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Finally, real estate agent compensation for 1031 tenant-in-common deals?

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A 1031 tenant-in-common (TIC) exchange allows property owners to exchange their management-intensive property for a partial interest in a potentially institutional grade property. Since 2002, the TIC industry has exploded, but because of the nature of securities, real estate agents were not legally allowed to be compensated for selling TIC investments, which are sold as securities.

The Issue - Security Vs. Real Estate (for sales purposes)

Since TIC interests, if structured properly, are real property for tax law purposes, why can they be sold by securities reps, but most often, not by real estate brokers? The answer is that the interests are, with few exceptions, considered securities for securities law purposes.

The issue of whether an investment is a security can sometimes be complex. The Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA - Created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange), State Securities Acts, Federal Law, and both federal and state cases all influence the determination of whether an interest is a security. It should be noted that both the FINRA and Colorado Division of Securities have been quite clear in their opinion that the vast majority of TIC investments are a security.

TIC sponsors have a built-in incentive to market TIC offerings through real estate brokers. After all, real estate brokers are generally involved in the sale of the relinquished property and marketing TIC offerings through those same real estate brokers would seem to be the most efficient way of identifying a prospective investor.

A conflict arises because FINRA has historically prohibited its members from paying persons, not registered associated persons, a commission or fee derived from a securities transaction. Thus, payments that are transaction-based made by members who are registered broker/dealers to non-registered persons, including real estate agents, are prohibited under FINRA Rule 2420, "Dealing With Non-Members."

Given that real estate brokers have a long history of paying referral fees for client referrals, the FINRA rule prohibiting the payment of such fees has caused great consternation. It is unfortunate that the rule, intended to protect the investor, instead serves as a disincentive for real estate brokers with respect to making their clients aware that TICs can be a viable option for the down-leg of a 1031 transaction.

The Possible Solution - NAR Exemption Request

The National Association of Realtors (NAR) has been working with the SEC and other stakeholders to change that situation, and now it looks like a breakthrough may be close at hand. It should be noted that NAR's request has been submitted in the form of an "exemption request" which would provide much stronger guidance from the SEC than the typical "No Action Letter."

Although exact details are not public, REALTOR Magazine Online reports that under the NAR proposal, real estate professionals who wanted to advise clients on the real estate aspects of a TIC deal would have to enter into an amended buyer agency agreement permitting them to advise clients and earn an advisory fee from the TIC sponsor. Those receiving such a fee would also need to meet certain requirements for experience and follow rules such as refraining from advertising TIC deals. Responsibility for all securities aspects of the transaction, including determining the suitability of the investor would remain with the securities broker-dealer.

While the proposal has not been approved by the SEC, a panel of TIC industry experts has expressed support for the exemption, and it is thought to be moving forward behind closed doors. It has been noted that there are remaining issues to be resolved such as whether transactions will be governed by the laws of the state where the property is located or where the investor lives and whether those holding the requisite securities license (e.g. registered representatives) should also hold a real estate license.

Advantages of Undivided TIC Interest Ownership

The purchase of a TIC ownership interest may solve many of the issues involved in successfully completing a 1031 exchange. It is often difficult, in the short 45-day time frame, to locate a property that has the right purchase price and debt ratio and to then arrange for any financing that may be required and close in a timely manner.

TIC advantages may include:

* Investment can often be diversified into more than one property.
* Can be identified and closed in a timely manner.
* Pre-arranged, usually non-recourse, financing.
* Potential increased after-tax cash flow.
* No active management hassles.
* Economies of scale.

Risks Associated With TIC Investments

Remember, all investments carry an element of risk. 1031 TIC offerings have the usual risks of most real estate transactions; such as, possible loss of principal, economic risk due to vacancy rates, risk of default if unable to make payments on leveraged properties, or potential lack of geographic diversification, among others.

These comments are for general educational purposes only, and do not address the entire topic. You must be an accredited investor.

Prior to implementing any strategy, taxpayers are urged to seek the advice of their tax advisors.

For more specific information on investment risks, you should consult the offering's prospectus.

Steven Wennerstrom, FINRA/SIPC, is the president of The Center For Commercial Real Estate and a registered representative of Pacific West Securities, Inc., Greenwood Village, Col.