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Tenancy-In-Common: An Old Dog Learns New Tricks*

By Lawrence H. Jacobson
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I. CONCURRENT OWNERSHIP AND TENANCIES-IN-COMMON

The tenancy-in-common (TIC) has survived into modern times as a method of concurrent ownership of real property. In a TIC, each owner is referred to as a tenant-in-common, and each owns a fractional interest of real property under a separate distinct title. TICs are common where the co-owners are not married or have contributed different amounts to the acquisition of a property. Insofar as each tenant-in-common owns an undivided interest in the entire property, each is entitled to an undivided interest in the revenues from the property, subject to the rights of the other co-tenants.

Until recently, a very popular form of ownership in the context of vacation home-sharing; people used TICs to share the ownership and usage of vacation properties with several other individuals, usually friends or family. In today’s investment marketplace, however, TICs have become popular investment vehicles, allowing groups of investors to acquire fractional interests in large commercial properties. TICs permit co-owners to reap the benefits of real estate ownership without participating in nuances of day-to-day property management.

A. Partition Problems

TICs present many practical and legal issues that individual investors must consider before entering into a TIC arrangement. One disadvantage of a TIC is that the property is subject to a co-owner forcing the sale of the property through a partition lawsuit. A partition action is essentially a complaint stating that the tenants-in-common cannot agree on how to manage the property and that the property should be either split into parts or sold.

Historically, a TIC was not subject to the threat of partition. Courts were reluctant to sever a piece of property through partition, presumably because doing so was something of a draconian measure. While modern law supports the notion that property ownership should be protected, under the laws of most states, including California, a tenant-in-common may now end the TIC by bringing an action for partition to force the sale of the property and distribute the proceeds. A mere desire of one of the owners is sufficient to authorize a court to dissolve the TIC.

B. Death and Probate

Unlike other forms of joint ownership, there is no right of survivorship that transfers a tenant-in-common's interest to the other tenants-in-common upon death. Thus, when one co-owner dies there must be a court-supervised administration of the estate of the deceased co-owner to transfer the TIC interest. This can subject the surviving tenants-in-common to probate court costs and delays.

C. Creditors

In a TIC, a creditor can reach the interest of a tenant-in-common. The creditor may assert liens against a co-owner’s interest in the TIC to satisfy a claim. By acquiring title through a levy on a TIC share, a judgment creditor becomes a tenant-in-common with the debtor-tenant-in-common’s co-tenants.

D. Decision Making

The unities of title, time, and interest of a joint tenancy are not present or required in the creation of a TIC. Only the unity of possession is required. Consistent with that principal, each tenant-in-common possesses the right to choose the highest and best use of the property. Conflict may arise between tenants-in-common regarding decisions to sell, borrow funds, lease, or hire a property manager. Resolving such disputes often requires court action, especially where one tenant-in-common believes the sale of the property is best, and the other tenant-in-common believes maintaining possession of the property is best.

II. LIKE KIND EXCHANGES AND TENANCIES-IN-COMMON

With the high cost of real estate, it has become more difficult for individuals to own quality real estate investments in their entirety. TICs provide an opportunity for individuals to acquire, for a relatively modest sum, a fractional interest in a large, institutional-grade investment property.

Moreover, TIC investments offer significant advantages over interests in real estate partnerships or limited liability companies (LLC). In contrast with a partnership or LLC where the investor merely owns an interest in a legal entity, a TIC investor owns the underlying real property. Thus, a TIC investor can transfer or devise his interest in the property freely.

A. Section 1031

Section 1031 of the Internal Revenue Code enables taxpayers to postpone the recognition of gain upon the sale of certain properties held for trade, business, or investment. The basic requirement of Section 1031 is that the property sold (Relinquished Property) must be exchanged for a “like-kind” property (Replacement Property) that constitutes a direct interest in real property. The term “like-kind” relates only to the nature of the property, and therefore virtually all real property qualifies. In addition, the person or entity selling the Relinquished Property must be the same person or entity purchasing the Replacement Property.

Section 1031 does not view partnerships or LLC interests, to be “like” real estate. Therefore, an interest in real property exchanged for an interest in an entity does not qualify as a like-kind exchange under Section 1031. In a partnership or LLC, the investor merely owns an interest in a legal entity, which in turn
suggests a real estate transaction classified under common law as a form of direct ownership, and owns the real estate. Unlike a partnership or LLC, a TIC is classified under common law as a form of direct ownership, and therefore, an owner of a TIC can use it as Replacement Property to satisfy the like-kind property criteria of Section 1031. Moreover, recent activity by the Internal Revenue Service (IRS) suggests a real estate transaction structured as a TIC will qualify for Section 1031 exchange treatment, provided it strictly adheres to the Revenue Procedure 2002-22.

Though partition, probate, and management problems previously led some investors to own commercial property through a partnership or LLC, the modern-day benefits of Section 1031 have caused many investors holding real property interests in a partnership or LLC to convert to TICs in order to facilitate tax-free exchanges. Moreover, by using the TIC structure, investors maintain the flexibility of deciding individually, rather than as a group, whether they want to pursue tax-free exchanges.

B. The Starker Decision

Prior to 1979, the Internal Revenue Code required parties in like-kind exchanges to transfer property simultaneously. In Starker v. United States, however, the Ninth Circuit allowed "delayed" Section 1031 exchanges to qualify for tax deferral. This gives investors the time necessary to find a desirable replacement property, while still qualifying for like-kind exchange treatment under Section 1031. However, the Replacement Property must be identified on or before the forty-fifth day after the day on which the Relinquished Property is transferred, and it must be purchased no later than the earlier of 180 days after the taxpayer transfers his Relinquished Property, or the due date (with any extension) of the taxpayer's return of the tax imposed for the year in which the transfer is made.

C. Cottage Industry for Tenancies-in-Common

Since the 1990's, a cottage industry of syndicators or "sponsors" companies has developed in order to meet the demand for TIC's as replacement properties in Section 1031 exchanges. Under such arrangements, commercial real estate projects are fractionalized into TIC interests, which are in-turn exchanged with investors seeking Replacement Properties. Sponsors often facilitate, structure, and arrange financing, as well as handle the property management for commercial real estate projects. For example, if a TIC owner sells his interest, in order to obtain the benefits of Section 1031, he has only 45 days to identify a suitable Replacement Property. Alternatively, a TIC owner may contact a sponsor company and purchase a TIC interest in another property, receive income from that property, and reap the benefits of Section 1031 quickly and conveniently.

III. DRAFTING TIC AGREEMENTS: INTERPLAY WITH REVENUE PROCEDURE 2002-22

A Relinquished Property held by an entity, such as a partnership or LLC may be restructured into a TIC in order to effectuate a Section 1031 exchange. A key issue in such a transaction is whether the Relinquished Property was "held for productive use in a trade or business for investment" as required by Section 1031(a)(1), and the IRS may scrutinize pre-exchange transfers in questioning compliance with Section 1031(a)(1). Thus, many tax practitioners suggest spinning the property out of a partnership or LLC and holding it as a TIC for at least one tax return reporting period, in order to attempt to avoid characterization as a sham transaction by IRS.

Once the transaction is complete, a TIC agreement should be adopted to set forth the rights and obligations among the tenants-in-common. Even though the TIC is not considered a separate entity, it is important to have a well-drafted TIC agreement that serves many of the purposes a partnership or LLC agreement would serve. There is often a blurred line, however, between TIC's and arrangements characterized as partnerships for tax purposes. Whether a TIC may be recharacterized as a tax partnership is critical to constructing the exchange. Therefore, it is important to structure TIC agreements in accordance with IRS Ruling Guidelines in order to avoid a TIC arrangement being characterized as a partnership for tax purposes.

Prior to 2002, the IRS had not provided explicit guidelines regarding its treatment of TIC interests under Section 1031. The resulting uncertainty plagued the use of TIC's in Section 1031 exchanges. Companies engaged in marketing replacement properties for like-kind exchanges lobbied the IRS to clarify the law concerning TIC's. The IRS responded with Revenue Procedure 2002-22, which sets forth requirements for provisions that must be contained in a TIC arrangement in order for the IRS to find that the arrangement is a TIC, rather than a partnership, for federal income tax purposes. Although Revenue Procedure 2002-22 is not a "de facto litmus test" to determine whether a relationship is a TIC, it clarifies the steps that TIC investors should take in drafting TIC agreements in order to satisfy their individual Section 1031 exchange requirements.

The IRS Ruling Guidelines have spurred significant growth in the TIC market by enhancing the appeal of TIC arrangements as flexible investment options. Although the IRS may still scrutinize TIC interests to determine whether they should be recharacterized as constructive partnership interests, with the tenants-in-common characterized as partners, the very essence of these Guidelines is the requirement that the investor be treated as a direct owner of real property rather than a mere investor in a business venture that owns real property. The fifteen conditions that form the essential framework for a tax-deferred exchange are as follows:

1. TIC Interest Under Local Law. The TIC interests held by owners must represent co-ownership interests under local law.
2. Number of Co-Owners. The number of TIC owners must not exceed 35 (a husband and wife are treated as a single TIC owner), and all persons who acquire TIC interests from a TIC owner by inheritance are treated as a single TIC owner).
3. No Entity-Like Activities. The TIC owners may not file a partnership or corporate tax return with respect to their arrangement, and may not represent themselves as partnership, shareholders, or members of a business entity.
4. Co-Ownership Agreements Permitted. It is permissible for TIC owners to enter into a TIC agreement, pro-
vided that the agreement complies with the specific Guidelines discussed below.

5. **Voting.** The IRS requires that the following actions be based on 100% unanimity: any sale, lease, re-lease of a portion or all of the property; any negotiation or renegotiation of indebtedness secured by the entire property; and the hiring of any manager, or the negotiation of any management agreement (or extension or renewal of such contract). All other actions with respect to the property can be subject to a majority or super majority vote of the TIC owners. 37

6. **Required Transfers and Partition Rights.** Each TIC owner must have the right to transfer, partition, and encumber his undivided interest in the property without the agreement or approval of any person, provided that (i) a transfer may be conditioned on lender approval (if such loan covenant is consistent with customary commercial lending practice); (ii) rights of first refusal among TIC owners are acceptable; (iii) others may have purchase rights at fair market value before a TIC owner exercises a right of partition; and (iv) other buy-sell provisions are acceptable to the extent discussed in Guideline 10.

7. **Proportionate Sharing of Capital Event Proceeds.** If the property is sold, any debt secured by the property must be satisfied and the remaining proceeds must be distributed to the TIC owners in accordance with their undivided interests in the property.

8. **Proportionate Revenue and Expense Sharing.** TIC owners must share in all revenues and costs associated with the property in proportion to their undivided TIC interests. Loans among co-owners, or from the program sponsor or manager, are not permitted, unless such advances are not for a period exceeding 31 days.

9. **Proportionate Sharing of Debt.** Indebtedness secured by the entire property must be shared in proportion to the TIC owners' respective interests.

10. **Options.** A TIC owner may issue a call option to another TIC owner to acquire his interest as long as the exercise price is at fair market value at the time that the option is exercised (majority premiums and discounts for minority interests are not allowed). A co-owner cannot acquire a put option of his TIC interest to the sponsor, a lessee or lender of the property, or any person related to any of the foregoing.

11. **Passive Operations Required.** The TIC activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property. For example, the TIC owners may not operate a restaurant, bookstore, etc. as part of their TIC arrangement.

12. **Management and Brokerage Agreements.** TIC owners may enter into property management and brokerage agreements, which may not exist more than one year (although they can be renewed). Management and brokerage agreements may be entered into with the program sponsor or another TIC owner, but not a lessee of the property. The management agreement may authorize the manager to maintain a common bank account for the collection of revenues and payment of expenses for the property. Net revenues must be disbursed to TIC owners within three months from the date of receipt. The management agreement may authorize (i) the preparation of management and property reports; (ii) the manager to obtain or modify insurance coverage; and (iii) the manager to enter into and modify leases or debt. However, those actions which require TIC owner approval cannot be undertaken by a manager without first obtaining the requisite approval. Fees paid to the manager cannot be based in whole or in part on the revenues generated from the property, and may not exceed the fair market value of such services.

13. **Leasing Agreements.** All leases must be bona fide leases reflecting the fair rental value for use of the property and respected as leases for federal tax purposes. Rents cannot be based in whole or in part on revenues derived from the property, other than an amount based on a fixed percentage or percentages of receipts or sales.

14. **Mortgage Lender Cannot be a Related Party.** The lender with respect to any debt that encumbers the property as a whole or with respect to any debt incurred to acquire an undivided interest in the property may not be related to any TIC owner, program sponsor, property manager or lessee of the property.

15. **Customary Fees to Program Sponsor.** Payments to the program sponsor must reflect the fair market value of the services they perform, and must not exceed the fair market value of the TIC interest that they sell to purchasers of TIC interest. Any such payments must not be based, in whole or in part, on the income or profits with respect to the property.

It is important to note that these Guidelines do not represent substantive law. A TIC arrangement that fails one or more of these standards nevertheless may be treated as a qualifying TIC interest. Consequently, the Guidelines should be viewed merely as a recommendation for practitioners trying to avoid partnership treatment for their clients' investments. 38

A strict application of these Guidelines poses problems when the TIC is used as a substitute for the limited partnership or LLC in real estate syndicates. The traditional participation in profits of the syndicator/general partner/manager who provides the "sweat" equity does not work in a TIC where everyone owns a direct interest in the property, and invests capital in proportion to their ownership. Frequently those offering TIC investments will try to structure management agreements that afford the managers the same interest in profits that a general partner would typically get in a limited partnership. This, however, flies in the face of Guideline 12, above. Such arrangements must be carefully drafted and investors should satisfy themselves (seeking the advise of independent tax professionals) that the arrange-
ment does not invalidate the TIC and cause it to be treated as a partnership, thus negating the tax-free exchange.

Another problem is the lack of common control and the lack of the ability to waive the right of partition. To a large extent, these issues can be successfully addressed since lenders almost universally require control provisions and waiver of the right to partition. Accordingly, TIC agreements will have provisions that provide these restrictions and waivers as long as the loan is in place. Since the lender is "requiring" these provisions among the investors, the IRS is more likely to allow them since it is a lender requirement.

IV. LENDER ISSUES

Because each tenant-in-common is treated as an individual borrower, investors should anticipate several commonly requested lender requirements. Although beyond the scope of this article to discuss these in detail, investors should expect that the interests will be required to be held in a separate bankruptcy remote special purpose entity (usually a LLC with specific lender required language in the Operating Agreement) and individual guarantees. Thus, investors will have less insulation from liability than in the traditional limited partnership or LLC investment.

V. INTERPLAY WITH SECURITIES LAWS: TENANCY-IN-COMMON OR INVESTMENT CONTRACT?

As with any real property investment, tax issues are only one factor among many to consider when structuring a TIC transaction. Though TIC arrangements consist of real estate interests, an investor must consider whether the sale of a TIC interest constitutes the sale of a security subject to federal and state securities laws. If the TIC interest is characterized as a security interest, it must be registered under applicable securities laws, documented as a sale of a security, and offered for sale and sold by a licensed securities broker.

To answer whether a TIC is subject to securities laws depends on whether it can be characterized as an "investment contract." In SEC v. Howey, the Supreme Court set forth a test to determine whether an investment is subject to regulation by the Securities and Exchange Commission. The Howey Court distinguished between the direct ownership of real estate without involvement in a business venture as a non-securities investment and the ownership of real estate as part of a business venture (large tracts of citrus acreage) as a securities investment regulated under securities laws. The court found that an investment contract exists when individuals invest money in a common enterprise with the expectation of profits to be derived solely from the efforts of others.

TIC interests appear to fall within the ambit of "investment contracts" as defined in Howey because investors depend solely on the labor of third parties who handle the leasing, management, and operation of the acquired property. Although investors have authority to make management decisions, this is probably not sufficient to preclude TIC interests from being characterized as investment contracts. However, even if a TIC interest is deemed an investment contract, and therefore subject to federal securities laws, registration under the Securities Act of 1933 can be avoided if the transaction is a private placement pursuant to Regulation D. In order to qualify for the Regulation D exemption, the TIC sponsor must make no general solicitation such as advertising in newspapers or other media, or at any meeting where the participants have been invited by general solicitation. In addition, a preexisting relationship should exist between the TIC sponsor and the TIC-seeking investor so that the sponsor can evaluate the investors' sophistication.

Moreover, investors can avoid registration under the securities laws in the state of California by using the Private Placement Exemption under Section 25102(f), Cal. Corp. Code. A key requirement for Section 25102(f) is that the offer and sale of the TIC interest should not be accomplished through general solicitation. Moreover, the sale must not be made to more than 35 persons, and all TIC-seeking investors must have a pre-existing personal or business relationship with the TIC sponsor.

VI. INTERPLAY: SUBDIVIDED LANDS ACT

In California, individuals marketing TIC interests must also consider whether a TIC is subject to the requirements of the Subdivided Lands Act. The Subdivided Lands Act was promulgated to protect real estate buyers from fraudulent transactions with unscrupulous land developers. It requires approval from the Department of Real Estate (DRE) prior to sale, lease, or offer of a subdivision. The definition of subdivision is broad, and includes lands in which five or more undivided interests are created. Thus, TIC arrangements may be characterized as legal subdivisions, and subject to the reporting requirements of the Subdivided Lands Act. An exemption is available for undivided interests to be purchased by no more than ten persons, if each purchaser furnishes a signed statement to the DRE commissioner attesting that he or she understands the risks involved in ownership, is purchasing without the intention to resell the interest, and waives protections afforded under the Act.

VII. CONCLUSION

Despite the complexity and risks involved in TIC transactions, TICs are a practical and efficient means for real estate investors to defer capital gains tax through the use of a Section 1031 exchange. TIC investments can offer huge advantages to investors seeking to invest in substantial properties through a tax-free exchange. Investors must carefully consider the separate aspects of such transactions, examining the legal issues involved in managing these properties under TIC agreements.

* A discussion by the author of some of the tax-free exchange issues as they relate to tenancy in common which appears in this article also appeared recently in the February 2007 issue of California Lawyer. This article discusses those issues in greater depth as part of an overall discussion of tenancy in common.
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ENDNOTES


See NATIONAL ASSOCIATION OF REALTORS®, Hot Topics - Answers to Current Business Issues: Tenants-In-Common Interests, REALTORS® COMMERCIAL ALLIANCE SERIES, issue 1, Fourth Quarter 2005.


See Bradley v. Harkness, 26 Cal. 69, 77 (1864).


See generally 26 U.S.C. § 1031 (2005); see also Lenobel, Wise and Neuman, supra note 4, at 1.


See Lenobel, Wise and Neuman, supra note 4, at 1.

See 26 U.S.C. § 1031(a)(2)(D) (2005). Special rules apply if the entity is classified as a “disregarded entity” for tax purposes (for example, a single-member LLC that does not elect to be taxed as a corporation).

Cuff, Working With Some Current Issues, supra note 16.


See Lenobel, Wise and Neuman, supra note 4, at 1; see also infra Section III.


Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). In Starker, the Ninth Circuit held that a deferred exchange can qualify for like-kind exchange treatment. The taxpayer transferred property to a corporation in exchange for its promise to acquire and transfer a suitable exchange property to the taxpayer within five years of the transaction. Pursuant to the agreement, the corporation transferred the properties within two years after the original transaction. The Court found that a simultaneous transfer of property is not required to qualify for a like-kind exchange. Id. at 1342-55.

See generally Toth, Section 1031 Extended To Nonsimultaneous Exchanges: Starker v. United States, supra note 23 at 845-49.


See Lenobel, Wise and Neuman, supra note 4, at 1.

See generally Swenson and Dickson, supra note 8.

Id.


Id.

Cuff, Revenue Procedure 2002-22, supra note 16.

See Pederson, 24 ANN. REV. BANKING & FIN. L. at 472.

Id.


The IRS also generally will not rule favorably if, e.g., a partnership dissolves and distributes TIC interest to its partners. In effect, once "pregnant" as a partnership, the IRS is skeptical that partners can become "unpregnant" and immediately attain TIC status.

A TIC owner who has consented to an action in compliance with this guideline may execute a power of attorney to another to carry out the action, but may not provide the manager with a global power of attorney.

40 Id. at 294.
41 Id. at 298.
42 See id.
44 Id.
45 Id.
46 CAL. CORP. CODE § 25102(f) (2005).
50 Id.
51 NATIONAL ASSOCIATION OF REALTORS, Hot Topics, supra note 5.
52 See generally Borden and Wyatt, supra note 49.
54 CAL. BUS. & PROF. CODE § 10249 (2005). “An application for registration shall be made on a form acceptable to the commissioner and include, together with a fee, a description of the offering, certification by the applicant that the subdivision is in compliance with all applicable requirements of the state or states wherein the project is located, evidence of this compliance, if applicable, and a consent to service as described in Section 10249.92.” Id.
55 Section, 10249.1, CAL. BUS. & PROF. CODE, provides that a subdivision includes: “(a) Improved or unimproved land or lands divided or proposed to be divided for the purpose of sale or lease, whether immediate or future, into five or more lots or parcels; (b) Improved or unimproved land or lands in which, for the purpose of sale or lease, whether immediate or future, five or more undivided interests are created or proposed to be created . . . .”
56 CAL. BUS. & PROF. CODE § 11000.1(b)(2).
57 See generally Lenobel, Wise and Neuman, supra note 4.