

TENANT-IN-COMMON GUIDE

A GUIDE TO HELP YOU UNDERSTAND THE TIC & 1031 EXCHANGE INDUSTRY



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1031 EXCHANGES

The 1031 exchange has become a driving force in commercial real estate sales transactions. Tax specialists say that the volume of 1031 exchanges, nationally, has risen 25% over the past three years. A 1031 exchange is recognized as a powerful tool for investors to keep more appreciation in their investment properties by deferring capital gains taxes. Combining the power of tax deferral with the Tenant-in-Common (TIC) structure provides an alternative for the passive minded real estate investor.

Considering the value of a 1031 exchange may represent a significant portion of an investor's net worth and retirement, all steps taken and decisions made should be carefully and thoroughly researched.

The rules for completing a 1031 exchange, as required by the Internal Revenue Service, are clear and require strict adherence. Properties must be held for productive use in a trade, a business, or as an investment. The investor may only exchange property for "like-kind" property. Like-kind property includes developed or undeveloped real estate (but need not be identical in type). In order to defer all applicable capital gains taxes, the value equity and/or debt on the replacement property must be equal to or greater than that of the relinquished property.

All proceeds to be exchanged must be deposited with an independent party called a qualified intermediary (QI) or exchange accommodator. The role of an experienced QI is important. The QI will assist with documenting the exchange process while safekeeping the funds in a properly established trust account. All steps to the exchange transaction will be recorded and monitored by the QI.

The IRS ultimately determines whether or not the investor will defer capital gains taxes. Indeed, an unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities, including tax penalties.

An investor has 45 days from the closing of the property to select and identify, in writing, property(ies) to purchase, and 180 days in total to close the purchase of the property(ies). This limited timeframe to decide on suitable property(ies) to purchase can be a daunting challenge. Holidays and weekends count, so this selection period can be shortened to, as few as, 30 working days.

The role of a securities Broker-Representative, as a property advisor, to help locate the best property(ies) for the investor's situation can be invaluable, given this restricted timeframe.

The source of the property(ies) should be carefully researched. An investor will own the property(ies) for some time into the future, during cyclical real estate markets and economic turns. The role of the real estate provider or Sponsor must be considered carefully in the exchange process. The investor should know as much as possible about the level of expertise and experience of the company.



...a powerful tool for investors to keep more appreciation...defer capital gains taxes



WHAT IS A TENANT-IN-COMMON (TIC) INVESTMENT?

Tenant-in-Common investment is a structure of property ownership where multiple investors pool their funds to own one entire property. As a TIC owner, an investor has an undivided fractional interest in one property and shares in their portion of the net income, tax shelters and property value.

Each TIC owner receives a separate property deed and title insurance for their portion in the property investment. This gives the investor the same rights of ownership that a single owner would enjoy. Because TIC offerings are often “packaged” with management and financing in place, TICs may offer a more simplified solution for the 1031 investor searching for replacement property.

Real Estate or Securities

- » For 1031 exchange purposes TICs are fractionalized interest and deeded real estate. Co-ownership of real estate in the form of TICs can be structured other than a partnership. The IRS Revenue Procedure 2002-22 provides further guidance in this area.
- » Securities include investment contracts. An investment contract is a financial arrangement where investors contribute capital with the expectation of profit and rely on the efforts of a Sponsor to oversee the investment process.
- » “The fact that TIC interests typically are investment contracts under securities laws does not inherently disqualify them as property that may be exchanged under Section 1031.”¹ TICs are fractionalized ownership in real estate and also investment contracts as securities.

TIC Advantages

- » TIC investments offer simplicity by eliminating active management headaches. Individuals who are ready to relinquish the day-to-day burdens of being a landlord, or who own land and would like an income producing property, may benefit from TIC investments. TIC programs provide a “mailbox

management” investment that may save time and money.

- » TIC ownership allows an investor the ability to diversify their 1031 exchange into more than one property, and to own potentially larger property(ies).
- » Cash flow from operations is generally paid monthly and is tax-sheltered via depreciation-pass-through and interest deductions (in many cases a portion of the investor’s net income is tax sheltered.)
- » A TIC investor may experience appreciation over the time a property is held.
- » Minimum equity requirements as low as \$200,000 allow an individual to invest in larger, possibly institutional-grade properties that they otherwise could not purchase.

TIC Risks

- » TIC interests are direct investments in real estate and are subject to all risks of owning, operating and disposing of real estate.
- » Results from investing in real estate vary through cyclical economic times.
- » The cost to acquire a TIC interest may be more than purchasing a property by the whole due to additional expenses of making the property available to multiple co-owners and marketing it in the form of a private security offering.
- » A TIC interest is an investment in real estate and is an illiquid investment. There is no established secondary market for the resale of TIC interests.
- » TIC investments may not be suitable for all 1031 exchange investors.
- » TIC investment related fees and expenses may outweigh the benefits of tax deferral.
- » Cash flow and property appreciation are not guaranteed, and there is potential for loss of principal invested.

¹NASD Notice to Members 05-18 March 2005



THE ROLE OF A QUALIFIED INTERMEDIARY (QI)

The IRS requires that the investor does not take possession of the proceeds from the sale of the property during a 1031 exchange. A qualified intermediary (QI), also known as a “facilitator” or “exchange accommodator”, acts as a fiduciary over the proceeds from the sale of the property during the exchange period, and provides services to help keep the investor in compliance with IRS rules and laws.

Independent Party

A QI must be an independent party to the exchange transaction, meaning the QI cannot also serve as the investor’s tax advisor, attorney, real estate broker, securities broker, or be the investor’s relative. Violation of this rule could result in the exchange being disallowed by the IRS.

Trust Account

The sale proceeds will be deposited in an account administered by the QI. The investor cannot have access to these funds unless the exchange is completed, the exchange has expired, or in certain circumstances, the exchange failed. Although not required, many QIs have fidelity bond insurance covering the trust account and their services.

Compliance with IRS Laws

Whether the investor is involved in a delayed exchange, or a more complicated reverse exchange, there are many steps in the

exchange process that cannot be overlooked or omitted. The Internal Revenue Code Section 1031 and the Regulations contain many rules with applicable deadlines. A knowledgeable QI will explain the rules and steps that must be taken to comply.

Federation of Exchange Accommodators

In 1990 the IRS issued Section 1031 Safe Harbor Regulations that defined the rules of conducting business as a QI. Shortly after, QIs established an association called the Federation of Exchange Accommodators (FEA) to provide regulation over its members and further its involvement in legislative matters and industry education. FEA also established a certified exchange specialist (CES) designation. CES designees must complete substantial requirements and demonstrate competence in the industry. All FEA members must comply with their code of ethics.

Fee for Service

QI fees vary from \$500-1,500+ for forward exchanges. The fees for more complex transactions are substantially greater. Most QIs do pay a stated rate of interest on the funds held and many retain any interest left as an additional fee.

...Exchange Accommodator that helps keep the investor in compliance with IRS rules and laws



THE ROLE OF A REAL ESTATE PROVIDER OR SPONSOR

A real estate provider, (commonly referred to as a Sponsor), sources the property, performs property due diligence, garners the financing, arranges for asset and property management, and offers it to potential investors/exchangers.

Sources the Property

The Sponsor will utilize its experience and resources to acquire investment grade commercial properties available in various geographical locations. Properties are sourced in off-market transactions, as well as, from national commercially listed properties. This process of acquiring institutional properties may require significant financial resources and management expertise.

Property Due Diligence

The Sponsor performs due diligence on the property before a commitment to purchase the property is made. This due diligence includes, among other things: property condition reports, environmental reports, engineering studies, tenant and lease reviews, property surveys, title reports, and pertinent market and competition information.

Garners the Financing

The Sponsor is responsible for arranging the financing of the property. Typical financing will consist of a non-recourse loan to the investors/exchangers that may require the Sponsor to pledge certain guarantees. In a Tenant-in-Common transaction, each co-owner will be required to individually qualify for the financing. Sponsors use their expertise and reputations to arrange for the best available terms of financing given current property and market conditions.

Asset Management

Property decisions involving management, refinancing and disposition are often coordinated by the Sponsor in a manner consistent with a majority vote of co-owners.

Property Management

An institutional property owned by co-owners requires daily property management. The Sponsor will either provide these services directly, or arrange for professional third party contractual management.

Investor Reporting

It is the responsibility of the Sponsor to communicate to the TIC owners, any and all developments with the investment through regular reports. Reporting topics include: property management roles, asset management outlook during changes in the marketplace, payment of distributed cash flow, year-end tax documentation, and overall structural condition.

Institutional Package

The Sponsor will package an institutional property so investors/exchangers may participate in a larger property not available to them on their own. Sponsors provide these real estate services in one complete package for investor consideration.

...Sponsor will utilize its experience and resources to acquire institutional properties



THE TIC SECURITIES BROKER/REPRESENTATIVE

Generally, TIC properties issued by Sponsors are private security offerings and are available to investors only through a licensed securities Broker/Representative. Although issued as securities, these TIC offerings of real estate generally comply with the IRS qualifications of a 1031 exchange.

The Securities Broker/Representative

An informed securities Broker/Representative can provide an investor access to many properties as Tenant-in-Common (TIC) ownership. The securities Broker/Representative can help investors understand the property fundamentals and advise regarding market characteristics. TIC opportunities are available in all real estate sectors and diverse locations and investors should investigate as many alternatives as possible before arriving at a decision. The 45 day time deadline exacerbates this property selection process. A securities Broker/Representative can shortcut the process by introducing many properties and TIC opportunities otherwise unknown to the investor.

Broker Fees and Commissions

Security Brokers/Representatives are paid a commission by the Sponsor of the property based upon the amount of equity investment. The amount of the commission is similar to what a real estate agent earns and is payable at the closing of the replacement property. A security Broker/Representative cannot share commissions or pay referral fees to anyone not licensed to sell securities.

Full Investment Disclosure

A TIC investment offered as a security can only be made by means of a private placement memorandum (PPM). The PPM is a highly detailed, stand alone document which allows an investor to make an informed and educated decision. The PPM is a legal document prepared by the Sponsor outlining and disclosing the terms of the investment, the associated risks and a description of the property. Before a PPM can be made available to investors, the security Broker/Representative must pass it through a process of due diligence, (a thorough review of the investment as set forth in the PPM). An investor must evidence, in writing, they have thoroughly reviewed the PPM before they are permitted to invest.

Investor Suitability

TIC investments come in many property types and diverse locations, with varied investment implications. A securities Broker/Representative is responsible to assess the investor's suitability for the TIC investment and make recommendations according to a familiarity with the investor's financial resources, tolerance for risk and investment experience.

...helps investors understand the property fundamentals & advise regarding market characteristics

KEY DEFINITIONS

45 Days

The number of days an exchange investor has to identify in writing replacement properties for a 1031 exchange. The period starts from the day the sold property closes including weekends and holidays until midnight of the 45th day.

180 Days

The number of days an exchange investor has to close the replacement property.

Accredited Investor

An investor who is financially qualified to experience the consequences from investing in private investment offerings. It is the duty of the registered securities Broker/Representative and Broker Dealer to determine the accredited status of a client before offering TIC investments. By SEC definition, generally an individual is accredited if his or her annual income is greater than \$200,000, \$300,000 for joint status, or, a joint net worth that is equal to or greater than \$1 million.

Agency

An agency is considered a fiduciary relationship, where the agent represents the principal and acts only with the principal's consent and is subject to direction and control.

Anchor Tenant

Any major tenant, such as a large department or discount store or supermarket, which forms the nucleus of a modern shopping center. The anchor tenant is the mainstay that draws the public and stabilizes the center by assuring a profitable operation for all the other tenants. Anchor tenants are usually sought out first by developers, and they are usually given favorable leases.

Appraisal

A fair market value of real property determined by a third party when considering implications from market, income and replacement costs of the property.

Basis

Method of measuring investment in property for tax purposes. Calculation: Original cost plus improvements minus depreciation taken.

Boot

Fair Market Value of non-qualified (not like-kind) property

received in an exchange. (Examples: cash, notes, seller financing, furniture, supplies, reduction in debt obligations.)

Broker Dealer

A firm that recommends, offers or sells investments to the public which is required to be registered with the SEC, the FINRA, and the state securities divisions in every state in which the firm operates or the customer resides.

Broker Dealer Supervision

A Broker Dealer firm that employs registered securities Brokers/Representatives has an obligation to supervise its Representatives. The SEC has stated that this duty of supervision "is a critical component of the federal investor protection scheme regulating securities markets." Broker Dealers must document, through stringent record keeping requirements, the supervision of registered Representatives.

Building Classifications

Class "A": Building has excellent location and access to attract the highest quality tenants. Building is well managed. Structure is of high quality finish, usually new or competitive with new buildings.

Class "B": Building with good location, management, construction, land and tenancy. Can compete at low end of Class A.

Class "C": Generally an older building with growing functional land/or economic obsolescence.

Capitalization Rate (Cap Rate)

1) Net Operating Income / Property Value. 2) The pre-tax return on investment of a property before deducting debt service. Net Income divided by the Price. 3) The rate that is considered a reasonable rate of return on and of investment. Rate used to determine the capital value of a property's annual net operating income. 4) The rate of interest which is considered a reasonable return on the investment and used in the process of determining value based upon net income. As the rated risk of the project rises, the Cap Rate also rises, resulting in a lowered final valuation of the project.

Cash-On-Cash Return

Rate of return realized on actual cash invested in the project. Differs from Cap Rate in that it refers to the percentage rate of return realized on actual cash invested in the project. For example, if \$500,000 were to be invested and the actual cash flow is \$50,000

per annum, net of all expenses and loan payments, then the project is referred to as showing 10% cash-on-cash return.

Compensation

The compensation a Broker Dealer receives for a client making an investment. Anyone who receives compensation of any kind associated with offers and sales of TIC interests by a Broker Dealer must be a licensed registered securities Broker/Representative.

Conflicts of Interest

A person recommending, offering or selling a security to an investor must disclose all material facts affecting the recommended investment. If circumstances affect the objectivity of the recommendation, a conflict of interest may exist. The failure to disclose the financial interest of all parties to the transaction deprives the customer of the knowledge necessary to make a decision based upon investment value. Misrepresenting or omitting to disclose material facts with respect to the investment is a violation of federal and state securities laws.

Constructive Receipt

Control of proceeds by an Exchanger (even though funds may not directly be in their possession).

Credit Tenant

Tenants not subject to a credit loss factor because of their exceptional ability to pay their rent obligations on time.

Depreciation

The annual loss in book value of improved real estate over its period of ownership as allowed by the IRS.

Disclosure

A person recommending, offering or selling an investment contract to an investor must disclose all material facts affecting the recommended investment. Such information includes the risks of the investment, the compensation paid to any person involved in recommending an investment, any conflict of interest between the firm and its professionals, and any other fact that may affect the objectivity of the recommendation.

Due Diligence

The process of verifying that all material facts and risks, which could possibly affect the outcome of an investment, are disclosed. Due diligence is the responsibility of the Broker Dealer and registered securities Brokers/Representatives prior to offering investments to their clients. In a best practices context, a thorough

due diligence should be completed on each investment prior to offering the investment to investors by Broker Dealers.

Exchanger

The property owner(s) seeking to defer capital gains taxes by utilizing a Section 1031 exchange. (The Internal Revenue Code uses the term "Taxpayer.")

Equity Investment

The portion of the total cost of the project which is not covered by financing. An investor usually calculates the potential of a deal based upon his return on investment (equity investment).

Finder's Fees

Referral or finder's fees are generally considered transaction based compensation. Any transaction based commission or compensation paid to an individual or firm involved in recommending, offering or selling TIC investments is compensation that can be paid only to a licensed registered securities Broker/Representative.

IRR (Internal Rate of Return)

1) The yield which equates the Net Present Value of a stream of cash flows to zero. Conversely, it is the annual return one expects based on an initial cash outlay, on a stream of future income. 2) A rate of return which would equate all of the cash inflows (including the sale proceeds) of a property with all the cash outflows (including the purchase price) – i.e. the break even rate of return.

Investor Suitability

Registered securities Brokers/Representatives who recommend an investment to a customer have a suitability obligation with respect to that recommendation. This duty requires a registered securities Broker/Representative to have a clear understanding of the investment goals and the current financial status of the investor, and to ensure that the recommended investment is suitable for that particular customer in light of his or her financial situation and objectives.

Like-Kind

To qualify as like-kind property in a 1031 exchange, the property must, by its nature, be real estate and not personal property. All real estate can be exchanged for real estate and qualifies as like-kind. Raw land for improved property is like-kind and vice versa.

Liquidity

An investment in a TIC private placement is an illiquid investment. There is currently no active market to resell a TIC interest. A TIC

investment in real estate is similar to a sole ownership interest in real estate, the owner of the TIC interest has the right to sell their interest at any time subject to the terms outlined in the TIC ownership agreement of the private placement memorandum.

Market Indicators

Statistical measures of construction and real estate activity, including issued permits, indices of building costs, deeds recorded and homes for sale.

Master Lease

A primary lease that controls subsequent leases and which may cover more property than subsequent leases.

Negative Leverage

The use of debt financing, which reduces the percentage return to equity because the rate of interest on the debt is higher than the free and clear rate of return on equity.

Net Operating Income

The sum derived after deductions from gross potential income for vacancy and expenses.

PPM

A document referred to as a “Private Placement Memorandum” is prepared by the Sponsor that is offering the investment to qualified individuals. A PPM discloses the facts of the property, terms of the investment offering, and potential risks associated with an investor’s participation in the investment.

Positive Leverage

The use of debt financing that increases the percentage return to equity because the rate of interest on the debt is lower than the free and clear rate of return on equity.

Pre-Marketing

The wrongful process of reserving indications of interest from investors for a TIC investment offering before the final PPM has been prepared by the Sponsor and a selling agreement is in place with the Broker Dealer.

Qualified Intermediary (QI)

The entity that facilitates the exchange for the Exchanger. The term “facilitator” or “accommodator” is also commonly used, although the Treasury Regulations specify the term “Qualified Intermediary.”

Real Estate vs. Securities

The offering of undivided interests in real estate, where the Sponsor sources the property and provides ongoing services with

the expectation of profits, meets the definition of an offering of securities in the nature of an investment contract. A TIC interest is a deeded fractionalized interest in real estate, and as such is capable of satisfying 1031 exchange rules. However, when undivided interests in a single property are offered to multiple owners and a Sponsor is sourcing the real estate and providing ongoing services for an expectation of profit, the TIC interest generally meets the definition of an investment contract and is subject to federal and state securities laws and rules of distribution to investors.

Real Property

In general, land and everything growing on it, attached to it, or erected on it. Examples of real property are single-family rental houses, apartments, shopping centers and office buildings.

Recapture

The amount of tax to be paid on the difference between book value after depreciation deductions and sales price. The tax rate on recapture is currently 25%.

Recourse

The right of a lender or holder of a note secured by a mortgage to look to the personal assets of the borrower or endorser for payment should they go into default, not just to the property assets.

Reg D Offering

A safe harbor exemption for TIC investment offerings where participating investors must be qualified as Accredited Investors. This is the most frequent type of TIC investment offering used by TIC Sponsors.

Registered Securities Broker/Representative

An individual who recommends, offers or sells investments in return for a commission. A registered securities Broker/Representative must be associated with a Broker Dealer and licensed as a securities professional with the SEC, the FINRA and all states in which he conducts business. Any unlicensed individual or firm involved in recommending, offering or selling TIC investments is in violation of federal and state securities laws.

Relinquished Property

The property sold by the Exchanger. This is sometimes referred to as the “exchange” property or the “downleg” property.

Replacement Property

The property acquired by the Exchanger. This is sometimes referred to as the “acquisition” property or the “upleg” property.

Revenue Procedure 2002-22

On March 19, 2002, Revenue Procedure 2002-22 was issued providing guidance regarding the conditions under which the IRS will entertain a private letter ruling that a TIC interest will not be treated as a partnership interest for tax purposes. The guidance clarifies the criteria which the IRS views as distinguishing a real estate TIC arrangement from a partnership, and enables Sponsors to create rental real estate structures that have ownership units capable of being used in a like-kind exchange.

Sponsor

A real estate provider that sources the investment property, garners the financing and manages the assets for the owners. Sponsors provide the service of packaging the investment property into a TIC format, allowing fractional undivided interests in one property to be sold to multiple co-owners as TIC interests.

Syndication

1) A combining of persons or firms to accomplish a joint venture of mutual interest. 2) The process of acquiring and combining equity investment from multiple sources.

Tenant-In-Common (TIC)

As a TIC owner, you have an undivided fractional interest in an entire property and share in your portion of the net income, tax shelters, and appreciation. Each TIC owner receives a separate property deed and title insurance for their portion in the property investment. This gives you the same rights of ownership that a single owner would enjoy.

TIC Distribution Process

A real estate provider sources an investment property and prepares an investment offering through a PPM. Broker Dealers conduct due diligence on the investment offering and execute an agreement to sell the TIC investment to qualified investors through its registered securities Brokers/Representatives. A cooling off period is then recommended allowing registered securities Brokers/Representatives and investors sufficient time to review the PPM and make a determination of the merits of the investment offering. Interested Investors then submit applications to participate in the TIC investment through their registered securities Brokers/Representatives and Broker Dealers to the Sponsors.





Phone: (801) 553-1031
Fax: (801) 545-8835
Toll Free: (866) 880-1031
www.omni1031.com

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