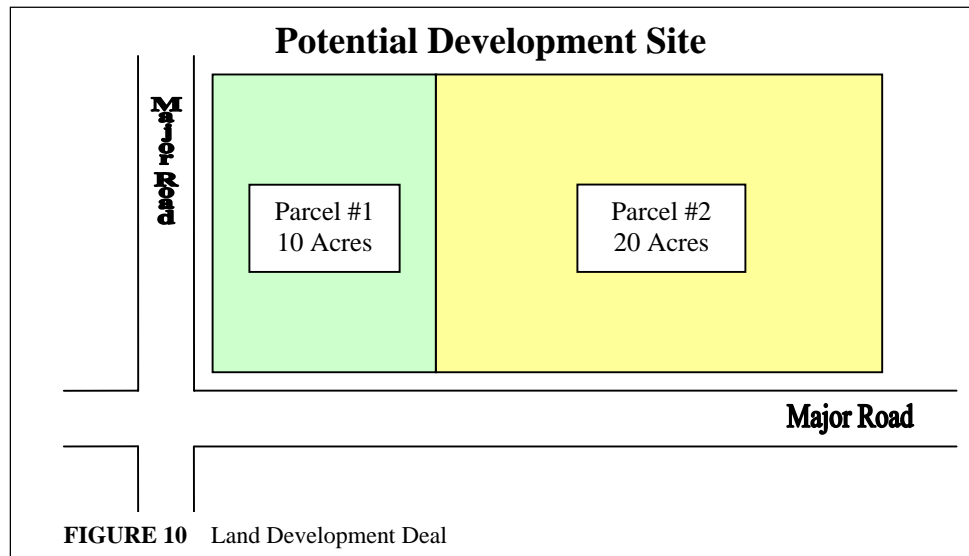
<sup>70</sup> Note: For a thorough review of portfolio theory see: David Geltner and Norman G. Miller, *Commercial Real Estate Analysis and Investments* (Ohio: South-Western Publishing, 2001), pp. 516-556.

<sup>71</sup> Nessen, *op. cit.*, p. 159.

There are two additional forces that must balance when structuring a value added transaction with TIC capital. First, the economic returns must be acceptable to the investor. Does the investment generate adequate monthly income and is there potential for appreciation in residual value? Most TIC investments generate monthly income, but offer only meager, if any, appreciation in value. Value added transactions by definition offer increased potential for appreciation; the difficulty is finding the proper structure to maintain monthly income in the process. The next few sections will shed light on finding the balance between monthly and residual income, and depict how some value added transactions can be structured to avoid the necessity of additional after-taxed equity.

### ***Retail Land Development***

One way TIC investors are able to participate in value added transactions is by land banking portions of large retail development sites. This idea is best illustrated by walking through a simplified development deal. Suppose a sponsor/developer places 30 acres of unimproved and unentitled farm land under option-to-purchase for \$100,000 an acre or \$3 million (Figure 10).



While under option, the sponsor entitles the entire 30 acres to permit a retail shopping center development and signs a lease with a major retail tenant such as Costco Wholesale to occupy parcel #1. Before exercising the option-to-purchase the property, the sponsor works through a broker-dealer network

to raise TIC capital to buy parcel #2, 20 of the 30 acres of land, for \$200,000 per acre (market price for entitled retail unimproved land) or \$4 million. Parcel #2 has doubled in value through the entitling and rezoning of the property, and by the fact that a nationally accredited tenant, like Costco Wholesale, has entered into a long-term lease on the adjacent site. Kenny Christensen, a developer at Hawkins-Smith Development, a company that specializes in commercial retail development and has developed over 5.5 million square feet in 17 states, says that “on average agriculture land will double in value as it is rezoned and entitled to accommodate commercial uses”.<sup>72</sup> In order to justify fair market value, the actual value would be verified by appraisal.

Through a simultaneous close, the sponsor utilizes the TIC capital and exercises the option-to-purchase, paying the farmer \$3 million. Post acquisition, a group of TIC investors, TIC-A, own 20 acres of land (parcel #2) for which they paid \$4 million. The sponsor now owns 10 acres of land (parcel #1) free-and-clear and has \$740,000 in additional funds after paying \$260,000 to cover the cost of raising the equity. Thus far the sponsor has simply created value by entitling land.

<u>TIC-A Return</u>			
4,000,000	Parcel #2 -- 20 Acre Sale Price		
50%	Loan-to-Value	7.00%	Interest Only Debt
2,000,000	Debt Amount	2,000,000	Debt Amount
2,000,000	TIC-A Equity Raised (Value Added TIC)	140,000	Annual Debt Payment
9.25%	Ground Lease as % of Land Price	370,000	Ground Lease Payment
370,000	Annual Ground Lease Payment	<u>(140,000)</u>	Annual Debt Payment
		230,000	TIC Annual Cash Flow
13%	% of Equity Raised Attributed to Non-Sponsor cost		
260,000	Non-Sponsor Cost to Raise Equity	<b>11.5%</b>	<b>TIC-A Cash-on-Cash</b>
740,000	Profit to Sponsor		
2 years	Years of Ground Lease Payment in Profit		

**FIGURE 11** TIC-A Return

As a concern, TIC-A is not generating any income on the unimproved land. To remedy this problem, the sponsor leases parcel #2 from TIC-A for a market ground lease payment of 9.25% or \$370,000 a year (Figure 11). This provides the investors steady income and also grants the sponsor the right to develop future phases on parcel #2 after parcel #1 is developed. The excess \$740,000 profit

<sup>72</sup> Kenny Christensen, Hawkins-Smith Development, Personal Interview, July 28, 2005.



retained by the sponsor from selling parcel #2 would be held to pay for the first two years of ground lease payments. The sponsor also retains a “call” option to buy parcel #2 at a market rate within a set time period, no sooner than two years. TIC-A now has an income generating property that should enjoy a much higher level of appreciation than typical TIC transactions, while the sponsor has benefited by funding the development with minimal out-of-pocket expenses (option payments and entitlement fees). Based on a 50% loan-to-value on parcel #2 and a 7% interest only land loan, the TIC-A investors would enjoy a 11.5% cash-on-cash return, much higher than the current TIC 7% cash-on-cash return.

The sponsor/developer builds the Costco and enjoys the rental income. At this stage, parcel #1 is sold to a different group of TIC investors, TIC-B, as a traditional income generating TIC transaction. Meanwhile, the co-owners of parcel #2 have enjoyed appreciation as a national tenant is now occupying a building on the adjacent property.

At this point, the sponsor/developer is the manager of parcel #1 (owned by TIC-B) and parcel #2 (owned by TIC-A), and is paying ground rent to TIC-A to lease parcel #2. The sponsor now focuses time on developing parcel #2 by signing additional build-to-suit leases with other national retailers. The sponsor must choose whether to exercise the call option and buy out TIC-A before starting construction of parcel #2 or continue with the ground lease payments and post adequate equity to appease a construction lender. It should be noted that TIC-A members would not be expected to subordinate their fee-simple ownership to the development, as the sponsor is ground leasing parcel #2 and is responsible for providing any such collateral or funding to start development. The fact that subordination is not required, allowed the TIC-A members to leverage their purchase of parcel #2, as their land would not be required collateral for any future development. The initial term of the ground lease would only be for 2 years, but the sponsor would have in excess of 35 years through renewal options if it chooses to renew and not buy the parcel. The ground lease offers the sponsor the needed freedom to move forward with a development deal, without having to involve the co-owners in every decision.

For this example, assume the sponsor exercises the call option before starting development on parcel #2. TIC-A investors would receive the fair market value for their property, based upon an

appraisal. The property should have appreciated due to the development of Costco next door; however, even if there is little or no appreciation the annual cash-on-cash yield of 11.5% grants a much higher return than typical TIC deals. The total yield on TIC investments averages around 8%. Assuming a three year hold and a conservative annual appreciation rate of 2.7% (average CPI over the last 15 years) on parcel #2, TIC-A investors would receive a 16.2% internal rate of return “IRR”, more than doubling the typical TIC average return. TIC-A investors would be able to exchange into another property or cash out of real estate.

After completing the development of parcel #2, the sponsor could sell parcel #2 to a new group of TIC investors, TIC-C. During this time, TIC-B would still be enjoying the income from Costco on parcel #1 and the associated depreciation expense. TIC-C would now own parcel #2 and would be enjoying the income from other national retailers, while also benefiting from the associated depreciation expense. The sponsor would continue to manage parcel #1 and parcel #2. In all, three different groups of TIC investors were used for this development, but the essential piece was TIC-A that bought into a value added investment. Their investment allowed the sponsor to initiate a development deal without contributing any capital and granted the TIC investors a much higher risk-adjusted return. In addition, the sponsor created and sold a new product in a supply-constrained TIC industry.

The two most relevant concerns in the hypothetical retail development transaction are the effects on TIC-A investors if the sponsor were to walk away and not renew the ground lease and if the land does not appreciate in value after TIC-A purchases parcel #2. As long as the sponsor maintains the ground lease payments the investors will enjoy at least an 11.5% return, even without any appreciation. Assuming the sponsor chooses not to renew the ground lease after year two, the investors would be stuck paying the annual debt payment on the land. Figure 12 on the following page is a sensitivity analysis of the retail land development transaction from the perspective of both the investor and sponsor. First, from the investor’s viewpoint two sensitivities were run comparing land appreciation and investment holding period for TIC-A investors. The first table, the base case, illustrates an investor’s IRR based upon continual ground lease payments from the sponsor until disposition. The second table, the pessimistic

case, depicts only two years of ground lease payments and negative cash flow thereafter to cover debt payments. The first two years of returns are identical for each scenario, as the ground rent is guaranteed for two years. However, once the ground rent ceases, returns quickly drop. In the base case scenario a 15% IRR is highlighted resulting from 2% annual appreciation and a 3 year hold, under the pessimistic case, such a return drops to 9.6%. The economics on the deal could quickly turn as there are only two years of guaranteed rental stream. The pessimistic case shows investors with a -4.3% return if the ground lease payments cease after year two, the land value decreases by 3% annually, and the investors are unable to sell their land until the end of year 4. This is a fairly drastic worse-case scenario and probably not overly realistic as land prices should increase in value due to the development of Costco on the adjacent property. If the property does not drop in value, even if the sponsor walks away after year two, the returns remain sufficiently robust to at least return the investors their equity with a slight return.

Retail Development Sensitivity Analysis								
<u>Investor Viewpoint</u>								
		<i>Annual Land Appreciation after Acquisition (Ground Lease Payments until Disposition)</i>						
<i>Base Case</i>		<b>-3.0%</b>	<b>-2.0%</b>	<b>-1.0%</b>	<b>0.0%</b>	<b>1.0%</b>	<b>2.0%</b>	<b>3.0%</b>
<i>Period (yrs)</i>	<b>1</b>	5.5%	7.5%	9.5%	11.5%	13.5%	15.5%	17.5%
	<b>2</b>	5.8%	7.7%	9.6%	11.5%	13.4%	15.3%	17.1%
	<b>3</b>	6.0%	7.9%	9.7%	11.5%	13.3%	<b>15.0%</b>	16.8%
	<b>4</b>	6.3%	8.1%	9.8%	11.5%	13.2%	14.8%	16.4%
	<b>5</b>	6.5%	8.2%	9.9%	11.5%	13.1%	14.6%	16.1%
		<i>Annual Land Appreciation after Acquisition (Ground Lease Payments End After Yr 2)</i>						
<i>Pessimistic Case</i>		<b>-3.0%</b>	<b>-2.0%</b>	<b>-1.0%</b>	<b>0.0%</b>	<b>1.0%</b>	<b>2.0%</b>	<b>3.0%</b>
<i>Period (yrs)</i>	<b>1</b>	5.5%	7.5%	9.5%	11.5%	13.5%	15.5%	17.5%
	<b>2</b>	5.8%	7.7%	9.6%	11.5%	13.4%	15.3%	17.1%
	<b>3</b>	-0.6%	1.6%	3.6%	5.7%	7.7%	<b>9.6%</b>	11.5%
	<b>4</b>	-4.3%	-1.9%	0.3%	2.5%	4.6%	6.6%	8.5%
	<b>5</b>	-6.9%	-4.3%	-1.8%	0.4%	2.6%	4.7%	6.7%
<u>Sponsor Viewpoint</u>								
		<i>Increase in Value Attributable to Entitlements</i>						
		20%	40%	60%	80%	100%	120%	140%
<i>Ground Lease Reserves in Yrs</i>		-3.4 yrs	-1.5 yrs	0 yrs	1.1 yrs	<b>2 yrs</b>	2.7 yrs	3.4 yrs

**FIGURE 12** Retail Development Sensitivity Analysis<sup>73</sup>

The analysis from the sponsor’s perspective illustrates the number of years of ground lease payments the sponsor will have in reserve based upon the increased value attributable to the entitlement process. For example, based upon a set 9.25% annual ground lease payment to investors and a 100%

<sup>73</sup> For purposes of the analysis, all assumptions not sensitized in Figure 12 remain as seen in Figure 11.

increase in value from entitlements, the sponsor would have two years of ground lease payments in reserve. If the land value only increases 60% in value then the sponsor is left without any profit for which to pay ground rent in the coming years, though the sponsor does receive the benefit of owning parcel #1 free-and-clear. Therefore, if the sponsor cannot achieve around 100% increase in value, the sponsor must rely upon additional sources of capital to fund all or a portion of the first two years of ground payments to investors. Without such increase in land value, the deal becomes significantly less attractive to the sponsor.

## **Legal Explanation**

Each element of the described structure was established to adhere to IRS guidelines. Walking through the complexities of the structure and the reasoning behind them, grants further understanding into the ability to fund value added transactions with TIC capital.

As discussed earlier, Revenue Procedure 2002-22 Section 6.10 allows a co-owner to issue a “call” option to purchase her undivided interest as long as the exercise price is the fair market value at the time of the exercise. Based upon this guidance, the TIC co-owners in the above development structure are allowed to issue a “call” option to the sponsor, but the price may not be preset, the price must be the fair market value once the sponsor exercises the option. Section 6.10 further stipulates that a co-owner may not acquire a “put” option to any party related to the transaction. Therefore, there can be no guaranteed take-out provision in which the TIC co-owners can “put” the property back to the sponsor at some point in the future. The TIC investors must be in a typical real estate at-risk situation that cannot be manipulated through financial engineering.

Section 6.13 stipulates that any lease arrangement must reflect the fair market value for the use of the property. Therefore, in this scenario, it is feasible to have a ground lease between the sponsor and co-owners as long as it is priced at the fair market value of a typical ground lease for entitled, but unimproved retail land.

The clause stipulating that the “call” option would not be exercised earlier than two years grants the TIC investors the ability to hold the property longer than the like-kind exchange guideline of at least one year, making the property an investment not a “dealer property” that is acquired for resale. It also guarantees the investors at least two years of income before being forced to exchange into another asset or cash out.

A land development raises some initial areas of concern. As discussed, to defer tax in a like-kind exchange, an investor must buy a replacement property of equal or greater value than the relinquished property and must use all net proceeds in the exchange. Therefore, leverage ratios such as loan-to-value (LTV) play a significant role as investors desire equal or higher LTV ratios in their replacement properties as in their relinquished properties to avoid placing additional after-taxed equity into the deal. Leverage ratios are not usually a concern in TIC transactions, as typical relinquished properties usually carry less leverage than newly acquired TIC deals and investors can always buy more than one property to increase the value of the replacement properties. However, since an investment in unimproved land will typically allow only up to 50% leverage, many potential TIC investors may be too highly leveraged in their relinquished properties to exchange into raw land without contributing additional equity. One solution is for highly leveraged investors to buy two replacement properties, one that is allocated the majority of the leverage and the other with relatively low leverage, allowing the combination of debt to equal the debt level on the relinquished property. That said, some sponsors in attempt to avoid burdensome land carrying costs caused by leverage, may choose to market only to all-equity investors or those with very low leverage.

Additionally, members of TIC-A are unable to enjoy any depreciation expense as they own the ground, but none of the improvements due to the ground lease with the sponsor. Depreciation expense lowers taxable income; however, the degree of benefit will vary significantly among investors as each carries forward his original depreciable basis from his relinquished property. In this example, the lack of depreciation expense is less of a concern as TIC-A is enjoying double digit returns even without the depreciation tax shield.

## ***Residential Land Development***

Similar to the retail land development described above, TIC capital could also be used in residential land developments. In a similar land banking scenario, TIC value added investors would purchase two separate portions of a site and hold the land until time for development. Residential land development may even be more compatible with TIC value added investments as more land appreciative changes are taking place during the holding period, i.e. hundreds of homes are being sold on adjacent land. However, there are slight modifications as a ground lease is ineffective in a residential development as land could obviously not be sold to an individual home owner subject to a ground lease.

40% of land (160 acres) Owned by TIC-2 Third lots to sell
40% of land (160 acres) Owned by TIC-1 Second lots to sell
20% of land (80 acres) Owned by Sponsor First lots to sell

**FIGURE 13** Residential TIC Deal

As an example, a sponsor/developer options 400 acres of unentitled and unimproved land for \$50,000 an acre or \$20 million (Figure 13). Upon completion of the entitlement process for all 400 acres, the fair market value of the land will be \$35 million (a 75% increase in value). According to Kirby Cochran, CEO of Castle Arch, a real estate investment company that specializes in single family residential development, it is common to see a 75%

increase in land value due to the rezoning and entitling of agricultural land into the preliminary plat approval for single family residential development.<sup>74</sup>

As seen in Figure 14, equity will be raised from two separate groups, TIC-1 and TIC-2. Each will pay \$13.3 million for a 40% portion of the 400 acres or 160 acres. This is a 5% discount below their fair market value of \$14 million (40% of \$35 million). The sponsor exercises the purchase option and uses the funds raised from both TIC groups to pay off the original land owner. As seen in Figure 14, after the fee for raising the funds is removed, the sponsor retains the excess amount to cover the future option payments on the two parcels of land owned by the TIC groups. Post acquisition, the sponsor owns 20% of the land (80 acres) free-and-clear and has \$3.14 million to use for future option payments.

<sup>74</sup> Kirby Cochran, Castle Arch, Personal Interview, 1 August 2005.

<b>VALUE &amp; INVESTMENT</b>				
	<u>Acreage</u>	<u>Value</u>	<u>Investment</u>	<u>Discount to FMV</u>
TIC-1	160	\$ 14 M	\$ 13.30 M	5%
TIC-2	160	\$ 14 M	\$ 13.30 M	5%
Sponsor	80	\$ 7 M	-	N/A
<b>Total</b>	<b>400</b>	<b>\$ 35 M</b>	<b>\$ 26.60 M</b>	

<b>SOURCES &amp; USES</b>			
<u>Sources</u>		<u>Uses</u>	
TIC-1	\$ 13.30 M	Pay Original Land Owner	\$ 20.00 M
TIC-2	\$ 13.30 M	13% Cost to Raise Equity	\$ 3.46 M
Total Sources	\$ 26.60 M	Option Payment Reserve	\$ 3.14 M
		Total Uses	\$ 26.60 M

**FIGURE 14** Sources and Uses

Simultaneous to the close of the property, the sponsor enters into two purchase option agreements, one with each tenant-in-common group, TIC-1 and TIC-2. The sponsor agrees to

pay a 6% return on their \$26.6 million purchase price as an option payment or approximately \$1.6 million per year. In consideration for this option money, TIC-1 and TIC-2 investors are restricted from developing their land. However, if the sponsor misses a payment then the options automatically terminate and the co-owners of TIC-1 and TIC-2 are free to sell their acreage at fair market value (\$14 million for each parcel) or develop it. As in the retail development, the sponsor is not permitted to exercise the purchase options anytime before two years, to guarantee the TIC owners adequate time to validate their exchange and to offer them at least two years of return before buyout.

Both TIC investment groups are in a typical at-risk real estate scenario. If the sponsor chooses to stop paying the option payments, then the TIC investors lose their monthly income. However, since they purchased the land at a 5% discount to fair market value (verified by an appraisal), they should be able to sell off the land if the sponsor were to walk away. In addition, the last phases of residential developments are usually worth considerably more than the first, as subdivisions become more stable with home and land price appreciation.

Once the lots on the sponsor's 80 acres are sold out, the sponsor would exercise the purchase option to buy out TIC-1's 160 acres. All purchase prices would be determined by appraisal with the aid of hundreds of recent comparable home sales on the development. Once the lots on those 160 acres are sold out, the sponsor would exercise the purchase option to buy out TIC-2's acreage. As mentioned

earlier, the purchase prices should continue to escalate granting each TIC group strong appreciation. It should also be noted that once the sponsor exercises a purchase option, all of the corresponding acreage owned by that group must be purchased, as incremental purchases would be detrimental to the marketability of 1031 exchanges.

A point of concern is that the option payment or yield to the TIC investors is only 6%, lower than the typical cash-on-cash return offered to TIC investors. The option payment amount must classify as a fair market rate, and a 6% option payment on purchase price is already aggressively high. However, the appreciation in residual value should greatly outpace other typical TIC investments. Based upon a three year hold, a 6% annual option payment, and a residual value of \$15.6 million (a 3.7%<sup>75</sup> annual increase over the \$14 million buy-in fair market value) an investor in TIC-1 would generate an 11.2% annualized return.

The largest concern for TIC-1 and TIC-2 is if the sponsor walks away in year three and stops making option payments. The TIC investors would be left without income. Figure 15 on the following page is a sensitivity analysis of the residential land development. Similar to the analysis on the retail land development, the base case assumes that the sponsor continues paying option money and purchases the parcels. The pessimistic case assumes the sponsor stops the option payments after year two, forcing the investors to sell to the market. The benefit in this example is that the TIC investors are all equity and have not leveraged the land. Therefore, if the option payments ceased neither group would be forced to cover a stringent debt payment, but would probably move quickly to sell their parcels. Assuming the pessimistic case, a land sale in year three, and a 1% decrease in fair market value, the investors would achieve a 4.8% IRR. If the investors were unable to sell until year four their IRR would drop to 3.4%.<sup>76</sup> As long as the land does not significantly decrease in value, the investors in a worse-case scenario are able to sell out and preserve their capital with a slight return.

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<sup>75</sup> 3.7% growth rate is 100 bps above the trailing 15 year CPI growth – conservative assumption for the amount of appreciative changes surrounding the development. See: U.S. Dept of Labor, *op. cit.*

<sup>76</sup> These robust returns are due to the fact that the investors initially bought in at 5% discount to fair market value.



<b>Residential Development Sensitivity Analysis</b>								
<b>Investor Viewpoint</b>								
<i>Annual Land Appreciation after Acquisition (Ground Lease Payments until Disposition)</i>								
<i>Base Case</i>		<b>-1.0%</b>	<b>0.0%</b>	<b>1.0%</b>	<b>2.0%</b>	<b>3.7%</b>	<b>4.0%</b>	<b>5.0%</b>
<i>Period (yrs)</i>	<b>1</b>	10.2%	11.3%	12.3%	13.4%	15.2%	15.5%	16.5%
	<b>2</b>	7.5%	8.5%	9.5%	10.5%	12.2%	12.5%	13.5%
	<b>3</b>	6.7%	7.6%	8.6%	9.6%	<b>11.2%</b>	11.5%	12.4%
	<b>4</b>	6.3%	7.2%	8.1%	9.0%	10.6%	10.9%	11.9%
	<b>5</b>	6.0%	6.9%	7.8%	8.7%	10.3%	10.5%	11.5%
<i>Annual Land Appreciation after Acquisition (Ground Lease Payments End After Yr 2)</i>								
<i>Pessimistic Case</i>		<b>-1.0%</b>	<b>0.0%</b>	<b>1.0%</b>	<b>2.0%</b>	<b>3.7%</b>	<b>4.0%</b>	<b>5.0%</b>
<i>Period (yrs)</i>	<b>1</b>	10.2%	11.3%	12.3%	13.4%	15.2%	15.5%	16.5%
	<b>2</b>	7.5%	8.5%	9.5%	10.5%	12.2%	12.5%	13.5%
	<b>3</b>	4.8%	5.8%	6.8%	7.8%	<b>9.5%</b>	9.8%	10.8%
	<b>4</b>	3.4%	4.4%	5.4%	6.4%	8.1%	8.3%	9.3%
	<b>5</b>	2.5%	3.5%	4.5%	5.5%	7.2%	7.5%	8.5%
<b>Sponsor Viewpoint</b>								
<i>Increase in Value Attributable to Entitlements</i>								
		25%	35%	45%	55%	65%	75%	85%
<i>Option Reserves in Yrs</i>		-3 yrs	-1.7 yrs	-0.6 yrs	0.4 yrs	1.2 yrs	<b>2 yrs</b>	2.6 yrs

**FIGURE 15** Residential Land Development Sensitivity Analysis

From the sponsor’s perspective, the land value must increase 75% to achieve two years of option money in reserve. The sponsor would need to achieve at least a 50% increase in land value to cover the cost of raising the TIC equity, however, at such an increase the sponsor would have to rely upon an additional source of equity to cover option payments.

If the assumed 75% increase in land value is obtained through entitlements, this type residential development funded by TIC capital is advantageous to the sponsor as he is able to initiate development with very little upfront capital. Also, the sponsor is capable of buying out TIC-1 and TIC-2 from sale proceeds on the initial 80 acres. In turn, the TIC investors also benefit through higher returns. This is a type of investment that would not dominate a TIC investor’s portfolio, but offers significant diversification to an investor looking for a higher risk-adjusted return.

### ***Major Renovation***

TIC investors can potentially participate in a value added transaction such as a major renovation project without being forced to fund additional after-tax equity. This is possible through refinancing. One of the greatest benefits of refinancing is that it is not a taxable event. As discussed earlier, IRC Section 1031 requires that all net proceeds from a relinquished property be used in the purchase of the

replacement property. Therefore, the only way additional leverage can be added at the time of exchange without creating “boot” (a portion of the exchange that becomes taxable) is if the investor uses all the net proceeds, buys a property of greater value, and increases the amount of leverage. However, the fault with this approach is that all the exchange monies must be used immediately in the purchase of the asset and cannot be held for future use. Refinancing offers more flexibility, as funds can be pulled out upon need and used for any purpose. An investor can exchange into an asset abiding by all IRC Section 1031 rules and have a successful exchange. Then after a year passes, that investor may choose to refinance the asset and pull some of the proceeds out to use for other purposes or plow the new debt proceeds into the renovation of the property. Though this is technically legal, the IRS does not want this to be the intent of an investor when entering a transaction. A deal must make economic sense without a refinancing option, but the option to refinance should also be a possibility.

As an example, TIC investors buy into an asset that is slightly dilapidated with little or no leverage. The asset makes economic sense in its current condition, even if the investors choose to maintain a low leverage level and avoid any type of refinancing, remembering it is the choice of the co-owners to make such decisions. However, after a year, if the co-owners choose to refinance, they must decide whether to place the money into renovations (value added play), or have the money returned.

From a marketing standpoint, the potential for refinancing should be disclosed in the marketing materials, but it should not be written as the intent of the deal. Nor should the deal be sold on the merit of its ability to be refinanced, but it should be mentioned as an option that the owners will have to decide upon in the future.

### ***More Risk-Averse Transactions***

On the risk spectrum, development and redevelopment are obviously more risky than buying a stable income producing asset. For those investors who may want a middle ground between development/redevelopment plays and traditional TIC transactions, sale-leaseback creation and construction buyout opportunities may fulfill their needs.

## **Sale-leaseback**

A very opportunistic value added play that can be done with TIC capital is that of a sale-leaseback of commercial real estate. In its simplest form, a sale-leaseback is a transaction wherein an acquirer of commercial real estate purchases a property from its user-owner and leases it back. Generally, these transactions are done for financing purposes and allow owners of real estate to “cash out” of equity that is tied up in the bricks and mortar of real estate and then use the proceeds from the sale as working capital in their core business, to pay down corporate debt, perform new acquisitions, provide dividends to business owners, etc... Additionally, sellers in the transaction can benefit from off balance sheet financing and maximize the proceeds they will receive as part of the sale due to the fact that they receive 100% of the leased fee value of the property as opposed to some percentage of that value if they were to use a traditional mortgage, not to mention the fact that a mortgage is obviously reported as a liability on the balance sheet.

Sale-leasebacks are usually structured as long-term absolute/bondable triple net leases, although some transactions are done with short-term leases wherein the acquirer is underwriting the property more from a real estate perspective rather than from the credit of the soon to be tenant, as is the case in the longer term deals. The triple net nature of the lease allows a seller to maintain operational control of the property while unlocking the value of the real estate.

This type of transaction sold to TIC investors is considered a value added play because as opposed to most TIC deals, wherein a property is simply divided into smaller interests and sold to investors, a sale-leaseback brings a new product to the market through the sponsor’s efforts. A lease that did not exist prior to the transaction is created and a corporation that did not previously lease its real estate has become a tenant. An additional benefit of a sale-leaseback to TIC investors is that, in most cases, standard transaction costs (i.e. – legal fees, lender fees, closing costs, purchaser due diligence costs, etc...) are borne by the seller, decreasing a significant portion of the load that an investor bears in a standard, non-value added, TIC deal. Also, financial risk to sponsors can be decreased through sale-leasebacks because dead deal costs can generally be charged back to potential sellers.

Because of the fact that the sponsor is creating a new leased asset through this type of transaction, it can be more lucrative to sponsors and investors than standard TIC investments because there is less price inflation. Reason being, this is not a property that the entire market is bidding on, forcing the price up. For this same reason, there is much more flexibility in the length of due diligence and closing periods that the sponsor can attain. This is particularly important for sponsors who coordinate a simultaneous closing with TIC investors, as opposed to those who take down the property before selling off interests.

Despite the various benefits that are noted above, trying to do a sale-leaseback with TIC capital also has its difficulties. First and foremost, most sellers in these transactions are very concerned with assuring that a transaction will close once a deal is made. Convincing a seller to do the transaction with a TIC sponsor, especially one that does not take down the property before selling off interests, may be difficult as the cash to consummate the sale is not in the sponsor's hand and the seller may have concern that the sponsor may not be able to raise sufficient proceeds from investors. Additionally, even with sponsors who take down the property first, some future tenants will choose to do the sale-leaseback with traditional real estate firms that focus on sale-leasebacks instead of with TIC investors because they may be wary of potentially dealing with up to thirty-five landlords instead of one. Accordingly, Tom Lewis, a Vice President with W.P. Carey, the largest provider of sale-leaseback financing in the U.S., said "In the very few situations where we have been up against a TIC trying to win a [sale-leaseback] deal, we are sure to communicate to the seller all of the problems with that kind of buyer. First, the fact that they probably don't have the money to do the deal - it's not going to be a sure close. Second, the fact that they will have to get consent from a ton of owners on future issues such as future expansions, takings/condemnations, landlord waivers, buyouts, etc.... will make doing the deal with the TIC very painful in the future."<sup>77</sup> This being said, if a corporate property owner is convinced to enter into a sale-leaseback with a sponsor, the TIC investors will greatly benefit.

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<sup>77</sup> Tom Lewis, W.P. Carey, Personal Interview, 5 July 2005.

## **Joint Ventures**

A final value added opportunity for TIC investors is that of a guaranteed buyer of newly constructed real estate created by the sponsor. In this example, TIC capital is not used in the development or renovation of the product, but is the agreed upon buyer once the construction project is completed and the tenant is paying rent. The negative aspect of this idea from a sponsor's perspective is that an additional source of non-TIC capital would have to be utilized to construct or renovate the asset. However, a sponsor would be creating a guaranteed pipeline of product in a real estate market where supply is scarce.

As an example, a sponsor group would start a separate development company to create product that would later be sold to TIC investors by the sponsor. One such approach would be for the newly created development company to joint venture with landowners to construct new product. To reduce the amount of capital required, the land owner would retain title to the property and the development company would raise sufficient non-TIC capital to construct a building on the site (majority raised through a construction loan). In the joint venture agreement, the development company would have the option to buyout the asset at a slightly higher than market capitalization rate (8.5-10% in today's market) on the income generated by the tenant upon occupancy, i.e. this guarantees a lower than market price. After construction is complete (or a year later to enable a 1031 exchange), the development company exercises its option and buys the finished product from the joint venture. The sponsor would simultaneously work through the broker-dealer network to purchase the project on behalf of TIC investors. The sponsor has now created a stable income generating asset that fits well within the traditional TIC investment criteria. The TIC investors benefit by buying a newly constructed property at a lower than market price, as the buyout price has not been bid up by the market.

## Conclusion

Tenant-in-common proponents claim that TIC investments exist because they fulfill a need. However, is that need being fulfilled at too high of a cost? In conclusion, it is necessary to revisit the advantages and disadvantages of regular tenant-in-common ownership and then determine the feasibility of using that type of capital in value added investments, while fully understanding the risks and benefits of such a decision.

Tenant-in-common investments are very advantageous. Investors desire the benefits of deferring taxes, diversifying among asset classes and geographic regions, owning institutional quality real estate that historically was out of their reach, and enjoying third-party professional property management. A 65 year-old retiree that has owned and maintained a four-plex apartment building as auxiliary income for twenty years is an ideal TIC investor. He personally spent long hours every month overseeing the bookkeeping of the asset, managing tenant concerns, leasing vacant space, and repairing structural issues. After years of hard work he decides to sell the asset, but soon realizes he has a large amount of built-in taxable gain. He chooses to defer his gain and participate in a like-kind exchange. What does he exchange into? REITs, public or private, are not interested in his property. He could buy another income producing asset and personally manage it or hire someone else to manage it. However, he is worried about keeping all of his real estate holdings in one asset and does not personally feel confident about quickly choosing an adequate replacement property on his own. Suddenly, tenant-in-common ownership makes profound economic sense. He is able to review dozens of properties complete with thorough due diligence packages until he finds the properties and their corresponding sponsors/managers that best fulfill his needs. He spreads his exchange funds into four different properties, each a different asset class and in a different part of the country. He is also assured by the sale flexibility inherent in TIC investments, not being forced to wait for asset disposition to sell his interest, nor remain with other co-owners in future transactions. This 65 year-old retiree then sits back and waits for his monthly checks to arrive in the mail, thankful that he will never again have to repair a dilapidated roof on an aging four-plex.

His once very time-intensive investment has now become a very passive, no-nonsense vehicle for enjoying stable real estate income. No other type of investment better fulfills the needs of this 65 year-old man.

In contrast, tenant-in-common investments do carry some strong disadvantages. Most importantly, due to IRS guidelines sponsors/managers receive almost their entire compensation upfront leaving little economic incentive for them to add value after acquisition. Tenant-in-common transactions are also quite expensive, with an average of 22 cents of every equity dollar covering fees instead of purchasing real estate. TIC ownership is complicated, is it worth the headache to adhere to so many legal guidelines? Finally, many believe TICs are securities, which not only increases the complexity of the deal structure but adds immense liability to those sponsors structuring deals as real estate.

Tenant-in-common investments are worth the effort. Sponsors/managers need to commit themselves to ethically abide by the fiduciary duty they have to their TIC investors, even when the majority of the sponsor's economic compensation has already been received. As reviewed earlier, tenant-in-common loads are roughly comparable to REIT loads, and still favorable to paying taxes and investing elsewhere. The only tax deferral option that initially makes more economic sense is for the investor to exchange into a property alone. However, such a decision offers less property, asset class, and market diversification. In addition, investing alone usually demands time intensive active involvement and reduces the opportunities to own institutional quality real estate. TIC transactions can be complicated; however, as the industry evolves and best practices are adapted, such complexities will diminish. Deals that depend significantly upon the efforts of the managers should be structured as securities to avoid potential security law liability. In all, the author firmly believes the benefits of TIC ownership greatly outweigh the costs for the right type of investor. However, part of a sponsor's fiduciary duty to investors is to only purchase real estate at economical prices.

Therefore it is the author's opinion that the best way to fulfill the demand for TIC investments is either to produce new product that has not been bid up by a competitive market or source private one-off transactions that are not publicly marketed. Most TIC sponsors acquire income producing real estate

from someone who developed the asset or from someone who initiated the lease stream on the asset, as in a sale leaseback transaction. In either case, the property in a sense is already prepackaged before the sponsor initiates due diligence. Conversely, a sponsor seeking a value added transaction steps into the value creation role and either uses TIC capital to fund the development/redevelopment of the asset or uses other funds to create the product with the goal of then selling it to TIC investors at a reasonable price. Any way a sponsor is able to tap into the unfulfilled TIC demand with a new type of investment would not only be profitable for the sponsor, but also very beneficial to TIC investors.

The focus of this thesis was to determine the feasibility of financing development and/or redevelopment (value added) transactions with TIC capital. After a thorough analysis, it is determined that value added TIC investments are feasible for the following three reasons: 1) They are legally possible through creative structures that abide by IRS and SEC requirements; 2) They are economically profitable to both the sponsor and TIC investor; and 3) They are adequately marketable to a certain segment of the industry.

First, there are legal structures that accommodate the use of TIC capital in value added plays. A sponsor must adhere to IRC Section 1031, Revenue Procedure 2002-22, and security laws. However, creative structures do exist that fulfill all legal requirements. In the author's opinion, the best way to reduce liability risk, maintain necessary flexibility, and guarantee investors complete fair and full disclosure is to structure value added deals as securities. Second, value added transactions with TIC capital are economical for all parties involved. The defined examples of retail/residential land banking, renovations through refinancing, sale-leaseback creation, and development buyouts after construction all grant risk-proportionate upside to the sponsors and TIC investors with returns far superior to traditional TIC deals. Third, the market will bear these types of transactions. As Baby Boomers enter retirement, real estate trades will increase<sup>78</sup>, and a certain portion of investors will react favorably to a higher risk-adjusted TIC investment that will diversify their portfolio. Jim Shaw, a registered representative and

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<sup>78</sup> Spencer Jeffries, "Ready or Not, Here Come the TICs," *op. cit.*, p. 1.



president of Cap Harbor, a TIC consulting company, believes “there is an appetite for higher risk and higher return opportunistic deals as long as the transactions are sound”.<sup>79</sup>

TIC sponsors and now developers can greatly benefit from the application of this source of equity. However, just because something is feasible, does not mean it should be used excessively. In any diversified portfolio, riskier assets that command higher returns are balanced by stable assets with conservative returns. As an example, the returns from the retail and residential land banking developments are significantly higher than those of traditional TIC transactions. However, as explained there are additional risks such as the loss of ground lease payments and the potential for a decrease in land value. The majority of a TIC investor’s portfolio should not be lopsided with higher risk value added transactions. However, a small and appropriate allocation to value added transactions offers potentially higher returns without placing the entire portfolio at risk. Likewise, sponsors should not source TIC capital to finance every type of development/redevelopment transaction, only those that are best positioned to fulfill investor needs.

The resulting conclusion is that it is feasible to use tenant-in-common capital in value added transactions. However, sponsors and investors should move cautiously, making sure all risks are understood and that all legal guidelines are followed.

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<sup>79</sup> Shaw, *op. cit.*

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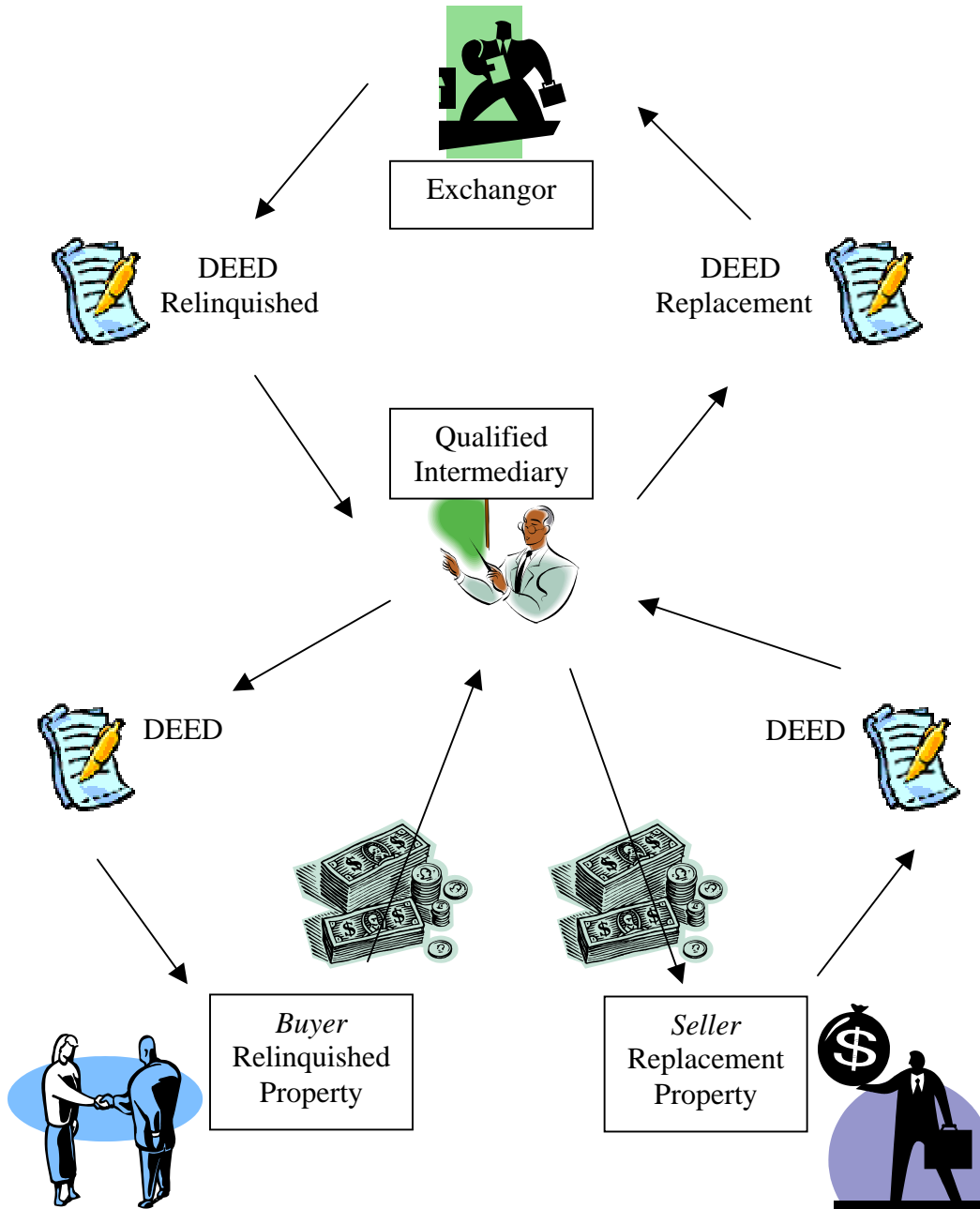
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# Appendix 1 – Like-Kind Exchange<sup>80</sup>



<sup>80</sup> Kimball, Halligan, and Ford, *op. cit.*, p. 8.

## Appendix 2 – Revenue Procedure 2002-22, Sections 4-5<sup>81</sup>

Basic information that is to be submitted to the IRS as part of a ruling request.

### SECTION 4 – Guidelines For Submitting Ruling Requests.

Where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single "Property." In such a case, the Service will generally not consider a ruling request under this revenue procedure unless: (1) each co- owner's percentage interest in each parcel is identical to that co- owner's percentage interest in every other parcel, (2) each co- owner's percentage interests in the parcels cannot be separated and traded independently, and (3) the parcels of property are properly viewed as a single business unit.

### SECTION 5.02 – Required General Information and Copies of Documents and Supplementary Materials.

Generally the following information and copies of documents and materials must be submitted with the ruling request:

- (1) The name, taxpayer identification number, and percentage fractional interest in Property of each co-owner;
- (2) The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of Property, including the sponsor, lessee, manager, and lender;
- (3) A full description of the Property;
- (4) A representation that each of the co-owners holds title to the Property (including each of multiple parcels of property treated as a single Property under this revenue procedure) as a tenant in common under local law;
- (5) All promotional documents relating to the sale of fractional interests in the Property;
- (6) All lending agreements relating to the Property;
- (7) All agreements among the co-owners relating to the Property;
- (8) Any lease agreement relating to the Property;
- (9) Any purchase and sale agreement relating to the Property;
- (10) Any property management or brokerage agreement relating to the Property; and
- (11) Any other agreement relating to the Property not specified in this section, including agreements relating to any debt secured by the Property (such as guarantees or indemnity agreements) and any call and put options relating to the Property.

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<sup>81</sup> U.S. RevProc. *op. cit.*, Sections 4-5.

## Appendix 3 – Regulation D 506 Guidelines<sup>82</sup>

### Rule 506

As discussed earlier, Rule 506 is a "safe harbor" for the private offering exemption. If your company satisfies the following standards, you can be assured that you are within the Section 4(2) exemption:

- You can raise an unlimited amount of capital;
- You cannot use general solicitation or advertising to market the securities;
- You can sell securities to an unlimited number of accredited investors (the same group we identified in the Rule 505 discussion) and up to 35 other purchasers. Unlike Rule 505, all non-accredited investors, either alone or with a purchaser representative, must be sophisticated - that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment;
- It is up to you to decide what information you give to accredited investors, so long as it does not violate the antifraud prohibitions. But you must give non-accredited investors disclosure documents that generally are the same as those used in registered offerings. If you provide information to accredited investors, you must make this information available to the non-accredited investors as well;
- You must be available to answer questions by prospective purchasers;
- Financial statement requirements are the same as for Rule 505; and
- Purchasers receive "restricted" securities. Consequently, purchasers may not freely trade the securities in the secondary market after the offering.

### An "accredited investor" is:

- ♦ a bank, insurance company, registered investment company, business development company, or small business investment company;
- ♦ an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
- ♦ a charitable organization, corporation or partnership with assets exceeding \$5 million;
- ♦ a director, executive officer, or general partner of the company selling the securities;
- ♦ a business in which all the equity owners are accredited investors;
- ♦ a natural person with a net worth of at least \$1 million;
- ♦ a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
- ♦ a trust with assets of at least \$5 million, not formed to acquire the securities offered, and whose purchases are directed by a sophisticated person.

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<sup>82</sup> U.S. SEC. Regulation D. *op. cit.*, Rule 506..

## Appendix 4 – Delaware Statutory Trust<sup>83</sup>

### “Seven Deadly Sins” of a DST

1. The trustee cannot dispose of the trust’s property and then acquire new property (although the trustee can sell the trust’s assets and dissolve the trust).
2. The trustee cannot enter into new leases.
3. The trustee cannot renegotiate a lease with an existing tenant.
4. The trustee cannot enter new debt encumbering the trust’s assets.
5. The trustee cannot renegotiate any existing debt.
6. The trustee cannot invest cash received to profit from market fluctuations (all cash must be invested in short-term Treasuries that will be distributed at the end of each calendar quarter).
7. The Trustee may not make more than minor, non-structural modifications to the trust’s property not required by law.

### Section 671

Section 671 provides that, where the grantor or another person is treated as the owner of any portion of a trust (commonly referred to as a "grantor trust"), there shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that the items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual (See Internal Revenue Service, Revenue Procedure 2004-86, LAW Section, par. 2.).

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<sup>83</sup> U.S. Internal Revenue Service. Revenue Ruling 2004-86.