Tenants in common: an alternative RE structure

Rob Hannah

National Real Estate Investor, Aug 1, 2000

There is a new real estate investment structure gaining popularity that allows individuals to own portions of buildings without liability and with all the tax benefits of being a landlord. It's referred to as "tenants in common" and is developing into a preferred investment strategy for clients worldwide.

Through the structure, an investor can now acquire 10% of an office building in New York, 25% of a shopping center in California and 15% of an industrial building in the Midwest all in the same investment. This is truly the state-of-the-art in real estate ownership and is quickly changing the way individuals view their portfolios.

Clients at Tax Deferred Services keep turning to tenants in common because they can diversify in the same way they diversify their stocks and do it without giving up the control and tax benefits. Plus, there is a bonus for the individual. Purchasers are given a deed to their portion of the property, leaving investors free to buy or sell their stake in a building without a group consensus. This multiple ownership structure is the only one of its kind that prevents consideration as a partnership by the IRS, which gives investors the ability to take advantage of deferment strategies to avoid capital gains taxes.

Tenants in common has only been around for a few years but has been reviewed and determined a sound investment vehicle by tax attorney Richard Lipton, ESQ of McDermott, Will and Emery. With tenants in common, there is a master lease held by individual owners. By owning a building or part of a building, investors can also realize cost-basis depreciation strategies to avoid capital gains taxes.

How does this impact you as a real estate professional? The tenants-in-common approach creates an interesting mechanism for funding existing projects, and can create a steady stream of beneficial 1031 exchanges for your clients.

A tenants-in-common investment holds other advantages over more traditional REITs and limited partnerships. Both partnerships and REITs lack control (of the asset) for the investor. REIT shares are simply shares in a company that is (usually) publicly traded. If you own shares in General Motors, for instance, you cannot tell it how to make cars or influence the type of cars the company will make next year. Therefore, you relinquish a certain level of control, which is not the case in a tenants-in-common structure.

You may be wondering, "What is IRC 1031?" It's a 79-year-old code that allows an investor to trade properties over time as a means for protecting gain against federal taxes. 1031 tax-deferred exchanges have been a popular way for corporations and individual investors to build real estate portfolios. But they also can become difficult to complete as a result of tight restrictions in timing and pricing, leaving many to settle for less than perfect matches.

IRS rules require that exchanges be conducted between like properties and must match dollar for dollar. If they don't, the investor either pays more for the new property, or pays taxes on any profits realized from the trade. On top of that, the IRS demands that all exchanges be formally identified within 45 days, sending many investors scrambling to identify a financially-like property that is also a desired acquisition to their portfolio. Because the tenants-in-common structure allows the investor to own a portion of a commercial property, it is easier to match an exchange dollar for dollar.

The tenants-in-common structure provides freedom for the individual investor, making it the next evolution in real estate investment. Is it the last stage? Doubtful. But for the moment, it has become the vehicle of choice for our more savvy clientele.