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1031 Tenant in Common Exchanges: A "Tic"king Time Bomb at the Intersection of Real Estate, Securities, and Tax Law?

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**1031 TENANT IN COMMON EXCHANGES: A “TIC” KING
TIME BOMB AT THE INTERSECTION OF REAL ESTATE,
SECURITIES, AND TAX LAW?**

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I. INTRODUCTION

Those who follow economic trends know that investing in real estate has recently become a hotbed of activity. In response to the stock market’s unpredictability, investors have been drawn to the commercial real estate market in record numbers, seeking to capitalize on low interest rates coupled with the rising appreciation such properties have offered.¹ In addition to the potential upside of such investments, many commercial property investors seek a tax deferral method for the capital gains they realized upon the sale of other previously owned property.² Section 1031 of the Internal Revenue

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¹ Michael Walters, *N.J. Prospects Looking Good*, 51 REAL EST. WKLY., Oct. 27, 2004, at S7, 2004 WLNR 14853679; see Ray A. Smith, *Real-Estate Investing Gets Riskier*, WALL ST. J., Jan. 5, 2005, at B6.

² See Beth Mattson-Teig, *A 1031 Exchange Vehicle for Small Investors*, NAT’L REAL EST. INVESTOR, Mar. 1, 2003, http://nreionline.com/finance/investors/real_estate_exchange_vehicle_small/index.html.

Code (“Section 1031”), under specially defined circumstances, allows for deferral of the tax liability that would otherwise be imposed as a result of real property capital gains.³ For a variety of reasons which will be discussed, greater numbers of investors are choosing to take advantage of Section 1031’s tax liability deferral by purchasing fractional interests in commercial real property through “1031 Tenant-in-Common (‘TIC’) exchanges.”⁴

The 1031 TIC exchange is a relatively new investment vehicle that raises a number of novel legal issues. Primarily, whether such an arrangement should be considered a “security” under federal tax, federal securities, and state securities laws.⁵ The provisions of Section 1031 specifically exclude exchanges involving “stocks, bonds, or notes”⁶ as well as “other securities.”⁷ Therefore, if a 1031 TIC exchange is deemed to be a security, it is questionable whether the arrangement would then meet the requirements of Section 1031 and entitle the investor to a tax deferral benefit.⁸

The Internal Revenue Service is “aware of the issue of whether, or under what circumstances, a TIC may constitute a security that may not be exchanged under Section 1031, and is watching how matters develop as the TIC concept evolves in the Section 1031 context.”⁹ This article will explore the burgeoning 1031 TIC industry, discuss the nuances of 1031 TIC exchanges, and provide an analysis of whether such transactions are in fact, securities, and if so, whether that status poses a problem for the taxpayer seeking the advantages of Section 1031.

II. SECTION 1031 OF THE INTERNAL REVENUE CODE

A. Mechanics of the Tax Deferral Provision

United States tax laws and Internal Revenue Service (“IRS”) rules generally provide that “[g]ain realized on the sale or exchange of property is included in gross income, unless excluded by law.”¹⁰ The “gain from the sale or other disposition of property” is computed as “the excess of the amount

³ 26 U.S.C. § 1031(a)(1) (2000).

⁴ Smith, *supra* note 1; Mattson-Teig, *supra* note 2; Terry Pristin, *Money Flowing to New Way to Pool Buyers*, N.Y. TIMES, Sept. 22, 2004.

⁵ See Smith, *supra* note 1; Mattson-Teig, *supra* note 2; Pristin, *supra* note 4.

⁶ 26 U.S.C. § 1031(a)(2)(B) (2000).

⁷ *Id.* § 1031(a)(2)(C).

⁸ See Smith, *supra* note 1; Mattson-Teig, *supra* note 2; Pristin, *supra* note 4.

⁹ General Information Letter from Michael J. Montemurro, Acting Branch Chief, Office of Associate Chief Counsel, Internal Revenue Service, to Jennifer Erdelyi (July 20, 2005) (on file with author).

¹⁰ Treas. Reg. § 1.61-6 (2005).

realized therefrom over the adjusted basis.”¹¹ “Basis” in property is generally the cost of the property,¹² but can also be adjusted upwards and down, to include expenditures and deductions related to the property.¹³ The entire amount of such gain is recognized upon the sale or exchange of property, except as otherwise provided in the Internal Revenue Code (“Code”).¹⁴ Section 1031 is a provision for the non-recognition of such gain when it is exchanged for “like kind” property.¹⁵ Section 1031 provides:

- (a) Nonrecognition of gain or loss from exchanges solely in kind.—
 - (1) In general.—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.
 - (2) Exception.—This subsection shall not apply to any exchange of—
 - (A) stock in trade or other property held primarily for sale,
 - (B) *stocks, bonds, or notes*,
 - (C) *other securities* or evidences of indebtedness or interest,
 - (D) interests in a partnership,
 - (E) certificates of trust or beneficial interests, or
 - (F) choses in action.¹⁶

Section 1031 provides a deferral, rather than an exclusion, of tax liability because the basis in the original relinquished property is transferred to the acquired replacement property, and therefore, depending upon the subsequent disposition of the replacement property, tax liability may be incurred at a later time.¹⁷ To comply with Section 1031, both the relinquished and the replacement properties must be “held for productive use in a trade or business or for investment.”¹⁸ There is no bright line test for determining whether property was held for productive use in a trade or business or for investment. Rather, courts have looked to the “investment

¹¹ 26 U.S.C. § 1001(a) (2000).

¹² *Id.* § 1012.

¹³ *Id.* §§ 1011(a), 1016(a).

¹⁴ *Id.* § 1001(c).

¹⁵ *Id.* § 1031.

¹⁶ *Id.* (emphasis added).

¹⁷ *See id.* § 1031(d); Treas. Reg. § 1.1031(d)-1 (2005).

¹⁸ 26 U.S.C. § 1031(a)(1) (2000).

intent” of the taxpayer in order to make their determination.¹⁹ Within the 1031 TIC real estate industry, a holding period of one to two years is generally suggested to be indicative of investment intent.²⁰ In order to benefit from the tax deferral provision of Section 1031, an exchange must also involve property that is “like kind.”²¹ The Internal Revenue Service has interpreted broadly whether real property is “like kind,” finding, for example, that the exchange of city real estate for a ranch or farm, complies with Section 1031’s “like kind” requirement.²²

Section 1031 exchange transactions must conform to the specific rules provided therein.²³ These rules include a requirement that replacement property be identified within forty-five days of the date of sale of the relinquished property.²⁴ In addition, the purchase of the replacement property must be completed no later than 180 days after the sale of the relinquished property.²⁵ These strict timeframes are often what provide an investor with the impetus to select a 1031 TIC exchange as the means to re-invest their gain from the sale of investment property into a new property, while enjoying the tax deferral offered by Section 1031.²⁶

B. History of the Exclusion of Securities from Section 1031

The regulation of securities in the United States began with the states themselves taking a leading role in preventing the sale of fraudulent investments by enacting “blue sky” laws.²⁷ Kansas was the first state to enact legislation regulating the sale of securities in 1911.²⁸ Congress followed suit

¹⁹ See, e.g., *Bolker v. Comm’r of Internal Revenue*, 760 F.2d 1039, 1045 (9th Cir. 1985).

²⁰ See, e.g., Bayview Financial Exchange Services, LLC, Tax Deferral Strategies for Real Property, <http://www.bayview1031.com/bfes/bfesweb.nsf/faq> (last visited May 1, 2005) [hereinafter Bayview]. Taxpayers who hold their relinquished property for two years satisfy the requisite intent for a 1031 Exchange (or two tax reporting periods, since in an audit the IRS may look backwards and forwards two tax returns). A holding period of over a year has generally been accepted, but may be subject to review by the IRS. *Id.*; see also Sheila Muto, *New 1031 Deal Takes High Prices Into Account*, WALL ST. J., Nov. 3, 2004, at B6.

²¹ 26 U.S.C. § 1031(a)(1) (2000).

²² Treas. Reg. §§ 1.1031(a)-1(b), (c) (2005).

²³ 26 U.S.C. § 1031; see also Treas. Reg. §§ 1.1031(a)-1 to 1.1031(k)-1 (2005).

²⁴ 26 U.S.C. § 1031(a)(3)(A) (2000).

²⁵ *Id.* § 1031(a)(3)(B).

²⁶ Keat Foong, *TICs Take Off: Enable Small Buyers to Compete for Big Deals*, MULTI-HOUSING NEWS, Apr. 1, 2005, available at http://www.multi-housingnews.com/multihousing/search/article_display.jsp?vnu_content_id=1000846942.

²⁷ 2 THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 8.1[1][A] (5th ed. 2005); see also 1 HAZEN *supra*, § 1.2.

²⁸ 1 HAZEN *supra*, § 1.2.

eleven years later with the passage of the Securities Act of 1933²⁹ and the Securities Exchange Act of 1934.³⁰

The exclusion of “stocks, bonds, or notes” and “other securities” from Section 1031’s tax deferral benefit dates back to the 1920’s. In 1923, as part of its consideration of amendments to the Revenue Act of 1921, the House Committee on Ways and Means solicited and received a letter from Andrew Mellon, Secretary of the United States Treasury Department.³¹ Mellon described widespread abuses that were taking place at that time as a result of “brokers, investment houses, and bond houses” which had established exchange departments to assist their customers in trading securities that had appreciated in value, for other securities and cash consideration, without realizing a taxable gain.³² Mellon deemed the resulting lack of tax liability “manifestly unfair and destructive of the revenues” and urged Congress to amend the law such that the tax-deferred exchange of securities would take place only in the context of the reorganization, consolidation, or merger of corporations.³³

Congress responded by passing a bill which amended the Revenue Act of 1921 to specifically exempt stock, bonds, notes, or other securities, among other exclusions, from the tax deferral benefit afforded by the like-kind exchange provision of the Revenue Act.³⁴ The terminology of “stock, bonds, notes” and “other securities” selected by Congress in 1923 has remained unchanged, despite numerous revisions to the Revenue Act and subsequent Revenue Code.³⁵

Not only did the legislature expressly exclude the named securities of “stocks, bonds, or notes,” but Congress also included the additional catch-all category of “other securities.”³⁶ This textual construction provides an interesting indication of the congressional intent to exclude securities of all types, not just stocks and bonds, and becomes relevant in our later discussion of whether 1031 TIC exchanges are in fact securities, and whether such transactions comply with Section 1031.

²⁹ 15 U.S.C. § 77a (2000).

³⁰ *Id.* § 78a.

³¹ H.R. REP. NO. 67-1432, at 1-2 (1923); *see also* S. REP. NO. 67-1113, at 1-2 (1923).

³² S. REP. NO. 67-1113, at 1-2 (1923).

³³ *Id.*

³⁴ H.R. 13774, 67th Cong. (1923).

³⁵ *See, e.g.*, Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) (creating paragraphs (2) and (3) of Section 1031 for organization purposes, but retaining the same terminology of the text within regarding securities). This Act also added “interests in a partnership” as an exception to Section 1031.

³⁶ *Id.*

III. THE 1031 TIC EXCHANGE MARKETPLACE

The forty-five day identification period and the 180 day exchange completion period mandated by Section 1031 must be stringently adhered to, for “[i]f an investor fails to close on the exchange, the investor is forced to pay a hefty capital gains tax on the original property sale.”³⁷ The deadlines imposed by the Internal Revenue Code are sometimes difficult for taxpayers to comply with, particularly considering the “hot real estate market” which has resulted in more investors competing for less inventory.³⁸ This “supply and demand” problem can be lessened by the opportunity for multiple investors to purchase fractional interests in large commercial properties, as is accomplished by a TIC exchange.³⁹

The TIC investment scheme provides individual investors with ownership opportunities in prime commercial properties, such as office buildings, retail shopping centers, and apartment buildings, which otherwise would not be available to them due to the price and status of the property as a whole.⁴⁰ Rather, the traditional bidders for such commercial properties, who now must compete with groups of TIC investors, are “publicly traded companies, pension funds and large private real estate companies.”⁴¹ Many 1031 TIC investors are attracted to what they view as “passive” or less “management intensive” investments due to the active role of a management company in the TIC property.⁴²

In order for individual investors to become involved in a TIC purchase, they often turn to companies which put together such deals.⁴³ The companies that sponsor such programs have grown from nine in 2001, to more than thirty-six in 2004.⁴⁴ Upon selling fractional interests, these sponsor companies receive brokerage fees and transaction costs which can result in profits to them of up to 20% of their cost in buying the property.⁴⁵ Not only have the number of companies organizing TIC deals expanded in recent years, but the amount of money being poured into such investment

³⁷ Mattson-Teig, *supra* note 2.

³⁸ Pristin, *supra* note 4; Muto, *supra* note 20.

³⁹ Pristin, *supra* note 4; Mattson-Teig, *supra* note 2.

⁴⁰ See Pristin, *supra* note 4; see also Foong, *supra* note 26 (noting that the availability of “TIC deals give mom-and-pop players the opportunity to partake in the ownership of institutional-quality real estate”).

⁴¹ Pristin, *supra* note 4.

⁴² Mattson-Teig, *supra* note 2; see also Foong, *supra* note 26.

⁴³ Pristin, *supra* note 4.

⁴⁴ *Id.*

⁴⁵ *Id.*

schemes has skyrocketed as well.⁴⁶ In 2005, TIC transactions surpassed \$6.4 billion, with at least five recent TIC deals topping \$100 million each.⁴⁷ Figures from 2001 indicate \$165 million was invested in TIC equity.⁴⁸ That figure has increased each year, in large part due to the IRS's issuance of Revenue Procedure 2002-22, which provided guidelines for such investments, and which will be discussed *infra*.⁴⁹

Tenant-in-common ownership, characterized by more than one owner holding an undivided interest in a single property, is a concept with historic origins, but has only recently been used as an investment vehicle.⁵⁰ In the typical 1031 TIC exchange, numerous investors are sought to partake in the purchase of a property through fractional fee simple interests.⁵¹ The investors each receive a separate deed for their proportionate interest in the building.⁵² A hallmark of the 1031 TIC transaction is that a master-lease agreement is effectuated between the new owners of the property and the sponsor, or an affiliate of the sponsor.⁵³ The master lessee then sub-leases the property, collects rents, handles all building management, and distributes profits derived from the building's operation to the owners.⁵⁴

Currently, some 1031 TIC sponsor companies market and sell their product strictly as real estate, while others sell the same type of investment as a security, often through private placements.⁵⁵ The rapid increase in sales of TIC investments has raised eyebrows with regulatory agencies and some real estate industry professionals. The Wall Street Journal reported on 1031 TIC transactions in January, 2005:

The programs have become so hot that the National Association of Securities Dealers and the Securities and Exchange Commission have been looking at how these interests are marketed and sold in order to make sure guidelines and rules regarding sales are being appropriately followed. One issue for regulators is whether these

⁴⁶ See *id.*; Smith, *supra* note 1.

⁴⁷ Jennifer S. Forsyth, *Joint Property Ownership Picks Up*, WALL ST. J., Apr. 5, 2006, at B7.

⁴⁸ Pristin, *supra* note 4.

⁴⁹ Smith, *supra* note 1.

⁵⁰ Pristin, *supra* note 4.

⁵¹ *Id.*

⁵² Foong, *supra* note 26.

⁵³ *Id.*

⁵⁴ See *id.*; see also FOR1031, *NNN PLUS Lease—Lease Advantage*, <http://www.for1031.com/nnnplus.aspx> (last visited May 1, 2005) [hereinafter FOR1031] (describing the typical day-to-day functions performed by the master lessee).

⁵⁵ Pristin, *supra* note 4; see also Bayview, *supra* note 20 (stating, "TICs are sometimes sold as securities and sometimes as real estate.").

investments are securities or real estate, since different rules apply for each.⁵⁶

Attorneys and real estate professionals fear that TIC investments sold without registration under the securities laws, or an exemption therefrom, put investors and themselves in danger by not fully disclosing all material information that may be needed by investors to evaluate the risks of their investment.⁵⁷ The nature of 1031 TIC transactions, characterized by numerous investors purchasing fractional interests in high-grade properties, coupled with the management of the property by the sponsor or its affiliate, raises the question: are these 1031 TIC investment products "securities?"

IV. A SECURITIES ANALYSIS: ARE 1031 TIC EXCHANGES SECURITIES?

Whether or not the described 1031 TIC interests are considered to be securities may just depend on which law's definition is used. Under United States tax law, although Section 1031 prohibits exchanges involving "stocks, bonds, or notes" and "other securities" from receiving the tax deferral benefit of that section, the terms are not defined in either the Internal Revenue Code or the Treasury Regulations for purposes of Section 1031.⁵⁸ The Internal Revenue Service has confirmed the absence of these definitions, stating that "the Internal Revenue Code and the Income Tax Regulations contain many references to stocks, bonds and securities. However, we know of no provision in either the Code or regulations defining the meaning of those terms for purposes of a Section 1031 exchange."⁵⁹

Under federal securities laws, the definition of a security can be found within the definition sections of the Securities Act of 1933⁶⁰ and the Securities Exchange Act of 1934.⁶¹ The definition sections of the two acts are similar and courts have interpreted them to be the same.⁶² Section 2(a)(1) of

⁵⁶ Smith, *supra* note 1. See also Pristin, *supra* note 4 (explaining that "[t]he explosive growth of tenant-in-common investments . . . has attracted the attention of NASD, the securities industry regulatory body, which is looking into how these programs are organized and marketed").

⁵⁷ Pristin, *supra* note 4 (quoting David B. Bayless, a former official with the SEC as stating, "It's pretty clear that these 1031 T.I.C. exchanges are almost always securities" and Cary Losson, president of a 1031 TIC consulting company, characterizing sponsors' sales of TIC interests without registration as "terribly reckless.").

⁵⁸ See 26 U.S.C. §§ 1031, 1236(c) (2000); Treas. Reg. §§ 1.1031(a)-1-1.1031(k)-1.

⁵⁹ Montemurro, *supra* note 9, at 1.

⁶⁰ 15 U.S.C. § 77b (a)(1) (2000).

⁶¹ *Id.* § 78c (a)(10).

⁶² Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985).

the 1933 Act lists numerous investments, among them: notes, stocks, bonds, debentures, and investment contracts, which are deemed to be securities “unless the context otherwise requires.”⁶³ Since a tenant-in-common interest is not specifically listed in the Securities Act definition, if a TIC interest is determined to be a security, it would likely be deemed so under the umbrella of an “investment contract,” which is a listed security in the Act.⁶⁴

Under the securities laws, an interest in a partnership may or may not be a security, depending upon whether the partnership interest is or is not an “investment contract.”⁶⁵ Thus, the enumeration in Section 1031 of “stocks, bonds, or notes,” “other securities or evidences of indebtedness” and “interests in a partnership” is perplexing from a securities law perspective, as partnership interests are not an enumerated category under the securities laws, unlike stocks, bonds, notes and investment contracts, which are specifically listed. Consider a hypothetical statute governing packaging of food products specifying exclusion for “carrots and other vegetables, meat, bread and tomatoes.” Are tomatoes fruit? Are we governed by the botanical definition (fruit) or that of the U.S.D.A. (vegetable)?⁶⁶ What about a case from 1893 which defined tomatoes as vegetables for purposes of a tariff?⁶⁷ Would that interpretation be binding for a statute concerning packaging as opposed to one pertaining to tariff issues?

A. *The Howey Test Applied to 1031 TIC Transactions*

To determine if a particular type of investment constitutes an investment contract, the Supreme Court developed a test in *Securities and Exchange Commission v. W.J. Howey Company*.⁶⁸ In *Howey*, multiple investors purchased fractional fee simple plots of land in a citrus grove and entered into a

⁶³ 15 U.S.C. § 77b (a)(1) (2000).

⁶⁴ See 1 HAZEN, *supra* note 27, § 1.6[9].

⁶⁵ James B. Porter, *Modern Partnership Interests as Securities: The Effect of RUPA, RULPA, and LLP Statutes on Investment Contract Analysis*, 55 WASH. & LEE L. REV. 955, 956 (1998).

⁶⁶ See Website of Dole Food Company, Inc., http://www.dole5aday.com/ReferenceCenter/NutritionCenter/FAQ/F_Home.jsp (last visited August 19, 2005). “Fruit or vegetable? Botanically, they are fruits, but the U.S.D.A. says they are vegetables.” *Id.* Dictionary definitions of tomato include: “mildly acid red or yellow pulpy fruit eaten as a vegetable,” WordNet Lexical Database, <http://wordnet.princeton.edu/perl/webwn>; and, “[t]he tomato is scientifically considered to be a fruit (because the seeds of the plant are contained within the tomato).” Website of Enchanted Learning, <http://www.allaboutspace.com/subjects/plants/glossary/indext.shtml> (both last visited August 18, 2005). See generally Note, *Looking It Up: Dictionaries and Statutory Interpretation*, 107 HARV. L. REV. 1437 (1994) (analyzing the Supreme Court’s increasing use of dictionaries as aids to statutory interpretation).

⁶⁷ *Nix v. Hedden*, 149 U.S. 304, 306-07 (1893) (determining that tomatoes are vegetables for purposes of the tariff act of 1883).

⁶⁸ 328 U.S. 293 (1946).

management agreement with the seller to farm the groves.⁶⁹ Profits were produced by pooling the citrus products and an amount proportionate to each investor's ownership interest was distributed to each investor.⁷⁰ The Supreme Court determined that the investment scheme described was indeed an "investment contract" and thus a security under the federal securities laws.⁷¹ At first glance, the 1031 TIC investments at issue bear a strong resemblance to the citrus groves in *Howey*. An analysis, applying the *Howey* test to a typical 1031 TIC exchange, follows.

The *Howey* test requires that: 1) a person invests money; 2) in a common enterprise; and 3) is led to expect profits; 4) from the efforts of others.⁷² There is no "risk capital test" involved in the federal analysis of an investment contract though the "modern risk capital test," which is broader and encompasses more factors, is used by many state courts.⁷³ For purposes of federal law, the Supreme Court said in *Howey* that it would not matter if it were a safe or speculative investment, just that it was an investment.⁷⁴ With regard to tenant-in-common interests, the first prong is easily satisfied. Investors clearly invest money in 1031 TIC interests, because in most cases, the primary purpose of the transaction is to re-invest capital gains realized on the sale of other investment property.⁷⁵ In fact, the amount of money invested by each individual is significant, with most sponsors requiring minimum investments of \$250,000.⁷⁶ As an example of the substantial sums being invested by individuals, the minimum investment in the recent offering of interests in a California shopping mall was \$1.6 million.⁷⁷

The circuit courts are split between the types of commonality they require to satisfy the second prong of the *Howey* test.⁷⁸ Horizontal commonality is characterized by a relationship amongst the investors in the transaction, and is typically seen as a pooling of investor funds.⁷⁹ Horizontal commonality is accepted in all circuits as meeting the second prong of the *Howey* test, however, it is required by the Third, Sixth, and Seventh Circuits, and is harder to find than vertical commonality.⁸⁰ Generally, more than one

⁶⁹ *Id.* at 295–96.

⁷⁰ *Id.* at 299–300.

⁷¹ *Id.* at 300.

⁷² *Id.* at 299.

⁷³ *Elson v. Geiger*, 506 F. Supp. 238, 241 n.1 (E.D. Mich. 1980).

⁷⁴ *Howey*, 328 U.S. at 301.

⁷⁵ *See, e.g., Smith, supra note 1; Mattson-Teig, supra note 2.*

Mattson-Teig, supra note 2.

⁷⁷ *Pristin, supra note 4.*

⁷⁸ *SEC v. Infinity Group Co.*, 212 F.3d 180, 187–88 n.8 (3d Cir. 2000).

⁷⁹ *SEC v. Lauer*, 52 F.3d 667, 670 (7th Cir. 1995).

⁸⁰ *See, e.g., Infinity Group Co.*, 212 F.3d at 187–88; *SEC v. Prof'l Assoc.*, 731 F.2d 349, 354 (6th Cir. 1984); *Lauer*, 52 F.3d at 670.

investor is required in order to have horizontal commonality, though one Seventh Circuit case held that even though only one investor was ultimately involved, an investment had horizontal commonality where the plan contemplated, and marketed to, multiple investors.⁸¹

Vertical commonality refers to the relationship between the promoter and the investors.⁸² There are two types of vertical commonality, broad and strict.⁸³ Broad vertical commonality is accepted by the Fifth and Eleventh Circuits.⁸⁴ It refers to investments where the investor will not make any profit without the promoter—where the fortunes of the investor are dependent upon the promoter's efforts and expertise.⁸⁵ Strict vertical commonality is required by the Ninth Circuit and involves the fortunes of the investor being interwoven with the fortunes and success of the promoter or manager.⁸⁶ This usually comes in the form of a splitting of the profits, with the promoter getting a certain percentage and the investors splitting the remainder.⁸⁷

The second prong also seems to be met in 1031 TIC transactions. The horizontal commonality characterized by a pooling of investor funds is realized in a 1031 TIC deal through the number of fractional interests in one whole property being sold to numerous investors.⁸⁸ While each investor owns his or her part of the building in fee simple, the property in its entirety is divided into smaller parts to be sold to multiple investors and it is through this common plan of ownership that the economic benefits of the transaction are realized.⁸⁹

The broad vertical commonality accepted by some circuits is present in TIC exchanges. The interplay between the investor and the promoter, in this case, the master lessee who is typically the seller or its affiliate, is an integral part of the success of the investment. In fact, marketing materials of some sponsors tout the passive nature of such investments, and the implicit ability of the investor to rely on the management's efforts and expertise.⁹⁰

⁸¹ *Lauer*, 52 F.3d at 670.

⁸² See *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478–79 (5th Cir. 1974).

⁸³ See *SEC v. Unique Fin. Concepts, Inc.*, 196 F.3d 1195, 1199–1200 (11th Cir. 1999).

⁸⁴ See *Koscot*, 497 F.2d at 478–79 (discussing the Fifth Circuit's adoption of broad vertical commonality); *Unique Fin. Concepts*, 196 F.3d at 1199–1200 (discussing the Eleventh Circuit's adoption of broad vertical commonality).

⁸⁵ *Unique Fin. Concepts*, 196 F.3d at 1199–1200.

⁸⁶ *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973).

⁸⁷ See *SEC v. R.G. Reynolds Enter., Inc.*, 925 F.2d 1125, 1134 (9th Cir. 1991).

⁸⁸ See *Mattson-Teig*, *supra* note 2.

⁸⁹ See, e.g., *id.* (noting that “another benefit of the TIC deals seems to be higher income for many investors”).

⁹⁰ See, e.g., *FOR1031*, *supra* note 54 (informing that “as long as the TIC owners desire, their

For those circuits that require strict vertical commonality, that is, for the fortunes and success of the promoter or manager to be interwoven with those of the investor, typically through a splitting of profits, 1031 TIC transactions may fit the bill. While “the details of the master lease can be a subject of intensive negotiation between the lessee and the lessor”⁹¹ and thus result in various profit-sharing arrangements, in at least some cases, the lessee keeps the difference between the income realized from the property and the promised contractual amount due to the owners.⁹² This arrangement would seem to meet the second prong’s strict vertical commonality requirement through a sharing of profits between the investor and the sponsor.

The third prong, “led to expect profits” refers to the motivation of the investor for investing.⁹³ The case of *United Housing Foundation, Inc. v. Forman* was analyzed by the Supreme Court using the *Howey* test.⁹⁴ In *Forman*, the Court held that an investment of shares of “stock” in a residential cooperative housing project was entered into for consumption purposes, as opposed to profit potential, and was therefore not a security.⁹⁵ However, the Court then went on to say in *Forman* that an investment with profits to come from appreciation could equal the investor being led to expect profits, which would meet the third prong of the *Howey* test.⁹⁶ Further guidance on this prong was provided by a recent United States Supreme Court case, *Securities and Exchange Commission v. Edwards*.⁹⁷ In *Edwards*, profits were held to be any return on the investment, including dividends, an income stream, or appreciation.⁹⁸ The circuit court which had considered the issue, erroneously held that earnings to come in the form of fixed, contracted payments could not be considered “profits from the efforts of others,” satisfying the *Howey* test.⁹⁹ The Supreme Court clarified that in *Howey* “profits” referred to the profits sought by the investor, and so the fact that the actual profits of the investment were fixed did not preclude the third prong of the *Howey* test from being met.¹⁰⁰

management responsibility during the lease period simply consists of receiving and depositing a monthly rent check”).

⁹¹ Foong, *supra* note 26.

⁹² FOR1031, *supra* note 54.

⁹³ See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852–53 (1975).

⁹⁴ *Id.* at 852.

⁹⁵ *Id.* at 852–53.

⁹⁶ *Id.* at 852.

⁹⁷ 540 U.S. 389 (2004).

⁹⁸ *Id.* at 394–97.

⁹⁹ *Id.* at 392–93; *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1284 (11th Cir. 2002).

¹⁰⁰ *Edwards*, 540 U.S. at 394.

The third prong again, appears to be satisfied in a typical 1031 TIC transaction. The motivations of the investors in such exchanges are clear: they seek deferral of the payment of taxes and a continued investment vehicle for their capital gains funds.¹⁰¹ The agreements involved in some TIC transactions offer a contracted percentage rate of return.¹⁰² Similarly to the *Edwards* case, the 1031 TIC investments rely heavily on the anticipated appreciation profits, as well as a monthly income stream, both of which the Supreme Court held are profits which satisfy the third prong of the *Howey* test.¹⁰³

Lastly, the fourth prong requires the profits to come “from the efforts of others.” Though the language of the *Howey* test originally referred to “solely from the efforts of the promoter or a third party,”¹⁰⁴ subsequent cases have held that to be deemed an investment contract, profits need not derive solely from the efforts of others, but that the “undeniably significant” or “essential managerial efforts which affect the failure or success of the enterprise” must be undertaken by a third party.¹⁰⁵ This interpretation allows the investor to do some work as part of the investment and still allow this prong to be met. As discussed above, not only are the master lessees in 1031 TIC transactions conducting the day-to-day, essential, managerial tasks that result in profits to the owners, the sponsor companies are marketing this service as a benefit of the investment, and thus the last prong appears to be satisfied as well.

B. *The Securities and Exchange Commission's Position*

In addition to the *Howey* test analysis, other securities law authority provides guidance on whether 1031 TIC investments are securities. The Securities and Exchange Commission (“SEC”) issued a Securities Release in 1973¹⁰⁶ in response to concerns about the sale of condominium units “coupled with an offer or agreement to perform or arrange certain rental or other services for the purchaser.”¹⁰⁷ The SEC made clear that while “this release speaks in terms of condominiums, it applies to offerings of all types of units in real estate developments which have characteristics similar to

¹⁰¹ See, e.g., *Pristin*, *supra* note 4.

¹⁰² *Foong*, *supra* note 26.

¹⁰³ 540 U.S. at 394–97.

¹⁰⁴ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).

¹⁰⁵ *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973); see also *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 480–84 (5th Cir. 1974).

¹⁰⁶ Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development, Securities Act Release No. 33-5347 (January 4, 1973), 1973 WL 158443.

¹⁰⁷ *Id.* at *1.

those described herein.”¹⁰⁸ The release explained that while a basic offer of real estate does not constitute the offering of a security, when certain other services are combined with the real estate offer, a security may be present in the form of an investment contract, and the *Howey* test is used to make that determination.¹⁰⁹ The SEC went on to discuss under what circumstances an offer of real estate together with an offer of services would be considered a security.¹¹⁰ Among others, these scenarios include real estate offered with a rental agreement or similar services, that are “offered and sold through advertising, sales literature, promotional schemes or oral representations which emphasize the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter in renting the units.”¹¹¹ The SEC stated that in such situations, “investor protection requires the application of the federal securities laws.”¹¹² The release explained that a review of the details of an offer is necessary to determine whether or not the offer constitutes a security and therefore, those involved in such offerings should submit written inquiries to the SEC to have that determination made.¹¹³

The SEC has specifically considered no-action letters on matters related to 1031 TIC exchanges. In 2000, counsel to a sponsor company of 1031 TIC exchanges requested a no-action decision for the company’s participation in classic 1031 TIC exchanges as discussed herein.¹¹⁴ The company sought the SEC’s no-action determination because they recognized that to comply with Section 1031, a replacement property must not be a security.¹¹⁵ The transaction described in the no-action request included a replacement property to be sold by real estate agents and brokers to multiple owners holding as tenants-in-common, and an affiliate of the sponsor company serving as the master lessee, paying a contracted rent payment to the owners.¹¹⁶ Counsel for the sponsor argued that the *Howey* test was not met because the primary profit of the transaction consisted of the tax deferral benefit realized by Section 1031, which did not fall within the type of profit contemplated by *Howey*.¹¹⁷ The sponsor further argued that the profits

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at *3.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.* at *4.

¹¹⁴ Triple Net Leasing, LLC, SEC No-Action Letter 2000 SEC No-Act. LEXIS 824 (Aug. 23, 2000).

¹¹⁵ *Id.* at *3.

¹¹⁶ *Id.* at *3-4.

¹¹⁷ *Id.* at *6-7.

related to the tax benefits did not result from the efforts of others as *Howey* requires,¹¹⁸ nor did other profits such as the capital appreciation¹¹⁹ and contracted rent payment.¹²⁰ The sponsor company also relied on the ability of the purchasing investor to manage the replacement property if they chose to do so, as indicative of the investor's control, such that the *Howey* result was not implicated.¹²¹ The SEC flatly rejected the sponsor's arguments, simply stating:

[T]he Division disagrees with your view that the real estate interests described in your letter are not securities within the meaning of Section 2(a)(1) of the Securities Act of 1933. As a result, the Division is unable to assure you that it would not recommend enforcement action to the Commission unless the offer and sale of the real estate interests are registered under the Section Act or exempt from registration.¹²²

This no-action letter nicely sums up the position of the SEC with regard to typical 1031 TIC transactions and more than likely, forms the basis of decisions by counsel of sponsor companies who have advised their clients to sell such investments as securities.

C. Real Estate Professionals and TIC Interests as Possible Securities

In 1999, an individual sought a no-action ruling from the SEC for his proposed practice of introducing certain professionals, such as commercial real estate brokers and accountants, to registered representatives for the purpose of the professionals' clients' exchange of real estate interests for real estate limited partnership interests as part of a 1031 transaction.¹²³ Despite assurance from the individual that he would not be directly involved beyond the initial introduction, the SEC determined that his role in putting the parties together was akin to soliciting investments and his transaction-based compensation was "one of the hallmarks of being a broker-dealer."¹²⁴ This

¹¹⁸ *Id.* at *7-8.

¹¹⁹ *Id.* at *8; *cf.* SEC v. Edwards, 540 U.S. 389 (2004).

¹²⁰ Triple Net Leasing, LLC, SEC No-Action Letter 2000 SEC No-Act. LEXIS 824, *9-11 (Aug. 23, 2000); *cf.* Edwards, 540 U.S. 389.

¹²¹ Triple Net Leasing, LLC, SEC No-Action Letter 2000 SEC No-Act. LEXIS 824, *11-12 (Aug. 23, 2000).

¹²² *Id.* at *1.

¹²³ John R. Wirthlin, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 83, *3-7 (Jan. 19, 1999).

¹²⁴ *Id.* at *2.

interpretation raises significant concern about the role that real estate professionals play in referring clients to broker-dealers or other sponsors who then sell 1031 TIC interests.

As a result of this concern, at least one state has passed legislation in an attempt to allow real estate professionals to be involved in 1031 TIC deals and to receive commissions and referral fees, despite the possible treatment of such deals as securities under federal law.¹²⁵ Utah State Senator Al Mansell, who sponsored Utah's new law, was also the 2005 president of the National Association of Realtors.¹²⁶ In his introduction of the bill to the state senate, Senator Mansell explained that the State of Utah's Securities Department interpreted all tenant-in-common transactions to be securities and that the state's real estate professionals, as well as the Legislative Management Committee of the Utah Legislature, disagreed with that interpretation.¹²⁷ Senator Mansell further described the reason behind the new law:

[W]e've prepared this legislation to try and draw a line that is definable between what is real estate and what you have to do if it's going to be a real estate transaction, and what you do if it's a securities transaction. There's no question that real estate in this arena can be securitized and so what this bill has tried to do is make it possible to be able to either create a tenant in common interest as a security, or a tenant in common interest as a real estate investment. It would make it possible to do either one and it would matter on how you structured it and how you sold it.¹²⁸

Among its provisions, the Utah law modifies the definition of "Security" in the Utah Uniform Securities Act such that the term does not include tenant-in-common interests like those involved in 1031 TIC transactions, when the characteristics of the transaction conform to those described in the law.¹²⁹ To be deemed "not a security," a transaction of more than ten owners of fractionalized interests subject to a management agreement must allow a

¹²⁵ See Corrie M. Anders, *Utah: Tenant-in-Common Deals Treated as Real Estate*, REALTOR MAG. ONLINE, Apr. 22, 2005, <http://www.realtor.org/RMODaily.nsf/pages/News2005042204?OpenDocument> (last visited February 2, 2006).

¹²⁶ *Id.*

¹²⁷ Audio Tape: Statement of L. Alma Mansell, *Past Floor Debates for Real Estate Transactions and Securities* S. B. 64, 2005 Leg., Gen. Sess. (Ut. 2005), available at <http://www.le.state.ut.us/jsp/jdisplay/billaudio.jsp?sess=2005GS&bill=> (follow "Senate Day 31 (SB0064S01)" hyperlink).

¹²⁸ *Id.*

¹²⁹ See S.B. 64, 2005 Leg., Gen. Sess. (Ut. 2005), available at <http://www.le.state.ut.us/~2005/htm/doc/sbillhtm/sb0064s02.htm> (follow Enrolled "PDF" hyperlink) (Enrolled Bill Text).

simple majority of the owners of the property to terminate or not renew the management contract.¹³⁰ In addition, the law places prohibitions on the lending or pledging of profits from the property to an entity affiliated with the manager, and requires the management agreement to comply with any requirements of the state's Real Estate Commission.¹³¹ The law also provides that state-licensed real estate agents and brokers may receive compensation in conjunction with the offer and sale of these statutorily-deemed "non-securities" without being considered broker-dealers or investment advisers.¹³² Utah's Governor signed the proposed bill into law on March 21, 2005.¹³³ It has been touted as the 'first of its kind' and possibly a national model.¹³⁴ Though this state law will only apply in Utah and not federally or under other states' blue sky laws, the passage of the Utah law demonstrates the quandary that real estate professionals and regulators are facing without adequate guidance as to whether TIC transactions represent securities, real estate, or both, and what laws and regulations govern them.

V. REVENUE RULING 73-476 AND REVENUE PROCEDURE 2002-22

The IRS issued a Revenue Ruling in 1973 regarding the applicability of tenant-in-common interests in 1031 exchanges.¹³⁵ The ruling involved the relinquishment of tenant-in-common interests in three separate properties in exchange for an undivided 100% interest in a different property.¹³⁶ The IRS determined that the gain realized in the transaction would not be recognized under Section 1031 and thus, the exchange was valid.¹³⁷ While this ruling may provide an indication that the IRS approves of TIC interests in 1031 exchanges, there were no facts presented to indicate the presence of a management agreement, rental income, or a guaranteed, contracted return¹³⁸ as is typical of today's 1031 TIC arrangements, and thus, this decades-old ruling is not of much practical use in evaluating the issue at hand.

On the other hand, in 2002, the Internal Revenue Service issued a Revenue Procedure that provided a list of conditions that 1031 TIC

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ See S.B. 64 2nd Substitute, 2005 Leg., Gen. Sess. (Ut. 2005), available at www.le.state.ut.us/~2005/htm/doc/sbillhtm/sb0064s02.htm (follow "Bill Status" hyperlink).

¹³⁴ Anders, *supra* note 125.

¹³⁵ Rev. Rul. 73-476, 1973-2 C.B. 300.

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

transactions must satisfy before requesting a ruling from the IRS on whether a particular TIC exchange qualifies as a tax-deferred transaction under Section 1031.¹³⁹ The particular issue that Revenue Procedure 2002-22 addresses is whether a tenant-in-common transaction involving co-ownership of property gives rise to a partnership, which is another of the express categories prohibited from receiving the benefit of tax-deferral provided by Section 1031.¹⁴⁰

This Revenue Procedure outlines fifteen specific requirements for TIC deals to follow in order to request a private letter ruling.¹⁴¹ Highlights of these conditions include:

- 1.) each co-owner must hold title as a tenant-in-common under local law;
- 2.) there may be no more than thirty-five tenant-in-common owners of a property;¹⁴²
- 3.) the co-owners may not file a common tax return, conduct business under a common name, or hold themselves out as a partnership;
- 4.) co-ownership agreements may be entered into, and can include agreements to require the right of first refusal before partition rights are exercised or to require the vote of majority co-owners for certain actions;
- 5.) co-owners must retain voting rights for certain actions and the sale of the property, leases, indebtedness secured by a blanket lien, hiring of management, and management contracts must be by unanimous approval of the co-owners;
- 6.) co-owners must have the right to transfer, partition and encumber their interests in the property (with the exception of customary restrictions required by lenders);
- 7.) upon the sale of the property, debt secured by a blanket lien must be paid and the balance distributed to the co-owners;
- 8.) co-owners must share in all revenues and costs of the property in proportion to their undivided interest in the property and co-owners, sponsors, and managers may not advance funds to a co-owner for expenses unless certain conditions are met;

¹³⁹ Rev. Proc. 2002-22, 2002-1 C.B. 733.

¹⁴⁰ 26 U.S.C. § 1031(a)(2)(D) (2000).

¹⁴¹ Rev. Proc. 2002-22, 2002-1 C.B. 733.

¹⁴² The limitation of thirty-five owners coincides with the amount of investors permissible in a limited offering under Rules 505 and 506 of Regulation D of the Securities Act of 1933. See 17 C.F.R. § 230.505, .506 (2005).

- 9.) any indebtedness secured by a blanket lien must be shared by the co-owners in proportion to their undivided interests;
- 10.) a co-owner may issue an option to buy the co-owner's undivided interest at fair market value, but a co-owner cannot obtain an option to sell to the sponsor, lessee, another co-owner, lender or one related to these persons;
- 11.) co-owners' activities can be only those which are typically performed in relation to the upkeep and repair of rental property;
- 12.) co-owners may enter into management or brokerage agreements renewable at least annually, with the sponsor or a co-owner, but not with a lessee; the agreement can provide for a common bank account to be maintained for rent collection and expense purposes but a manager must disburse net revenues to the co-owners within three months from receipt; the agreement can allow a manager to prepare statements for the co-owners, obtain insurance, and negotiate modifications to leases and indebtedness with the co-owners' approval; the fees paid by the co-owners to the manager cannot be based upon the income or profits generated by any person from the property and must not exceed the fair market value of the services provided;
- 13.) lease agreements must be bona fide leases for federal tax purposes; rents must be based upon fair market value, and must not be based upon the income or profits generated by any person from the property;
- 14.) the lender of any debt encumbering the property must not be related to any co-owner, sponsor, manager or lessee;
- 15.) the amount of any payment to the sponsor for the purchase of a co-ownership interest must be based upon the fair market value of the ownership interest, and may not depend on the income or profits derived by any person from the property.¹⁴³

Revenue Procedure 2002-22 has been viewed in the TIC real estate industry as somewhat of a panacea, resolving any general issues that may have existed about the validity of TIC interests in 1031 exchanges.¹⁴⁴ The issuance

¹⁴³ Rev. Proc. 2002-22, 2002-1 C.B. 733.

¹⁴⁴ See, e.g., Gary Gorman, *Supreme Court Hints at TIC Referral-Fee Rules for Real Estate Brokers*, COLO. REAL EST. J., Apr. 2004, available at <http://www.expert1031.com/pdfs/crej0404.pdf> (stating that "the IRS issued Revenue Procedure 2002-22 which blessed Tenant-In-Common, or 'TIC' . . . properties as qualifying for Section 1031 as replacement properties"); Cecily A. Drucker, *IRS-Approved Tenancy-In-Common Arrangements: Are These De Facto Limited Partnerships?*, 21 CAL. REAL PROP. J. 21, 22 (2003) available at <http://www.abanet.org/cle/programs/nosearch/materials/b04bficm1.pdf> (clarifying that "[t]he

of this Revenue Procedure is largely responsible for the explosive growth of 1031 TIC transactions because it clarified what characteristics the IRS considers in determining whether a 1031 TIC arrangement is a partnership or not.¹⁴⁵ However, though many in the industry view Revenue Procedure 2002-22 as resolving the issue of whether TIC interests are securities,¹⁴⁶ according to the Internal Revenue Service, the ruling actually provides guidance only on the question of whether such ownership interests in real property constitute partnerships.¹⁴⁷ While some within the industry bank on Revenue Procedure 2002-22 as a safe harbor, the questions of whether a TIC interest constitutes a security and if so, whether such an interest is permissible as replacement property in a 1031 exchange, remain unanswered by the IRS at this time.¹⁴⁸

VI. CONCLUSION: MORE REGULATORY GUIDANCE IS NEEDED

It is important to settle the issue of whether 1031 TIC transactions are securities for numerous reasons. The Securities Act of 1933 requires that securities be registered with the SEC¹⁴⁹ unless they meet the criteria of an exempted security or transaction, such as an intrastate offering¹⁵⁰ or a private placement.¹⁵¹ If 1031 TIC arrangements are in fact securities, then sponsors of such deals will need to follow the securities laws in regard to the registration, marketing, and issuance of the investments, as well as the anti-fraud provisions of the federal securities laws.

Rev. Proc. is not a 'silver bullet' providing absolute defense for TIC Investments, even though it is now regarded by many tax practitioners as a *de facto* 'safe harbor').

¹⁴⁵ See Rev. Proc. 2002-22, 2002-1 C.B. 733; Mattson-Teig, *supra* note 2 (positing that "[t]he IRS Revenue Procedure helps clarify whether multiple owners have an interest in real property, or are a partnership and therefore not eligible for the 1031 Exchange program").

¹⁴⁶ See, e.g., Daniel E. McCabe, *No More Nervous 'TIC': IRS Clarifies Status of Tenancy in Common*, COLO. REAL. EST. J., Sept. 18-Oct. 1, 2002 available at <http://www.virtual-markets.net/vme/ixg1031/updates/tic.html> (stating that "Rev. Proc. 2002-22 sets forth a laundry list of characteristics that may qualify a particular arrangement as a tenancy in common in real estate, rather than a security or partnership investment" (emphasis added)).

¹⁴⁷ Montemurro, *supra* note 9, at 2 (stating "[t]he revenue procedure does not address the question of whether a TIC is a security within the meaning of § 1031(a)(2)(B) or (C)"); Drucker, *supra* note 144, at 22.

¹⁴⁸ Montemurro, *supra* note 9, at 1 (stating that although the IRS is aware of the issues discussed herein, "[a]t present . . . there is no item on the Service's Chief Counsel Published Guidance Plan addressing the issue.").

¹⁴⁹ 15 U.S.C. § 77e (2000).

¹⁵⁰ See *id.* § 77c(a)(11). Registration with state regulatory agencies may still be required for intrastate offerings under state blue sky laws.

¹⁵¹ See *id.* § 77d(2); 17 C.F.R. 230.504, .505, .506 (2005).

The purpose of the federal and state securities laws is two-fold – to protect the investing public and to protect the integrity of the securities market.¹⁵² Both of these goals are implicated with respect to 1031 TIC investments. The potential for individuals to invest substantial amounts of money into TIC investment property based upon the representations and guarantees of a sponsor, mandates that disclosure be provided to the same degree as that required for other types of securities products. The possibility of fraud and unprofessional behavior exists, particularly when those involved in TIC transactions do not know what set of rules or regulatory body governs. A lack of uniformity across the state legislatures and regulatory bodies may begin to develop, as states take matters into their own hands and decide, like Utah, that TIC interests can sometimes be securities and sometimes real estate, despite how Congress or the IRS may view them. The 1031 TIC real estate market is already showing signs of a downward trend in the quality of its investment properties, despite rising prices, due to the sheer number of investors involved in these new transactions.¹⁵³ The TIC real estate investment market may benefit from regulation that ensures its integrity, much like our stock markets have.

Determining that TIC interests are securities is only the first step though. The sponsors of 1031 TIC transactions who are selling these investments as securities appear to have preemptively determined that such interests are securities according to the securities laws of the United States and state blue sky laws.¹⁵⁴ However, a logical paradox develops as a result of their attempts at legal compliance. If in fact, these investment schemes are “securities,” then it may follow that the transactions do not qualify as valid like-kind exchanges under Section 1031 which expressly prohibits “other securities” in addition to those specific types of securities listed.¹⁵⁵ This result would force the industry into a tailspin, as investors would presumably no longer be interested in 1031 TIC transactions if such investments did not further the goal of tax deferral.

The solution to the worst-case scenario described is a determination, whether in the form of a statutory revision by Congress or an Internal Revenue Service regulation, that “other securities” as used in Section 1031

¹⁵² *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).

¹⁵³ See Smith, *supra* note 1 (explaining TIC investors are “pouring money” into dated properties that are less than fully leased and that represent a riskier investment than in the past history of the industry).

¹⁵⁴ See Cary Losson, *1031 Exchange and Tenancy-in-Common*, CAL. REAL EST. J., Mar. 15, 2004 available at http://1031exchangeoptions.com/pdf/CREJ_repring_031504.pdf (stating that firms selling 1031 TIC interests must be licensed as broker-dealers under the state and federal securities laws).

¹⁵⁵ 26 U.S.C. § 1031(a)(2)(c).

signifies a different meaning than the term “securities” as defined under securities law. It might rightfully be determined that “securities” means something different under federal tax law than it does under federal securities law or state blue sky laws.¹⁵⁶ The Supreme Court has held that the meaning of a word used by Congress in different statutes or even in different parts of the same statute, “well may vary to meet the purposes of the law, to be arrived at by a consideration of the language in which those purposes are expressed, and of the circumstances under which the language was employed.”¹⁵⁷ Applying this logic, perhaps it makes good sense for the term “securities” to have different meanings under tax and securities statutes based on the differing purposes of those laws. Whether that is so or not, however, it is essential for real estate professionals, investors, and their attorneys, that the law in this regard is clarified. By making the law clear, investors can be sure that they are receiving the protections of full disclosure of investment risks intended by Congress in enacting the federal securities laws, while also realizing the benefit of tax deferral of their capital gains derived from real estate investments, as provided by the federal tax laws.

¹⁵⁶ See *Sec. Indus. Assoc. v. Bd. of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 174–75 (1984) (O’Connor, J., dissenting). Justice O’Connor stated:

In determining the meaning of a term in a particular statute, the meaning of the term in other statutes is at best only one factor to consider, and it may turn out to be utterly irrelevant in particular cases. Congress need not, and frequently does not, use the same term to mean the precisely the same thing in two different statutes

Id. In that case, which determined the meaning of “securities” according to the since-repealed Glass-Steagall Act, Justice O’Connor further opined, “[t]hat the term ‘securities’ should have different meanings in the different statutes makes good sense. The purposes of the banking and securities laws are quite different.” *Id.* at 175.

¹⁵⁷ *Atl. Cleaners & Dyers, Inc. v. United States*, 286 U.S. 427, 433 (1932).