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TIC Arrangements and Section 1031 Exchanges*

Section 1031 of the Internal Revenue Code ("Code") allows a taxpayer to engage in a tax-free exchange of *property held for productive use in a trade or business or for investment* if such property is exchanged solely for property of *like kind* which is to be held either for productive use in a trade or business or for investment. Generally, an interest in real estate or personal property held as a business asset or investment qualifies for the tax-free exchange treatment when such interest in real estate or personal property is exchanged for a real estate interest of like-kind. There are some investment-assets listed in Section 1031 which do not qualify for the tax-free exchange treatment. An interest in a business entity such as corporate stock, partnership interest, and membership interest in a limited liability company are examples of assets that do not qualify under Section 1031.

1. **Exchange of Interest in Entities.** More specifically, when a real estate asset is owned via a partnership/LLC or another type of business entity, the exchange of interest in such entity does not qualify for the tax-free exchange treatment under Section 1031. Accordingly, the like-kind exchanges of real estate must be engaged in by the entity which owns the underlying real estate and not the individual partners/members/owners. In situations where not all partners/members/owners are interested in continuing their investment in the real estate being exchanged, it may be difficult to accommodate the differing desires (like-kind exchange for some but not for others) of all the partners/members/owners. One method to avoid this situation and to accomplish other investment goals (e.g., asset-protection, financial and estate planning), is to have the underlying real estate investment owned by the investors as tenants-in-common (TIC). Generally, state laws do not view TIC arrangements as entities. However, entity v. non-entity classification of a TIC arrangement is a troublesome question under federal tax rules.

2. **Classification as Entity.** A problem under federal tax law arises when some services need to be provided as part of holding the commercial real estate project. This is because federal tax law may view a TIC arrangement (although evidenced only by a private contract) as an "entity" carrying on a trade or business. A TIC arrangement's classification as an entity (either as a partnership or a corporation) would defeat the tax benefits and related tax-free exchange planning.

*This summary is intended to provide general information regarding the subject matter addressed. It is not legal advice and cannot be relied upon as such. For legal advice, please contact one of our firm's attorneys.

3. **Federal Tax Guidelines.** In Revenue Ruling 75-374 and Revenue Procedure 2002-22, the IRS has provided general guidance which may be followed to structure a TIC arrangement so that it will not be classified as an entity. However, these guidelines do not rise to the level of a "safe-harbor" on which taxpayers may rely for predictable tax treatment. Accordingly, careful analysis of the specific facts of each transaction is necessary to structure the TIC arrangement and to ensure favorable treatment under Section 1031.

4. **Financing/Liability Concerns.** Other areas where a TIC arrangement runs into problems are financing and limitation of legal liability. As part of any financing arrangement, a third-party lender generally requires the loan obligation to be secured by a mortgage and each TIC participant's promise of repayment. Since in a TIC arrangement the real estate is owned directly by each TIC participant, any liability arising from the commercial/business activities associated with underlying commercial real estate will flow directly to each such participant. Hence, it is difficult to structure non-recourse financing or to otherwise limit the legal liability of the TIC participants. With careful planning and professional guidance, these issues can be addressed without jeopardizing the favorable tax treatment under Section 1031.

5. **Promotion of TIC Interest.** Over the last few years, TIC interests are being promoted by various institutional investment promoters. Generally, these TIC interests appear to offer investors the ability to hold a relatively smaller investment in large real estate projects while maintaining the ability to engage in future tax-free exchanges into other TIC interests. The underlying real estate projects generally are leased to tenants with superior credit rating and, therefore, carry a lower risk of default. Various comments and concerns have been raised as to the viability of these TIC interests under federal/state tax and securities laws. For instance, the regulatory regime applicable to securities brokers/dealers versus the rules under which real estate brokers operate overlap (and must be reconciled) when applied to promotion/marketing of TIC arrangements.

6. **TIC Interest as "Security".** One of various concerns in this area relates to the question whether a syndicated TIC interest is a "security" for purposes of federal/state securities laws. If so, such interest must either be registered under applicable securities laws or a valid exemption from such registration must be available. From federal tax standpoint, a finding that a specific TIC interest constitutes a "security" may disqualify the exchange of such interest from receiving a favorable treatment under Section 1031. An argument (mostly out of necessity) has been advanced by various commentators that a TIC arrangement may be validly treated as a "security" for federal/state securities laws without being disqualified from favorable treatment under Section 1031.

7. **Conclusion.** Since the issuance of Revenue Procedure 2002-22, many taxpayers have relied on this procedure to seek favorable tax-free exchange treatment of various TIC arrangements. Some have even deviated from the strict guidelines to accommodate a variety of unique circumstances. However, many of these TIC arrangements may not pass IRS scrutiny if subjected to an examination. Therefore, taxpayers and their advisors must carefully analyze underlying facts and circumstances when devising specific TIC arrangements within the framework of the published guidelines. With appropriate planning taxpayers should be able to structure a TIC arrangement which would pass IRS scrutiny and achieve other important financial goals.