



Benefits and Pitfalls of Investing in TIC's: Part 1 – The Benefits *By Brian Stevens, CPA, CES®*

Most real estate investors are aware of the generous provisions of Section 1031, which allow investors to defer taxes on the sale of real estate if they acquire like-kind replacement property. But many investors are not aware that they can replace their property in a tenant in common (TIC) form of ownership, whereby it is purchased by two or more persons that have undivided, fractional interests in the asset.

TIC investments have been used in exchanges for a long time, as when a father and son acquire a duplex together. But when a savvy real estate sponsor would bring together several passive investors together to acquire TIC's in an exchange, there was concern that this would not qualify under Section 1031. Why? Because the Internal Revenue Code prohibits the purchase of partnership interests as replacement property. And when taxpayers are very passive and rely entirely on the expertise and management of someone else, their investment looks more like a partnership.

In 2002, the IRS brought great clarity to this TIC vs. partnership issue when they provided 15 criteria they would use to distinguish whether the investment was a TIC or not. With that guidance, the TIC industry exploded into a multibillion-dollar industry.

The TIC industry has been fueled by TIC sponsors (companies that specialize in the

The 15 TIC Criteria

1. Must have title as a TIC
2. Number of owners cannot exceed 35
3. No "entity" treatment
4. Co-ownership agreements allowed
5. Voting must be allowed
6. No restrictions on interest transfers
7. Proportionate sharing of proceeds & liabilities
8. Proportionate sharing of profit & loss
9. Proportionate sharing of debt
10. No put options
11. No business activity
12. Annually renewable management agreements
13. Lease agreements at market value
14. No loan agreements between members
15. Sponsor receives fair market payment

acquisition and management of real estate), who promise steady cash flows, appreciation, and hassle-free management.

What Are the Benefits and Pitfalls of TIC ownership?

In this issue we will cover some of the benefits. Pitfalls will be discussed in next quarter's issue:

- **Access to investment grade properties.** The greatest benefit in TIC ownership is that it allows the average real estate investor to access higher cash flowing properties. For example, the average investor that has \$200,000 of equity



must compete with many other investors to acquire a \$600,000 building, and as a result, may have to pay a premium price. But if several average investors pooled their dollars together, they can purchase \$10 million or \$20 million properties that typically provide much greater cash flow.

- **Access to credit tenants.** Likewise, the pooling of funds gives the investors greater access to more leases with Fortune 500 companies or government entities, which gives the investor a more secure position.
- **Access to other regional real estate markets.** For taxpayers that live in hot real estate markets, it is extremely difficult for them to acquire properties that give them reasonable cash flow. The TIC sponsors will typically acquire properties in cooler, steady markets, which give the investors steady, higher cash flows. For example, in today's market, a property in Kansas City would probably cash flow better than a property in Seattle.
- **Passive nature of the investment.** At some point in their lives, most real estate investors want to go "passive" with their

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What at first was plunder assumed the softer name of revenue.

~Thomas Paine



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Benefits of TIC's (cont. from pg 1)

investments. They become tired of tenants, phone calls and decisions. They just want to collect checks. It is these people the TIC industry is targeting.

- **Access to favorable borrowing terms.** Most TIC's are leveraged. And most have very good lender packages, often with insurance companies who offer long-term fixed, low-interest loans. The individual investor can rarely get a similar loan package.
- **Ease of diversification.** TIC's can easily bring diversification. For example, a taxpayer with \$900,000 could purchase three different TIC's for \$300,000. By doing this, he could get geographic diversification, investment type diversification (by getting one office building, one retail center and one apartment building), and management company diversification (by using different sponsors).

Thus, for certain cash-flow seeking, passive investors, TIC's may be one of the best investments out there. But there are many pitfalls in TIC investing, which can include shaky loan packages, misleading cash flow projections, high loads, lack of management experience, and tax issues that a prudent investor should be aware of. Watch for a follow up article in our next issue, which will address many of these pitfalls.



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Can I Exchange Flipped Properties?

By *Felip Holbrook, CES®*

We are frequently asked if “flipped” property is eligible for exchange. A “flipped” property is a property that was purchased at a good price and then immediately sold for a higher price, or first remodeled and then sold.

The answer? It all depends on your intent.



If a property is purchased with the intent to flip it, you may not be able to exchange it. Even though you might consider the property an “investment” because you are making money on the transaction, the IRS may not. Section 1031 specifies that a property can be exchanged if it is “HELD for the productive use in a TRADE or BUSINESS or for INVESTMENT”. If your intent was to sell it, not to hold onto it, it doesn't meet the requirement for an exchange. Similar to a builder who buys lots and then builds spec homes for resale, your intent at the time of purchase was to re-sell the property. Like those who flip properties, a builder can't do a 1031 exchange on his spec homes. This is

because property intended for resale is considered inventory, like clothing at a retail store. Ordinary income tax (at federal rates up to 35% plus state tax) must be paid on any profit made from the sale of inventory.

In some cases, your intent may not be to re-sell your property, but you may end up selling it anyway. Let's say you buy a property at a good price with the idea of hanging onto it as a rental property. Then, just a week later, someone comes along and offers you a high price for the property that you just can't refuse. You technically just “flipped” the property even if you hadn't intended to do so. But you should be able to do an exchange, right? Sure. But if asked, how do you prove your intent was always to hold the property? If the buyer making the offer writes a letter explaining the offer was unsolicited by you, this could help prove your original intent was not to sell. And it may also help to save any records that show you had analyzed the property for its value as a rental.

Other factors that may allow you to exchange a recently purchased property are “circumstances beyond your control”. For instance, if you had intended to buy property to keep for investment or rental, and then an unexpected divorce, sudden job change or medical reason forces you to sell earlier than expected, the property may qualify for a 1031 exchange. Again, good records are important in these cases.

What if you fix up the property before selling it? If it appreciates during that period is it eligible as an investment? Maybe -- it would depend on if the increase in value were due to actual market appreciation. If so, it may qualify. But if the increase in value is due to your skill and effort as a developer or contractor, it may not qualify.

(Continued: See “Flipped Properties” on page 4...)

It's tangible, it's solid, it's beautiful. It's artistic - from my standpoint...and I just love real estate.

~Donald Trump

