IF I HAD A MILLION DOLLARS!

Tenancy In Common (TIC)

By Tim Crockett

Real Estate Investment Opportunities

So you're looking to invest a million dollars (or possibly a few hundred thousand to several million dollars) and want to know what's best for you. Only you can answer that question.

Among the many options offered by people who will be all too eager to "help" you spend your hard-earned nest egg on the latest get-rich-quick scheme, here's some information you should consider.

Fractional Ownership

Consider fractional ownership of real estate. Don't think of that little time share on your last vacation to the beaches of Walla Walla. Think more like owning two or three percent of institutional-grade, income properties like the Galleria or that new high-end apartment complex. By using three little helpers buried deep in the IRS tax code, you can build new wealth and, perhaps even more importantly, protect the wealth you have already accumulated.

Little Helper #1

The first helper was written in 1921 as section 1031 of the tax code, which allows an investor to "exchange" one property for another investment property and avoid paying capital gains tax at the time of the transaction. Fortunately, a number of improvements have been added over the years that have made it more practical to use this powerful tool. Don't get hung up on the word "exchange." While it was the original requirement to exchange, few if any investors actually swap properties anymore. Enlist the services of an Accommodator or Qualified Intermediary to hold your sale proceeds BEFORE you sell your property who will then deliver your funds to the escrow closing of your new property. Frequently, they are a related arm of a title company and charge a flat fee of only several hundred dollars to facilitate such a transaction.

Little Helper #2

The second helper came on the scene almost five years ago, single-handedly giving birth to a new industry, one that has grown to over $15 billion of transactions per year, with expectations, as more people become aware of its benefits, to becoming the real estate investment vehicle of choice. This activity took off when the IRS issued "Revenue Procedure Act 2002-22," which further amended section 1031 of the tax code. This is one of the biggest changes in commercial real estate in my lifetime. In essence it says that an investor doing a 1031 exchange is not required to buy all of a single property, but rather they can now buy part of a larger property with other investor/owners through a tenant-in-common structure. Rather than owning 100 percent of a smaller, lower-quality property, think of owning a small piece of the nicest new apartment complex or large new retail power center.

How "New" Is this Idea?

Many brokers and investors are under the false assumption that Tenant In Common, or TIC's, are a new phenomenon. Tenancy In Common, much like a corporation or partnership, is simply a legal entity that allows different owners each to own an undivided interest in a single real property. Tenancy In Common was created in the Magna Carta in the year 1215, hardly what you would call a new idea.

Find a Tenant In Common Sponsor and invest alongside them as a co-owner in one or more of these large institutional-grade investment properties. Select and benefit from a sponsor who buys large, high-quality income properties, say properties worth $20 million or more, making accessible properties that would normally be out of reach for an individual investor. My favorites? New Class-A apartments, large retail centers and student housing. In addition, be sure the sponsor likes the property enough to invest a significant amount of their own equity.

When buying retail, to lessen your risk, choose multi-tenant retail properties as opposed to single-tenant properties. There are quality companies in single-tenant investment opportunities, but I can think of several such tenants that no longer exist. Focus on national tenants. They usually have better credit, have longer lease terms and invest in their own interior construction, making them less likely to move away from that location.

Avoid buying into a property where the sponsor is wearing multiple hats, such as where they have installed themselves as the permanent property manager sometimes for an above-market monthly fee. Finally, ask how you can get out of the investment. Can you sell your piece before the group decides to sell the whole property? To whom and at what price can you sell?

The legal structure of these investment/ownership groups is a Tenancy In Common, frequently referred to as a TIC. Per the IRS, ownership is limited to a maximum of 35 co-owners in a single property, but may have as few as two. Over 90 percent of the TIC Sponsors I have seen are set up as a security so that individual investors are actually buying stock in a company that owns real estate. Look for a deal structure where each or co-owner is buying real estate and receives deeded title in his/her name just as if you had purchased an entire property yourself. This way you get the depreciation benefits associated with directly owning the real estate and sell without having to engage the expensive services of a security broker.

The idea in a fractional ownership is for you to pool your equity with other investors so as to own a larger and better quality property. One million won't even buy a rent house in many of Houston's neighborhoods. By combining equity, you can increase the quality of your investment or portfolio and buy a portion of a trophy property such as a Class-A apartment project or new retail power center with tenants like Best Buy, Wal-Mart, The Gap, Lowes and Bed Bath & Beyond as opposed to owning all of a smaller, local-credit or single- tenant asset.

Although not a requirement by most sponsors, the majority of co-investors elect to utilize 1031 exchange proceeds, a powerful tool in building wealth, as it defers capital gains taxes and depreciation recapture an unlimited number of times for an investor, rolling from one investment property to another and another over time. The challenge with 1031's is the short time frame required to identify a replacement property (called an up-leg) within 45 days of closing the property being sold (the down-leg). The investor has an additional 135 days to close escrow. The problem lies in that first 45-day period, when an investor must find a suitable property, negotiate both the price and terms, arrange financing, start and complete comprehensive due diligence to ensure the property does not have some lethal flaw such as a major environmental problem or inability to finance that could prevent you from being able or wanting to close on the purchase. By selecting a property offered by a TIC sponsor, you can avoid the fire drill of rushing through all of these important and necessary steps.

This new investment vehicle of investing 1031 funds as a Tenant In Common with a sponsor, both solves the problem of locating and researching new properties for the investor as well as allows average investors to purchase much larger assets formerly available to institutional investors. A large sponsor has the manpower to review hundreds of properties every month to find the best available. They can negotiate price and terms, complete third-party due diligence, arrange financing, open (and in many cases actually close) escrow, all before the co-investor is ever brought into the picture. When an investor is ready to invest, most or all of the leg work has been completed, making it a less stressful and faster transaction. He has the additional benefit of being able to select the exact size or piece of the new property that matches the amount of funds he has available to invest.

Little Helper #3

The third helper in building financial wealth is cost segregation depreciation. With the 1986 tax reforms, which resulted in most investors using longer depreciation schedules, the IRS took a lot of fun out of investing in real estate. There is a better way. The IRS does recognize that certain components of an asset, such as in an apartment complex, have different (read shorter) economical lives for some portions of the property. Obviously the mini-blinds covering the windows can't be expected to last as long as the bricks, and the furniture can be depreciated over a shorter life. Even the landscaping creates opportunities for faster write offs. By moving some of the building components from a 30-year depreciation schedule to 15, seven or even five years, you can offset income and impact your cash flow. To evaluate your personal situation, you should of course seek the counsel of your real estate broker, attorney or CPA.

For me, it boils down to knowing if the sponsor is the largest investor in each property, making it more likely that they buy quality assets as opposed to sponsors who are simply promoting a deal for a fee. Also, to assure that the deal be a transparent transaction (i.e., you do not want your deal arbitraged, the common practice of a sponsor buying an asset for one price then secretly marking it up to a higher price before others are invited to buy into the deal), ask to see the original closing statement from the sponsor's acquisition of the property.

Additionally, be sure that you are not locked into the sponsor also being the asset or property manager, nor taking fees for management. This could create a conflict of interest where a sponsor is motivated by making more money from management fees than from the property's cash flow and appreciation. Instead, look for a sponsor who hires a professional, third-party firm as asset manager and, even better, who also hires another separate, unrelated, firm as the property manager. While some sponsors have fees or loads of 25 to 30 percent, look for the lowest fees in the industry, usually six to eight percent.

Be sure you as a co-investor receive deeded title in your name, thus enabling you to sell your undivided interest at any time. Although it is no guarantee of future performance, ask the sponsor if he has ever lost any co-investors' money, has ever been sued or has ever had a cash call in any property. If an investor puts in five percent of the equity on a property, will he receive five percent of the monthly cash flow every month, five percent of the annual depreciation and five percent of the proceeds when the property is sold, or does the sponsor take a "carried interest," taking a small percentage of the deal for their own account? You want the sponsor to pay for its piece just like you. Avoid sponsors who take a carried interest and look for those who purchase their interest by investing their own cash into the property.

The Bottom Line

When you're buying real estate, look at the quality of the underlying real estate. Is it high-quality construction located in a growing market? Does it have income from multiple quality tenants? Does it have financial reserves set aside for future repairs? Is it overly leveraged? Are you subject to interest rate increases in the future? Does the property provide good appreciation potential, etc? Remember that return OF equity is much more important than return ON equity. Receiving a six percent return when you are expecting 10 percent is one thing; receiving a phone call that your $1 million equity investment has disappeared can be life changing!

Or you could always just hop on a plane to Nevada, put your money on red and let it roll. **N**

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