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No Nervous TIC

April 30, 2007

San Diego real estate investor Jason Kendall and his dad spent 30 years in a tough business: buying, fixing up and managing apartment complexes in Southern California. They bought foreclosures in East Los Angeles, money-losing, problem-plagued buildings in hard-scrabble neighborhoods of Compton and Long Beach and, with their savvy and sweat, transformed them into profitable properties.

Then when they felt timing was right, the Kendalls would sell and trade up, redeploying their equity and profits into more luxurious apartment communities in Pasadena and Arcadia. "But we were only getting a 2% return on our cash, and we still had all the management headaches," recalls Kendall. They were also paying capital gains taxes on the apartments sold.

The TIC Approach

In 2002, the Kendalls met Tim Snodgrass, president of San Clemente-based Argus Realty Investors LP, who introduced them to a then little-known tax-deferral real estate investment strategy called an IRC 1031 Tenant-in-Common (TIC) property exchange. The heart of the investment wasn't new. The 1031 section of the Internal Revenue Code dates back to 1921 when farmers and ranchers could swap adjoining acreage tax free. But the tenant-in-common structure had been created in 1995 by Darryl Steinhouse, a partner with the large San Diego law firm of Luce Forward Hamilton & Scripps.

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Steinhouse's client: TMP Investments, created by two Southern California real estate entrepreneurs—Tony Thompson and Bill Passo. They were seeking to raise \$2.5 million from a small group of investors. The offer? An investment with tax benefits, direct ownership of an institutional-grade commercial property, monthly income and the opportunity to participate in any property or rental cash flow appreciation. TMP sponsored the first TIC offering—co-ownership of the Upland Square Shopping Center east of Los Angeles.

Owning interests in commercial real estate designed to make money was critical. Steinhouse and his clients knew the last thing investors wanted was a circa 1980s tax shelter limited partnership built mainly to create losses and write-offs, not generate income or a return on the dollars invested.

Most of those deals later collapsed in a pile of financial rubble with investors often losing their principal and getting hit with IRS tax disallowances and penalties. Instead, a 1031 TIC investment, as Steinhouse designed it, would allow a real estate owner to sell his property and defer the capital gains tax by buying another property if certain conditions were met.

(Passo went on to form Passco Companies and Thompson co-founded Triple Net Properties, deemed the first two TIC investment sponsors.) By the time the Kendalls met with Snodgrass, seven years after the trailblazing Upland Square Shopping Center TIC investment offering, the IRS had issued a ruling called Revenue Procedure 2002-22. Not a law, it provided guidelines on what a TIC investment had to be and what an investor had to do to qualify for the tax deferral. Thus, a subsector of the real estate industry was formalized, and the timing was fortuitous. "We had sold several of our residential apartment complexes, and we were looking for better returns," says Kendall.

Snodgrass explained the ground rules. An investor could sell his highly appreciated, underperforming real estate and reinvest the entire gain in another investment property. But to execute an exchange and defer the capital gains tax on the sale, the investor has to identify the replacement property within 45 days, then buy it and close on the transaction within 180 days. Snodgrass, a lawyer who later co-founded the Tenant-in-Common Association (www.ticassoc.org) and served as its first president in addition to his Argus role, was quick to point out that the tax-deferral was no slam dunk. If an investor dilly-dallied and didn't close on the replacement property within the six month deadline, which is the heart of the IRC 1031 exchange, he or she would lose the deferral and have to pay the capital gains tax.

But as TICs took root, the question immediately arose: Is this a real estate or securities investment? Do investors buy it through a state-licensed real estate broker or a federally licensed securities broker? There's no hard and fast rule on this. But Argus and the majority of the sponsors insist that the investor receives the most information on the property and has the greatest protection when a TIC is sold by an investment representative or financial advisor licensed and regulated by the National Association of Securities Dealers (NASD).

Indeed, sponsors do not sell TICs directly to investors. They acquire the building and offer co-ownership interests to a maximum of 35 investors. But the sale is made by a registered representative working for an NASD licensed broker/dealer—or again, in some cases by a real estate broker. Almost always the broker/dealer analyzes the investment offerings of a number of sponsors before recommending them to a client. What's more, if the TIC is sold as a security, the investor gets a private



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placement memorandum (PPM), a dry-as-dust legal disclosure document provided by the sponsor that describes in great detail the property, historical performance, risks, fees and costs. Notes Steinhouse of Luce Forward: "The investor gets several different levels of due diligence on the property. The law firm [preparing the PPM] is doing its due diligence. The lender who finances the acquisition does its due diligence.

And the broker/dealer firm is doing its due diligence." Plus, the sponsor acquiring the property has hopefully done due diligence to determine whether the property has the potential to pay off as an investment for the registered representative's client. Meantime, since the offering is a private placement investment, the Securities and Exchange Commission bans sponsors from advertising, promoting or touting a TIC.

Varying Degrees of Success

As with any investment, some TICs are strikeouts, some singles, some grand slams. Kendall says he always tours the property before he invests but, still, his first investment with Argus four years ago in a high-rise office building in Salt Lake City "didn't do so well—an 8% return overall. But then I got a 58% appreciation plus monthly cash flow on Heritage Conference Center in Santa Fe Springs, where we bought 10% of the ownership of that major office center."

He reinvested the proceeds into two Argus Realty Class A office buildings in a Class A location—Buckhead—the upscale shopping and financial center of Atlanta.

"All sponsors have good and not-so-good investments," Kendall says, "but I haven't lost any money yet." He made a 30% return on Triple Net's Xerox Center in Santa Ana after a two-year hold. He also co-owns a build-ing in Richardson, Texas, sponsored by Santa Ana-based Triple Net. "We've had no cash flow for a year and a half, but it looks like we may sell it at a 5% return," he adds.

A few TICs have been busts for investors who have had to pony up extra cash when, for instance, major repairs to a building are needed and the sponsor has not set aside adequate reserves. Or when several large tenants move out and the space cannot be re-leased. "There is no shortage of risks in real estate," says Kendall.

Investors in 1031 TIC programs should do their own homework. Good news: There is seasoned expertise in San Diego.



Bill Exeter, president of Exeter 1031 Exchange Services, is what's known as a "qualified intermediary" or "QI." This service is required in all 1031 transactions. The QI handles all the legal documents and is like an escrow officer, holding the proceeds from the sale of the property until the investor closes on the acquisition of the replacement property. That may sound like a passive role, but Exeter is hardly a shrinking violet. With 21 years in his specialized business, he is a solid source of good advice. Exeter cautions TIC investors not to be swayed by a sponsor's glowing private placement memorandum. "Do not shop based on projected cash flow rates. I've seen clients sit down with this gorgeous PPM and say 'nice property, nice cash flow, nice returns—let's go ahead and buy it.' They do no research."

He insists investors do their due diligence on the property. For example, Exeter says the upfront load or the broker's sales commission, disclosed in the PPM, range from 6% to 8% of your equity investment. "But I've seen them up to 18%, which is ridiculous." Does the sponsor have in-house property management or outsource it? Typically, those fees range from 3% to 5% annually. Exeter says there will always be an asset management fee of 1% to 2% annually to cover the sponsor's research and decisions to hold, sell, change leasing strategies and generally look at the property's "big picture."

Exeter adds: Check the PPM for back-end fees, costs, commissions or clauses and discuss them with the broker selling the property. He also says an investor should "always" have their own tax attorney or CPA, who need to be familiar with TICs,

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review the PPM before making any investment decision. Choosing a qualified intermediary is an important decision, says Exeter. "QIs are not required to be licensed, insured, bonded or regulated. Anyone can set up shop as a QI." He suggests investors ask a sponsor or broker/dealer to recommend a qualified intermediary they respect and then make sure they have a fidelity bond, errors and omissions insurance, and experience. A normal QI fee is a flat \$750 plus a share of the interest income from the funds held. Generally, the QI's share is 30%, but Exeter advises to ask about the split in advance.

Another TIC authority in San Diego is Aubrey Morrow, president of Financial Designs, Ltd., a financial planner who also hosts a radio show on KOGO. A former Marine Corps captain who saw action in Vietnam and an ex-IBM computer sales-man, Morrow says 1031 TICs give investors greater leverage and power than most investments do. "Investors actually hold title to their percentage ownership in the property, not the sponsor. And if the property manager is not performing, the owners can vote to remove him."

Morrow advises real estate investors to diversify their TIC investments. "You've sold your appreciated property in a seller's market, so rather than invest proceeds in one TIC program, own interests in four different institutional properties in areas where it's a buyer's market."

Reluctant to take the leap or worried that you'll miss out on further appreciation? Morrow has a suggestion. "Look at your 1040 tax return, go to schedule E, then line 22 that shows your net income from your rental property. If you have a million dollars in equity in a property and you're taking home \$20,000 a year on it, you're making 2% a year. With a TIC structured by a good sponsor, you can average 6% or \$60,000 a year on your \$1 million, plus the appreciation potential on the property and greater tax benefits."

Like Exeter, Morrow cautions investors to be wary of sponsors projecting more than a 6% annual cash flow in their PPM. "They may be manipulating the projections because people want a higher cash flow."

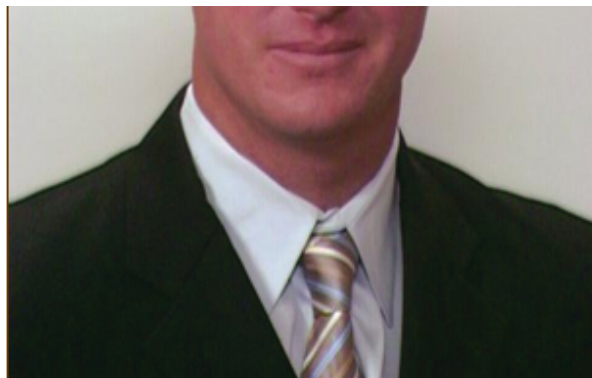
Be wary of hype and take a hard look at real estate economics, advises



Todd Williams, chief marketing officer of Argus Realty Investors. "The housing bubble has burst in many markets, and we're starting to see declines in prices in residential properties and possibly equity gains eliminated," he notes. "This may signal the time to exit an over-appreciated market."

Therefore, a 1031 TIC tax exchange can be a real estate "stop loss," he adds. "You free up your equity, defer the capital gains tax, reinvest in a more stable asset class such as an office building, industrial park or a retail center that may have a higher cash flow, and have greater tax deductions and none of your own time spend on management."

Williams, a lawyer who practiced in San Diego and who is



also a qualified intermediary, says Class A, well-located commercial real estate with 90% to 100% tenant occupancy “can be a good investment hedge, a safety play, plus the cash flow to investors has built in adjustments (in tenant leases) for inflation. He said Argus recently bought the Wachovia Capitol Center office tower in Raleigh, North Carolina for \$153.4 million and more than a dozen pension funds and institutional investors were bidding on it. Says Williams: “A 1031 TIC offering lets the individual investor own a piece of the same building that these giant real estate funds wanted so very badly.”

8 TIC Tips

Weighing an investment in a 1031 Tenant-in-Common property exchange investment is a decision not to be taken lightly. You’re trading full ownership of a hands-on

property for a fractional ownership of a major piece of real estate where decisions are made for you. Here are some TIC tips:

- 1 Get comfortable with having partners you may never meet. A TIC property can have up to 35 investors. As a group, you have final say over how it’s being managed.
- 2 Find out exactly what the sponsor paid for the property you’re investing in, plus fees built into the loaded final property price. Understand all fees and if they’re reasonable. Shop, compare, ask.
- 3 Are the tenants solid businesses—local or national credit? When do the leases expire?
- 4 Does the building generate “phantom income”—money set aside for reserves, tenant improvements, leasing commissions, capital improvements? It’s income to the investors but not a deductible expense. You’ll pay taxes on it.
- 5 How has the property performed historically vs. its first year projected cash flow?
- 6 Is there a projected increase in cash distributions to the investor and what must happen for that to occur?
- 7 What must the property sell for so you can get even on your initial investment, and will the future income support that price?
- 8 How are you, as a TIC investor, protected? Find out your rights and the regulatory agencies involved.

Info provided by David J. Hartness, managing director & real estate principal for 1031 Exchange Properties Inc.

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