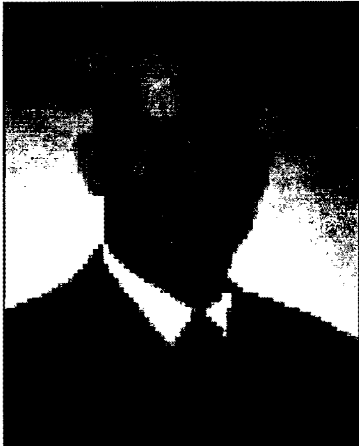
20 Tips For Becoming A Successful Tenancy In Common Sponsor



Eric C. Perkins
is founding owner of Perkins Law PLLC, in Richmond, Virginia. He specializes in Regulation D private placements (including TIC and DST programs) and other real estate securities matters. He has been practicing law in Virginia since 1996, advising entrepreneurs, business owners and executives, franchisors, franchisees, real estate sponsors and investors, charitable organizations, and professionals in the sports entertainment field. He can be reached at eric@ericperkinslaw.com.

Eric C. Perkins

Even in the current troubled real estate environment, TIC sponsorship is still an attractive choice—if you go about it the right way.

REAL ESTATE SPONSORS have raised over $10 billion in equity over the past five years through securitized tenant-in-common (TIC) transactions. (Source: OMNI Consulting & Research.) Although the TIC industry has suffered greatly over the past eighteen months, when the industry emerges from the current economic downturn along with the rest of the commercial real estate market, others in the real estate industry will naturally be inclined to take notice and evaluate whether becoming a TIC sponsor makes sense. The purpose of this article is to identify primary issues for the prospective TIC sponsor to consider.

I. Organizational Issues

1. How much start-up capital and time are necessary to establish a new TIC sponsor?

TIC industry experts recommend new sponsors commit between $500,000 and $1 million in start-up capital and a minimum of 18 to 24 months to start a successful TIC business. In a best-case scenario, a new TIC sponsor might expect to close its first TIC offering within nine to 12 months of getting started.

2. Understand the essential functional areas typically seen in a successful TIC sponsor.

A successful TIC sponsor will have experienced staff covering the following business areas:

- Acquisitions and dispositions;
- Property management and asset management;
- Finance, budgeting, and financial reporting;
- Broker-dealer relations and distribution network development;
- Investor relations and closing coordination;
- Human resources; and
- Marketing and public relations.

While all of these functions are important, most industry experts likely would rank acquisitions and investor relations as the two most important functions for a new TIC sponsor.

3. Identify the parties involved in a typical TIC offering.

On the real estate side, the relevant parties typically will include a third-party seller (unless the sponsor has previously developed or acquired the subject property) and the seller's attorneys, one or more lenders and their respective attorneys and representatives, real estate broker, mortgage broker, title/escrow company, sponsor's legal counsel (possibly multiple law firms in a given transaction), third-party consultants (e.g., appraiser, environmental engineer, etc.), and qualified intermediaries assisting the TIC investors with section 1031 exchanges.

On the securities side, the relevant parties will typically include sponsor's legal counsel (which may be the same as sponsor's real estate counsel), a managing broker-dealer or selling group of broker-dealer firms (and their registered representatives), a third-party due diligence analyst (typically a law firm), and investors and their representatives.

4. Characteristics TIC investors and broker-dealers look for in a TIC sponsor.

Broker-dealers, lenders, and investors look for many different attributes in a TIC sponsor but, generally speaking, they prefer sponsors who consistently demonstrate:

- A concentration on a specific property type or geographic market;
- Relationships with third parties that promote efficient transactions;
- Sufficient staff and internal controls to ensure the proper acquisition and management of quality real estate assets;
- Professional staff focused on investor relations;
- Financial capability and commitment to satisfy sponsor obligations to investors; and
- A strong commitment to securities and corporate compliance and business ethics.

5. Become familiar with TIC sponsor "best practices" standards promulgated by the Real Estate Investment Securities Association (REISA).

In October 2005, REISA (formerly known as the Tenant-in-Common Association) published Alert 05-03, representing a collaborative, multi-disciplinary effort to memorialize the then-current conventional wisdom of the TIC industry as to "best practices" relating to TIC programs. These best practices covered topics such as offering disclosure, tax opinions, due diligence, and marketing. The most recent version of the "Best Practices Memorandum" was released in March 2008 and is available at www.reisa.org.

II. Real Estate Issues

6. Understand the most common forms of compensation paid to TIC sponsors and their affiliates in a TIC transaction.

While specifics vary depending upon the situation, a sponsor and one or more of its affiliates will receive compensation from a TIC offering through one or more of the following:

- A straightforward mark-up in the purchase price of the real estate in excess of what it paid the third-party seller;
- Acquisition fees;
- Real estate commissions (subject to applicable state law);
- Managing broker-dealer fees;
- Securities sales commissions and non-accountable allowances for marketing and due diligence;
- Loan fees;
- Property management and/or asset management fees; and
- Disposition fees.

The typical range of sponsor "profit" in a TIC offering is between 5 percent to 15 percent, but again, variations from this range are not uncommon.

7. Understand the typical rates of return being paid to investors in TIC programs.

According to market research conducted by Omni Consulting & Research, average cash-on-cash returns in securitized TIC programs fell from 7.2 percent to 6.8 percent between 2005 and 2006, with even further slippage observed throughout 2007 and 2008. This is in contrast to the 8 percent to 10 percent cash-on-cash returns typical for TIC offerings four to six years ago. A variety of economic factors are cited as the cause of this phenomenon (e.g., rising interest rates, rising insurance costs, decreasing cap rates).

8. Establish relationships with lenders, environmental consultants, title companies, and escrow agents who have experience in closing TIC transactions.

From an acquisition perspective, TIC sponsors feel increasing market pressure to distinguish themselves from other bidders when pursuing potential acquisitions. When feasible (and occasionally when not so feasible), sponsors will agree to abbreviated due diligence periods and quick closing deadlines to get a desirable property under contract. In these situations, having solid working relationships with third-party consultants who can conduct property inspections, Phase I assessments, and the like on an expedited basis is essential.

One of the biggest challenges facing TIC sponsors today is finding third-party financing on acceptable terms. Accordingly, establishing and maintaining solid relationships with lenders willing and able to finance TIC transactions is especially important.

On a related note, while viewed in many respects as single transaction, closing a TIC transaction with nearly three dozen TIC investors is, for practical purposes, the equivalent of conducting three dozen real estate closings at one time. The logistics can be mind-numbing, and working with a title company and escrow agent experienced in closing TIC transactions is enormously helpful.

9. Be prepared to disclose all material aspects of a potential real estate acquisition to your potential investors.

As discussed in more detail below, most TIC transactions are (or should be) structured as the offering and sale of a security. In terms of disclosure requirements to potential buyers, selling a security is the direct opposite of selling real estate. While the "caveat emptor" principle may be alive and well in the real estate industry, federal and state securities laws are more concerned with the concepts of investor protection and full and fair disclosure. Compliance with the securities laws—along with the extra expense associated with securities compliance—is perhaps the most unexpected and frustrating aspect of a new sponsor's entry into the securitized TIC industry.

10. Understand how TIC investors are typically involved with the ongoing operation and management of the subject property.

For both practical and legal reasons, TIC investors come into these deals as passive investors; however, as TIC owners of the subject property, they do retain certain rights. These rights are typically described in a TIC agreement and will include the right to approve any sale or lease of the subject property, refinancing, operating budgets, and hiring/firing of property managers, among other important matters.

III. Securities Issues

11. Understand that TIC offerings constitute the offer and sale of securities under applicable law.

From a securities law perspective, the typical TIC offering constitutes the offer and sale of securities or, more specifically, an investment contract. This is not a universally accepted view, and there are some types of TIC deal structures that arguably (or are intended to) fall outside the definition of a security; however, most TIC offerings are structured and sold as securities offerings. The U.S. Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), defined an "investment contract" as "a contract, transaction, or scheme whereby a person invests money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party."

From the perspective of both federal income tax and state real estate law, however, that same TIC offering should, if structured properly, be deemed to constitute the offer and sale of real estate. This concept is difficult to grasp and reflects the multi-disciplinary nature and legal complexity of TIC transactions.

12. Comply with applicable securities laws.

Simply put, there are three kinds of securities offerings: registered; exempt; and illegal. The process of registering an offering with the Securities and Exchange Commission (SEC) is a lengthy and expensive process and otherwise impractical for TIC transactions. The potential civil, regulatory, and criminal consequences of conducting an illegal offering of securities speak for themselves. Fortunately, there are a variety of federal and state exemptions to the registration requirements that allow sponsors to raise money through private offerings. The most popular federal exemption utilized for TIC offerings is Rule 506 of Regulation D, 17 C.F.R. §230.506.

Regulation D consists of three transactional exemptions from federal registration requirements adopted in 1982 making it easier for smaller companies to raise capital in the private equity markets. Rule 506 provides an exemption for offerings of an unlimited dollar amount to an unlimited number of accredited investors (and up to 35 non-accredited investors who have sufficient financial and business knowledge to evaluate the merits and risks of the offering).

13. Understand who can sell TIC securities to potential investors.

With very few exceptions, securitized TIC offerings may only be sold through licensed securities broker-dealer firms and their registered representatives. Developing working relationships with these firms is an essential part of being a successful TIC sponsor.

14. Understand that there are strict limitations in marketing a TIC offering.

While selling real estate typically involves widespread advertising through a variety of media outlets, selling TIC interests through a securities offering is the polar opposite. Selling securities in a Regulation D private placement is very different than selling real estate. General solicitation and advertising are strictly prohibited under Rule 506 of Regulation D; therefore, TIC sponsors must learn to stifle their creative marketing instincts or redirect them in a manner that complies with applicable securities law. Generally speaking, Regulation D private offerings are meant for investors with whom the sponsor (or the selling registered representative) has a pre-existing relationship, not members of the general public who learn about the offering through a radio commercial, cold call, or email solicitation. TIC sponsors can market themselves and certain aspects of their business to some degree, but they cannot publicly promote, either directly or indirectly, their securities offerings. This is a very gray area of the law with little definitive guidance, and one can quickly locate dozens of examples of noncompliance throughout the industry (e.g., Internet Web sites, newspaper and magazine advertisements, seminars and conference calls, among others).

15. Understand what the term "accredited investor" means and why it is important.

Because virtually all TIC offerings are open only to accredited investors, it is important to know whom or what constitutes an accredited investor. Rule 501(a) of Regulation D defines eight categories of individuals and entities that qualify as accredited investors. Proposed amendments to Rule 501(a) are currently under consideration by the SEC that could result in some modest changes to the definition, but for practical purposes, the majority of TIC investors fall within one of the following categories:

a. Individuals with High Net Worth (Rule 501(a)(5)). This category of accredited investor includes any natural person whose net worth at the time of purchase exceeds $1 million. Net worth may be either the individual net worth of the investor or the joint net worth of the investor and his or her spouse.

b. Individuals with High Income (Rule 501(a)(6)). This category accredits any natural person who had an individual income in excess of $200,000 in each of the last two years (or $300,000 joint income with his or her spouse) and who reasonably expects to have individual income in excess of $200,000 in the current year (or $300,000 joint income with his or her spouse). For purposes of Rule 501(a)(6), the SEC has chosen to apply a broad, flexible approach to defining "income," but has specified that one should look to an individual's net income rather than gross income in analyzing Rule 501(a)(6) issues. Unrealized capital appreciation in securities generally may not be included in calculating income, but contributions to retirement plans are considered income to the extent that the individual's rights to such contributions are vested. See SEC Interpretive Letter re: Raymond James & Associates, Inc. (December 19, 1984).

c. $5 million Trusts (Rule 501(a)(7)). In its 1988 amendments to Rule 501(a), the SEC extended accredited investor status to trusts with total assets in excess of $5 million so long as the trust was not formed

for the specific purpose of acquiring the securities offered and the investment decision to purchase the securities was made by a "sophisticated person" as described in Rule 506(b)(2)(ii).

d. Entities Owned Entirely by Accredited Investors (Rule 501(a)(8)). This category of accredited investor includes any entity (e.g., corporation, partnership, or limited liability company, etc.) in which all of the equity owners are accredited investors under any other category.

IV. Tax and Finance Issues

16. Understand the connection between section 1031 of the Internal Revenue Code and TIC transactions.

Most investors invest in TIC offerings as a means of completing section 1031 like-kind exchanges. Section 1031 of the Internal Revenue Code provides that no capital gain will be recognized (i.e., a taxpayer may defer capital gain that would otherwise be taxed) on the sale of property held for investment if the taxpayer reinvests the sales proceeds in "like-kind" property. Section 1031 exchanges can be structured in several ways, but the most widely used is the so-called "delayed exchange." In this type of exchange, the taxpayer:

- Sells his relinquished property;
- Identifies one or more replacement properties within 45 days after the sale of the relinquished property; and
- Completes the purchase of the replacement property within 180 days after the sale of the relinquished property. Accordingly, TIC offerings appeal to taxpayers looking to identify and acquire one or more replacement properties to complete their section 1031 exchanges.

17. Understand Revenue Procedure 2002-22 and how it affects the structure of a typical TIC deal.

Most TIC industry experts point to the 2002 release of Revenue Procedure 2002-22, 2002-1 C.B. 733 (the "Rev. Proc."), as the catalyst giving rise to the TIC industry as we know it today. While not creating substantive law, the Rev. Proc. sets forth the conditions under which the Internal Revenue Service (IRS) will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in Section 614) is not an interest in a business entity within the meaning of Treas. Reg. 301.7701-2(a) of the Procedure and Administration Regulations. Through the Rev. Proc., the IRS symbolically, if not practically, legitimized the TIC industry and provided a general roadmap for a proper TIC structure. As a quick summary, the Rev. Proc. sets forth the following factors or conditions:

a. TIC Ownership. Each TIC owner must hold title to the subject property (either directly or through a disregarded entity) as a tenant in common under local law. In other words, title to the subject property as a whole may not be held by an entity recognized under local law.

b. Number of TIC Owners. The number of TIC owners must be limited to no more than 35 persons. For this purpose, "person" is as defined in IRC section 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a TIC owner by inheritance are treated as a single person.

c. No Treatment of Co-Ownership as an Entity. The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The IRS generally will not issue a ruling under the Rev. Proc. if the co-owners held interests in the property through a partnership or corporation immediately before the formation of the co-ownership.

d. Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership 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 (determined as of the time the partition right is exercised) before exercising any right to partition; or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the property.

e. Voting. The co-owners must retain the right to approve the hiring of any manager, 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. Any sale, lease, or re-lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the property. A co-owner who has consented to an action in conformance with this section may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

f. Restrictions on Alienation. In general, each co-owner must have the rights 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. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

g. Sharing Proceeds and Liabilities upon Sale of Property. If the subject 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.

h. Proportionate Sharing of Profits and Losses. 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, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

i. Proportionate Sharing of Debt. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

j. Options. A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided the exercise price for the call option reflects the fair market value of the property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the property is equal to the co-owner's percentage interest in the property multiplied by the fair market value of the property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

k. No Business Activities. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real estate (customary activities). *See* Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in section 511(a)(2) from qualifying as rent under section 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the subject property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to 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 (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the property for less than six months.

l. Management and Brokerage Agreements. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. A management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the subject property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the man-

ager must disburse to the co-owners their shares of net revenues within three months from the date of receipt of those revenues. A management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the property. In addition, a management agreement may authorize the manager to obtain or modify insurance on the subject property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the subject property, subject to the approval of the co-owners. The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

m. Leasing Agreements. All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the subject property, cash flow, increases in equity, or similar arrangements.

n. Loan Agreements. The lender with respect to any debt that encumbers the subject property or any debt incurred to acquire an undivided interest in the property may not be a related person to any co-owner, sponsor, manager, or lessee of the subject property.

o. Payments to Sponsor. Except as otherwise provided in the Rev. Proc., 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.

18. Aside from the tax-deferral benefits of a section 1031 exchange, understand that there are other potential tax benefits associated with a typical TIC transaction.

Like other types of real estate investments, a properly structured TIC investment can offer tax benefits common to other types of real estate investment structures. For example, a TIC investor may be able to utilize depreciation deductions stemming from the property to offset what would otherwise be taxable income. Similarly, a TIC investor may enjoy tax benefits related to the deductibility of interest payments on the mortgage debt encumbering the property.

19. Understand how TIC investors report their investment returns for tax purposes.

At the beginning of each year, the TIC sponsor or property manager should provide the TIC owners relevant tax reporting information (e.g., income, interest, and depreciation) for their use in preparing their individual income tax returns. A partnership tax return should not be filed, nor should the TIC owners receive 1099s.

20. Establish relationships with senior and mezzanine lenders experienced in TIC lending.

Some lenders are very experienced in TIC transactions, while others shy away from financing TIC transactions. Unfortunately, given the recent collapse of the CMBS market, many conduit lenders with significant experience in TIC lending are currently not financing TIC transactions, forcing TIC sponsors to rely on regional and local banks, life insurance companies, and others for senior financing. In today's market, there is a significant premium on having productive relationships within the lending community.

Mezzanine debt financing has become popular and readily available in the TIC industry in recent years, as TIC sponsors have increasingly found it necessary to be in a position to close quickly on real estate acquisitions regardless of whether they had time to raise sufficient equity from TIC investors. Although this form of short-term debt is more expensive than traditional long-term mortgage financing and creates additional risk to sponsors, most sponsors have accepted this "necessary evil" as part of doing business in today's TIC industry.

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