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The tenant-in-common (TIC) real estate solution to your investment portfolio

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In many respects, the tenant-in-common (TIC) industry is bringing commercial real estate investment opportunities to individual investors in the 21st century as the mutual fund industry brought diversified stock ownership to the public in the late 20th century. For the millions of baby boomers who own trillions of dollars worth of appreciated investment real estate, pursuing a TIC investment can be an effective strategy to defer capital gains taxes, generate current income, and enjoy the benefits of capital appreciation and passive ownership of institutional-grade assets historically beyond the reach of individual investors.

TIC is a legal form of joint ownership of real property. A TIC investor owns an undivided, fractional interest in the subject property. TIC owners receive a deed for their undivided interests, and they share the economic benefits and burdens of real estate ownership on a pro rata basis. TIC owners are typically bound to one another through a series of contracts that govern the TIC relationship and administration of the subject property.

The TIC industry developed initially as a mechanism to facilitate tax-deferred exchanges of investment real estate. Under section 1031 of the Internal Revenue Code, real estate investors can sell appreciated real estate held for investment and defer payment of capital gains tax if the sales proceeds are reinvested in a like-kind investment property. Structuring and completing a 1031 exchange is complicated and requires professional assistance, but taxpayers have been doing 1031 exchanges for over 60 years, and recent research conducted by Lou Weller, director of real estate transaction planning services at Deloitte Tax LLP, estimates that over 150,000 like-kind exchanges involving over $120 billion were consummated in 2007.

For purposes of completing a typical 1031 exchange, the TIC industry offers two important benefits. First, timing is critical when structuring a 1031 exchange and historically taxpayers have had a difficult time satisfying the strict deadlines imposed by section 1031. The TIC industry has helped alleviate that problem by creating a robust and increasingly diverse market of TIC investment opportunities for investors trying to complete 1031 exchanges. According to research compiled by OMNI Consulting & Research, LLC, during the fourth quarter of 2007, there were 24 different TIC programs on the market. These programs involved properties of different asset classes (e.g., apartments, hospitality, industrial, office, retail, etc.) in locations scattered across the country. Not only do investors have a steady supply of replacement property options in the TIC market from which to choose, but experienced TIC sponsors promoting these investments are able to efficiently work with investors and their representatives to close these transactions in a short period of time.

Second, investment amounts in a TIC program are usually adjustable on an investor-by-investor basis. This flexibility permits investors to maximize the tax-deferral benefits under section 1031 by reinvesting 100% of the sales proceeds from their relinquished property into one or more replacement TIC properties.

While real estate companies and investors have been putting together TIC deals for years, the TIC industry as we know it today began in 2002 when the IRS released Revenue Procedure 2002-22. For practical purposes, this Revenue Procedure provided guidance on how to properly structure a TIC transaction that arguably would satisfy relevant 1031 requirements. Armed with this guidance, the key players in the industryâ€"real estate sponsors, attorneys, accountants, lenders, securities broker-dealer firms, and investorsâ€"became more comfortable with the TIC structure and its associated benefits. From 2002 to 2007, the number of real estate companies sponsoring TIC offerings increased from fewer than a dozen to between 60-75 and the amount of equity raised on an annual basis went from $500 million to $2.7 billion (including a peak of $3.6 billion in 2006).

TIC investments can be structured several different ways but, generally speaking, they offer real estate investors the following benefits:

1. Higher quality asset. TIC programs typically feature class A or class B properties that most individual real estate investors could not afford to acquire on their own. For example, one group of tenants in common recently acquired Alexandria Corporate Park, a 271,000 s/f industrial property located in Alexandria, Va., for the purchase price of $52.5 million. Typical TIC investment minimums range between $250,000 - $400,000 in cash, plus assumption of a pro rata portion of a mortgage loan that is usually negotiated by the TIC sponsor and put in place before the TIC investors come into the deal.

2. Cash flow and capital appreciation. Most TIC investment programs are structured to provide monthly cash flow to the TIC owners with annual cash-on-cash returns ranging from approximately 4.5% to 7.5% in the current TIC market. If a property experiences unexpected problems, however, net operating income could decrease or disappear altogether. If the problems are significant, the TIC investors could be required to contribute additional capital to cover expenses and debt service. Most TIC programs are projected to have a holding period of five to seven years, thus some degree of real estate appreciation is expected, although certainly not guaranteed. When the subject property is ultimately sold, many TIC investors will reinvest those sales proceeds into another TIC investment via a 1031 exchange, thereby continuing to defer capital gains taxes.

3. Asset diversification. TIC investors looking to reinvest proceeds from the sale of investment real estate in a 1031 exchange often will opt to invest in multiple TIC programs to diversify their real estate holdings into different asset classes, geographic markets, or real estate sponsors. Some TIC programs themselves include multiple properties packaged together in one offering.

4. Professional property management. Many TIC investors are eager to transition away from investment property that required their personal attention and day-to-day management responsibilities (e.g., the proverbial "toilets, tenants, and trash") and enjoy the benefits of owning a predominately passive investment that is professionally managed. TIC owners, however, retain control over major decisions concerning the subject property, such as decisions regarding refinancing, leasing, and selling the property.

5. Leverage with non-recourse debt. Most TIC programs are structured with equity and debt components which help maximize investor returns on invested equity and also provide tax deductions for interest paid on the mortgage debt. While TIC sponsors have had a difficult time obtaining third-party financing over the past year due to the credit crunch, traditional third-party TIC financing is non-recourse, subject to recourse carve-out exceptions that apply to certain prohibited actions.

6. Due diligence and disclosure. The overwhelming majority of TIC programs today are packaged and sold as securities through securities broker-dealer firms. Contrary to the traditional real estate industry principle of caveat emptor (buyer beware), TIC securities offerings are characterized by lengthy disclosure documents that describe all material aspects of the TIC program (including risk factors). Various parties involved in a typical TIC offering perform thorough due diligence and financial analysis of a TIC program. These efforts directly and indirectly benefit investors by helping prevent poorly structured or otherwise inappropriate TIC offerings from being brought to market.

Can anyone invest in a TIC offering? No. Almost all TIC offerings are sold through securities broker-dealer firms and are open only to investors who are "accredited" as defined under federal securities law. There are eight different categories of accredited investors, but the two most common categories are individuals with a net worth in excess of $1 million or annual income in excess of $200,000 (or joint annual income with spouse of more than $300,000) for the two prior years with an expectation of meeting or exceeding that level in the current year. Securities representatives are required under FINRA rules to make suitability determinations on an individualized basis after considering a variety of factors, including the investor's financial experience and investment goals. Because of the way they are structured under the securities laws, TIC offerings cannot be marketed through public advertising or general solicitation, so real estate investors in search of possible TIC investments must first establish a relationship with a securities professional who sells this type of investment product.

Are there risks to TIC investments? Absolutely. Like any real estate investment, TIC investments involve risk and should be carefully analyzed with financial, legal, and tax professionals. Certain risks are unique to the TIC structure, including potential administrative and logistic hurdles of obtaining unanimous approval of nearly three dozen TIC owners who are total strangers for major decisions regarding the subject property as required under the Revenue Procedure. Investors should review with their advisors the disclosure documents provided by TIC sponsors describing the material risks and other terms of the TIC investment and conduct their own due diligence as they would for any other real estate investment.

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