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Change is good—exchange is better. Savvy investors give up toilets and tenants for TICs.

by Marsha Ginsburg, Chronicle Staff Writer

Andy Mendell liked investing in residential property. He really liked deferring capital gain taxes through that most marvelous of IRS regulations, the 1031 exchange.

But he hated the headaches that came with being a landlord - the repairs, the maintenance, the managing.

Problems solved. In the past few years, Mendell and an increasing number of investors have discovered a new wrinkle on 1031 exchanges: tenancy-in-common ownership.

Before you say "sounds too complicated," listen up. It means a real estate investor can exchange his or her property -- without paying capital gains taxes -- for a fractional interest in a larger, potentially more lucrative property, such as an office building or a shopping center.

Because TICs are packaged through a sponsor who has the management and financing already in place, investors find it an attractive way to take a less active role without giving up tax benefits. Often they increase cash flow at the same time.

The big difference with a TIC is the void it's filling. It's creating a vehicle for people who are sick of managing, and creating a vehicle for trading up without having to (manage).

"It's getting rid of all the t's -- tenants, toilets, trash and turnover," said Mendell, who is selling a Pacific Heights condo and using the proceeds to buy a piece of a shopping center on Kauai.

In past years, to qualify for a 1031 exchange, named for the tax code section that covers such transactions, sellers of investment properties were required to buy another of equal or greater value within a certain time to defer capital gains taxes.

In the 1990s, brokers began creating tenant-in-common investments, in which buyers could exchange their properties for an undivided fractional interest in one or more other properties.



Chronicle / Deanne Fitzmaurice

Andy Mendell, and his wife, Linda, are swapping a Pacific Heights condo for a piece of a shopping center on Kauai.

The deals were neither forbidden, nor expressly approved by, the Internal Revenue Service. But in 2002, guidelines for TICs were released by the IRS. It took a lot of the grayness out. And it shows.

OMNI Brokerage Inc., a 1031 replacement firm in Salt Lake City, says the market has grown from \$167 million in TIC equity in 2001 to \$756 million in 2003. It is expected to more than double to \$1.56 billion this year.

Brokers say Baby Boomers seeking retirement and seasoned investors are turning to this relatively new money-making opportunity as another source of income and real estate growth.

Many people who own property but no longer want to manage or pay for maintenance find the TICs appealing, said Tony Thompson, CEO of Triple Net Properties in Southern California.

"Now they can sell that entire property, take the profits, defer the gain and buy a piece of a new office building in downtown Los Angeles or a grocery-anchored retail center in Tampa or a 100-unit apartment building in Chicago," he said.

"They can diversify their income, give up the management chores and still get a check every month," he said, adding that such investments will expand opportunity in the real estate investment

market. "It's like going from being a single-stock investor to a mutual fund."

Mendell, who was 22 when he bought his first rental property in Berkeley, bought and sold investment homes as a sideline until 1988, when he sold his alarm company and became a full-time investor.

In 1997, he bought 10 Moraga condos in a 56-unit complex that took almost five years to rehab. He and his wife, Linda, earned a big profit when they sold three of the condos but they also got hit with a huge tax bill.

That's when he decided to try the TIC option. He exchanged one condo for a part of a shopping center in Mission Viejo (Orange County). Today he and Linda have eight TIC properties in five states.

"I love the idea," said Mendell, 52. "I tripled my cash flow by going into these large, institutional-quality properties. My actual after-tax spendable cash is three times as much as when I was managing my own property," he said. His investment is diverse, spread over commercial, residential, retail and industrial properties.

Brokers point out that TIC investments are not always easy or risk-free.

Investors must adhere to strict time restrictions. Buyers must identify the property they want to purchase within 45 days after the sale of the original property, which is stressful for some people.

They have 180 days to close escrow on the new purchase.

Experts advise that investors, who must pay transaction costs including escrow and attorney fees, compare those costs with tax liability to make sure it's the right option.

Another potential downside is that in order to qualify under co-ownership guidelines outlined by the IRS, all the co-owners must agree on when to sell the property.

They also warn that the property can't be unloaded at will. Investors must own their share until the property is sold or a broker arranges for a replacement investor.

Although experts say the program is typically used by experienced investors, it's not necessary to be a multimillionaire.

Investors typically have \$1 million in assets, but the range for TIC investors runs from \$200,000 to \$1.5 million, experts say. The average investment is \$350,000 per TIC property. Most properties are worth between \$15 million and \$100 million.

"You have to be an accredited investor," Mendell said. "The joke is that an accredited investor is a homeowner in California."