

# CHAPTER 11

## A DEFENSE OF TICs AND DSTs

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## ¶ 1100 NOT ALL TICs ARE “TICKY TACKY TICs”

In a recent article in the Journal of Real Estate Taxation, Terry Cuff highlighted a number of potential risks and considerations with respect to syndicated tenancy in common, or TIC transactions, and the TIC industry as a whole.<sup>1</sup> Terry is a well-know expert in the area of like-kind exchanges and the author of numerous articles on the subject. His article requires a response. In the authors' view, while Terry's intent to educate investors on the risks involved in TIC investments and to provide them with tools to make better investment decisions is laudatory, the article glosses over many of the important benefits that have contributed to the dramatic rise in demand for TIC offerings over

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<sup>1</sup> Terence F. Cuff, “Research Can Prevent an Investment in a Ticky Tacky TIC,” 33 Real Estate Tax'n 4 (Third Quarter 2006).

the past five years and that, barring regulatory changes, will continue to grow in the future.

As described in more detail below, in a typical TIC transaction, a sponsor will offer undivided interests in real estate to a group of accredited investors who will become co-owners with respect to the property. To date, the primary, though by no means exclusive, investors in TIC transactions have been individuals looking to acquire qualified replacement property in connection with a like-kind exchange under Section 1031.<sup>2</sup> When properly structured, the undivided interests acquired in a TIC offering ("TIC Interests") are treated as interests in real estate and therefore as qualified replacement property for taxpayers disposing of other real estate in a like-kind exchange. Most TIC offerings are structured as securities offerings, although some sponsors offer TIC Interests as real estate under a somewhat modified structure.

Terry's article is particularly concerned with what it terms "Ticky Tacky TICs". The article states that it is principally concerned with "bad TICs, not the good ones." Terry clearly states that "[g]ood TICs are sensibly constructed . . . offer acceptable investments for a like-kind exchange" and "are much to be encouraged." He also agrees that "[t]heir promoters provide a valuable service." By contrast, "Ticky Tacky TICs" are "just bad investments." Unfortunately, Mr. Cuff believes, Ticky Tacky TICs "infect the marketplace." In addition to potentially unscrupulous sponsors marketing poor investments, Mr. Cuff criticizes such TICs on the ground that they are burdened by heavy up-front fees, have weakly developed exit strategies, and may not qualify as good replacement property for investors participating in like-kind exchanges if the sponsor is cavalier about complying with IRS guidelines. Mr. Cuff urges potential investors to carefully investigate both particular TIC transactions and the sponsors offering them in order to distinguish good TIC transactions from bad ones and provides an extensive discussion of the principal risks and considerations investors may take into account. Ultimately, Mr. Cuff is concerned that TIC investors "are so intoxicated by TICs as replacement property for Section 1031 exchanges that they forget to undertake the normal investigation required for investing in real property."

<sup>2</sup> Unless stated otherwise, all Section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

None of this is objectionable as far as it goes. Bad investments are simply that, whether they are undivided interests in real estate or in dot-com stocks. One hopes that most investors, and their advisors, appreciate that tax savings alone are not a sufficient justification for trading a profitable investment for an unprofitable one. The potential for profit and loss depends on the characteristics of a particular piece of real estate and the experience of the persons managing it to a far greater degree than for many other types of investments; investors must therefore be careful in selecting a suitable property in which to invest. Unscrupulous or cavalier sponsors are a threat to both investors and the industries in which such sponsors operate.

Nevertheless, while there is no doubt that some Ticky Tacky TICs exist and investments must be chosen with care, the TIC industry has grown so significantly (to date more than \$10 billion of TIC offerings have been made) because TIC investments offer a number of advantages, particularly to individual investors. Obviously, a TIC investment is not suitable for all investors, must be carefully evaluated, and must be weighed against alternative investments in real estate as well as other types of investments. For these reasons, the authors believe that with adequate due diligence and regard for pitfalls, TICs (and syndicated offerings of undivided interests in real estate offered through Delaware Statutory Trusts, or DSTs) can accomplish the needs of many taxpayers in the market for suitable replacement property for Section 1031 exchanges.

#### **¶ 1101 BACKGROUND ON SECTION 1031(a), TICs AND DSTs**

A tenancy in common is one of the traditional concurrent estates in land and has existed for hundreds of years. The laws of virtually all states recognize a tenancy in common (or its equivalent) as an estate in land. The essential feature of a tenancy in common is that each owner is deemed to own individually a physically undivided part of the entire parcel of property.<sup>3</sup>

By contrast, the syndicated TIC industry is approximately fifteen years old and has experienced its most rapid growth in the past five to six years. There is currently approximately more than \$10 billion in

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<sup>3</sup> Rev. Proc. 2002-22, 2002-1 CB 733.

equity invested in interests in TICs and DSTs. The TIC industry generally involves two basic types of syndicated real estate transactions. The first are syndicated offerings of undivided tenancy in common or TIC Interests from which the name of the industry is derived. The second are syndicated offerings of beneficial interests in DSTs. For historical reasons, the industry is often referred to as the TIC industry although this technically is not correct since ownership of an interest in a DST does not create a tenancy in common for state law purposes. For the sake of convenience, references to the TIC industry or TIC Interests in this article refer to both types of interests except where otherwise indicated.<sup>4</sup>

The primary, though by no means exclusive, investors in TIC Interests are individuals seeking to complete a like-kind exchange under Section 1031. Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment for property of like-kind which is to be held either for productive use in a trade or business or for investment. Under Section 1031, virtually all types of interests in domestic real estate qualify as like-kind with respect to other domestic real estate. However, certain types of property are statutorily excluded from qualifying for nonrecognition treatment under Section 1031, including interests in a partnership (even if the sole asset of the partnership is real estate), certificates of trust or beneficial interests, and securities.

When properly structured, an interest in a TIC or a DST may qualify as an interest in real property for purposes of Section 1031 and therefore can be exchanged for other real property in an otherwise qualifying Section 1031 exchange. However, that is where the similarities between TICs and DSTs end. The two forms of investment have little in common apart from the fact that either may constitute an interest in real property for purposes of Section 1031. The IRS has issued two separate authorities to provide guidelines for when an

<sup>4</sup> There is also wide variation between tenancy in common transactions. Tenancy in common transactions can be structured as asset managed deals in which an asset manager oversees the operation of the property on behalf of the investors or by having the investors master lease the property to a master lessee. In addition, as discussed below, tenancy in common offerings have been structured as securities offerings in some cases and as sales of real estate in others.

interest in a TIC or DST will be considered like-kind property in a Section 1031 exchange and it is the authors' view that the guidance issued by the Service with respect to TICs should only be applied to interests in a TIC, and likewise the guidance with respect to DSTs should only be applied to interests in a DST.<sup>5</sup> The two authorities are mutually exclusive and interests in TICs and DSTs should be analyzed separately under the specific guidance issued for each.

Rev. Proc. 2002-22<sup>6</sup> sets forth guidelines under which the Service will consider issuing a private letter ruling that an interest in a TIC constitutes an interest in real property, as opposed to an interest in a business entity (i.e., a partnership) under Treas. Reg. 1.7701-3. Rev. Rul. 2004-86<sup>7</sup> addresses whether a trust will be treated as a trust under Treas. Reg. 1.7701-3 or classified as a business entity under Treas. Reg. 1.7701-3. Beneficial interests in a DST that is classified as a trust which also satisfies the requirements of a grantor trust under Section 671 will be treated as interests in the property owned by the trust rather than as an interest in a partnership or a trust for purposes of Section 1031 exchanges. Although legal authorities discussing tenancy in common structures and the tax treatment of DSTs existed prior to the issuance of Rev. Proc. 2002-22 and Rev. Rul. 2004-86, and some transactions were undertaken based on those authorities, the substantial growth in the TIC Industry over the past several years is due principally to the additional certainty provided by the issuance of these rulings. Both Rev. Proc. 2002-22 and Rev. Rul. 2004-86 are discussed in greater detail below.

TICs and DSTs, much like Section 1031 exchanges in general, are here to stay for the foreseeable future. As the like-kind exchange industry continues to profit from the sale of TIC and DST interests, and as taxpayers continue to find tax deferral success with Section 1031 exchanges, more sophisticated and creative methods will continue to emerge. Taxpayers must at once be prepared to take advantage of these opportunities while at the same time being cautious of Ticky Tacky TICs and other pitfalls.

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<sup>5</sup> See Richard M. Lipton, Arnold Harrison & Todd D. Golub, "The Intersection of Delaware Statutory Trusts and Tenancies in Common", Real Estate Taxation (1<sup>st</sup> Qtr. 2006).

<sup>6</sup> Rev. Proc. 2002-22, 2002-1 CB 733.

<sup>7</sup> Rev. Rul. 2004-86, 2004-33 IRB 191.

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# ¶ 1102 WHAT A TIC IS NOT

The popularity of TIC Interests is due in part to the fact that they provide a convenient source of replacement property for taxpayers desiring to obtain the benefits of tax deferral under Section 1031 and can be tailored to the size of the investment a potential investor desires to make. However, tax deferral alone is not a sufficient reason to purchase a TIC Interest. The decision to acquire a TIC Interest must be weighed against the benefits available from alternative real estate investment opportunities, including investment opportunities that may not provide any tax deferral. Moreover, even if a taxpayer has determined that a TIC investment is the best option, the taxpayer must still determine which TIC Interest to purchase. A TIC Interest is not a bond, CD, annuity or other investment providing a fixed and relatively certain return but an investment in real estate that is subject to the normal risks and benefits associated with real estate investments.

TIC investors need to conduct adequate due diligence with regard to the TIC property, much the same as they would if they were purchasing the property in fee. Merely because a property is a TIC does not preclude the possibility that the replacement property may have unforeseen problems. In evaluating TIC investments and alternatives, potential investors need to understand what a TIC is and what a TIC is not.

## ¶ 1102.1 Comparison to Fee Simple Ownership

At the outset, potential investors considering an investment in a TIC offering need to understand that a TIC Interest is not the same as a fee simple interest in property. The owner of a fee simple interest possesses the entire interest in the property and, subject to legal and regulatory restrictions, is entitled to all of the benefits of ownership of the property, and can develop, sell, encumber, lease or otherwise utilize the property as he or she sees fit. By contrast, the owner of a tenancy in common is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants in common the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights are exercised to the detriment of the other tenants in common.

An interest as a tenant in common affords the taxpayer less control over the property, since he must obtain the consent of the other tenants in common to sell, lease, encumber or otherwise utilize the property.

The purchase of a TIC Interest, as opposed to fee simple ownership, makes sense for many taxpayers, but not for all. A TIC Interest may give an investor the opportunity to invest in a larger property or provide diversification by allowing the investor to invest in a different property class that the investor lacks the resources to acquire as a fee owner. The size of a TIC Interest can be tailored to an individual taxpayer's needs, and the TIC industry can provide reduced hassle and a less time-consuming method for taxpayers to locate suitable replacement property within the requirements of Section 1031. TIC investors do not have to manage the property themselves and will generally have the benefit of professional management, while the owner of a fee simple interest must either manage the property themselves or hire their own professional property managers. On the other hand, syndicated TIC Interests are sold commercially by sponsors or promoters who receive significant fees for the risk they assume in structuring the offering and for undertaking the due diligence with respect to the property that an investor would otherwise have to conduct on its own. In some cases, these fees may be higher than an investor would incur to acquire fee ownership in a smaller property. In that respect, each potential investor must balance the cost of sponsor fees and their impact on the investor's return on (and return of) his or her investment capital in relation to the benefit obtained by the purchase of syndicated TIC Interests.

### ¶ 1102.2 Comparison to Real Estate Funds and REITs

A TIC Interest also differs substantially from other forms of real estate investments including real estate funds organized as partnerships and real estate investment trusts (REITs). Like TIC Interests, these types of investments free investors from the burden of being actively involved in property management. Because TIC offerings typically include a single property or at most a few properties, they provide significantly less diversification and may carry more risk than real estate funds or REITs that are heavily diversified (although the level of risk will depend significantly on the investment goals and risk profile of the particular real estate fund or REIT and on the performance of the specific properties held by the fund or REIT). While real estate funds



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offered as private placements are relatively illiquid investments, public REITs offer significantly greater liquidity. Like TIC investments, the persons who organize and manage real estate funds and REITs receive substantial fees for their services. While the fee structures for real estate funds and REITs typically differ significantly from those charged in connection with TIC transactions, they can significantly impact the return on the investment.

Due in part to the fact that the TIC industry is relatively new and in part to restrictions imposed on TIC investments by the IRS guidelines discussed in more detail below, TIC offerings currently offer fewer opportunities for investors to make tradeoffs between risks and rewards (such as investing in turnaround or distressed properties in the hopes of realizing significantly higher capital appreciation in the value of their investments) than are available in various real estate funds and REITS. This may be less of a distinction between TIC offerings and investments in other syndicated real estate investments than it first appears. To date, anecdotal evidence suggests that TIC investors strongly favor the certainty of current income distributions over the potential for capital appreciation. In addition, creation of upfront reserves necessary for properties that are not producing sufficient cash flow to cover expenses creates potential boot issues that render such properties less attractive to TIC investors.

Despite these differences, TIC Interests provide an important and attractive alternative to other forms of syndicated real estate investments for many investors. Real estate funds often require minimum investments in excess of amounts that an investor is willing or able to invest. Thus, one of the advantages of TICs is that they enable smaller investors the opportunity to invest in professionally managed real estate that otherwise would be unavailable to them. The typical TIC investor will have to make his or her investment in a real estate fund or REIT with after-tax dollars. Because a TIC investor is able to defer the gain on the disposition of its relinquished property, it may make a larger equity investment and generate a return on that investment. In addition, a TIC investor may be able to structure its disposition of the TIC Interest as a like-kind exchange and obtain the benefits of additional tax deferral. Tax-deferred exit strategies typically are not available to investors in real estate funds and REITs. Management rights also differ substantially between TIC Interests and other syndicated real estate investments. In the case of a TIC Interest, the consent

of each of the investors is generally required for major decisions regarding the property such as a sale of the entire property, loans that encumber the property, and leases. These rights are beneficial in the sense that TICs have input into major decisions regarding the property, but can cause difficulties when unanimous consent cannot be obtained. In typical TIC transactions these difficulties are ameliorated to some degree by giving TICs the right to purchase the interests of dissenters when a specified percentage of investors have approved a particular course of action. By contrast, investors in other syndicated real estate transactions may have few, if any, voting rights.

A TIC Interest does not automatically qualify as an interest in real estate for purposes of Section 1031. As discussed in more detail below, the IRS has issued guidance discussing criteria for treating TIC Interests as interests in real property. While practitioners generally agree that satisfaction of all of these requirements is not necessary for a TIC Interest to qualify as real estate, certain of these requirements are critical, while other requirements are not. Taxpayers must ensure that their TIC Interests will qualify as like-kind exchange property. TIC Interests that deviate too far from the published guidance or that violate critical requirements may not qualify as real estate for purposes of Section 1031.

### ¶ 1102.3 Comparison to Partnerships

A TIC is not a partnership. Rather, a TIC specifically seeks to avoid partnership classification. Section 1031 specifically provides that it does not apply to an exchange of interests in a partnership.<sup>8</sup> Rev. Proc. 2002-22 sets forth advance ruling guidelines under which taxpayers can acquire TIC Interests as replacement property without fear that the Service will attempt to recharacterize the TIC Interest as an interest in a partnership. A TIC does share some similarities with a partnership. Both a TIC and a partnership could involve the co-ownership of property and sharing of the income derived from that property. A partnership arises when the parties to a venture join together capital or services with the intent of conducting a business or enterprise and sharing the profits and losses from that venture. A TIC, on the other hand, involves passive ownership of real estate in which the co-owners

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<sup>8</sup> Section 1031(a)(2)(D).

benefit from the rent and appreciation in the value of the property, as opposed to business operations.

There is a well-established body of case law that concerns the definition of "partnership" for tax purposes. One seminal case is the U.S. Supreme Court's decision in *Commissioner v. Culbertson*<sup>9</sup> in which the Court stated that whether a partnership is created depends on whether the alleged partners really and truly intended to join together for the purpose of carrying on business and sharing the profits and losses or both. This determination is a question of fact, to be determined by the partners' testimony, their agreement and their conduct. Post-*Culbertson* decisions, such as *Luna*,<sup>10</sup> set forth specific factors to be considered in determining whether an arrangement should be treated as a partnership for tax purposes.

### ¶ 1103 TICs, DSTs AND PARTNERSHIPS

Although TICs and DSTs are often referred to as TIC Interests, TICs and DSTs have little in common except that an interest in either may constitute an interest in real property for purposes of Section 1031. The rules concerning TICs and DSTs arise under separate provisions of the regulations. The IRS has issued two separate authorities to provide guidance for when an interest in a DST or TIC can be used as like-kind property in a Section 1031 exchange. Rev. Proc. 2002-22 sets out guidelines under which the IRS will consider issuing a private letter ruling that a TIC constitutes a direct interest in real property, and not an interest in a partnership under Treas. Reg. 1.7701-3. Rev. Rul. 2004-86 provides guidance regarding whether a trust will be treated as a trust under Treas. Reg. 1.7701-4 or will be classified as a partnership under Treas. Reg. 1.7701-3. Under Section 1031(d), an interest in a partnership does not qualify as good replacement property for purposes of Section 1031. Understanding the differences between a TIC, a DST and a partnership is therefore critical.

A TIC is a non-entity seeking to avoid entity classification. A TIC is a form of holding property which is based on state law (concurrent interests in land), and a TIC seeks to avoid treatment as a partnership.

<sup>9</sup> 337 U.S. 733 (1949).

<sup>10</sup> 42 TC 1067 (1964).

If TIC Interests were treated as interests in a partnership, the like-kind exchange would fail. Because a TIC is not a legal entity, the relationship between the co-owners is governed by a contract. The advance ruling guidelines set forth in Rev. Proc. 2002-22 test whether the relationship between the parties (including co-owners, sponsors, lenders, etc.) resembles a partnership. Decision-making and sharing of profits that more closely resemble a partnership than a co-ownership of real estate may cause the arrangement to be classified as a partnership. The mere co-ownership of property that is maintained, kept in repair, and rented or leased does not, however, constitute a separate entity for federal tax purposes.<sup>11</sup>

A DST is an entity seeking investment trust classification. The most important distinction in analyzing the tax treatments of a DST and a TIC is that the latter involves a determination of whether the relationships and activities constitute a partnership for tax purposes, whereas with a DST, the existence of an entity is assumed, but the entity has to be classified.

The fundamental concept underlying Rev. Rul. 2004-86 is that a DST is an entity for federal income tax purposes that is recognized as separate from its owners. Creditors of the beneficial owners of the DST could not assert claims directly against the property held by the DST. A DST may sue or be sued, and the property of a DST is subject to attachment and execution as if it were a corporation. The beneficial owners of a DST are entitled to the same limitation on personal liability stemming from actions of a DST that is extended to shareholders of a Delaware corporation. A DST may merge or consolidate with or into one or more statutory entities or other entities, such as a partnership, and a DST can be formed for investment purposes. Based on the purpose of, and powers and privileges afforded to, a DST and the beneficial owners thereof, the IRS concluded in Rev. Rul. 2004-86 that the trust was an entity that could not be disregarded for federal income tax purposes. Thus, it was necessary to classify it as either a business entity or a trust.

A partnership is an entity taxed as an entity. It is another means by which individuals can collectively own an interest in real estate. Treas. Reg. 301.7701-1(a)(2) provides that a joint venture or other contractual

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<sup>11</sup> Treas. Reg. § 301.7701-1(a)(2).

arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation or venture and divide the profits therefrom. A partnership, therefore, is an entity seeking to be taxed as an entity for federal income tax purposes. DSTs and TICs both seek to avoid treatment as a partnership.

#### ¶ 1104 FEDERAL INCOME TAX TREATMENT OF TENANCY IN COMMON ARRANGEMENTS

Prior to 2002, the IRS had considered the treatment of TIC Interests in Rev. Rul. 75-374,<sup>12</sup> which concluded that a two-person co-ownership of an apartment building rented to tenants was not a federal tax partnership. In that Ruling, the co-owners employed an agent to manage the apartments on their behalf. The agent collected rents; paid property taxes, insurance premiums, and repair and maintenance expenses; and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The Ruling concluded that the agent's activities were not sufficiently extensive to cause the co-ownership to be characterized as a partnership for federal income tax purposes.

In contrast to Rev. Rul. 75-374 were several court decisions in which a co-ownership arrangement was found to be a tax partnership. For example, in *Bergford*,<sup>13</sup> 78 investors purchased "co-ownership" interests in computer equipment that was subject to a seven-year net lease. The investors authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the investors to decide by majority vote whether to sell or lease the equipment at the end of the initial lease term; absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10% of the equipment's selling price or lease rental whether or not an investor terminated the agreement or the manager performed any remarketing. An investor could assign her interest in the property only after fulfilling numerous conditions and obtaining the manager's consent.

<sup>12</sup> 1975-1 CB 261.

<sup>13</sup> 12 F.3d. 166 (9<sup>th</sup> Cir. 1993).

The *Bergford* court held that the co-ownership arrangement was a partnership for tax purposes. In reaching this conclusion, the court emphasized the limitations on each investor's ability to sell, lease, or encumber either her interest or the underlying property, as well as the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Two other courts reached similar conclusions where a promoter/manager maintained a significant economic interest in the property that was sold to co-owning investors.

In another important decision, *Madison Gas & Electric Company*,<sup>14</sup> the court held that a co-generation operation conducted by three utilities as tenants in common was a partnership for tax purposes because the parties shared expenses and divided the jointly produced property among themselves.

In Rev. Proc. 2002-22, the IRS set forth new ruling guidelines for purposes of determining whether a TIC arrangement involving rental real estate which is treated as a tenancy in common for local law purposes would be treated as the ownership of real estate or a partnership for tax purposes. Rev. Proc. 2002-22 states that these guidelines are to be used solely in assisting taxpayers in preparing ruling requests, and the IRS in issuing rulings, and that they are not intended to be substantive rules or used for audit purposes. The Service ordinarily will not consider a request for a ruling if the conditions provided in Rev. Proc. 2002-22 are not satisfied, although even if all such conditions are met the IRS still may decline to issue a ruling whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration. Investors should recognize that Rev. Proc. 2002-22 does not establish a safe harbor for taxpayers that do not elect to request a ruling. Because most sponsors do not request a ruling, a TIC offering should always include an opinion from reputable tax counsel stating that the TIC Interests should be treated as interests in real property and not as interests in a partnership or a security for federal income tax purposes.<sup>15</sup> Investors and their independent tax advisors should carefully

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<sup>14</sup> 633 F.2d 512 (7<sup>th</sup> Cir. 1980), *aff'd* 72 TC 521 (1979).

<sup>15</sup> Investors should be aware, however, that in accordance with the requirements of Circular 230, most tax opinions bear a legend stating that (i) the opinion of tax counsel is not intended or written to be used, and it cannot be used by any taxpayer for the

review this opinion. Every TIC structure must be closely scrutinized and variations from Rev. Proc. 2002-22 should be carefully analyzed to determine whether the IRS would have a strong argument for classifying the arrangement as a partnership.

A detailed discussion of all of the requirements in Rev. Proc. 2002-22 is beyond the scope of this article.<sup>16</sup> Practitioners, however, are rapidly becoming comfortable with the idea that while several of the requirements in Rev. Proc. 2002-22 are "essential elements" of a TIC arrangement, other requirements are not as critical or can be modified to a certain degree. As a result, sponsors are obtaining favorable opinions from counsel for TIC transactions that satisfy the most essential elements of Rev. Proc. 2002-22 but that may contain variations on minor points.

The key requirements listed in Rev. Proc. 2002-22 are as follows:

1. Tenancy in Common Ownership. Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law.<sup>17</sup> Thus, title to the property as a whole may not be held by an entity recognized under local law. As a practical matter, this means that the IRS will not issue a ruling if the property is held in a state law partnership, even if the partnership elects out of partnership status for tax purposes under Section 761. In a typical TIC offering each investor will hold his or her interest in the property through a single member limited liability company ("SMLLC").

If state law treats limited partnerships more favorably than limited liability companies, most practitioners are comfortable with having interests held by a limited partnership in which 99% of the limited partnership interests are held by the investor and a 1% general partnership interest is held by a

purpose of avoiding penalties that may be imposed under the Code; (ii) the opinion was written to support the promotion or marketing of this transaction, and (iii) each prospective investor should seek advice based on such investor's particular circumstances from an independent tax advisor.

<sup>16</sup> See Richard M. Lipton, "New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges," 96 J. Taxation 303 (May 2002).

<sup>17</sup> Rev. Proc. 2002-22, 2002-1 CB 733.

single member limited liability company that is 100% owned by the investor.

For purposes of determining whether a limited liability company is treated as a disregarded entity or as a partnership for federal income tax purposes, a husband and wife who own property as community property can elect to treat the limited liability company as a disregarded entity under Rev. Proc. 2002-69.<sup>18</sup> The investors must take care to ensure they comply with all of the requirements under Rev. Proc. 2002-69. It is particularly important to determine whether the property is or will actually be held as community property under state law (it is not sufficient that the spouses are from a community property state).

2. Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons.<sup>19</sup>
3. 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). Most TIC agreements contain a specific provision under which an investor covenants not to take such actions. Although not explicitly permitted by Rev. Proc. 2002-22, most practitioners are comfortable that operating the property under a trade name by the tenants in common as tenants in common is permissible.
4. Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. A co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the company, or the lessee at fair market value before

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<sup>18</sup> 2002-2 CB 831.

<sup>19</sup> Rev. Proc. 2002-22, 2002-1 CB 733.



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. Co-owners agreements should comply with these requirements in all material respects.

5. 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.<sup>20</sup>

Most TIC agreements now contain an "implied consent" provision under which each of the co-owners is provided notice of an event (a sale, lease, financing, or reappointment of the property manager), and each co-owner is then given a specified period of time to object (usually 72 hours for a lease, and much longer for a sale, financing, or reappointment of the property manager). If none of the co-owners objects to the proposed action, it is deemed to have been approved. This type of "implied consent" was approved by the IRS in Priv. Ltr. Rul. 200327003. However, it is unclear whether a deemed consent would satisfy the provisions in Rev. Proc. 2002-22.<sup>21</sup> In addition, there is no certainty as to whether the time periods provided under the deemed consent provisions would be acceptable to the IRS.

In addition, although not specifically permitted under Rev. Proc. 2002-22, a number of practitioners are comfortable with the use of leasing guidelines that are narrowly tailored and

<sup>20</sup> Id.

<sup>21</sup> The IRS has issued Priv. Ltr. Rul. 200327003 which permitted a negative consent, (i.e., the provision is approved unless the provision is affirmatively rejected).

approved annually by the tenants in common. Leases entered into in accordance with the leasing guidelines would not require the unanimous consent of the tenants in common. Leasing guidelines are most commonly used in connection with residential rental property where lease terms are likely to be more uniform and predictable (and where unanimous consent to each lease may be difficult to obtain based on the sheer number of leases to be approved). They may also be used in connection with commercial or retail property, but practically it may be difficult to develop sufficiently narrow guidelines for commercial properties in advance because commercial or retail leases are often more heavily negotiated and exhibit greater variation than residential leases. The argument that such leasing guidelines are not inconsistent with the lease approval requirements under Revenue Procedure 2002-22 is that there is no material distinction to an investor approving every lease and having the investor approve leases in advance as long as the criteria for approval are narrow, specific and subject to review and revocation annually.

6. Restrictions on Alienation. Each co-owner must have the right 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 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 before exercising any right to partition.<sup>22</sup>
7. Sharing Proceeds and Liabilities upon Sale of Property. If the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed

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<sup>22</sup> Rev. Proc. 2002-22, 2002-1 CB 733.

to the co-owners.<sup>23</sup>

8. Proportionate Sharing of Profits and Losses. Each co-owner also must share in all revenue generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property, under section 6.08. In addition, "[n]either 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."

The requirement is that the investor that owns a TIC must have recourse liability for any amounts advanced by another TIC or its owner. This provision effectively would mandate that the individuals who own the interests in the single member limited liability company that actually holds the TIC Interest would be personally liable to contribute cash to the single member limited liability company in the event that any other co-owner made an advance to cover operating deficits. As a practical matter, the effect of this provision would be to convert potentially nonrecourse liabilities into recourse obligations. Moreover, most lenders require that the single member limited liability company be a "bankruptcy remote" entity, so that the single member limited liability company is not obligated for the debts of its owner, and vice versa. The individual liability of the owner of the single member LLC would be contrary to the covenants required in most loan documents, so that a choice would need to be made between compliance with Rev. Proc. 2002-22 or compliance with the loan covenants. Because transactions need to comply with lender requirements, this parenthetical is ignored in most TIC transactions in which there is debt financing, particularly if the debt is securitized.

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

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<sup>23</sup> Id.

their undivided interests.<sup>24</sup> This requirement is complied with in most TIC offerings.

10. Options. A co-owner may issue an option to purchase the co-owner's undivided interest, provided that 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.<sup>25</sup> This requirement is complied with in most TIC offerings.
11. No Business Activities. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property. 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 property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners.<sup>26</sup>
12. 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. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The determination of any fees paid by the co-ownership to the manager must not

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<sup>24</sup> Id.

<sup>25</sup> Id.

<sup>26</sup> Id.

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.<sup>27</sup> These requirements are closely observed in most TIC offerings.

It is common for asset management agreements to utilize a deemed consent procedure under which an investor is given notice of his or her right to terminate the agreement annually and consent is presumed if the investor does not reply within a particular time. As this does not reduce the right of an investor to terminate the agreement annually, it is not viewed by practitioners as violating Rev. Proc. 2002-22. Moreover, as noted above, the IRS has approved the use of deemed consent provisions in the past.

One issue that arises in master lease transactions concerns fees for services in helping to market and sell the property at the end of the hold term. Rev. Proc. 2002-22 prohibits a master lessee from providing such services, but an affiliate of the sponsor could do so. This can arguably be accomplished by having the right to provide such services in a separate agreement that is subject to annual renewal. This solution appears to be perfectly acceptable under the terms of Rev. Proc. 2002-22.

13. 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).<sup>28</sup> These requirements are closely observed in most TIC offerings. This provision obviously applies to a master lease in a transaction structured as a master lease. The tax opinion in such a transaction should include an analysis of whether the

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<sup>27</sup> Id.

<sup>28</sup> Id.

master lease qualifies as a true lease for tax purposes.

14. Loan Agreements. The lender with respect to any debt that encumbers the property or with respect to any debt incurred to acquire an undivided interest in the property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the property.<sup>29</sup> This requirement is closely observed in most TIC offerings.
15. Payments to Company. 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.<sup>30</sup>

A major issue in most TIC offerings is whether there is loss sharing, either among the investors, or between the investors and the sponsor or its affiliates and guarantors. Most real property loans are nonrecourse obligations, meaning that the lender can look only to the underlying assets (and not to the borrowers) to recover in the event that the value of the property drops. Most lenders will require that the nonrecourse nature of the loan be disregarded in the event that certain events occur ("nonrecourse carve-outs"). These carve-outs will frequently include:

- Fraud, intentional misrepresentation, or willful misconduct.
- The borrower's amendment, termination, cancellation, modification, or replacement of the tenancy in common agreement without the lender's consent.
- The borrower's filing of a partition action or a lien or other encumbrance against the property.
- The failure to obtain the lender's approval of any subordinate financing or voluntary lien encumbering the property.
- The failure to obtain the lender's approval of any assignment, transfer, or conveyance of the property or any interest in the

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<sup>29</sup> Id.

<sup>30</sup> Id.

property.

- The failure to comply with the provisions of the mortgage loan documents with respect to the leasing of the property.
- A transfer of control of the borrower or its SMLLC not in compliance with the requirements of the mortgage loan documents.
- The SMLLC ceases to be a single-purpose entity.
- The SMLLC files a voluntary petition under the U.S. bankruptcy code or any other state or federal bankruptcy or insolvency law.
- The borrower, its SMLLC, or their affiliates file or acquiesce in the filing of any involuntary petition under the U.S. bankruptcy code or any other state or federal bankruptcy or insolvency law.

The types of remedies that are available to the lender on the occurrence of one of these specified events often will vary. On the occurrence of any of the first three provisions set forth above, the loan documents often will provide that the borrower is liable for any losses incurred by the lender as a result of the event. In contrast, if any of the last seven events occur, the loan documents frequently will provide that the entire loan will become a recourse liability of the offending borrower. This is usually referred to as a "springing recourse" loan, meaning that it becomes a recourse loan only if certain unanticipated events occur.

The first question is whether existence of these nonrecourse carve-outs are inconsistent with the basic requirement that all obligations are shared pro rata amongst the TIC investors. The general view of most practitioners is that the existence of the nonrecourse carve-outs should be disregarded for this purpose because these events are not supposed to ever occur. Otherwise, every loan could be treated as a recourse obligation, even though the likelihood of recourse is so remote as to be negligible.

The second question is the scope of liability the TICs and their investors may have under the nonrecourse carve-outs. An agreement to share losses is a strong indication of a partnership. Ideally, therefore, each TIC and its related investor will only have recourse liability for

his or her own "bad acts". Most practitioners will not give an opinion on partnership status if the investors that own the TICs have liability under the nonrecourse carve-outs, subject to one major exception. Because of the scope of potential liability for owners of property for environmental liabilities, most practitioners will give an opinion even if the investors who own the TICs are jointly and severally liable for environmental liabilities on the theory that the investors already have such liability under existing law. Of course, from a business and marketing standpoint, the investors should try to avoid nonrecourse carve-outs for environmental liabilities.

A more frequent question will involve whether the person who arranged the TIC offering (the sponsor) also can be obligated in the event one of the investors violates one of the nonrecourse carve-outs. A lender who is providing a loan to TIC investors usually knows the sponsor but not the investors, and the lender frequently will be relying on the sponsor to sell interests only to "good" investors who do not violate the loan requirements. Moreover, the sponsor or its affiliate often will serve as the master lessee or property manager, giving the sponsor effective control over the property. If one of the investors turns out to be "bad," the lender likely would want or expect the sponsor to pay for any damages incurred by the lender.

This natural instinct of the lenders has to be overcome, however. Indeed, it is now standard in TIC transactions for each investor to be responsible only for its own actions, and for the sponsor to be responsible solely for its actions and those of its affiliates. Thus, the lender's request that the sponsor be liable for the actions of TIC investors usually will be declined. The only exception to this general rule could involve situations in which the sponsor has failed to perform on its own obligations, e.g., if the sponsor is the property manager, insurance proceeds should never find their way into the hands of the investors, so that a misappropriation by an investor is really the sponsor's fault. Similarly, if the asset manager or master lessee is an affiliate of the sponsor, they are presumably in control of the property and most practitioners are comfortable with the sponsor having liability for theft or waste committed at the property by a TIC.

#### ¶ 1105 KEY ASPECTS OF A DST

In Revenue Ruling 2004-86, the IRS addressed the tax treatment of trusts in very limited situations and held that if an entity is classified as



a fixed investment trust, as opposed to a business entity, for federal income tax purposes, and if the trust also satisfies the requirements of a grantor trust under Section 671, interests in that trust will be treated as interests in the real property owned by the trust for purposes of applying the like-kind exchange rules under Section 1031. Thus, a taxpayer who disposes of real estate in an otherwise qualifying like-kind exchange can acquire an interest in a DST as qualifying replacement property. If, however, the trust is treated as a business entity, interests in the trust will be treated as interests in a partnership, which will not constitute valid replacement property under Section 1031. Rev. Rul. 2004-86 is still the leading guidance on whether beneficial interests in a DST are qualifying replacement property.

### ¶ 1105.1 The Trust and the Lease

In Rev. Rul. 2004-86, an individual (John) borrowed money from an unrelated bank and signed a ten-year, interest-bearing, nonrecourse note. John used the loan proceeds to purchase rental real property (Blackacre), which was the sole collateral for the loan from the bank.

Immediately thereafter, John “net” leased the property to Mary for ten years.<sup>31</sup> Under the terms of the lease, Mary was required to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, she was required to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. Mary was free to sublease Blackacre to anyone she chose.

The rent paid by Mary to John was a fixed amount that could be adjusted by a formula described in the lease agreement that was based on a fixed rate or an objective index, such as an escalator clause based on the Consumer Price Index, but adjustments to the rate or index were not within the control of any of the parties to the lease. The rent paid by Mary was not contingent on her ability to lease the property or on her gross sales or net profits derived from Blackacre.<sup>32</sup>

<sup>31</sup> The Ruling did not indicate whether John was related to Mary, but given that the IRS stated that Mary was not related to persons described in the Ruling other than John, it can be assumed that she may be related to him.

<sup>32</sup> Although the lease from John to Mary is described in the Ruling as a “net” lease, it is not clear whether the lessor or the lessee would be required to make capital improvements or major repairs to the property. Thus, the lease might be “double net,”

On the same date that John acquired Blackacre and leased it to Mary, John also formed a DST ("the trust") to which he contributed fee title to Blackacre after entering into the loan with the bank and the lease with Mary. The trust assumed John's rights and obligations under the loan from the bank as well as under the lease with Mary. In accordance with the nonrecourse nature of the note, neither the trust nor any of its beneficial owners were personally liable to the bank for the loan, which continued to be secured by Blackacre.

The trust agreement provided that interests in the trust were freely transferable, although the interests were not publicly traded on an established securities market. The trust was to terminate on the earlier of ten years from the date of its creation or the disposition of Blackacre, but would not terminate on the bankruptcy, death, or incapacity of any owner, or the transfer of any right, title, or interest of the beneficial owners of the trust. The agreement further provided that interests in the trust would be of a single class, representing undivided beneficial interests in the assets of the trust (i.e., Blackacre).

Rev. Rul. 2004-86 does not indicate whether the trustee was an individual or an institution, although it expressly states that the trustee was not related to the bank or the lessee of the property. Under the trust agreement, the trustee was authorized to establish a reasonable reserve for expenses incurred in connection with holding Blackacre that might be payable out of the trust's funds.

All available cash less reserves had to be distributed quarterly to each beneficial owner in proportion to their respective interests in the trust. In addition to the right to a quarterly distribution of cash, each beneficial owner had the right to an in-kind distribution of its proportionate share of the property of the trust.

The trustee was required to invest cash received from Blackacre between each quarterly distribution. All cash held in reserve had to be invested in short-term obligations of (or guaranteed by) the U.S., or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee was permitted to invest only in obligations

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in which the lessor remains liable for certain capital improvements and repairs (such as repairs to the roof), instead of a "triple net" lease in which the lessee is responsible for the property in all events.

maturing prior to the next distribution date, and was required to hold such obligations until maturity.

The agreement provided that the trustee's activities were limited to the collection and distribution of income. The trustee could not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) for the trust from the beneficiaries. The trustee also could not renegotiate either the terms of the debt used to acquire Blackacre or the lease with Mary, or enter into leases with tenants other than Mary except in the case of Mary's bankruptcy or insolvency.

In addition, the trustee was permitted to make only minor, non-structural modifications to Blackacre, unless otherwise required by law. The agreement further provided that the trustee could engage in ministerial activities to the extent required to maintain and operate the trust under local law. Finally, the trustee did not enter into a written agreement with John, or indicate to third parties, that the trustee (or the trust) was his agent.

Immediately after John formed the trust, he conveyed his entire interest in the trust to Dick and Jane in exchange for interests in Whiteacre and Greenacre, respectively. Dick and Jane were not related to the lending bank or to Mary (the lessee of Blackacre), and neither the trustee nor the trust was an agent of Dick or Jane. John did not claim that his exchange qualified as a like-kind exchange under Section 1031 (which would be difficult for him to do because he did not acquire Blackacre for investment or for use in a trade or business). Dick and Jane, however, desire to treat the interests in the trust that they acquire as replacement property in a like-kind exchange for their relinquished properties, Whiteacre and Greenacre, respectively.

### ¶ 1105.2 Classification

The fundamental concept that underlies Rev. Rul. 2004-86 is that a DST is an entity for federal income tax purposes that is recognized as separate from its owners. Creditors of the beneficial owners of the DST could not assert claims directly against the property held by the DST. A DST may sue or be sued, and the property of a DST is subject to attachment and execution as if it were a corporation. The beneficial owners of a DST are entitled to the same limitation on personal liability

any additional contributions of assets (including money) for the trust. The trustee could not renegotiate the terms of the debt used to acquire Blackacre and could not renegotiate the lease with Mary or enter into leases with tenants other than Mary except in the event of her bankruptcy or insolvency. In addition, the trustee could make only minor non-structural modifications to its property except to the extent required by law.

The limited power of the trustee was, in the Service's view, the key to distinguishing this situation from Rev. Rul. 78-371.<sup>35</sup> In that Ruling, a trust was classified as a business entity because the trustee had powers unrelated to the conservation of the trust's assets. In Rev. Rul. 2004-86, however, the trustee had none of the powers that would indicate an intent to carry on a profit-making business. Because all of the interests in the trust were of a single class representing undivided beneficial interests in the assets of the trust, and because the trustee had no power to vary the investment of the beneficiaries of the trust so as to benefit from fluctuations in the market, the trust was classified as a trust under Treas. Reg. 301.7701-4(c)(1).

### ¶ 1105.3 Using Trust Interests in a Like-Kind Exchange

The next question considered in Rev. Rul. 2004-86 was whether the purchase of interests in the trust by Dick and Jane would be treated as an acquisition of interests in the real property (Blackacre) owned by the trust (in exchange for their interests in Whiteacre and Greenacre that were conveyed to John). The IRS indicated that this analysis was to be made under the grantor trust provisions.

Section 671 provides that, where the grantor or another person is treated as the owner of any portion of a trust, the taxable income and credits of the grantor or the other person will include those items of income, deduction, and credit of the trust that are attributable to that portion of the trust to the extent that the items would be taken into account in computing taxable income or credits against the tax of an individual.

Under Treas. Reg. 1.671-2(e)(1), a grantor includes any person to the extent such person either creates a trust or directly or indirectly

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<sup>35</sup> 1978-2 CB 344.

makes a gratuitous transfer of property to a trust. Treas. Reg. 1.671-2(e)(3) provides that "grantor" includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in an investment trust. Under Section 677(a), the grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is (or, in the discretion of the grantor or a non-adverse party, or both, may be) distributed or held or accumulated for future distribution to the grantor or the grantor's spouse. A person that is treated as the owner of an undivided fractional interest of a trust (under Section 671) is considered, for federal income tax purposes, to own the trust assets attributable to that undivided fractional interest.

In Rev. Rul. 2004-86, IRS determined that Dick and Jane should be treated as grantors of the trust under Treas. Reg. 1.671-2(e)(3) when they acquired their interests in the trust from John, who had formed the trust. Because Dick and Jane have the right to distributions of all the income of the trust attributable to their undivided fractional interests, they are treated under Section 677 as the owners of an aliquot portion of the trust, and all income, deductions, and credits attributable to that portion would be includable by Dick and Jane in computing their taxable incomes. Because the owner of an undivided fractional interest of a trust is considered to own the trust assets attributable to that interest for federal income tax purposes, Dick and Jane were thus each considered to own an undivided fractional interest in Blackacre for federal income tax purposes.

Based on this reasoning, the IRS then concluded that the exchange of real property (Whiteacre and Greenacre) by Dick and Jane for an interest in the trust was the exchange of real property for an interest in Blackacre, and not the exchange of real property for a certificate of trust or beneficial interest under Section 1031(a)(2)(E). Because the properties exchanged were of like-kind, and assuming that the other requirements of Section 1031 were met by Dick and Jane (e.g., they held Whiteacre and Greenacre for investment or for use in a trade or business, and they timely identified and acquired interests in the trust as replacement property), the exchange of real property for an interest in the trust qualified for nonrecognition of gain or loss under Section 1031. Moreover, because the trust was a grantor trust under Section 671, the outcome to the parties would have been the same even if John had transferred interests in Blackacre to Dick and Jane, who then

immediately contributed their interests in Blackacre to the trust.

#### ¶ 1105.4 Impact of Revenue Ruling 2004-86

The grantor trust aspect of Rev. Rul. 2004-86 is quite helpful to taxpayers. For years, many practitioners had been hesitant, for purposes of completing a Section 1031 exchange, to treat an interest in a grantor trust the same as an interest in the property owned by the trust. The limited guidance concerning what constituted a “certificate of trust or beneficial interest” under Section 1031(a)(2)(E) led to fear that the IRS could assert that an interest in a grantor trust was not the same as an interest in the underlying assets of the trust.

Moreover, Section 671 does not explicitly state that the taxpayer holds property held by a grantor trust—it just treats the grantor as the owner of assets of the trust for purposes of computing the grantor’s taxable income. Accordingly, some practitioners were concerned that the acquisition of replacement grantor trust interests might not satisfy the “held for” requirement in Section 1031(a)(1). Rev. Rul. 2004-86 puts these fears to rest by expressly stating that the interest of a grantor in a grantor trust will be treated the same as the ownership of the underlying property held by the trust. As a result, taxpayers can acquire property by obtaining an interest in a grantor trust or, in the alternative, they may transfer property to a grantor trust immediately after its acquisition without any fear that the IRS will assert that Section 1031(a)(2)(E) applies.

The use of a grantor trust in such situations, however, requires that the ownership interest that is acquired is in a trust (within the meaning of Treas. Reg. 301.7701-4(c)) and not in a business entity. The IRS expressly warned in Rev. Rul. 2004-86 that it would have reached a completely different conclusion if the trustee had been given additional powers under the agreement. Specifically, the trust would have been classified as a business entity (under Treas. Reg. 301.7701-3) if the trustee had been given the power to do one or more of the following:

- (1) Dispose of Blackacre and acquire new property.
- (2) Renegotiate the lease with Mary.
- (3) Enter into leases with tenants other than Mary (except in the case of Mary’s bankruptcy or insolvency).
- (4) Renegotiate the obligation used to purchase Blackacre.

- (5) Refinance the obligation used to purchase Blackacre.
- (6) Invest cash received to profit from market fluctuations.
- (7) Make more than minor nonstructural modifications to Blackacre that were not required by law.

If the trustee had the power to commit any one of these “seven deadly sins,” or if the trustee could vary the investments of the trust (for example, by obtaining additional property or money from the beneficiaries), the trust would have been classified as a business entity. Furthermore, because the assets of the trust would not be owned by the beneficiaries as co-owners under state law, the trust would not be able to elect out of Subchapter K under Section 761.<sup>14</sup>

The limitation on the *powers* of a trustee of a trust is a very important aspect of Rev. Rul. 2004-86. It is not sufficient that the trustee never commits one of the “seven deadly sins” that would cause classification of the trust as a business entity—the trustee must lack the power to undertake those actions. This aspect of Rev. Rul. 2004-86 is consistent with the case law in which a trust is classified in accordance with the powers that the trustee has under the trust agreement and without regard to what actions, if any, the trustee has performed other than to conserve and protect the property of the trust.

It must be emphasized that there is no relationship between the requirements that apply to a DST and the requirements that apply to a TIC. Each involves multiple ownership of property for purposes of a like-kind exchange, but there the relationship stops. A DST is an entity that seeks to be disregarded for tax purposes (because it is classified as a trust), whereas a TIC involves a non-entity owned by multiple persons (tenants in common) who are seeking to avoid partnership classification. It is easy to think that a DST must satisfy the requirements of Rev. Proc. 2002-22, and that Rev. Rul. 2004-86 somehow applies to a TIC arrangement, but that simply is not accurate.

Nevertheless, it still is necessary to avoid classification of a DST arrangement as a partnership. The owners of beneficial interests in a DST could be treated as partners if there were unequal sharing, for example, or if the sponsor were somehow subject to their obligations. Thus, if the lender with respect to a DST transaction wanted to impose recourse liability on the sponsor as a result of violations by the owners of beneficial interests, the question would arise whether there was

improper risk shifting that could give rise to a partnership. The issues that arise in structuring a TIC interest—to prevent a partnership from arising—apply in the DST context, even if Rev. Proc. 2002-22 does not.

Even though DSTs have been approved by the IRS, the limitations provided in Rev. Rul. 2004-86, particularly the seven deadly sins, will make it difficult to use a DST in many situations. Because a DST is a separate legal entity that holds fee title to the property, it is more “efficient” from a lending perspective than a TIC arrangement (where there are multiple owners of interests in the property), so that a DST could be useful. As a practical matter, however, the beneficiaries of a DST are not permitted to contribute any funds to the DST to address the routine financial needs that arise in connection with the ownership and operation of rental properties. As a result, the DST is most useful for holding real estate investments where additional capital is not needed, e.g., a triple net lease to a “credit tenant”<sup>15</sup> (such as a Wal-Mart store) or an investment in land that is then leased to a user (e.g., a long-term ground lease).

Even where it is not expected that any additional funding will be needed, bad events can arise (who would have thought that Enron or Arthur Andersen would collapse?). To address these situations, most DSTs contain a “lifeboat” provision—if the assets of the DST are imperiled due to unexpected circumstances, the trustees of the DST are authorized to contribute the assets to a partnership or LLC (often referred to as the “kickout LLC”) and then distribute assets in the kickout LLC to the beneficiaries in liquidation of the trust.<sup>16</sup> This approach appears to be consistent with both the letter and spirit of Rev. Rul. 2004-86, and it is also consistent with prior rulings from the IRS in which a trust was permitted to contribute its assets to a corporation and then distribute the corporate stock in liquidation. No authorities expressly permit this provision in a DST, although it has become quite common.

What about using a DST to hold a typical commercial property? Some practitioners have structured transactions in which a commercial property is made subject to a long-term master lease (to the sponsor or its affiliate), and then the property is contributed to a DST. These transactions are not for the faint of heart, however, because if any capital needs arise with respect to the property, there is no way to obtain the needed funds without terminating the DST. Moreover, if the



sponsor wants to make the capital investment needed for the property, it could probably do so in its capacity as a master lessee, but because the master lease cannot be altered, there is no way for the sponsor to ever get its additional investment back. As a result of these practical considerations, most sponsors have concluded that a DST is best suited for ground leases or property subject to a long-term triple-net lease to a credit tenant, where no additional funds are required.

#### ¶ 1106 TICs v. DSTs — A DIFFERENT SET OF RULES

As discussed above, the requirements for TICs and DSTs are not one and the same. Rather, the Service has issued separate guidance for TICs and DSTs, and, in the authors' view, the rules for each are mutually exclusive. The following discussion highlights some of the major differences that should be considered to determine whether interests in a TIC or DST (if either) will be appropriate given an individual investor's needs.

##### ¶ 1106.1 Number of Co-Owners

Rev. Proc. 2002-22 technically provides that the TIC structure be limited to no more than 35 owners. In Rev. Proc. 2002-22, the Service was concerned that a co-ownership arrangement may be so large as to indicate some type of business entity present in a situation where one was not legally formed. This 35-owner limitation is primarily relevant for purposes of obtaining a ruling under Rev. Proc. 2002-22, as there is no direct substantive legal basis for it. Nevertheless, it is always safer to abide by the guidelines than to disregard them.

Despite a 35-owner limitation in a TIC offering, no such limitation exists on the number of beneficial owners of a DST. Because a DST involves only the passive holding of real estate, beneficial owners may not need to be as concerned with a large number of co-owners. Despite the fact that there is no explicit limit on the number of beneficial owners of a DST, the Securities Exchange Act of 1934 provides that companies with more than \$10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports. Therefore, for all practical purposes, a DST may not have more than 500 beneficial owners.

**¶ 1106.2 Decision-Making**

TIC investors must retain certain rights, such as the right to hire any manager, sell or otherwise dispose of the property, lease a portion or all of the property (though leasing guidelines, if unanimously approved, may be used) and refinance the property. Such decisions must be made by unanimous approval of the TICs. For all other actions, the TICs may agree to be bound by the vote of those holding more than 50% of the undivided interests in the property. Many TIC agreements will contain "deemed consent" provisions where co-owners are given notice of a renewal of management agreement, lease, or other event which requires consent, and if none of the co-owners object, they are deemed to have consented. The Service allowed such deemed consent in Priv. Ltr. Rul. 200327003 with regard to the renewal of the management agreement. Similarly, the Service, in Priv. Ltr. Rul. 200513010, allowed the approval of leasing guidelines, under which the co-owners annually approve the form of lease and rental guidelines. Such leasing guidelines permit the property manager to enter into certain leases without seeking approval from the co-owners for each lease.

In a DST, all decisions concerning a trust and the property owned by the trust are made by the trustee; the beneficiaries have no decision-making power. This lack of power is required to support its trust status.

In this respect, TICs and DSTs are polar opposites; a TIC requires maximum decision-making authority be afforded to co-owners, whereas a DST provides no decision-making power to its beneficial owners.

**¶ 1106.3 Management and Leases**

In a TIC structure, the TICs may hire a property manager (by unanimous vote) to manage the property on their behalf. A manager cannot be hired for a period in excess of one year, and the co-owners cannot grant a global power of attorney.<sup>36</sup>

The trustee of a DST, on the other hand, can enter into a long-term management agreement for a manager of the property, provided that the management agreement does not involve a sharing of net income or

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<sup>36</sup> Id.

loss (which could result in a deemed partnership between the DST and the manager).

Unanimous approval is required for leases in a TIC, but leasing guidelines may be approved (which provide deemed consent for certain leases which comply with the guidelines). As noted above, the use of such leasing guidelines was approved in Ltr. Rul. 200513010. In addition, in a TIC a lease cannot be entered into with a co-owner.<sup>37</sup>

In a DST, the trustee may not renegotiate the leases or enter into new leases. To do so would be a violation of Rev. Rul. 2004-86. Thus, properties in a DST are commercial properties subject to long-term leases. In a TIC, however, residential rental properties with much shorter term leases are just as common as commercial properties.

#### ¶ 1106.4 No Business Operations

Rev. Proc. 2002-22 provides that co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). Activities are customary for this purpose if they would not yield income that is not treated as rent under Section 512(b)(3)(A), i.e., the income would not be unrelated business taxable income. The practical effect of this requirement is that rent cannot be based on the net income of any tenant, although participating rent is permitted if it varies on the basis of a fixed percentage of the *gross* receipts of a tenant.

With regard to DSTs, the beneficial owners are not permitted to engage in any activities whatsoever. The DST structure can generally only be used for the passive holding of rental real estate. The trustee of a DST cannot lease, improve, or re-finance the property, but rather acts in the role of recipient of rental payments.

### ¶ 1107 TICs — ADVANTAGES AND DISADVANTAGES

#### ¶ 1107.1 Veto Powers v. Call Rights

In a TIC, many decisions, such as the sale of the property, renewal of the management agreement, and leasing of the property require

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<sup>37</sup> Id.

unanimous approval of the other TICs (although, as discussed herein, the Service has allowed certain deemed consent provisions). The requirement of unanimous approval essentially gives each TIC veto power over the other TICs, at least for certain major decisions. Other decisions only require a majority vote of the TICs. This veto power allows TICs to retain some control in a co-ownership structure; while the TICs will not have the unfettered control of fee ownership, such veto powers ensure that major decisions will not be made without each individual TIC's approval. This veto power is balanced by the implementation of a call agreement in most TIC structures. The TICs will usually enter into a call agreement which will generally provide that if a majority of TICs, but not all the TICs, approve a decision that requires unanimous approval, then the other TICs may issue a call for the interests of the dissenting TICs. Rev. Proc. 2002-22 allows a co-owner to grant a call option to any other person, provided that the purchase price under the call option reflects the fair market value of the property determined at the time of the call.

#### ¶ 1107.2 Liquidity v. Burden on Other Co-Owners

TIC structures involve restrictions on alienation. In general, TICs must have the right to transfer, partition, and encumber the TIC's interest in the property without the agreement or approval of any person. 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. While TIC interests can be considered relatively illiquid in that TICs, the sponsor or the lessee may have a right of first offer to purchase the TIC Interest. And a co-owner may agree to offer its TIC Interest for sale to the other co-owners, the sponsor or the lessee at fair market value before exercising any right of partition, with fair market value to be determined as of the time the partition right is exercised.

Subject to the right of first offer that is common in most TIC structures, if one co-owner decides to sell, the burden is placed on the other co-owners to buy him out. In addition, TICs must share pro rata in both the revenue and costs associated with the property. If a co-owner experiences financial instability and cannot meet his share of cost responsibilities, the other co-owners will have to bear that burden.

**¶ 1107.3 Non-Abusive Form of Ownership**

A TIC is a non-abusive form of ownership based on the fact that TICs cannot exercise their rights to the detriment of other TICs. The right of first offer essentially eliminates the possibility that a TIC may coerce other TICs into taking certain actions by threatening to sell to an undesirable or unknown party.

From a tax perspective, Rev. Proc. 2002-22 requires the TIC co-owners to share pro rata in all revenues and costs associated with the property. A non-pro-rata sharing of costs or benefits of the operation of the property would be evidence of a partnership arrangement rather than a mere co-ownership of real property. The pro rata sharing of costs and expenses is an essential element of a TIC. Special allocations of profits, losses, costs or expenses are factors that could lead to a determination that an arrangement is a partnership, and not a TIC. Thus, there is no possibility of using abusive special tax allocations in a TIC.

**¶ 1107.4 No Carry**

Sponsors may not have a carried interest in TICs and DSTs. The presence of a carried interest is a factor that could lead to a determination that the arrangement is really a partnership, as opposed to a TIC or DST. One advantage to using a REIT or real estate fund roll-up structure, as discussed later in this article, is that sponsors may have a carried interest. A carried interest can serve as performance-based compensation for the sponsor, which may tend to better align the interests of investors and sponsors. A carried interest could also potentially cause a conflict of interest between the sponsor and the investors, since the sponsor's compensation will depend on the performance of the REIT or fund.

**¶ 1107.5 Interests Tailored to Smaller Investors**

TICs can provide a means for smaller investors to purchase property that would otherwise be unaffordable. A taxpayer may be financially unable to purchase an office building outright, but he may be able to join together with others and purchase an interest in the building as tenants in common with the other owners. This potentially provides a means for taxpayers who routinely engage in Section 1031 exchanges to diversify the type of properties they invest in.

However, even though taxpayers can make smaller investments to acquire TIC Interests in properties they would not otherwise be able to acquire, the TICs must still be prepared to conduct adequate due diligence with respect to the property. In the case of a larger and more complex property, the due diligence will likewise be more expensive and time-consuming (if adequately conducted). And investing with other owners (especially other owners a taxpayer has likely never met) can carry its own risk. TICs generally have no idea as to the financial stability of the other TICs. And because many decisions require unanimous consent, dissenting TICs can easily create more hassle for the other TICs. A well-drafted call agreement can serve to eliminate some of the difficulties, but the fact is that a TIC Interest merely carries with it certain burdens that fee ownership does not.

Another potential disadvantage of an investment in a TIC is the relative lack of diversification. Most TIC structures will involve, at most, a couple of properties. While individual investors can diversify their own TIC portfolio, each sponsored TIC offering will not offer much diversification.

## ¶ 1108 DSTs — ADVANTAGES AND DISADVANTAGES

### ¶ 1108.1 A Fixed Investment

Section 301.7701-4(c)(1) provides that an “investment” trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power to vary the investment of the certificate holders.<sup>38</sup> A power to vary the investment of the certificate holders exists where there is a managerial power, under the trust agreement, that enables a trust to take advantage of variations in the market to improve the investment of the trust.

The existence of a power to sell trust assets does not always give rise to a power to vary the trust’s investments. The courts and Service have concluded that even though a trustee may possess the power to sell

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<sup>38</sup> Rev. Rul. 2004-86, 2004-33 IRB 191.

trust assets under certain limited circumstances, such a trust arrangement can still qualify as an investment trust classified for federal income tax purposes as a trust.<sup>39</sup>

Thus, DSTs offer a fixed investment to its beneficial owners. On the one hand, a relatively safe investment that is not likely to significantly decrease in value. On the other hand, the DST structure severely limits the ability of investors to deal with the property and to take advantage of the market to increase or improve on the investment.

### ¶ 1108.2 Kick Outs

In the event that a property becomes unsuitable for the purposes of a DST, the trustee may elect to contribute or “kick out” the assets to a partnership or LLC and the kick out entity will then distribute the assets to the beneficiaries in liquidation of the trust. There is no direct authority to permit such kick out provisions in a DST, although they have become fairly common in DST structures. Kick out provisions allow the trustee to ensure that the DST will not fail to be treated as a DST under Rev. Rul. 2004-86.

A kick out event will clearly alter the value of a beneficial owner's interest in the DST. Less properties in the trust will result in a lower rate of return. The properties that are kicked out will be distributed to the beneficial owners, which may result in tax recognition to those owners. A kick out may limit the ability of investors to use a like-kind exchange as an exit strategy.

### ¶ 1108.3 Lack of Control

Beneficiaries of a DST do not have any say in the operations or control of the trust's investment operations. Their role is to receive the distributions in accordance with the trust's terms. The trustee has the power to “protect and preserve” the property for the beneficial owners. This lack of control can be viewed positively or negatively, depending on the investor. On the one hand, a lack of control means the owner's investment is truly in someone else's hands. On the other hand, the owners do not have to concern themselves with managing the property or voting on any decisions. Beneficial ownership in a DST is truly a passive investment.

<sup>39</sup> Rev. Rul. 78-371, 1978-2 C.B. 344.

**¶ 1108.4 Multiple Properties and Master Leases**

DSTs, unlike TICs, are not concerned with holding multiple properties. A DST may theoretically hold any number of properties. One concern is how to manage all of these properties (especially given the lack of control that is inherent in a DST). One solution that has arisen in the industry is the use of a master trust DST structure. In that case, the beneficial owners own interests in a master trust, and the master trust owns multiple "property level" trusts which each hold an individual property. This results in a sort of centralized management that eliminates some of the control problems inherent in holding multiple properties.

One of the biggest advantages DSTs have over TICs is the fact that a DST can have up to 500 beneficial owners/investors, whereas a TIC is technically limited to 35 owners/investors. A DST is also most beneficial where there is a triple-net lease to a credit-worthy tenant, and where no capital expenditures or significant improvements are required with respect to the property.

**¶ 1109 INDUSTRY PROBLEMS**

As discussed by Terry Cuff in his "Ticky Tacky TIC" article, there are some noticeable problems in the like-kind exchange industry, much as in any industry.

**¶ 1109.1 Sponsor Fees**

Under Rev. Proc. 2002-22, the amount of any payment to the sponsor for the acquisition of the co-ownership 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. Sponsors in the like-kind exchange industry take fees for the syndication of these deals. Taxpayers must consider whether the fees and expenses of a TIC transaction, specifically fees to the sponsor, will outweigh the potential tax benefits. The like-kind exchange industry, however, is constantly growing, and much like any other industry, it is logical to presume that increased competition will regulate, and even push down, sponsor fees.

**¶ 1109.2 Poor Structuring**

There is a (valid) concern that some syndicated like-kind exchanges



may be poorly structured. The TIC rules provide some guidance regarding how TICs should be structured. The investor should conduct its own due diligence, prior to investing, to ensure that the TIC is properly structured. The investor should carefully review the tax opinion accompanying the offering. The tax opinion should contain a section analyzing the extent to which the TIC Interest complies with Rev. Proc. 2002-22 (in the case of TICs) or Rev. Rul. 2004-86 (in the case of DSTs). The tax opinion should discuss any areas of noncompliance and their significance. As discussed above, although practitioners generally agree that in the case of TICs, some variations from Rev. Proc. 2002-22 are permissible, the tax opinion should discuss the variations and why they should not adversely affect the classification of the TIC Interest. A properly structured DST offering should avoid violating any of the "seven deadly sins".

### ¶ 1109.3 Securities Law

The general view among practitioners is that most syndicated TIC Interests are "securities" for purposes of federal and state securities law. More specifically, these TIC Interests are generally viewed as investment contracts, which is any contract, transaction or scheme in which persons invest their money in a common enterprise, with the expectation of profits to be derived predominantly from the efforts of others. Because registering a TIC offering under federal and state securities laws would typically be unduly expensive, TIC offerings generally are sold only to accredited investors and are otherwise structured to qualify for an exemption from registration. TIC Interests are typically sold through registered broker-dealers.

Some practitioners (including the authors of this article) have concluded that a TIC offering may be structured to qualify as a sale of real estate rather than an offering of securities. The structure of such offerings must incorporate significant modifications to the structure of the typical TIC offerings. TIC offerings structured as sales of real estate are sold through real estate brokers and would be subject to the oversight of state real estate regulators. It is generally regarded as important that investors be represented by their own real estate broker rather than dealing directly with a broker representing the sponsor.

One of the challenges facing the TIC Industry is the uncertainty over whether state and federal securities agencies or real estate regulators will assert jurisdiction over TIC offerings. A few states have proposed

or passed legislation attempting to classify TIC Interests either as securities or as real estate, but the issues generally remain unsettled. There is a risk that the Securities and Exchange Commission or state securities agencies will claim that the TIC Interests marketed as real estate actually constitute securities and were sold in violation of securities laws. There is also some risk that state real estate regulators will take the position that TIC Interests marketed as securities are in fact real estate and were sold in violation of state real estate laws. The fact that TIC Interests were sold in violation of securities or real estate laws should not expose investors to any direct liability. However, sponsors who sold such TIC Interests could be subject to substantial claims that could impair their ability to oversee and manage the property. Investors may also have the right to rescind the purchase of their interests and receive the return of their equity. Exercise of rescission rights could cause the offering to fail or force an early sale of the property for a substantial loss.

Classification of TIC Interests as a security, as opposed to real estate, for purposes of federal and state securities laws should not affect their classification as interests in real property for purposes of Section 1031. Section 1031(d) generally prohibits a like-kind exchange of securities. If the IRS were to determine that TIC Interests were securities for Section 1031 purposes, the interest in the TIC or DST would not qualify for Section 1031 purposes, and an investor could recognize gain on the exchange of property for an interest to the extent the fair market value of the interest exceeded the adjusted basis of the relinquished property. The term "security," however, is not defined in either Section 1031 or the Treasury Regulations thereunder. Where the term is defined in other areas of the Code, or in Tax Court cases, it is narrowly defined and such definitions would not likely include interests in a TIC or DST. Thus, whether the TIC Interests will be deemed securities for Section 1031 purposes (which disallows securities to be used as like-kind property) is analyzed separately from whether the interests are securities for federal and state securities law purposes. The tax opinion that accompanies the private placement memorandum should discuss this issue and reach a conclusion that the interests *should not* be securities for 1031 purposes. A tax opinion which does not reach a "should" level opinion or that does not address the securities law issue should be closely scrutinized.

**¶ 1109.4 Overpayment for Interests**

Another valid concern is the effect of potential overpayment for TIC and DST interests. In addition to the costs of the property or properties, TIC and DST investors have the added cost of sponsor fees and other placement-related costs. As a result, TIC Interests are generally sold for an aggregate price that exceeds the appraised value of the property. TIC investors will only recover their investment (apart from current distributions of cash flow from the property) if the property substantially appreciates during the period the investor owns its TIC Interest. This risk is usually prominently disclosed by scrupulous TIC sponsors and investors should make sure they take into consideration any difference between the appraised value of the property and the price at which it is being offered to investors.

**¶ 1109.5 Liability Under Nonrecourse Carve-outs**

An investor who purchases stock or a bond incurs no liability with respect to the activities of the issuer. Limited partners in syndicated real estate funds also generally do not have to execute guaranties for nonrecourse carve-outs. Sponsors have done a good job to date in negotiating to limit the liability of investors under nonrecourse carve-outs or to substitute insurance to cover the same risks. At the present time, whether an investor violates a nonrecourse carve-out is largely within his or her control with the exception of potential environmental liabilities. Nevertheless, investors considering investing in TIC offerings need to clearly understand that there is some potential for personal liability under the nonrecourse carve-outs and should review the final loan documents, and particularly any guarantees, carefully.

**¶ 1110 THE FUTURE****¶ 1110.1 TICs Are Here to Stay**

Barring adverse action by the Service or other legal change, the TIC and DST industry is here to stay and will only grow larger. There is currently approximately more than \$10 billion in equity invested in interests in TICs and DSTs. This number will only continue to increase as investors continue purchasing TIC and DST interests and sponsors continue to sell such interests.

A growing industry is more beneficial for purchasers of interests. As more investors and sponsors continue to infiltrate the TIC and DST market, competition will likely drive down sponsor and placement fees and "bad deals" will sell slowly as more investors come to understand the nuances between a good deal and a bad deal.

### ¶ 1110.2 REITs

One recent change in the industry is the REIT roll-up structure that many sponsors are now including in their planning. The REIT roll-up is a structure designed to permit certain investors who hold tenant in common interests to diversify their interest in a single TIC, or a limited number of TICs, by "rolling up" the TIC Interest(s) into interests in a REIT which holds a multiple property portfolio. The result is a REIT roll-up. Such a structure can be an Umbrella Partnership REIT ("UPREIT"), which is a REIT that owns a controlling interest in an Umbrella Partnership, which in turn owns real estate assets. The Umbrella Partnership is also referred to as an "Operating Partnership," since all or most of the operations take place at the partnership level. The REIT is the general partner of the Operating Partnership, which issues one share of stock for each general partner interest and each limited partnership interest it holds in the Operating Partnership. The other holders of limited partnership units have the right to exchange their units for shares of the stock in the REIT at certain times at a specified conversion ratio. Such exchanges of stock are taxable at the time of the exchange, and therefore taxable income is deferred until the unit holder decides to convert all or part of the units held. If the unit holder retains the units until death, a basis increase eliminates the taxable gain.

### ¶ 1110.3 Real Estate Funds

Another potential roll-up structure is a real estate fund. A real estate fund is a limited partnership in which investors exchange their TIC Interests for limited partnership interests and enter into a partnership agreement with the other partners. A sponsor or affiliate would likely serve as the general partner of the fund, and as such would be responsible for the majority of decisions relating to the fund.

Both REITs and real estate funds have the additional benefit of allowing a carried interest, which may better align the interests of

sponsors and investors. A carried interest is essentially performance-based compensation for the sponsor (who is generally the general partner).

Both the REIT and real estate fund roll-up structures would result in a more passive form of holding real estate than a tenancy in common structure. Unlike the tenancy in common structure, the investors would not be required to make significant decisions with respect to the property and its management.

#### ¶ 1111 CONCLUSION

The maxim "caveat emptor" is as fitting in the TIC and DST industry as in any other. Ticky Tacky TICs exist and investors must conduct due diligence with respect to the purchase of any interest in like-kind exchange property. The industry is rapidly changing and expanding and the best regulation for bad deals and Ticky Tacky TICs is competition. As sponsors become more creative and options for taxpayers conducting like-kind exchanges increase, investors must prepare to take advantage of the marketplace. Education on the requirements of TICs and DSTs is key, as is reliance on an independent advisor. But with proper investigation, interests in TICs and DSTs can be a great investment tool for the right investors.