National Asset Services

## 5 Options For TIC Co-Owners Facing Loan Maturity

Commercial mortgage backed securities [CMBS] issuance rose dramatically from $94 billion in 2004 to $168 billion in 2005 and hit a peak of $230 billion in 2007. Many of the loans issued during that period were repackaged 10-year loans. Over $193 Billion of these loans are scheduled to come due over the next two-year period [2016-2017]. Let's take a look at the pros and cons of options tenants-in-common co-owners have to consider in order to meet the financial requirement of loan maturity. The best option for one property and/or one co-owner may not be the best option for another. The "best option" depends on a variety of factors that can vary greatly at different properties and within a given market. These factors can include the following: the property's physical and financial condition, current and projected market demographic and economic factors and the overall financial health of the co-ownership group, combined with the ever changing condition of the capital markets. This is why the decision to sell or to refinance should be considered in advance of loan maturity.

Here are some of the pros and cons of options that tenant-in-common co-owners have when faced with an imminent loan maturity.

### I. Refinance - Reorganize and Secure Financing as a New Legal Entity

With this option, financing is secured after a new legal entity is created for ownership of the property. Often referred to as an IRC "721-rollup," all tenants-in-common exchange their tenant-in-common ownership for membership interests in the new entity on title. This strategy may be used if the co-owners want to retain their investment in the property, but the property's economic and physical condition and the number of co-owners make capital sources unwilling to loan money to a TIC structure.

**Pros:**

- May be a larger pool of capital sources
- Loan may be at a lower interest rate [and other more favorable terms]
- Members retain their 1031 capital gains tax deferral in place one last time
- Where the TICs can recapitalize their investment within their own ranks and do not need outside capital, dilution of TIC interests is not necessary.
- TICs not willing to move forward and refinance can be bought out at the close of the new loan under certain circumstances.

**Cons:**

- Some loss of control is typically experienced, as most decisions are made by a Governance Committee, with a few major decisions still available to all of the membership or partnership interests by majority, super-majority or unanimous vote.
- Potential dilution of interest if new capital from outside of the original TIC group is necessary.

National Asset Services has been successful in executing this strategy at various properties across the country.

*Read NAS News Article*: NAS Salvages Commercial Real Estate Property Investment

*Read NAS Success Story*: Cooper Glen

## II. Refinance - Keeping TIC Ownership Structure Intact

With this option, the property's loan is refinanced while retaining the current tenant-in-common structure. This refinancing strategy may be used if the co-owners want to retain their separate fractional interests in the property and the financial position of the co-owners and physical condition of the property is amenable to a new lending source.

**Pros:**

- The tenants-in-common remain as co-owners of the property.
- Investment hold period continues with all 1031 tax advantages in place.
- Where the TICs can recapitalize their investment within their own ranks and do not need outside capital, no dilution of TIC interests is necessary.
- TICs not willing to move forward and refinance can be bought out at the close of the new loan, under certain circumstances and as provided under the governing TIC documents.

**Cons:**

- The number of capital sources available for refinancing a tenant-in-common property may be limited.
- The refinancing loan may be subject to a slightly higher interest rate due to the Lender's additional risk with TIC structures (ie. multiple TIC borrower entities).
- Potential increased legal fees due to the increased lender legal documentation process required for each tenant-in-common borrower.
- Lender will require credit-worthy guarantors for all non-recourse carve-outs.
- Lender may require that an affiliate of each tenant-in-common co-owner guaranty certain non-recourse carve-outs.

NAS is in a unique class of management companies that has been able to leverage capital resources in securing refinancing, while keeping the property's tenant-in-common ownership intact.

*Read NAS News Articles:*

Refinancing of Multifamily Property Keeps TIC Structure In Place

NAS Announces Successful Refinancing of a TIC Property

## III. DST Structure

With this option, the property's loan is refinanced with all tenant-in-common co-owners contributing their interests to a DST [Delaware Statutory Trust]. This refinancing strategy may be used if the co-owners want to retain their equity interests in the property and the financial position of the property and physical condition of the property is amenable to a new lending source.

**Pros:**

- The tenants-in-common become beneficiaries of the DST.
- Investment hold period begins anew with new loan and with 1031 tax advantages in place.
- TICs not willing to move forward and refinance can be bought out at the close of the new loan, under certain circumstances and as provided under the governing TIC documents.

**Cons:**

- If there are any unforeseen needs of the property that require new capital at any time during the hold period, new capital may NOT be brought in to solve the issue.
    - To add new capital is a default under the IRS Code for DST
    - This could potentially blow up the DST and the preservation of 1031 safeguards and benefits
- TICs delegate all of their decision making to the Trustee of the DST.
- There is a dilution of TIC interests, the degree of which varies from deal to deal.
- The number of capital sources available for refinancing a tenant-in-common property may be limited.
- Potential increased legal fees due to the increased lender legal documentation process required to convert to DST structure.

## IV. UPREIT [Umbrella Partnership Real Estate Investment Trust]

Real estate investment trusts [REITs] are companies in the business of owning and managing commercial real estate. A REIT is organized to pool assets consisting of real estate or real estate mortgages. REITs are not mutual funds, unit trusts or limited partnerships. Created in 1992, the UPREIT structure emerged to address potential taxes related to the formation of a REIT. The UPREIT structure was developed to avoid recognition of taxable income on the transfer of appreciated property to a REIT. An UPREIT owns interests in real estate, either directly or through other partnerships with other non-REIT investors in an umbrella partnership. UPREITs offer attractive yields and stable investment opportunities.

**Pros:**

- REITs generally permit distribution of pretax income in the form of dividends. Dividend increases have traditionally outpaced inflation.
- TICs can monetize their interests in a real estate portfolio without triggering capital gains on previous transactions.

- Liquidity of investment – "OP Units" serve as acquisition currency for UPREITs.
- Provides deferral of capital gains tax for real estate sellers.
- Diversification of asset geographically and by tenant base, typically.

**Cons:**

- The pool of assets which comprise the REIT may not be performing and this can drag down the ultimate yield and return on your investment.
- Potential "lock out periods" when OP shares may not be sold.
- Your property must be one that is desired by the UPREIT sponsor as the property is ultimately incorporated into the pool of assets that constitutes the UPREIT.

## V. Selling the Property

This decision is usually made when either the tenant-in-common co-owners vote to sell in order to cut their losses or if the property's value has maximized its potential appreciation and the time is right to sell the asset.

**Pros:**

- The real estate investment has gone full cycle and co-owners realize the gains from their investment or are able to relieve themselves from a distressed asset.
- The co-owners retain the option to 1031 exchange into a new investment.

**Cons:**

- Investors who decide to completely cash out are subject to the capital gains tax that had been originally deferred plus any additional taxes that may be assessed with the gains from the sale of the property, including but not limited to recapture of depreciation.
- Many TICs are finding the challenge of replacing the income stream difficult, and others are becoming too liquid.
- If the investors decide to reinvest into another 1031 exchange, they only have a 45-day window after closing the sale to identify replacement real estate and they are subject to the quality of real estate investments available within the market at that time.
- If an investor decides to reinvest into other financial instruments, they may not find an investment that has the same or greater return as they were enjoying with the tenant-in-common property and they may be required to invest additional cash in order to purchase the replacement property. In addition, they may still be subject to the capital gains tax.

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