A MATTER OF SEMANTICS: SHOULD TENANCIES-IN-COMMON BE TREATED AS SECURITIES OR REAL ESTATE INTERESTS?

Lenín E. López

8 J. BUS. & SEC. L. 1

TABLE OF CONTENTS

INTRODUCTION

Investors entering the housing market one year ago with the hopes of home values appreciating as rapidly as they did a few years earlier are painfully aware that this is not the case. While the housing market may not be as attractive as it once was, the commercial real estate market has seen a flood of new investors.[1] These new investors have been attracted by low interest rates coupled with the rising appreciation that the sector has offered.[2]

The average investor does not have the capital necessary to individually purchase a 30 million dollar office park. Within the past 10 years the tenant-in-common model of ownership has allowed a number of individual investors to own an undivided fractionalized interest in commercial real estate and also defer recognizing capital gains from the sale of other investment property.[3] The amount of commercial tenant-in-common (hereinafter "TIC") properties sold in 2006 totaled approximately $8 billion.[4] To put this figure into perspective, TIC properties sold from 2001 to 2004 totaled $7 billion.[5]

In a recent survey addressing trends in state securities enforcement, four states reported an increased number of cases involving TICs.[6] A major issue facing the TIC industry is whether these state security agencies, or even whether federal agencies, should have jurisdiction over TICs. That is, it is unclear whether the fractional interests sold are securities, subject to federal and state securities regulations, or whether the fractional interests are real estate interests.

This article will discuss the mechanics of a typical TIC transaction, explore whether these transactions are securities or real estate interests, and ultimately suggest what treatment would prove most efficient with respect to administration, regulation and enforcement.

I. BASES

TICs are the result of a number of rules and regulations established by federal regulatory bodies and national agencies. The following section will explore the most fundamental of these conventions.

A. Section 1031 Exchanges

Section 1031 of the Internal Revenue Code[7] has increased the attractiveness of TICs to investors. It allows for an individual to sell investment property with a low tax basis and roll the proceeds into similar investment property without recognizing capital gains.[8] Section 1031 specifically states:

---

[1] Marilyn B. Cane & Jennifer C. Erdelyi, *Tenant In Common Exchanges: A "TIC"king Time Bomb at the Intersection of Real Estate, Securities. And Tax Law?,* 14 U. Miami Bus. L. Rev. 273, 273 (2006).
[2] *See* Scott Patterson, *The Other Real-Estate Boom,* Wall St. J., Dec. 11, 2006, at C1.
[3] Darryl Steinhause, *Tenants in Common: Are TIC's Taking Over the World?,* 24 Cal. Real Prop. J. 26, 26.
[4] *See* Vivian Marino, *Buying a Small Part of Something Big,* N.Y. Times, Oct. 15, 2006, at 322.
[5] *Id.*
[6] Christine A. Bruenn and Michael R. Weissmann, *Trends in State Securities Enforcement,* 38 SRLR 1733 (2006).
[7] 26 U.S.C. § 1031(a)(1) (2000).
[8] *Id.*

> No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.[9]

As an illustration, a typical Section 1031 exchange may involve an individual who owns an apartment building. They may have the opportunity to purchase another apartment building in a more attractive location that will appreciate faster than the property they currently own. Motivated by the promise of higher returns, the individual wants to purchase the new property, but must first sell the old building to raise enough capital. Without Section 1031, the individual would have to pay taxes on any gain associated from the sale of the original property. For instance, if they initially purchased the apartment building for $50,000 in 1970 and sold it for $800,000, they would have to pay taxes on $750,000. Without 1031, the sale may never take place. As discussed above, Section 1031 allows the individual to defer the taxes owed on the sale if they reinvest the proceeds into similar property. In this case, another apartment building would suffice.

Historically courts have looked to the "investment intent" of the investor to determine whether property was held for productive use in a trade or business.[10] With respect to a TIC structured to qualify under Section 1031, a holding period of one to two years is suggested to be indicative of investment intent.[11] As to whether the exchange involves a property of "like kind", the Internal Revenue Service (hereinafter "the Service") has interpreted this broadly.[12] The Service has held that "like kind" may include any real estate whether improved or unimproved, so long as it is of the same kind or class as the exchanged property. In addition, the Service has made clear that city real estate, for example, could be exchanged with a farm and be deemed to have met the "like kind" requirement.[13]

Section 1031 contains language that may on the surface appear troubling to the TIC industry. According to Section 1031, the subsection would not apply to any exchange involving "stocks, bonds, or notes" and "other securities".[14] TICs structured as real estate transactions are immune to this exception for obvious reasons. However, TICs structured to comply with securities laws would not be able to benefit from Section 1031 deferral benefits without an exception.

B. Revenue Ruling 73-476

The Service issued a Revenue Ruling in 1973 that addressed TICs with regard to Section 1031.[15] The ruling involved three individual tax payers that each owned an undivided interest in three separate parcels of real estate held for investment purposes. Each taxpayer exchanged their undivided interest in their respective property for a 100 percent ownership interest in a single parcel. Each taxpayer continued to hold the exchanged interest in the single parcel of

---

[9] *Id.*
[10] *See, e.g., Bolker v. Comm'r of Internal Revenue*, 760 F.2d 1039, 1045 (9th Cir. 1985).
[11] Cane & Erdelyi, *supra* note 7, at 276.
[12] Treas. Reg. §§ 1.1031(a)-1 to 1.1031(k)-1 (2005).
[13] *Id.*
[14] 26 U.S.C. § 1031(a)(2) (2000).
[15] Rev. Rul. 73-476, 1973-2 C.B. 300.

land as an investment. The Service concluded that any gain or loss realized as a result of the exchange of the property interests would not be recognized for tax purposes.[16] That is, the exchange qualified as a valid 1031 exchange. This clears up a single type of 1031 exchange involving TIC interests. However, the most popular type of TIC exchange involves management agreements, fixed rental income, and other agreements not addressed in the 1973 Revenue Ruling. The Ruling does not serve as a useful guide for compliance purposes when one considers current TIC structures.

C. Revenue Procedure 2002-22

Revenue Procedure 2002-22 provides guidance on how TIC interests in real property can qualify as replacement property for purposes of a 1031 exchange.[17] It must be stressed that the requirements described under the Revenue Procedure are procedural requirements to obtain a private letter ruling and are not substantive law with respect to what qualifies as a valid 1031 exchange. The requirements described can solely be used as a guide in structuring TIC arrangements.

The ruling provides fifteen requirements to request a private letter ruling regarding a TIC arrangement.[18] One of the more important conditions required to obtain a private letter ruling is the requirement that the number of co-owners in a TIC must be limited to no more than 35 persons.[19] Due to the time sensitive nature of 1031 exchanges[20], it is unrealistic to expect individuals to request a private letter ruling, a process that could take six to twelve months. Many in the industry have resorted to attorney opinion letters as a precaution if the Service questions the validity of an offering.[21]

Again, it must be stressed that the 2002 Revenue Procedure only serves as a guide. While it may assist practitioners in structuring TIC arrangements, it does not provide an answer as to whether TIC interests are securities.

II. THE STRUCTURE

Individual investors that want to embark on a TIC purchase generally turn to TIC sponsors.[22] Sponsors search, find, and negotiate purchases of suitable property and some go through the process of underwriting or starting a private placement.[23] Once their role in the purchase is complete, TIC sponsors can reap up to 20% of the cost of the property.[24] When the cost of an average TIC property is $30 million dollars, it is no wonder that receiving a portion of the potential $6 million dollars in fees is attractive to any possible participant.

---

[16] *Id.*
[17] Rev. Proc. 2002-22, 2002-1 C.B. 733.
[18] *Id.*
[19] *Id.*; I.R.C. § 7701(a)(1) (2000) ("The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.").
[20] Section 1031(a)(3) requires that like-kind property must be identified within 45 days of the sale and the exchange must be completed within 180 days after the sale of the initial property.
[21] Kathy Heshelow, *Effortless Cash Flow: The ABC's of TICs (Tenant in Common Properties)* 18 (2006).
[22] Terry Pristin, *Commercial Real Estate; Money Flowing to New Way to Pool Buyers*, N.Y. Times, Sept. 22, 2004, at C10.
[23] Heshelow, *supra note 21*, at 39.
[24] Pristin, *supra* note 22.

Some TIC sponsors offer these investments as strictly real estate, while others offer the same investments as a security through a private placement. Among other things, the treatment determines who can participate in the offering and who can get paid for services rendered.

A. Typical Structure of a TIC Offered as a Security

TIC sponsor companies that promote properties as security interests generally use a variation of the direct ownership approach.[25] In the direct ownership approach, the TIC sponsor will purchase the target property and then will sell undivided fractional interests to investors. Upon purchase of their interest, investors will normally either enter into a property management agreement or a master lease agreement with an affiliate of the TIC sponsor.[26]

In reality, the property management agreement transforms the affiliate of the TIC sponsor into the property manager of the TIC property.[27] This property manager will receive a fixed property management fee and, in some cases, an asset management fee. While it is true that the property manager can be removed by the investors, it is usually subject to approval by the lender. Once the TIC investment is operational, the TIC sponsor does not provide economic protection if the investment turns sour.[28]

The master lease agreement provides more investor protection than the property management agreement.[29] Once entered, the master lease agreement transforms the affiliate of the TIC sponsor into a master tenant. The master tenant subleases the property to building tenants. The agreement will specify fixed rental payments to the TIC investors as landlord. Upon TIC investors receiving their share of fixed rental payments, the master tenant may retain any of the excess rental proceeds. In some cases, TIC investors would share in a portion of these excess rental proceeds. If building tenants fail to fulfill their obligation of paying rent, the master tenant remains liable to pay the rent, but only to the extent that they have capital. The main drawback to a master lease agreement is that TIC investors do not have any control over the property.[30]

1. The Howey Test

Despite the type of agreement is entered into, a property management or master lease, TIC sponsors that offer these investments as security interests rely on interpretations of federal securities law. The Securities Act of 1933[31] and the Securities Exchange Act of 1934[32] list a number of investment instruments deemed to be securities. Courts have interpreted the definition sections of each to be the same.[33] TIC interests are not discussed in either definition section; however, Section 2(a)(1) of the 1933 Act lists "investment contracts" as a

---

[25] Steinhause, *supra note 3*, at 26.
[26] *Id.*
[27] Steinhause, *supra note 3*, at 26.
[28] *Id.* at 27.
[29] *Id.*
[30] *Id.*
[31] 15 U.S.C. § 77b (a)(1) (2000).
[32] *Id.* § 78c (a)(10).
[33] *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985).

security interest.[34] The Supreme Court in *Securities and Exchange Commission v. W.J. Howey Co.*, formulated a test to determine what types of investments amounted to "investment contracts."[35] Those TIC sponsors that offer their investment as securities rely on the *Howey* interpretation of investment contract.[36]

Howey involved multiple investors, many located outside the state of the actual investment, who purchased fractional interests in plots of land in a citrus grove and in conjunction with the purchase also entered into an "optional" service agreement with the seller.[37] The service agreement gave the seller complete discretion and authority over the cultivation of the groves, their subsequent harvest, and marketing.[38] The service contract essentially amounted to a management agreement. Profits were derived from the citrus products that the seller managed and the investors shared in the earnings and profits in proportion to their individual ownership interests. The Supreme Court found that the investment, as structured, amounted to an investment contract and thus a security subject to federal securities laws.[39]

Howey espoused a four part test to determine whether an investment constitutes an investment contract.[40] The Howey test requires: 1) a person to invest money; 2) in a common enterprise; and 3) is led to expect profits; 4) solely from the efforts of others.[41] When applied to TICs, it is clear that participants invest money. The primary purpose that TIC investors have in entering such arrangements is to establish a cash flow, to preserve capital by not recognizing realized gain, and ultimately make a profit.[42]

The appropriate legal standard to establish a common enterprise has historically depended upon what circuit court one chooses to follow. Some courts require that one show horizontal commonality.[43] Horizontal commonality involves multiple investors pooling their assets and sharing in the profits and risks of the enterprise.[44] Other courts have followed a different legal doctrine, vertical commonality.[45] Vertical commonality requires that investor's fortunes be interwoven with the promoter's success.[46] The legal standard has two variants: broad vertical commonality and narrow vertical commonality.[47] The first variant, broad vertical commonality requires only that the investors rely on the expertise of the promoter.[48] Conversely, narrow vertical commonality also requires that investors' fortunes be interwoven

---

[34] 15 U.S.C. § 77b (a)(1) (2000).
[35] 328 U.S. 293, 298-99 (1946).
[36] *Tenancies in Common: Are They Securities?*, 34-MAY Real Est. L. Rep. 4
[37] 328 U.S. at 295-96.
[38] *Id.* at 296 (although offered as "optional," 85% of the acreage sold to investors was covered by the service contract).
[39] *Id.* at 300.
[40] *Id.* at 298-99.
[41] *Id.*
[42] Heshelow, *supra* note 21, at 32.
[43] *SEC v. SG LTD*, 265 F.3d 42, 49 (1st Cir. 2001).
[44] *See SEC v. Infinity Group Co.*, 212 F.3d 180, 187-88 (3rd Cir. 2000); *SEC v. Lauer*, 52 F.3d 667, 670 (7th Cir. 1995).
[45] *See SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478-79 (5th Cir. 1974).
[46] *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001).
[47] *Id.*
[48] *See SEC v. Unique Fin. Concepts, Inc.*, 196 F.3d 1195, 1199-1200 (11th Cir. 1999).

with the gains and success of the promoter or manager.[49] This essentially means that the promoter or manager stands to lose if the venture were to fail; they take on risk.

When applied to TIC transactions, the horizontal commonality legal standard is met. The TIC investors pool their money with other investors to purchase a single commercial property. It is through this common ownership that investors expect to be able to purchase the property and ultimately benefit from any profits associated with it.

Broad vertical commonality may be present in both the master lease and property management structures. Investors place day-to-day management decisions in the hands of whatever management they put in place. In both management arrangements, investors rely on the efforts and expertise of the master tenant or the property manager, respectively, to make the enterprise profitable.[50] Narrow vertical commonality, as discussed above, requires that investors' fortunes and the fortunes of the promoter or manager be interwoven. It is arguable that TICs using property management agreements do not have the characteristic of having the investors' fortunes interwoven with the fortunes of the promoter or manager. That is, the fixed property management salary is paid to the property manager no matter the level of success or failure of the investment.

The same can not necessarily be said of TICs using master tenants.[51] Master tenants are generally paid any rents in excess of the fixed rents that must be distributed to the TIC investors.[52] Arguably, the master tenant has an incentive to search for as many tenants as possible so as to increase his ultimate share. For example, if the master tenant is unable to find enough tenants to fully occupy the property then his share of the profits will go down, as will the share that is distributed to the investors. The investors are to be paid their fixed rental payments no matter the success of the investment, but the master tenant arrangement only offers limited protection since the master tenant may have limited capital to cover any discrepancies. It follows that TIC investors not only want a solvent master tenant, but a master tenant that has the experience necessary to manage the investment without any incident where solvency would be an issue. It is apparent in this case that fortunes are intertwined.

The "led to expect profits" requirement is met in most TICs. The Supreme Court has determined that investors can be said to expect profits in two situations: 1.) capital appreciation from the original investment, and; 2.) participation in earnings resulting from the use of investors' funds.[53] It has also been held that an expectation of profits does not exist when an individual purchases property for personal use or consumption.[54] Generally, TIC investors do not invest with intentions to personally use the properties. In many cases, the attraction of the TIC structure is that it is a vehicle to get passive income to investors from properties that re miles away. TIC investors also invest with hopes of deferring capital gain recognition if they enter into a TIC by way of a 1031 exchange.[55] Whether investors choose to purchase an interest in a TIC through a 1031 exchange or through a cash purchase, they do

[49] *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 n. 7 (9th Cir. 1973).
[50] Steinhause, *supra* at 26-29.
[51] Heshelow, *supra* at 90.
[52] Steinhause, *supra* at 27.
[53] *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975).
[54] *Id.* at 858.
[55] As noted earlier, a valid 1031 exchange requires the exchange of investment property which by definition excludes the characteristic of being for personal use.

so expecting a flow of income from future rents, property appreciation, and the option to move their investment into another TIC structure through a 1031 exchange. TIC investors expect profits.

Lastly, TIC transactions meet the fourth requirement of the *Howey* test. TIC investors expect profits solely from the efforts of others (i.e., property management or master tenants). The courts of appeals have held that the requirement is satisfied as long as "the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[56] The Supreme Court also addressed this fourth requirement, explaining that "the touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[57] While TIC investors may retain some control with respect to capital improvement decisions, the TIC structure is essentially managed and controlled by third parties, the property manager or the master tenant. Third parties oversee the essential business operations of the investment property. Absent their efforts, the venture would likely fail.

Even if the *Howey* test is met, it is still unclear whether it should apply. It is difficult to analytically distinguish a case where three individuals share ownership of an investment property of a small apartment building under a property management agreement from the larger-scale commercial TICs discussed above. Typically, the former type of investment is not deemed a security interest.

A danger exists if we choose to equate an investment to a real estate interest or to a security interest based arbitrarily on the number of investors. Placing a numerical threshold on what constitutes a security interest would be desirable to protect potential investors, but it would come at the expense of the real estate economy. For instance, if federal securities laws applied to TICs involving at least seven investors, many potential smaller investment projects would be abandoned or restructured to avoid the reach of the federal securities laws. For example, eight related investors who want to jointly purchase investment property may abandon the project because they lack the capital to restructure the project to avoid federal securities laws and complete the project.

2. Private Placements

TIC structures that do treat the investments as securities must contend with strict, time consuming, and costly registration requirements under the Securities Act.[58] These rigorous registration requirements place undue expenses upon a transaction given the typical level of investor sophistication and the relative size of the transactions. TIC transactions avoid the costs associated with registering under the Securities Act by making a private placement offering. Private placement offerings, made in reliance on an exemption prescribed under Regulation D, do not require registration under the Securities Act.[59] The private placement exemption represents the notion that registration under the Securities Act is unnecessary when investors are adequately sophisticated and informed to protect themselves.

---

[56] *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir. 1973)
[57] *United Hous. Found.*, 421 U.S. at 852.
[58] Stephen J. Choi and A.C. Pritchard, *Securities Regulation: Cases and Analysis*, 551 (2005).
[59] *See, generally*, 17 C.F.R. § 230.501-230.508 (2007).

Regulation D prescribes three types of offerings that are exempted from registration under the Securities Act.[60] Rule 504 and Rule 505 offerings cannot exceed $1 million and $5 million, respectively. While some TICs may choose to make a Rule 505 offering, the restrictiveness of the $5 million cap often requires making an offering in reliance on Rule 506. Rule 506 does not place any cap on the amount of the offering.

Under Rule 506, TICs can ultimately sell interests to an unlimited number of "accredited" investors, but are limited to no more than 35 "nonaccredited" investors that have sufficient knowledge and experience in business and financial matters to evaluate the investment.[61] "Accredited investor" is defined in Rule 501 and includes, but is not limited to, individuals with a net worth of more than $1 million or a salary of at least $200,000 in the each of the two most recent years or at least $300,000 in the current year if married. Most TIC investors qualify as accredited investors by being high net worth individuals.[62] Nonaccredited investors must demonstrate to the TIC sponsor's reasonable belief that they "either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."[63] The rules are silent with respect to how to determine whether "nonaccredited" investors are able to evaluate the merits and risks of the investment.[64] Due to the ambiguity associated with nonaccredited investors meeting the sophistication requirement, most Rule 506 offerings are offered exclusively to accredited investors.[65] TIC sponsors typically require that potential investors complete investor questionnaires demonstrating their accredited status and it is imaginable that they may be able to provide similar questionnaires to establish a nonaccredited investor's sophistication.

Both Rule 502 and Rule 506 offerings prohibit the TIC sponsor or anyone acting on their behalf to offer or sell the securities interests based on general solicitations or general advertising.[66] General solicitations or general advertising include communications published in any newspaper or similar media or any open seminars or open investment meetings whose attendees have been invited by any general solicitation or general advertising.[67] The SEC has interpreted that a solicitation is not general when a "preexisting relationship" exists between the TIC sponsor or anyone acting on their behalf and the potential investors.[68] The "preexisting relationship" requirement is meant to make certain that the TIC sponsor or related party know the level of sophistication of the potential investor. Ultimately, the

---

[60] *Id.*

[61] The total number of investors is effectively limited to 35 co-owners total due to the Rev. Proc. 2002-22. More than 35 co-owners could be perceived by the Service to be a partnership and ultimately lose the benefits of IRC § 1031.

[62] Heshelow, *supra* at 55.

[63] 17 C.F.R § 230.506(b)(1),§230.502(b)(1) (2007).

[64] TIC sponsors may be able to establish their "reasonable belief" of a purchasers sophistication by focusing on net worth, business or investment experience, level of education, etc.

[65] Choi and Pritchard, *supra* at 567; John G. Balboni and Robert J. LeDuc, *TIC Interests: ideal section 1031 replacement property*, Real Estate Weekly, April 27, 2005.

[66] 17 C.F.R. § 230.502(c). (2007)

[67] *Id.*

[68] *See generally*, E.F. Hutton & Co. Inc., SEC No-Action Letter, 1985 WL 55680 (Dec. 3, 1985); Bateman Eichler, Hill Richards, Inc., SEC No-Action Letter, 1985 WL 55679 (Dec. 3, 1985); H.B. Shaine & Co., Inc., SEC No-Action Letter, 1987 WL 107907 (May 1, 1987); Woodtrails-Seattle, Ltd., SEC No-Action Letter, 1982 WL 29366 (Aug. 9, 1982).

"preexisting relationship" requirement compels TIC sponsors to rely on securities firms to prescreen potential investors.

Investors that end up purchasing TIC interests in a private placement cannot resell to unqualified investors.[69] Resales to unqualified investors would transform the offering into a public distribution requiring registration under the Securities Act.[70] TIC sponsors therefore place restrictions on the interests sold to avoid falling outside of the protection of Regulation D.[71]

3. NASD

Furthermore, in 2005, the National Association of Securities Dealers (NASD) issued Notice to Members 05-18 that reiterated their position that TIC interests are securities for purposes of the federal securities laws and NASD rules.[72] The Notice also makes clear that the sale of TIC interests must be made through registered broker-dealers.[73] Registered broker-dealers are prohibited from directly or indirectly paying a real estate agent who is not a registered broker-dealer for participating in the transfer of a TIC interest that is structured as a security.[74] This is problematic when TIC interests are purchased with funds raised through 1031 exchanges. Real estate brokers invariably are involved in helping investors sell the property whose proceeds are rolled into the TIC structure. It is clear that real estate brokers would be unable to receive commissions for their services and it is for this primary reason that many in the real estate community have been structuring TIC interest sales as sales in real estate versus sales in securities.

B. TIC Interest Offered as a Real Estate Interest

It is understood that the direct ownership of real estate is an investment and that the form of ownership does not amount to a security interest.[75] At the core of the real estate approach are the principle notions that the TIC ownership of commercial real estate does not equate to a business enterprise and that agreements used in structuring TICs are common tools in commercial real estate not governed by federal securities regulation.

In 2006, Alvin Robert Thorup, an attorney in Utah[76], proposed a non-security TIC structure.[77] As proposed, a Seller using its own substantial capital would acquire commercial investment property. TIC investors that purchase the Seller's property must not acquire any

[69] 17 C.F.R. § 230.502(c) (2007).
[70] *Id.*
[71] TIC sponsors typically require purchaser representations concerning their investment intent, restrictive legends on certificates, and general restrictions on transfers. 17 C.F.R. §230.502(d) 2007).
[72] Notice to Members 05-18 (2005).
[73] *Id.*
[74] *Id.*
[75] The Supreme Court recognized this in Howey. Specifically noting that even if bought for an investment, the land itself does not constitute a common enterprise and "securities" are interests in an enterprise. *Howey*, 328 U.S. at 298-99.
[76] Utah passed legislation in 2005 that deemed a TIC offering of real property located in Utah as a sale in real estate. Utah Code Ann. §61-2-3 (West 2007).
[77] Alvin Robert Thorup, *TIC or Treat: How Tenant-in-Common Real Estate Sales Can Avoid the Reach of the Securities Laws*, 34 Real Est. L.J. 422, 426-431 (2006).

interest in the Seller. Furthermore, the Seller may not use profits from the transaction to fund any other business venture in which the purchaser participates. TIC investors must be experienced and sophisticated commercial property owners and/or advised by a real estate professional. The Seller would rely on real estate professionals to bring and advise TIC investors. Real estate professionals involved in these transactions would be compensated according to real estate industry standards.[78]

Sellers would be able to maintain a small TIC interest in the property and participate with the other TIC investors in the ownership and management of the property.[79] However, TICs must ultimately be able to exercise total control. To ensure that the TIC would ultimately have control of the property, a Seller maintaining a small interest in the TIC would be advised to always vote in the same manner as the majority of the other TIC investors. The initial management arrangement would be provided by the Seller or with an affiliate of the Seller, but the TIC would have the authority to cancel the arrangements at any time for any reason. The TIC would not have any financial interest in the business operations or success of the management entities.[80]

Similar to the securities approach to TIC interests, the real estate approach also places restrictions on transfers.[81] Looking to standards associated with the sale of typical real property interests, a TIC investor would be able to sell her interest at will. The TIC itself would be able to agree that if any investor wanted to sell their interest, then the TIC would have the option to purchase the interest at fair market value. Absent this agreement, the TIC investor would be able obtain the economic benefits of a judicial partition. That is, the TIC investor could convert their undivided fractionalized interest into a specific fragment of the TIC property that could be resold. In the end, lenders providing capital to fund the purchase of the TIC properties require that TIC investors temporarily waive their right to seek partition of their TIC interest since the loan is generally secured by the entire property.[82]

It is evident that the real estate approach to TIC structures attempts to maintain the appearance of an arms length transaction between the Seller and the TIC investors. A key to this structure is the notion that TIC investors and the Seller are not engaged in a business enterprise. Also, TIC investors in the non-security TIC structure appear to have a liquid investment.[83] The characteristics of the non-security structure espoused by Thorup, attempts to make it similar to typical non-security real estate transactions. While the structure may be similar to non-security real estate transactions, the crucial inquiry is whether the structure escapes federal securities regulation.

1. How the Non-Security TIC Structure Escapes the Howey Test

Like "TIC interests", "real estate" is not listed as an investment instrument in the Securities Act of 1933[84] and the Securities Exchange Act of 1934[85]. While *Howey* has been

[78] *Id.*
[79] Thorup, *supra* at 426-428.
[80] *Id.*
[81] *Id.* at 430.
[82] *Id.* at 431.
[83] In reality, as discussed above, this is not the case due to lender requests to give up rights to resell and/or requirements/agreements required by the TIC investors themselves restricting resells.
[84] 15 U.S.C. § 77b (a)(1) (2000).
[85] *Id.* § 78c (a)(10).

used to further the argument that TIC structures are "investment contracts" and thus securities, the real estate approach distinguishes *Howey* and claims that the Supreme Court's decision in defining an "investment contract" drew a line between investment in real estate and an investment contract.[86]

The real estate approach argues that *Howey*, as opposed to the non-security TIC structure, involves something more than the direct ownership of real estate.[87] It is purported that the growing of orange trees coupled with the subsequent sale and marketing of the oranges created a business enterprise, something absent from the non-security TIC ownership of leased real estate.[88]

In applying the *Howey* test to the non-security TIC structure, it is conceded that there is an "investment of money" with an "expectation of profits".[89] Consequently, the classification of the structure depends upon the analysis of the second and fourth prong of the *Howey* test, a "common enterprise" and "solely from the efforts of others", respectively.

a. Common Enterprise

The non-security TIC structure does not contain either horizontal or vertical commonality.[90] With respect to horizontal commonality, the TIC investors pool their money to purchase property from the Seller; they do not pool their money into a common enterprise or business. TIC investors simply own a unique direct ownership interest in specific real estate with the ability to sell at any time and the ability to replace management or lessees at any time. This ability to sell at will allows individual TIC investors to avoid being bound to the group as a whole beyond the practical limitations of owning separate undivided interests in the same parcel of real property.

Once more, vertical commonality has two variants: broad and narrow vertical commonality. Generally, vertical commonality is based on the concept that investor's fortunes are tied to the Seller or manager of the real estate's success rather her fellow investors.[91] Investors in the non-security TIC structure do not have a direct or indirect interest in the Seller or manager of the real estate. TIC investors rely on the managers or lessees to operate the real estate on their own account, with obligations to turn over rents to the TIC investors. In any case, the TIC investors' profits are reaped solely from the unique parcel of real estate and not from any other business venture of enterprise.

Thorup describes *Howey* as distinguishable from real property cases because the subsequent sale and marketing of the oranges created a "business enterprise", something apparently absent from leased real estate.[92] It should be noted that "business enterprise" is not actually used in the *Howey* decision. Howey uses the phrase "common enterprise".[93] This is

---

[86] Thorup, *supra* at 435.
[87] *Id.*
[88] *Id.* This position relies heavily on the following portion of the Howey decision: "[Mr. Howey offered] something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by [Howey]." 328 U.S. at 293, 299.
[89] Thorup, *supra* at 448.
[90] *Id.* at 452.
[91] *S.E.C. v. SG Ltd.*, 265 F.3d 42, 49 (C.A.1 (Mass.) 2001).
[92] Thorup, *supra* at 435.
[93] *Howey*, 328 U.S. at 298-299.

significant because "business enterprise" denotes the need for some sort of generally accepted form of a "business". This is not the case. It has been held that the Howey test must be administered without regard to nomenclature.[94]

Nomenclature aside, a court could reasonably conclude that the second prong of the *Howey* test is met in the non-security TIC structure. While the non-security TIC structure is a variation of leased real estate that generally does not fall under the auspices of the Securities Act, all the participating TIC investors' fortunes are related to some degree. This sharing of risk and profit through the pooling of investment funds is what the second prong of Howey addresses.[95]

b. Solely From the Efforts of Others

The fourth prong of the *Howey* test is met when "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[96] The non-security TIC structure allows the investors to retain direct ownership in the property. TIC investors have similar rights as that of any direct real estate owner. Namely, TIC investors may sell or pledge their interest without restriction; terminate the management or lessee agreement by majority vote at any time and for any reason.[97] Federal courts have found that this prong of the *Howey* test may be averted if the structure places control over significant decision in the hands of the TIC investors.[98] It is suggested that the analysis of these structures should be similar to the analysis of an individual property owner that leases real property or hires a property manager. In those cases the property owner is a passive participant in the sense that they collect rents. However, the property owner, like TIC investors, retains ultimate control of the property.

The non-security TIC structure relies heavily on the notion that its investors retain a sufficient level of control to avoid meeting the fourth prong. It has been held that when a structure's agreement allocates sufficient power to the investors to exercise ultimate control, as a majority, then the presumption is that the structure is not a security.[99] This presumption can be rebutted by providing evidence that the investors are unable to exercise the powers described in the structure's agreement.[100]

One situation where the presumption can be rebutted is when the investors are so dependent on a particular management arrangement that they cannot replace it or otherwise

---

[94] *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558; *S.E.C. v. SG Ltd.*, 265 F.3d 42, 47 (C.A.1 (Mass.), 2001).
[95] *Howey*, at 296.
[96] *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 n. 7 (9th Cir. 1973); *Rivanna Trawlers Unlimted v. Thompson Trawlers, Inc.*, 840 F2d 236, 240 n.4 (4th Cir, 1998).
[97] Thorup, *supra* at 450-451.
[98] *See, Gordon v. Terry*, 684. F.2d 736, 741 (11th Cir. 1982) (interests in limited partnerships organized to hold and develop real property were presumed to not be securities if an investor has the ability to control his investment either through her own efforts or through majority vote); *Williamson in Rivanna Trawlers Unlimited v.Thompson Trawlers, Inc.*, 840 F.2d 236, 241 (4th Cir. 1988) (holding that when an investor agreement allocates significant control to investors to exercise ultimate control then it is presumed that the investment is not a security, unless it is shown that it is practically impossible for the investors to exercise such control); *Matek v. Murat*, 862 F.2d 720, 729 (9th Cir. 1988) (used rule that if the investment agreement provides for effective legal control in the investors will be enough to avoid being labeled an "investment contract").
[99] *Rivanna Trawlers Unlimited*, 840 F.2d at 241.
[100] *Id.*

exercise control.[101] While the non-security structure may provide a road map to TIC structures yet to be realized, it is important to note that what may actually materialize may be quite different from what was originally intended in the agreement. Furthermore, the Supreme Court has noted that economic reality is to govern over form in determining what a "security" is.[102]

The problems noted with the non-security TIC structure may in fact be minor considering the lack of federal guidance, but until the SEC has spoken directly on the issue, these structures will function in a grey area of the law.

III. PROTECTION AND REMEDIES

A TIC structure classified as a security or real estate ultimately dictates what protection and remedies investors have available to them. The following will discuss the options available under the security and real estate classifications. The discussion will make use of the following hypothetical:

> Charles, a TIC investor, entered the venture via a § 1031 exchange. He is currently dissatisfied with the current property management of the TIC property and also feels that the broker and the private placement memorandum (PPM) did not disclose all the risks associated with the property. The other TIC investors do not think there is a problem with the current property management arrangement and replacing the current system requires a majority. Charles has also received word from other the other TIC investors that the Service may be under the impression that the body of investors qualified as a partnership at the time of the private placement, thus voiding his ability to use § 1031.

A. Remedies Associated With the Securities Classification

A primary purpose of the SEC is to protect investors through strict mandatory disclosure requirements. Failure to abide by the disclosure requirements could lead to civil and criminal liability under the Securities Act and the Exchange Act.[103] However, before discussing the liability provisions of the federal securities laws and whether they apply to TICs, a word must be said about broker-dealers and the National Association of Securities Dealers (NASD).

If classified as security interests, TIC interest must be effected by broker-dealers registered with the SEC.[104] Registration as a broker-dealer under Section 15 of the Securities Act prompts a number of compliance requirements that are meant to ensure broker-dealer competency, provide the public with information regarding the business integrity of broker-dealers, promote financial solvency of broker-dealers and subject broker-dealers to the

[101] *Williamson v. Tucker*, 645 F.2d 404, 422 (5th Cir. 1981).
[102] *International Brotherhood of Teamsters, Chauffeurs, Warehousemen & Helpers of America v. Daniel*, 439 U.S. 551, 99 S.Ct. 790, 58 L.Ed.2d 808 (1979); *United Housing Foundation, Inc*, 421 U.S. at 848.
[103] *See*, §§ 11, 12, 15 and 17 of the Securities Act and §§ 10, 18, and 20 of the Exchange Act.
[104] Under Section 3(a)(4)(A) of the Exchange Act, a "broker" is defined as a person "engaged in the business of effecting transactions in securities for the account of others."

auspices of the NASD.[105] The NASD serves as a regulatory body overseeing the national securities industry. Together, the SEC and the NASD provide a body of rules that espouse a level of conduct that if violated may result in disciplinary proceedings resulting in the cancellation of the broker-dealers' registration with the SEC and NASD.[106]

The NASD imposes suitability requirements on it brokers.[107] It requires that broker-dealers make reasonable efforts to obtain information regarding the tax status and investment objectives of their customers.[108] So in the hypothetical described above, any broker-dealer involved in a deal with George must make reasonable efforts to make certain that George is well diversified and knowledgeable on the subject prior to completing the investment. While intended to protect the investors, as practical matter it may not make much of a difference. Most TIC investors are accredited investors and well diversified and the protection provided by the NASD while very relevant for many investors may not be necessary in TIC cases.[109]

If George feels that property dropped in price when it should have risen in light of fraudulent and misleading projections given by the broker, he may file a complaint with the NASD. If successful, George may be able to get an order for monetary sanctions associated with the broker-dealer's misconduct, restitution and/or rescission, and the broker-dealer may in some egregious cases be suspended from acting in the capacity as a broker-dealer for up to two years.[110]

So what avenues are available to George under the securities laws if he feels his rights as an investor have been violated? Section 12(a)(1) of the Securities Act and Rule 10b-5 under the Exchange Act.

1. Section 12(a)(1)

Section 12(a)(1) of the Securities Act states that any person who "offers or sells a security in violation of Section 5"…shall be liable to the person purchasing such security from him.[111] Furthermore, it allows a successful purchaser under Section 12(a)(1), who still owns the security he acquired in a transaction that violated Section 5, a remedy of rescission.

Section 12(a)(1) is essentially a strict liability provision. This means that the TIC investor could have known about the violation at the time of the sale[112] or did not have to rely on the violation and still be able to recover under Section 12(a)(1).[113] A disgruntled TIC investor

---

[105] § 15(b)(8), 15 U.S.C. § 78(o)(b)(8), requires that any registered broker-dealer involved in effecting transaction in any security to be a member of the NASD. It should be noted that there are exceptions where broker-dealers need not join as members of the NASD, but this is generally not an issue with TICs. Rule 15b9-1 [17 C.F.R. § 240.15b9-1]. *See also* Exchange Act § 15(b)(8).

[106] *See generally*, Section 15(b) of the Exchange Act; NASD Rules 8300 et seq.

[107] NASD Rule 2310.

[108] *Id.*

[109] Choi and Pritchard, *supra* at 567; John G. Balboni and Robert J. LeDuc, *TIC Interests: ideal section 1031 replacement property*, Real Estate Weekly, April 27, 2005.

[110] *See generally*, http://www.nasd.com/RegulatoryEnforcement/NASDEnforcementMarketRegulation/NASDSanctionGuidelines/GeneralPrinciplesApplicabletoAllSanctionDeterminations/index.htm

[111] 15 U.S.C.A. § 771(a)(1).

[112] *Rosenberg v. Hano*, 121 F.2d 818, 822 (1941); *McDaniel v. Compania Minera Mar de Cortes, Sociedad Anonimo, Inc.*, 528 F. Supp. 152, 158 n.3 (1981).

[113] *Newberg v. America Dryer Corp.*, 195 F. Supp. 345, 352 (1961).

need only show that a sale took place, identify the defendant who sold the securities, prove that a registration statement covering the securities was not in effect, and prove that mails or facilities of interstate commerce were used in connection with the sale.[114]

George, the disgruntled TIC investor, may argue that the offer and sale of the TIC interest should have been registered under federal securities law. The Seller would likely attempt to establish the propriety of the private placement offering. George could take issue with any of the private placement requirements, but arguably, one of the most vulnerable areas of attack in TIC offers is the general solicitation requirement. A search on the internet for "TIC investments" results in a number websites that offer information regarding TIC interests and the steps to ultimately purchase a TIC interest. A Seller who offers their TIC interests as securities will not likely fall prey to this mistake, but those that offer TIC interests as real estate interests may not be so fortunate.

If George was led to purchase an interest through one of these websites or even if he wasn't but other fellow investors were, George may have a viable argument for a relief under Section 12(a)(1). If George attacks the validity of the private placement exemption, the Seller may attempt to invoke the safe harbor defense under Rule 508 for insignificant deviations and avoid liability to certain purchasers in the offering under Section 12(a)(1).[115] However, Rule 508 would not shield the seller in this case since a violation of the general solicitation requirement is deemed to be a significant deviation.[116]

a. Consequences of a successful Section 12(a)(1) action

If George successfully brought an action under Section 12(a)(1) and still owned the TIC interest he would be entitled to rescission. Rescission would effectively return George and seller to the positions they occupied prior to making the contract. In most contract cases, rescission is a desirable remedy; however, in TICs it is not so simple. Since most TICs are entered into via a 1031 exchange, any monies awarded by the court to the TIC investor through rescission must be recognized as income. That is, what the court is returning to George is the money that was deferred from the original 1031 exchange. Absent an exception, this amount must be recognized as income.[117]

Investors in George's position may be able to avoid gain recognition through an application of Section 1033(a). Section 1033(a) provides that:

> A taxpayer may elect not to recognize gain on the involuntary conversion of property into cash if the gain is realized as a result of its complete or partial destruction in whole (e.g., due to natural disaster), theft or condemnation, provided that the cash is reinvested in property that is similar or related in use to the lost property.

[114] *See, Swenson v. Engelstad*, 626 F.2d 421, 424 (1980) ← check this again Could not find support on page listed.
[115] Rule 508 provides a safe harbor for *Insignificant Deviations from a Term, Condition, or Requirement of Regulation D.*
[116] Rule 508(a)(2).
[117] *See* Section 61 of the I.R.C.

The provision has been described by courts as a relief provision that is entitled to liberal construction.[118] One may argue that the violation under Section 12(a)(1) amounted to a theft. Theft as used in the Internal Revenue Code is intended to cover any criminal appropriation of another's property to the use of the taker, "particularly including theft by swindling, false pretenses, and any other form of guile."[119] Extending theft to include a broker-dealer's failure to meet Section 5 requirements falls in line with the purpose of the statute to relieve the taxpayer of unanticipated tax liability arising from involuntary conversion of his property. George may characterize the deal as being completed under false pretenses. Specifically, if George can prove that the broker-dealer purposely misled him into believing that the transaction was either sound under federal securities law, then theft may be established.

A 1993 Technical Advice Memorandum (TAM) lends some credence to the section 1033 argument.[120] It involved a taxpayer who claimed that his broker-dealer made an unauthorized sale of his stock. Taxpayer repurchased approximately the same amount of shares for a significantly higher price than the sale price of the shares sold previously. He hoped that the repurchase would partially undo the earlier sale by causing it to be treated as rescinded for income tax purposes. The taxpayer and the broker-dealer entered into a "Rescission and Settlement Agreement and Release" whereby the broker-dealer, without admitting liability, paid the taxpayer the difference between the repurchase price and the previous sale price.

The Service held that section 1033 did not apply because the settlement agreement specifically denied the broker-dealer's liability. It went on to state that even if an unauthorized sale was proven, that would not amount to a type of involuntary conversion.

The TAM can serve as a guide to structuring an argument for the applicability of section 1033.[121] George must avoid a settlement agreement that denies broker-dealer liability and must also prove that the broker-dealer convinced him to enter the transaction under false pretenses. The TAM also involved an "unauthorized sale." This is distinguishable from George's case because George would have authorized the purchase of a TIC interest but it would have been made under false pretenses.

If successful, George would essentially have two years to roll the proceeds from the rescission into replacement property.[122]

2. Rule 10(b)(5)

Rule 10b-5 allows TIC investors to bring a private action against any person whose fraudulent activity was conducted "in a manner reasonably calculated to influence the investing public."[123] Additionally, to establish a violation of Rule 10b-5 in a private action, the Supreme Court has held that the defendant must be shown to have knowingly made material misstatements or omissions.[124] Any plaintiff, including George, would also have to

[118] *E.R. Hitchcock Co. v. U.S.*, 382 F.Supp. 236 (D.C.Conn. 1974).
[119] *See,* Edwards v. Bromberg, 232 F.2d 107, 110 (5th Cir. 1956); Nichols v. Commissioner, 43 T.C. 842, 884 (1965); Gerstell v. Commissioner, 46 T.C. 161, 171-72 (1966).
[120] I.R.S. Tech. Adv. Mem. 94-08-004 (Feb. 25, 2004).
[121] Section 6110(j)(3) of the I.R.C. provides that TAMs may not be used or cited as precedent.
[122] I.R.C. § 1033(a)(2)(B)(i).
[123] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d[] Cir. 1968). [cert. denied, 394 U.S. 976 (1969)].
[124] Aaron v. SEC, 446 U.S. 680, 695 (1980); SEC v. Rubera, 350 F.3d 1084, 1094 (9th Cir. 2003) (requiring a showing of recklessness to reflect "some degree of intentional of conscious misconduct.").

establish that the fraudulent activity was a substantial factor in causing the transaction complained of.[125]

The remedies available under Rule 10b-5 include injunctive relief[126] and damages.[127] Damage remedies under Rule 10b-5 are governed by section 28(a) of the Exchange Act. It limits recovery to "actual damages." The correct measure for damages under Rule 10b-5 is the "out of pocket" measure.[128] The "out of pocket" measure is the difference between the price paid for the interest and the true value at the time of the purchase. It is meant to place the purchaser back in the financial position had there not been fraudulent conduct.

Any out of pocket damages awarded to George would likely be characterized as boot gain and would need to be recognized.[129] As discussed earlier, George may be able to argue that the damage award was the result of a section 1033 involuntary conversion. If successful, he would be able to roll the award into another TIC structure.

Also under Rule 10b-5, if George dealt face-to-face with the defendant to purchase the securities, he may sue for rescission rather than damages.[130] The section 1033 argument may be made here as well.

B. Remedies Associated With the Non-Security Classification

Real estate brokers are regulated under the Real Estate Law associated with their respective state. Like broker-dealers, real estate brokers are subject to a regulatory body, the National Association of Realtors (NAR). Each state has its own branch of the NAR and each branch is divided into separate jurisdictions governed by a local board of realtors. The purpose behind the NAR is to protect the public from the damages and risks associated with unskilled or dishonest real estate professionals, to raise the standards or practice of the real estate industry, and to educate those engaged in the real estate business.[131]

While the NAR may be similar to the NASD in the sense that it provides standards of practice, the NAR does not offer the same level of enforcement against real estate brokers that the NASD offers against broker-dealers. For instance, if a real estate broker is registered under the NAR and a TIC investor believes that they have been defrauded, the NAR can generally only go so far as to impose small fines and disciplinary action that ranges from a letter of reprimand to expulsion from the NAR.[132] However, the NAR's Code of Ethics[] may

---

[125] Wilson v. Comtech Telecomms. Corp., 648 F.2d 88, 92 (2d Cir. 1981); Feinberg Testamentary Trust v. Carter, 652 F. Supp. 1066, 1079 (S.D.N.Y. 1987).

[126] Injunctive relief is a remedy reserved for actions brought by the government, not individuals.

[127] *See, e.g.*, Tully v. Mott Supermarkets, Inc., 540 F.2d 187, 194 (3rd Cir. 1976).

[128] Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972).

[129] I.R.C. § 1031(b).

[130] In re Letterman Bros. Energy Sec. Litig., 799 F.2d 967, 972 (5th Cir. 1986)[, cert denied, 480 U.S. 918 (1987)]; Huddleston v. Herman & MacLean, 640 F.2d 534, 554 (5th Cir. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375 (1983).

[131] N.A.R. Const., art. II.

[132] *See generally, National Association of REALTOR'S Code of Ethics* available at http://www.realtor.org/mempolweb.nsf/pages/code?opendocument; *Grievance procedures for Placer County Association of Realtors and Sacramento Association of Realtors* available at *http://www.pcaor.com/pcar/grievance.htm.*

be admissible in determining a real estate broker's assumed standard of conduct under actions brought under real estate law.[133]

Real estate law is comprised of a combination of contract, tort, and agency law.[134] Theoretically, George would be able to claim that the real estate broker's failure to disclose the risks and or problems associated with the property constituted a breach of real estate law. Like federal securities regulations, real estate law requires that a real estate broker disclose every material fact that affects the value or desirability of the property.[135] Failure to do so may result in liability under tort law. Generally, tort damages are figured through the same out-of-pocket measure used in Rule 10b-5 actions. A claim may also be brought under contract law. Contract law would allow damages or rescission.

Remedies afforded under real estate law are very similar to those afforded under federal securities law. Any damage award or cash received as a result of rescission would trigger gain recognition to the taxpayer. Again, the only apparent exception to gain recognition would be a section 1033 argument.

IV. FEDERAL BASIS FOR PROTECTION

A. What Does Federal Securities Law Seek to Protect?

The Securities Act and Exchange Act were reactions to the stock market crash associated with the Great Depression.[136] Prior to the Acts and the Great Depression, individual states offered protection to investors, but the protection was imperfect. The infrastructure was not in place to assist defrauded investors in Wisconsin to exercise jurisdiction over sellers in New York. The Acts remedied the state imperfections and currently anything included within the definition of a security is subject to reporting, monitoring, and enforcement by the SEC.[137]

The Great Depression justifications do not help to justify inclusion of TIC interests under the definition of a security due to the current sophistication of Blue Sky laws. Even current rationales for federal securities regulations that are aimed at thwarting the use of informational advantages to exploit the market and unwary investors do not help in the argument. Informational advantages are difficult to exploit with respect to real property values. Generally, investors will have the option to seek the services of independent appraisers. Besides, any benefit and subsequent injury stemming from the use of informational advantages in commercial property can be handled under real estate law as easily as it is handled under federal securities law. TIC investments are characterized by investments in real property and not intangibles. Intangibility is something characteristic of a security.

---

[133] Easton v. Strassburger, 152 Cal.[]App.[]3d 90, 101, n.5 (1984); Pepper v. Underwood, 48 Cal.[]App.[]3d 698, 714 (1975).

[134] For purposes of clarity, this section will focus on California's Real Estate Law. Bus. & Prof. Code, §10000 et seq.

[135] CA BUS & PROF CODE §§ 10176-10177.2.

[136] Choi and Pritchard, *supra* at 104.

[137] *Id.*

V. FOLLOW THE LEADER – WHAT STATES DO?

Generally, state securities laws have not taken a position on whether TIC interests are security or real estate interests. Washington and Utah are two states that have made definitive determinations on the subject. Their respective approaches shed some light on how to possibly regulate TIC interests and whether it is an issue better left to individual states.

A. Washington and Utah

In 2005, the state of Washington took the position that TIC interests are securities for purposes of the Washington securities law.[138] This provides guidance within the state. Compliance with Washington securities laws would equate to meeting SEC requirements if it was determined that TIC interests were securities.[139] So, while proponents of the non-security TIC structure may steer clear of the state of Washington, those that follow its guidelines would in theory be in compliance of SEC requirements if the SEC determined TIC interests to be securities.

Washington was not the only state to address the TIC issue in 2005. The Utah legislature amended its securities law to designate TIC interests as real estate interests to be regulated exclusively under Utah's real estate laws.[140] Additionally, to not qualify as a security in Utah, the TIC structure must be subject to a management agreement. "As a result of the [amendments, a] TIC interest[] in property located within the state of Utah [is] excluded from the definition of a 'security' under the Utah Uniform Securities Act."[141] What remains problematic despite Utah's treatment is that TICs could still be subject to federal securities regulations.

TIC property interests within the state of Utah must be sold by a real estate agent-broker licensed in the state.[142] Utah also requires that the real estate agent-broker be paid for services rendered.[143] This means that a California based TIC deal treated as a security with the assistance of NASD registered broker-dealers selling an interest to a Utah resident would need to use and pay a Utah real estate-broker to complete the transaction. This situation illustrates the conflicts associated with NASD regulations and Utah securities law. A simple solution in this case would be to structure the TIC deal as a real estate interest in California since the California Department of Corporations has yet to make a final determination of how TIC interests should be classified. Although, changing the classification of a TIC structure just to include a Utah investor is unlikely and so it is more likely that the deal would proceed without the Utah investor.

---

[138] *See*, DEP'T OF FIN. INSTS., STATE OF WASH., ALERT: TENANCY-IN-COMMON INTERESTS AS "SECURITIES", (Sept. 8, 2005), http://www.dfi.wa.gov/sd/pdf/tenancy_in_common.pdf.

[139] TIC interests under Washington securities law must meet the *Howey* test. It follows that if the SEC deemed TIC interests security interests for federal purposes, TIC investments in Washington would be in compliance with federal guidelines.

[140] *See*, STATE OF UTAH DEP'T OF COMMERCE, SALES OF REAL ESTATE INVESTMENTS IN UTAH, (Dec. 6, 2006), http://www.securities.utah.gov/TIC.pdf.

[141] *Id.*

[142] *Id.*

[143] *Id.*

One solution to the problem involving the NASD and the use of a real estate agent-broker was addressed by the SEC in a No-Action Letter.[144] The letter requested approval for a registered broker-dealer to employ a real estate agent or real estate broker as an associated independent contractor in a TIC deal. The SEC approved of the planned action.[145] The No-Action Letter also indicated that the NASD had already approved of the proposal in 2005.[146]

Even more difficult to reconcile would be a situation where a TIC deal based in Washington attempted to include a Utah investor. Washington would not have the option to change its classification to comply with Utah's treatment and the deal would likely proceed without the Utah investor. It should be noted that the Utah Real Estate Act provides an exemption from employing the assistance of a licensed real estate agent-broker.[147] The exemption only allows not using a licensed real estate agent-broker if the seller is a broker-dealer and the security being sold is registered either under federal or Utah securities law.[148] Registration of the interests would not allow the TIC structure to benefit from a private placement. As a practical matter, the registration requirement makes the use of the exemption a non-issue.

VI. SUGGESTED APPROACH

In the absence of federal guidance, states may follow Utah and Washington and make their own determinations with regard to TIC classification. As discussed, inconsistent treatment leads to a host of problems, one of which is the possible exposure to federal securities laws should the SEC determine TIC interests to be securities. The SEC must address this issue and should ultimately prescribe a determinate decision on the issue.

The process of determining what TIC structures are securities and which ones should be classified as real estate interests is laden with problems. For instance, the SEC could come to the same conclusion as Utah. That is, TIC structures that contain property management agreements should be regulated under real estate law. This conclusion would not be without merit. So long as the property manager did not receive payments above and beyond a fixed management salary, the structure could reasonably avoid the *Howey* test.[149] By this reasoning, TIC structures with master lease agreements would be deemed security interests. However, it is foreseeable that TIC structures would be structured to comply with the real estate classification to avoid the costs associated with private placements.

Tax law may be useful in making a final determination. As noted above, Rev. Proc. 2002-22 has served as a guide to structuring TICs. It suggests that no more than 35 investors can be

---

[144] Welton Street Investments, LLC, SEC No-Action Letter, 2006 WL 1896896, at *1 (June 27, 2006).

[145] The SEC approved of the planned action, but noted in particular (1) the limitation on activities of the associated independent contractor and the real estate brokerage firms that they were associated with, (2) the conditions on fee arrangements meant to ensure that securities activities engaged in by the independent contractor not affect the amount of compensation received by the real estate brokerage firms, and (3) that the registered broker-dealer comply with applicable requirements of the Exchange Act. *Id.*

[146] *Id.*

[147] U.C.A. 1953 § 61-2-3.

[148] *Id.*

[149] By restricting payments to the third party to a fixed management fee, the structure may reasonably avoid the vertical commonality requirement of the Howey test. The fortunes of the third party would not be intertwined with the investors as vertical commonality requires. Rather the third party would be due the same fixed salary whether the investment succeeded or failed.

involved in a TIC structure for it not to run afoul of 1031 exchange requirements. This is already somewhat of an established rule followed by TIC planners. Conceivably, a transition to deem all TICs as security interests would be smoother if it complied with tax law.

Then there is the protection that should be afforded to the investor. Each classification provides its own benefits. As a whole, federal securities laws provide the most protection, but the question remains whether very wealthy individuals necessarily need all the protection. The problem with focusing on wealthy individuals is that while current TIC structures are generally only offered to the very wealthy, it is not unreasonable to foresee a situation where smaller sized TIC structures are offered to upper middle class families who have second homes as investment property.[150] A shortsighted view of the TIC industry may expose these investors to fraud. Securities treatment, while costly and possibly unnecessary in certain situations, may protect new waves of potential TIC investors.

CONCLUSION

On the whole, TICs are an efficient way to continue investment in real estate, minimize tax liability, and avoid management headaches associated with sole ownership. However, the popularity of TICs has created a need to get a definitive answer from the SEC. As states continue to develop their own approaches to the issue, a lack of uniformity may swell to the point that potential investors may effectively be barred from investing in out-of-state TICs. As the amount of TICs offered increases, so does the danger of fraudulent activity by all of those involved and uniform regulation may ultimately serve to curb this.

[150] Vacation TICs are one example of relatively accessible TIC products available to upper middle class investors. [Specifically, an investor may be able to purchase a TIC interest in a vacation TIC from $35,000 to $65,000.] Carrol Llloyd, *Fractional Fairy Tale: The Dream of owning a vacation home can come true via tenancy-in-common*, S.F. Gate, May 11, 2007, available at http://sfgate.com/cgi-bin/article.cgi?f=/g/a/2007/05/11/carollloyd.DTL.