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Tenant-in-Common Deals Allow Buyers to Chip In On Commercial Properties

By Jennifer S. Forsyth

Cathy Scullin was in a pickle.

Enticed by high prices, the Beverly Hills, Calif., commercial real-estate broker began selling off pieces of her small southern California real-estate portfolio about two years ago. Only then did she realize she couldn't use the profit to buy another property.

"Everything I found needed an enormous amount of work and, in my opinion, was way overpriced," says Ms. Scullin. If she didn't reinvest in real estate quickly, she would have to pay capital gains taxes on the proceeds.

Her solution: a Tenant-in-Common transaction, where she joined a group of investors who each bought a fractional share of investment property--in this case a small retail center.

TICs--the real-estate version of chipping in for a pizza and then grabbing your own slice--have been around for years, but their popularity soared in 2002 when the Internal Revenue Service said they would be allowed for so-called 1031 Exchangers. That refers to the portion of the U.S. tax code that allows investors to defer capital-gains taxes if they reinvest the proceeds of an investment-property sale in a "like kind" of property within 180 days.

Though it is too early to know if most of these investments will pay off, TICs are proving particularly attractive to baby boomers who invested in real estate years ago but, upon retirement age, are looking to shed the hassles of management, such as spending on upkeep and negotiating with tenants. Investors can get the benefits of property ownership--rental income and profit on any future sale--but leave the day-to-day details to professional managers. "It's something they can understand, it's relatively safe and it produces income that can grow over time," says Marc Paul, president of Los Angeles-based SCI Real Estate Investments, one of the largest TIC companies that match properties and investors. (Graph Insert)

In 2002, about \$550 million flowed into TIC investments, according to the research firm Real Capital Analytics, Inc., based in New York. In 2005, TIC transactions surpassed \$6.4 billion.

As the number of investors and TIC companies increased, so have the blockbuster deals. At least five recent TIC acquisitions topped \$100 million each, according to Real Capital Analytics.

But here is the rub: As with all real-estate investments, TIC property can fail to meet projected returns and investors should perform due diligence as with any piece of property. Real-estate experts also warn that

TIC investors, focusing too narrowly on the tax benefit, may be bidding up prices on marginal deals. Another possible pitfall: If an investor needs to get out before a property is sold, it may not be easy to find a buyer for the share.

Gary Gorman, managing partner of The 1031 Exchange Experts LLC, an investment advisory firm, says his company tracked the case of an apartment complex bought by a TIC two years ago. He says the complex, which he declines to name, was on the market for \$15 million, but was really worth about \$12 million. A TIC company promised to pay the \$15 million, then sold individual shares to investors for a total of \$18 million. "The building is still only worth \$12 million," Mr. Gorman says. "So that property has got to appreciate 50% before those people are going to break even."

Mr. Paul of SCI believes those are isolated incidents, saying his company often finds itself outbid for properties by pension funds or publicly traded real-estate investment trusts. "We're just paying the market rates."

Gilbert Reese, a retire ophthalmologist from Menlo Park, Calif., says his \$750,000 investment in two TIC's in 2001 hasn't worked out. In one of those, he says high-profile tenants emptied out of a Denver-area office building as the tech market soured. A new tenant recently moved in, but he says its rental rate is considerably below the original leases, reducing the likelihood of cash disbursement to the investors for some time. So far, he hasn't found a buyer for his share. Tony Thompson, chief executive of Triple Net Properties LLC, the Santa, Calif.-based TIC investment company that managed the transaction, says that, unfortunately, the building was bought at market peak, but he believes the Denver market is showing signs of recovery.

But Ms. Scullin, the Beverly Hills broker, is happy with her TIC's \$16.8 million investment in a retail center in Rancho Cucamonga, Calif. "It's something I could never dream of owning on my own," says Ms. Scullin, who is now investing in her 12th TIC. Returns for her properties have met projections, she adds, though none of her TIC investments have been sold yet.

Experts say that many investors simply won't know if their TICs will pay off until more properties are put back on the market. Says Harold Hunt, a research economist with the Real Estate Center at Texas A&M University, "We're just not far enough down the line yet to say whether this is a great idea or a bad idea."

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