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BUSINESS NEWS FROM THE FOUR-COUNTY REGION

## FOCUS

# SEC continues to mull tenant-in-common exemption

Last November the Securities and Exchange Commission asked for comments on a proposal to let real estate brokers receive commissions when tenant-in-common properties are sold.

The proposal came by way of an exemption requested by the National Association of Realtors. The proposed exemption proved extremely controversial. It has set off a firestorm of comments, which are available on the SEC's Web site.

In the past, the Internal Revenue Service has outlined 15 elements that it will evaluate to determine if a real property interest structured as tenant-in-common ownership can be considered a real estate interest for tax purposes, or whether it is the owner's participation in a partnership. This is Revenue Procedure IRC 2002-22.

This determination is critical to evaluating whether the purchaser can use the benefits of tax deferral provided in Section 1031 of the Internal Revenue Code. That section allows owners who sell a property to exchange into a replacement property and defer the tax on the gain so long as the replacement is "like kind."

A partnership interest is personal property and therefore not "like kind" with respect to the sale of investment real property.

Following the introduction of Revenue Procedure 2002-22, a cottage industry of TIC sponsors exploded. The sponsors locate properties, complete due diligence, arrange financing and then syndicate the ownership of the property to investors, who are often completing the second leg of their 1031 exchange transaction. The sponsors do all this to obtain the equity necessary to satisfy the acquisition financing requirements.

These structures always involve the sale of real estate, but they also often involve the sale of a security under what's called the Howey analysis.

In *SEC v. W.J. Howey Co.*, the United States Supreme Court provided a definition of an "investment contract," which is relevant to determining whether an interest in real estate could be a security.

Based on Howey and subsequent cases, if an individual makes an investment of money into a common enterprise with an expectation of making profit based solely or primarily on the efforts of others, then the product purchased is often an



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investment contract, and thus a security.

The TIC interests sold by sponsors are often TIC "securities" because the sponsor puts forth all or a significant portion of the effort to pull the project together and then manages the property on behalf of the investors following closing.

Many sponsors have continued selling their TIC product as real estate and have avoided, or tried

to avoid, the Howey analysis by causing the investors to have hands-on responsibility for managing their own investments.

This is sometimes handled through requirements for unanimous approval of master leases or the investors' personal selection of a property manager.

The National Association of Realtors wants an exemption to allow commissions to be paid to licensed real estate agents or brokers for the sale of TIC securities.

The exemption would allow a "real estate advisory fee" to be paid in a TIC securities transaction if the commercial real estate professional had substantial experience in the sale of commercial real estate. That would be evaluated on a facts and circumstances test, but would include certain common broker certifications.

The exemption would apply only if the broker's primary business is the sale of commercial real estate other than TIC interests.

This last noted criteria can be puzzling since one would expect the SEC to prefer the experienced brokers who specialize in the sale of TIC properties.

In every transaction in which a real estate broker is going to be paid a commission, there must also be a securities broker dealer involved and earning a commission. There are a variety of other less crucial elements that apply to the exemption, but if all of the elements are satisfied, then the sponsor would be allowed to pay a commission to a real estate broker for participation in the sale of the TIC security.

Some TIC industry insiders I have spoken to believe that the exemption will be issued substantially as it was when released for comment.

Other authors believe that the exemption will never be passed.

The real question is what will the SEC do if the exemption is adopted? If that happens it's likely that some real estate TIC sponsors will shift their program to sell TIC securities because they will be able to pay commissions to the real estate brokers they have been working with for many years.

This will be particularly likely among those TIC sponsors who have received indications that the SEC views their product to be a security because of a master lease or other similar structure.

However, some TIC sponsors will resist the switch because of their well established marketing channels and the fact that in the sale of real estate by brokers, there is no prohibition on advertising and general solicitation, while securities brokers and real estate brokers who are selling TIC securities will not be able to advertise and generally solicit.

## Industry rumors have questioned whether the SEC will make a pronouncement that all TIC interests are securities.

If the exemption is adopted, the SEC will likely flex its enforcement muscle and pressure TIC real estate sponsors who are "on the line" into converting to a securities product.

Industry rumors have questioned whether the SEC will make a pronouncement that all TIC interests are securities. However, I personally don't think the SEC would take any such action as it could face an uphill, precedent-setting battle in court under a Howey analysis.

Whatever happens, the road to the exemption is a bumpy ride, and whatever the result, the process will dramatically affect the industry. This will be an interesting dynamic to observe as the exemption unfolds.

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