

# *Fordham Journal of Corporate & Financial Law*

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*Volume 12, Number 1*

2007

*Article 2*

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## A “TIC”ing Time Bomb: Rule 506 Meets Section 1031

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A “TIC”ING TIME BOMB: RULE 506 MEETS  
SECTION 1031

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## I. INTRODUCTION

In 2002, the Internal Revenue Service issued Rev. Proc. 2002-22, clarifying when acquisition of a tenant-in-common interest in real estate qualifies as replacement real estate under Section 1031. The result was creation of a new type of security, known as a tenants-in-common or "TIC," sold primarily through lower-tier securities broker-dealers under the private placement exemption safe harbor contained in Rule 506 of Regulation D.<sup>1</sup> The TIC industry has grown exponentially in the four years since adoption of Rev. Proc. 2002-22.<sup>2</sup> Inherent in the TIC structure, however, is a tension between strict timing requirements under federal tax law and the prohibition on general solicitation in connection with the sale of privately placed securities under federal securities laws. Recently, this has resulted in a slowdown of TIC sales and an increase of inventory despite increased demand. This article discusses this tension and possible resolutions under current securities law and regulations, as well as through possible new regulatory action.

## II. THE TENANT-IN-COMMON STRUCTURE

With a current federal capital gains tax rate of fifteen percent for capital gains<sup>3</sup> and twenty-five percent for recaptured depreciation on the sale of real estate,<sup>4</sup> not to mention state tax obligations on those items, a

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1. 17 C.F.R. § 230.506.

2. In 2002, \$235 million in TICs were sold, and in 2003 the number had nearly tripled to \$735 million. In 2004, TIC sales topped the \$1.7 billion mark and reached \$3.2 billion in 2005, with \$4.1 billion anticipated in 2006. Kathy Heshelow, *EFFORTLESS CASH FLOW: THE ABC'S OF TICs (TENANT IN COMMON PROPERTIES)*, at 2, (iUniverse, Inc. 2006) (hereinafter "EFFORTLESS CASH FLOW"); Joe Gose, *More Property Owners Join as Tenants-in-Common*, INVESTORS BUS. DAILY, Mar. 16, 2006 (hereinafter "Gose"), available at [http://www.acres4u.net/article.php?article\\_id=11](http://www.acres4u.net/article.php?article_id=11); Donna Mitchell, *Tenancy-in-Common Industry Prepares to Self Regulate*, SHOPPING CENTERS TODAY, Nov. 2005; *TICs New Tack for Property Owners*, REALTOR MAGAZINE ONLINE, Feb. 14, 2005; Susan Branscome, *Tax Avoidance Shaky Reason to Invest*, CINCINNATI BUS. COURIER, Jan. 14, 2005, available at <http://cincinnati.bizjournals.com/cincinnati/stories/2005/01/17/focus2.html>; Industry Update Presentation at Tenants in Common Assn. Conference (Oct. 16, 2006), available at [http://www.ticassoc.org/06-conf-pres/tic\\_industry%20update.pdf](http://www.ticassoc.org/06-conf-pres/tic_industry%20update.pdf).

3. 26 U.S.C. § 1(h)(1)(C).

4. 26 U.S.C. § 1(h)(1)(X).

taxpayer selling investment real estate can face a significant tax burden. Internal Revenue Code Section 1031, adopted more than 50 years ago,<sup>5</sup> provides that “[n]o 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.”<sup>6</sup> Under Section 1031, a taxpayer may defer capital gains tax not only on appreciation but also on recaptured depreciation for investment property, including investment real estate.<sup>7</sup>

For purposes of Section 1031, all real estate is considered like-kind. Therefore, a taxpayer selling an apartment building could exchange it for an office building, shopping mall, or any other type of investment real estate.<sup>8</sup> However, other types of investments, such as stocks, bonds, partnership interests, or personal property, are not considered like-kind with real estate for purposes of Section 1031. Therefore, a person selling investment real estate may not defer taxation of gains by reinvesting in a real estate investment trust (“REIT”), real estate limited partnership, or in an ongoing business, such as a nursing home that happens to own real estate, even though there are real estate aspects to these new investments.

The traditional Section 1031 exchange involves a taxpayer selling one piece of investment real estate and reinvesting the proceeds into another piece of investment real estate of equal or greater value.<sup>9</sup> Although this provides tax deferral of gains on the sale of the relinquished property, it does not always meet the taxpayer’s needs. As the baby boomers age, they may want to sell their self-managed apartment buildings but not want to reinvest the proceeds into other real

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5. 26 U.S.C.S. § 1031, History. As early as 1921, the Internal Revenue Code provided that certain gains or losses from the exchange of property which did not result in liquidity from which to pay taxes would not be recognized as income for federal income tax purposes. James D. Bryce, *Deferred Exchanges: Nonrecognition Transactions After Starker*, 56 TUL. L. REV. 42, 49-51 (1981). The like-kind exchange rules have remained substantially the same since 1923. See generally, Tenants in Common Association, Treatment of Tenancy-In-Common Interests as Securities, 9-11 (Feb. 22, 2006) (unpublished white paper submitted to the Senate Finance and House Ways and Means Committees) (hereinafter “TICA White Paper”).

6. 26 U.S.C. § 1031(a)(1).

7. See generally Frank J. O’Connell, Jr., *Beware of Recapture Gain in Like-Kind Exchanges*, 9-96 TAX ADVISOR 534 (1996).

8. 26 C.F.R. § 1.1031(a)(1).

9. See EFFORTLESS CASH FLOW, *supra* note 2, at 7-8.

estate that they must manage.<sup>10</sup> These investors may want to invest in a higher quality real estate asset<sup>11</sup> that is more amenable to professional management and which they hope will be less dependent on a particular tenant's occupancy for income. Such investors may want to defer taxation of their gains while also attempting to increase the security of their investment by diversifying through investment in multiple properties in different markets throughout the United States. Purchase of a fractional, undivided interest in high quality real estate, known as a "Tenant-in-Common" interest under state law, can meet the needs of such investors.<sup>12</sup>

TICs are not a new form of real estate syndication.<sup>13</sup> Until recently, however, there was concern that sponsored TIC offerings—in which a sponsor either leases back the real estate or continued to manage it after a sale to investors—could create a partnership between the investors and the sponsor which would not qualify for like kind exchange with real estate under Section 1031.<sup>14</sup> Although there were a few small TIC

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10. *Id.* at 5; *see generally* Gose, *supra* note 2; William A. Halama, *Real Estate Offerings: Hidden Fees and Conflicts of Interest*, FIN. PLANNING ASS'N J., Art. 9 (Jul. 2005); Spencer Jeffries, *Optimism, Concerns at TICA Symposium*, TIC TALK 8 (1st Quarter 2005) (available at <http://www.omni1031.com/apps/downloads/dwnFiles/TIC%20Talk%20Qtr%201.pdf>); *Cap Harbor Outlines Tenant-in-Common Interests for 1031 Exchange Transactions*, N.Y. REAL EST. J. (Mar. 30 - Apr. 12, 2004).

11. *See* EFFORTLESS CASH FLOW, *supra* note 2, at 5; *see also* TICA White Paper, *supra* note 5, at 14.

12. *See* EFFORTLESS CASH FLOW, *supra* note 2, at 9; *see also* Rev. Proc. 2002-22, 2002-1 C.B. 733; 2002-14 I.R.B. 733 § 2 (April 8, 2002) (citing Richard R. Powell, POWELL ON REAL PROPERTY §§ 50.01-50.07 (Michael Allan Wolf ed., 2000)).

The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each Tenant-in-Common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a Tenant-in-Common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common.

*Id.*

13. Since the 1990s, sponsors have been offering TIC investments to investors, mostly located in California. However, until the IRS officially sanctioned TICs as Section 1031 replacement property in 2002, there were only a small number of TIC sponsors. *See* EFFORTLESS CASH FLOW, *supra* note 2, at 5.

14. In the late 1990's sponsors attempted to address this issue by applying for private letter rulings from the IRS. *Id.* at 6. The IRS then indicated that it would not issue further private letter rulings for TICs. *Id.* In 2002, the IRS took what appeared to

offerings, mostly in Southern California, in the 1990s it was not until 2002 when the IRS issued Revenue Procedure 2002-22<sup>15</sup> that the TIC industry began to grow.<sup>16</sup> Rev. Proc. 2002-22, which describes “the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property . . . is not an interest in a business entity,”<sup>17</sup> applies in determining whether an undivided fractional interest in real estate acquired by a taxpayer qualifies as “like-kind” property in exchange for real estate under Section 1031. In addition to acquiring “like-kind” property, a taxpayer must also satisfy certain timing and deposit requirements to qualify for deferral of taxes under Section 1031.<sup>18</sup>

Rev. Proc 2002-22 sets forth fifteen conditions to be satisfied, including the following:

- (1) Each of the co-owners must hold title to the Property as a Tenant-in-Common under local law, so title to the Property as a whole may not be held by an entity.<sup>19</sup>
- (2) The number of co-owners must be limited to no more than 35 persons.<sup>20</sup>
- (3) The co-owners may enter into a limited co-ownership agreement that may run with the land.<sup>21</sup>
- (4) The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation

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be a complete turnaround and issued Rev. Proc. 2002-22, which sets forth the procedure for obtaining a private letter ruling for a TIC offering. Rev. Proc. 2002-22, *supra* note 12, § 2.

15. Rev. Proc. 2002-22, *supra* note 12.

16. See Matthew Padilla, *Tenancy-in-Common Deals Grow*, WASHINGTON POST, Jan. 28, 2006, at F14.

17. Rev. Proc. 2002-22, *supra* note 12, § 1; “The guidelines set forth in [Rev. Proc. 2002-22] are not intended to be substantive rules and are not to be used for audit purposes.” *Id.* § 3.

18. See *infra* notes 29-30 and accompanying text.

19. Rev. Proc. 2002-22, *supra* note 12, § 6.01. Most investors are a single member limited liability company (“SMLLC”), which is a special purpose entity with the sole function of owning the tenant-in-common interest in real estate. *Id.* The SMLLC is a disregarded entity for federal tax purposes but provides some insulation from liability for the investors under state law. *Id.*

20. *Id.* § 6.02. Note that a husband and wife are treated as a single person. *Id.*

21. *Id.* § 6.04.

or modification of a blanket lien.<sup>22</sup>

- (5) Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property.<sup>23</sup>
- (6) The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.<sup>24</sup>
- (7) The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee.<sup>25</sup>
- (8) All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property.<sup>26</sup>
- (9) Generally, "the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property."<sup>27</sup>

If an application of the conditions of Rev. Proc. 2002-22 determines that an undivided fractional interest in real estate acquired by a taxpayer qualifies as "like-kind" property in exchange for real estate under Section 1031, such taxpayer is thereby qualified for deferral of taxes with respect to the gain upon sale of the relinquished real estate. Most taxpayers defer purchase of the replacement property until after the closing of the sale on the relinquished property (called a "delayed exchange") instead of acquiring the replacement property at the same

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22. *Id.* § 6.05.

23. *Id.* § 6.08.

24. *Id.* § 6.09.

25. *Id.* § 6.12.

26. *Id.* § 6.13. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements. *Id.*

27. *Id.* § 6.15. Note that additional conditions are contained in Sections 6.03, 6.06, 6.07, 6.10 6.11, and 6.14.

time as the sale of the relinquished property. Doing so enables the taxpayer to most easily engage in an exchange without requiring additional cash.<sup>28</sup> If a taxpayer engages a delayed exchange, in addition to requiring that the replacement property be “like-kind,” the taxpayer must identify the replacement property within 45 days after the sale of the relinquished property<sup>29</sup> and must close on the sale of the replacement property within 180 days after the sale of the relinquished property.<sup>30</sup> Failure to meet one of these deadlines will result in loss of tax deferral and imposition of capital gains tax on the gain and recaptured depreciation from the sale of the relinquished real estate.<sup>31</sup>

Issuance of Rev. Proc. 2002-22 has resulted in a dramatic increase in the number of sponsored TIC offerings. TIC offerings generally fall under one of two structures:<sup>32</sup> the first consists of a sponsor affiliate serving as asset and property manager for the investors; the second consists of a sponsor affiliate entering into a master lease for the real estate that is coterminous with the mortgage on the real estate.<sup>33</sup> With both of these structures, the sponsor negotiates a non-recourse conduit mortgage loan for the real estate.<sup>34</sup> Since the mortgage loans for TIC properties are later securitized, the loan documents typically require that investors obtain lender approval for transfers of their TIC interests, and hold their TIC interests through a limited liability company that qualifies as a special purpose entity.<sup>35</sup> Moreover, the loan documents typically

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28. Although purchase of the replacement property at the same time as sale of the relinquished property (called a “simultaneous exchange”) is possible under § 1031, due to difficulties in coordinating two simultaneous closings on real estate, taxpayers seldom utilize simultaneous exchanges. Taxpayers also can acquire the replacement property prior to sale of the relinquished property (called a “reverse exchange”). However, to complete a reverse exchange in compliance with IRS requirements, a taxpayer must have sufficient cash to purchase the replacement property without use of the proceeds from the relinquished property. Most taxpayers do not have sufficient liquid assets for a reverse exchange or if they do have such assets do not want to use them for this purpose.

29. 26 CFR §§ 1.1031(k)-1(b)(1)(i) & 1(b)(2)(i).

30. *Id.* § 1.1031(k)-1(b)(1)(ii) & 1(b)(2)(ii).

31. *Id.* § 1.1031(k)-1(b)(1)(i) & 1(b)(1)(ii).

32. There is a third structure, the Delaware Statutory Trust (“DST”), utilized by some TIC sponsors. DST offerings are structured under Revenue Ruling 2004-86 and are beyond the scope of this article. *See* Rev. Rul. 2004-86, 2004-2 C.B. 191.

33. *See*, EFFORTLESS CASH FLOW, *supra* note 2, at 71.

34. *Id.* at 5, 49, 76 & 93.

35. These limited liability companies are structured as single member limited liability companies so as to be disregarded entities for federal income tax purposes,

require a principal or the sponsor to execute an environmental guaranty, prohibit investors from terminating the management agreement or master lease with the sponsor affiliate, and prohibit the investors from filing an action for partition.<sup>36</sup> Lenders depend upon the experience and reputation of the sponsor in making the loan and want to assure that the sponsor stands by the transaction while the loan is outstanding. Also, because lenders do not want to have to provide notices to each TIC, lenders require that the sponsor serve as agent of the TICs, enabling them to receive loan notices.<sup>37</sup> Therefore, lenders typically prohibit the TICs from terminating the management agreement or master lease with the sponsor-entity without the lender's consent, effectively tying the TICs to the sponsor for the term of the loan.<sup>38</sup>

For finding the real estate opportunity, providing due diligence services, and negotiating the loan, sponsors typically receive compensation upon sale of the TIC interest through fees variously characterized as "acquisition fees," "loan fees," and sometimes simply "sponsor compensation."<sup>39</sup> Therefore, investors typically purchase their TIC interests at a price that exceeds their pro-rata share of the appraised value of the real estate.<sup>40</sup> While the investors own their TIC interests (the "hold period"), sponsors typically receive additional compensation either through an asset management fee (in the case of the management agreement structure), or through a spread between the lease payments under the master lease and the actual net revenue from operation of the real estate (in the case of the master lease structure).<sup>41</sup> Typically, sponsors are also entitled to a disposition fee when the investors sell the real estate at the end of the hold period.<sup>42</sup> Therefore, between the

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thereby avoiding any tax issues that otherwise would be associated with acquisition of an interest in an entity in exchange for the relinquished real estate. *Id.* at 23.

36. *Id.* at 93-95.

37. *Id.*

38. *Id.* at 114-17.

39. *Id.* at 64.

40. Although this could be perceived as unfair to investors, it is important to remember that TIC sponsors provide valuable services by locating quality real estate with high returns, conducting due diligence, obtaining a lender and negotiating loan terms, structuring the transaction, and assuming risk that otherwise would be the investor's responsibility (e.g., signing the environmental guaranty and in the case of the master lease structure, assuming the risk of net operating income being less than anticipated).

41. EFFORTLESS CASH FLOW, *supra* note 2, at 64.

42. Under Rev. Proc. 2002-22, these fees must be reasonable and reflect the fair

continuing sponsor obligations under the master lease or management agreement and lender prohibitions upon cancellation of those sponsor relationships, the sponsors are nearly inextricably tied to the property and to the investors during their hold period.

### III. TICs ARE SECURITIES SUBJECT TO REGULATION UNDER THE SECURITIES EXCHANGE ACT OF 1933

Since most TIC investors depend upon the efforts of the TIC sponsor for the profitability of their investments, TICs are generally considered “investment contracts” and therefore classified as securities under Section 2(1)<sup>43</sup> of the Securities Act of 1933 (the “1933 Act”).<sup>44</sup> In *SEC v. W.J. Howey & Co.*, (“Howey”),<sup>45</sup> the Supreme Court considered whether the sale of real estate to investors constituted an investment contract when the seller managed the real estate after purchase by the investors.<sup>46</sup> In *Howey*, the management agreement was optional, although most investors selected that option.<sup>47</sup> The Supreme Court found that the arrangement in *Howey* constituted a security and established the classic definition of an “investment contract” under the 1933 Act: investors investing “money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves.”<sup>48</sup> Unlike the situation in *Howey*, TIC investors do not have the option of attempting to manage the real estate themselves; they must enter into either a management agreement or master lease with the sponsor.<sup>49</sup> There is little debate that the traditional TIC structures involve investment of money in a common enterprise with an expectation of profit from the efforts of the sponsor, and that those TIC investments are securities.<sup>50</sup> Indeed, in 2000 the SEC

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market value of the services provided. Rev. Proc. 2002-22, *supra* note 12, § 6.15.

43. 15 U.S.C. § 77b(a)(1).

44. 15 U.S.C. § 77a, *et seq.*

45. 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946).

46. *Id.* at 294-97, 66 S. Ct. 1101-02, 90 L. Ed. 1245-47.

47. *Id.*

48. *Id.* at 298, 66 S. Ct. at 1103, 90 L. Ed. at 1249.

49. *See supra* notes 33-36 and accompanying text.

50. *See* Ronald L. Raitz, *The ABCs of TICs – Learn the Fundamentals of the 1031 Exchange Strategy*, COMMERCIAL INVESTMENT REAL EST. (Jan./Feb. 2005) available at [http://www.ciremagazine.com/article.php?article\\_id=18](http://www.ciremagazine.com/article.php?article_id=18). There are TIC sponsors which claim to structure their TIC investments as purely real estate so that the TICs do not constitute securities. *See generally* Gose, *supra* note 2. Whether those particular TIC

Division of Corporation Finance declined to issue a no-action letter for TICs utilizing a master lease to a sponsor-entity unless the TICs were either registered or subject to an exemption from registration under the 1933 Act.<sup>51</sup> In doing so, the SEC implicitly determined that TICs are securities.

#### IV. TICs ARE GENERALLY SOLD UNDER THE EXEMPTION FROM REGISTRATION PROVIDED BY RULE 506 OF REGULATION D

##### A. Rule 506 Generally

Since TICs are securities, Section 5 of the 1933 Act requires that these securities be registered unless an exemption is available.<sup>52</sup> Generally, TICs are sold through lower-tier securities broker-dealers under a safe harbor contained in Rule 506 of Regulation D,<sup>53</sup> promulgated under the private placement exemption in Section 4(2) of the 1933 Act.<sup>54</sup> To qualify for the safe harbor under Rule 506, an offering must meet the following requirements:<sup>55</sup>

- (1) There must be sales to no more than 35 non-accredited

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investments constitute securities is beyond the scope of this article. The NASD also considers TICs to be securities. Mary L. Schapiro, Vice Chairman, NASD President, Regulatory Policy and Oversight, Address at the NASD Spring Conference (May 25, 2005), *available at* [http://www.nasd.com/PressRoom/SpeechesTestimony/MaryL.Schapiro/NASDW\\_014261](http://www.nasd.com/PressRoom/SpeechesTestimony/MaryL.Schapiro/NASDW_014261).

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

52. 15 U.S.C. § 77d.

53. 17 C.F.R. § 230.506.

54. 15 U.S.C. § 77d(2).

55. Rule 502 of Regulation D contains an integration rule such that offerings that are made within six months of each other may in certain cases be considered part of a single offering. 17 C.F.R. § 230.502(a). Although there is no guidance in Regulation D regarding when two offerings are considered part of a single offering, SEC Release 33-4552 contains the following five guidelines, which are generally used in making such a determination: (1) whether the sales are part of a single plan of financing; (2) whether the sales involve issuance of the same class of securities; (3) whether the sales have been made at or about the same time; (4) whether the same type of consideration is being received; and (5) whether the sales are made for the same general purpose. SEC Release 33-4552, 27 Fed. Reg. 11316 (Nov. 6, 1962). It is not clear whether multiple TIC offerings by the same sponsor and similar structures but involving different real estate would be integrated for purposes of Regulation D.

investors.<sup>56</sup>

- (2) If an issuer sells securities to non-accredited investors, the investor must receive information that would be contained in a registration statement or offering circular, including certain audited financial statements.<sup>57</sup>
- (3) There must be no general solicitation or general advertising in connection with the sale of the securities.<sup>58</sup>
- (4) The securities may not be resold without registration unless there is an available exemption.<sup>59</sup>

TIC offerings are usually limited to accredited investors because sponsors are unable to meet the disclosure requirements required for sales to non-accredited investors. Although Rule 506 permits sales of a securities offering to up to 35 non-accredited investors, when a Rule 506 offering is made to non-accredited investors, there are enhanced reporting requirements in Rule 502(b).<sup>60</sup> These requirements include the provision of audited financial statements to prospective investors.<sup>61</sup> TIC offerings are usually sold pursuant to a private placement memorandum that largely follows the SEC's Industry Guide 5, and which provides most of the disclosure required by Rule 502(b). However, since TIC sponsors usually sell TIC offerings contemporaneously with acquisition of the real estate, the sponsors are dependent upon the sellers of the real estate for financial information about the real estate's prior performance. The financial information obtained from the sellers is usually unaudited,

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56. 17 C.F.R. §§ 230.501(e) & 230.506. Accredited investors are defined generally in Rule 501(a) to include banks, insurance companies, investment companies, employee benefit plans, business development companies, charitable or educational institutions with assets of more than \$5 million, certain high level persons affiliated with the issuer, any individual who, together with their spouse, has a net worth of more than \$1 million, any individual who has an annual income of more than \$200,000 (or who, together with their spouse, has an annual income of more than \$300,000) and who expects that income level to continue, and any trust with more than \$5 million in assets which is managed by a "sophisticated person," and entities owned entirely by accredited investors. 17 C.F.R. § 230.501(a). Since tax-exempt entities have no need for the tax advantages offered by TICs and since institutional investors have the means to manage their own real estate investments, TIC investors generally are either investors, trusts, or closely-held entities owned entirely by accredited investors.

57. 17 C.F.R. § 230.502(b).

58. *Id.* § 230.502(c).

59. *Id.* § 230.502(d).

60. *Id.* § 230.506(b).

61. *Id.* § 230.502(b).

making it impossible for sponsors to provide the financial information required by Rule 502(b) if the offering is made to non-accredited investors. Therefore, sponsors have no choice but to limit sales of TIC offerings to accredited investors.

To qualify for the safe harbor in Rule 506, an offering made solely to accredited investors must meet the following two requirements: (1) there must be no general solicitation or general advertising in connection with the offering and sale of the securities;<sup>62</sup> and (2) the securities may not be resold unless they are registered or subject to an exemption from registration.<sup>63</sup>

### B. The General Solicitation and General Advertising Prohibition

Application of the prohibition on general solicitation and general advertising creates tensions with the timing requirements in Section 1031. These requirements—particularly the one demanding that the taxpayer or investor identify replacement property within 45 days of the sale—frequently create an urgent need for a TIC investment if the investor is to successfully defer their otherwise substantial tax liability. The prohibition on general advertising and general solicitation, however, can make it difficult for sponsors and broker-dealers to gain access to investors, despite investors' clear need for a TIC investment.

Prohibition of general solicitation and general advertising is required for a Rule 506 offering to qualify as a private placement under Section 4(2) of the 1933 Act. Rule 502(c), which sets forth the prohibition on general solicitation and general advertising provides:

[N]either the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

- (1) Any advertisement, article, notice or other communication published in any newsletter, magazine, or similar media or broadcast over television or radio; and
- (2) Any seminar or meeting whose attendees have been invited by

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62. *Id.* § 230.502(c).

63. *Id.* § 230.502(d). Additionally, issuers are responsible under Rule 502(d) for taking reasonable care to ensure that the purchasers of their securities are not underwriters under Section 2(a)(11) of the 1933 Act. Although TICs are illiquid investments and no secondary market for TICs has developed, the few TIC interests that are resold are sold under the safe harbor provision contained in Rule 144. See EFFORTLESS CASH FLOW, *supra* note 2, at 10.

any general solicitation or general advertising.<sup>64</sup>

There is no definition of “general solicitation” or “general advertising” in either the 1933 Act nor in Regulation D beyond that in Rule 502(c). Rather, the concept of what constitutes general solicitation and general advertising has evolved over the past 30 years through a series of “no-action” letters the SEC has issued or declined to issue, interpreting Regulation D or its predecessor, Rule 146. The SEC has noted that

[t]he analysis of facts under Rule 502(c) can be divided into two separate inquiries. First, is the communication in question a general solicitation or general advertisement? Second, if it is, is it being used by the issuer or by someone on the issuer’s behalf to offer or sell the securities? If either question can be answered in the negative, then the issuer will not be in violation of Rule 502(c).<sup>65</sup>

In applying this two-part inquiry, the SEC noted that a determination as to whether there is general advertising for the sale of securities “requires an evaluation not only of the content of the specific advertisements but also of the actual use of each advertisement in relation to the offering of securities.”<sup>66</sup>

The SEC has inferred actual use in relation to the offering of securities even where the issuer articulated an apparently legitimate business for the advertising that was unrelated to any offering of securities. For instance, the SEC declined to issue a no-action letter where the issuer was engaging in general advertising to sell its products at the same time as it was engaged in a private placement of securities, because the advertising could be deemed a part of its plan to offer and sell securities.<sup>67</sup> The SEC also declined to issue a no-action letter where the issuer proposed to make a cold mass mailing of its private placement memorandum to at least 200 broker-dealers, investment advisers, accountants, and attorneys obtained from an organization’s membership list.<sup>68</sup> However, the SEC has issued no-action letters when

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64. 17 C.F.R. § 230.502(c).

65. SEC Release 33-6455 (Mar. 3 1983); 17 C.F.R. § 231.

66. Printing Enter. Mgmt. Sci., Inc., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2250, at \*2 (Apr. 25, 1983).

67. *Id.*

68. Pennsylvania Sec. Comm’n, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 45, at \*2-3 (Jan. 16, 1990).

communications, though public, were not deemed to have been made by or on behalf of an issuer. Specifically, the SEC has issued no-action letters when a person unaffiliated with any issuer desired to compile a guide that set forth public information about outstanding securities from selected issuers<sup>69</sup> and also when non-profit entities proposed to create generally advertised matching services to match businesses needing capital with potential investors.<sup>70</sup>

Although there are presently no SEC no-action letters discussing the prohibition of general advertising and general solicitation in TIC offerings, letters in connection with other types of real estate syndications are useful in determining what standards apply to TICs. The thrust of these no-action letters is that sponsor-advertising is prohibited if the sponsor's only business is the sale of privately placed real estate syndications, because everything that the sponsor does is presumed to be in furtherance of the sale of privately placed securities. For instance, in *Gerald F. Gerstenfeld*,<sup>71</sup> the SEC declined to issue a no-action letter where an issuer proposed to engage in general "institutional" advertising regarding the general nature of investments available through the sponsor. The SEC stated that its analysis was not affected by whether the issuer had any securities offerings for sale at the time, since the issuer planned to issue securities in the near future.<sup>72</sup> The SEC also declined to issue a no-action letter where an issuer proposed simply to publish a tombstone advertisement of the completion of an offering.<sup>73</sup> The SEC also has declined to issue a no-action letter when

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69. Colorado Capital Alliance, Inc. SEC No-Action Letter, 1995 SEC No-Act. LEXIS 503 (May 4, 1995); Texas Capital Network, Inc., SEC No-Action Letter, 1994 SEC No-Act. LEXIS 253, at \*12-15 (Feb. 23, 1994).

70. Nancy H. Blasberg, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2519 (Jul. 12, 1986).

71. SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2790, at \*7-9 (Dec. 3, 1985).

72. *Id.* at \*2. The SEC stated, when denying the no-action letter:

In the Division's view the primary purpose of the advertisement is to sell securities of entities that are, or will be, affiliated with the syndicator. Accordingly, if the advertisement is used while the syndicator is in the process of offering and selling securities, the advertisement would constitute an offer in violation of Rule 502(c). In addition, because the primary purpose of the advertisement is to sell securities and to condition the market for future sales, the advertisement would constitute an offer even at a time when securities are not being sold if the syndicator expects in the near future to offer and sell securities.

*Id.*

73. Alma Sec. Corp., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2647 (Aug. 2, 1982) (stating that "where a sponsor or issuer conducts an ongoing program of

a broker-dealer was advertising for “fully structured real estate limited partnerships,” because acquisition of the limited partnerships would be the first step in an offering.<sup>74</sup> These no-action letters effectively prohibit all forms of sponsor advertising, even if the advertising makes no mention of an available offering of securities and even if the sponsor in fact has no securities for sale at the time of the advertisement.<sup>75</sup>

The SEC has given more latitude for broker-dealer advertising. With respect to communications by broker-dealers, the SEC has issued no-action letters permitting identification of prospective investors for privately placed securities through general solicitation or general advertising only when the advertising or solicitation does not mention any particular securities and the investors are not offered any securities offered or contemplated when the broker-dealer’s relationship with the investor was established.<sup>76</sup> The SEC has stated that “a satisfactory response by a prospective offeree to a questionnaire that provides a broker-dealer with sufficient information to evaluate the respondent’s sophistication and financial situation will establish a substantial relationship” with the investor.<sup>77</sup>

These no-action letters were issued more than a decade ago and were concerned with traditional print advertising. Print advertising may be considered to be thrust upon every reader of the publication in which the advertising appears, since the reader cannot read the publication without seeing the advertising. As discussed in section VI(G) of this Article, the Internet, and in particular, Internet websites, provide new challenges. Unlike traditional print advertising which may be viewed by people who do not want to see it, a person generally sees an Internet website only if that person chooses to do so. This raises key questions

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private or limited offerings, tombstone announcements for the completion of each individual offering could be used to solicit investors to the program as a whole”).

74. Econative Corp., SEC No-Action Letter, 1978 SEC No-Act. LEXIS 659 (Feb. 27, 1978) (issued under Rule 146, the predecessor to Regulation D).

75. A sponsor that is engaged in businesses in addition to the sale of privately placed TICs should be able to lawfully advertise those other businesses as long as the advertisement is carefully crafted so as not to appear to be soliciting investors for the sponsor’s TIC business. TIC sponsors advertising other businesses should have safeguards in place to ensure that that advertising is not used to solicit investors for the sponsors’ TIC offerings.

76. Bateman Eichler, Hill Richards, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2918, at \*1 (Dec. 3, 1985).

77. H. B. Shaine & Co., Inc., SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2004, at \*1 (Oct. 1, 1986).

as to whether a sponsor or broker-dealer which does not solicit potential investors to visit its website is engaged in general advertising or general solicitation merely by having a public website. These questions are complicated when sponsors and broker-dealers pay for preferential placement with search engines or subscribe to a “pay-for-click” service.

These twenty-first century questions were not contemplated by the existing no-action letters. Nevertheless, these outdated no-action letters form the only SEC guidance available to TIC sponsors and broker-dealers selling TICs as to compliance with the prohibition on general solicitation and general advertising. Therefore, TIC sponsors engaged only in the sale of TIC securities may not safely engage in any type of advertising for their businesses, even if that advertising makes no mention of any TIC offering and even if the sponsor has no TIC offerings for sale at that time. Broker-dealers, however, may safely engage in general advertising without mentioning specific TIC offerings as long as they only sell securities that were not offered or contemplated when the broker-dealer formed a substantial relationship with the investor.

### C. NASD Notice to Members 05-18

Recognizing the challenges broker-dealers were facing with the sale of TIC securities, in March 2005, the National Association of Securities Dealers (“NASD”), the self regulatory organization for securities broker-dealers, issued Notice to Members 05-18 “Private Placements of Tenants-in-Common Interests” (“NTM 05-18”).<sup>78</sup> NTM 05-18 identifies four areas of concern applicable to broker-dealers selling TICs: (1) suitability and due diligence; (2) payment of referral fees; (3) licensing, supervision, and recordkeeping; and 4) private offering exemption—general solicitation and general advertising.<sup>79</sup>

Unfortunately, NTM 05-18 did not attempt to update the guidance available in existing SEC no-action letters to address current issues, such as broker-dealer websites. The NASD did, however, make its position

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78. NASD NTM 05-18 (Mar. 2005), *available* at [http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_013455.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013455.pdf). Although NTM 05-18 was not approved by the SEC as an NASD rule and therefore, is not technically binding upon broker-dealers, it establishes a standard of conduct to which the NASD is likely to expect broker-dealers to adhere. *Id.*

79. *Id.* Although some of these concerns are interrelated, the focus of this article is on the fourth concern, private placement exemption.

on the applicability of the outdated SEC no-action letters to TIC offerings abundantly clear. NTM 05-18 effectively extends the mandates of the SEC no-action letters (traditionally barring general solicitation via print advertising) to Internet websites. With respect to the private offering exemption, NTM 05-18 provides:

If a communication is made by general solicitation, then an issuer or its agents will have made a prohibited general solicitation if the communication includes an offer of the privately placed securities. If the communication references a security that is currently offered or contemplated to be offered at the time of the communication, the communication will generally be considered an offer of that security. In addition, if the person solicited via the communication is subsequently offered a security that was currently offered or contemplated to be offered at the time of the communication, the communication would generally be considered an offer of the security.<sup>80</sup>

The NASD further stated in NTM 05-18 that “[a] critical factor in determining whether a communication is appropriately limited, and thus not a ‘general solicitation,’ is the existence of an adequate pre-existing relationship between a member [of the NASD] and the TIC offeree.”<sup>81</sup>

Since a major source of broker-dealer referrals for TIC sales came from general advertising on websites that are accessed by investors through search engines, NTM 05-18 sent shock waves through the TIC community. Before NTM 05-18, many broker-dealers had not determined that Internet websites, which were visited by investors on their own initiative, constituted general advertising. Therefore, those broker-dealers had not necessarily limited sales to such investors to TIC offerings offered and contemplated after the broker-dealers formed a substantial relationship with those investors. NTM 05-18 appeared to apply no-action letters regarding print advertising to Internet advertising and thereby potentially cut off an important source of prospective investors for those broker-dealers.

In May 2005, the Tenants-in-Common Association (“TICA”), an organization comprised of real estate companies, broker-dealers, broker-dealer registered representatives, real estate brokers, attorneys, sponsors, and others involved in the offer and sale of TICs,<sup>82</sup> issued TICA Alert

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80. *Id.* at 7.

81. *Id.* at 6.

82. TICA Alert 05-02 (May 2005), available at <http://www.ticassoc.org/>

05-02, *NASD Notice to Members 05-18; General Solicitation under Regulation D* ("TICA Alert 05-02"), addressing how NTM 05-18 and the prohibition on general solicitation and general advertising affect TIC offerings. This was followed in March, 2006 by TICA Alert 06-01, *A Guide to Certain TIC Best Practices, 2006* ("TICA Best Practices")—item 8 of which further elaborated on how the prohibition on general solicitation and general advertising affect TIC offerings.<sup>83</sup> Since, unlike the NASD, TICA is voluntary and is not a self regulatory organization under federal securities laws, the TICA Alerts were designed only to provide information to TICA members so that they could "better evaluate their course of conduct" in complying with the general solicitation prohibition under Regulation D and the NTM 05-18.<sup>84</sup> These TICA Alerts not only assisted TIC sponsors, broker-dealers, and registered representatives in complying with applicable laws, but also created industry standards to which those in the TIC industry are expected to comply.

#### V. HOW THE PROHIBITION ON GENERAL ADVERTISING AND GENERAL SOLICITATION AFFECTS TICs

The prohibition on general advertising and general solicitation poses particularly acute problems in TIC offerings. Most TICs are sold through lower tier broker-dealers and their registered representatives, many of whom engage in only the privately-placed direct participation securities, and a few of whom engage only in sale of TICs. Therefore, unless an investor has made a previous investment in a TIC or other direct participation security, the investor is unlikely to have a pre-existing substantial relationship with the broker-dealer.

Complicating this issue is the 45-day period within which one must identify replacement property under Section 1031.<sup>85</sup> Many people do not consider the tax consequences of the sale of their relinquished real estate until after that sale has closed and the 45-day clock has begun ticking. Some intend from the beginning to reinvest the proceeds of their sale in TICs but delay contacting a broker-dealer's registered representative until a substantial portion of their 45-day identification

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documents/Alert-05-02.pdf.

83. TICA Alert 06-01 § 10(a) (Mar. 2006), available at <http://www.ticassoc.org/documents/Best%20PracticesP3.pdf>.

84. TICA Alert 05-02, *supra* note 82, at Introduction.

85. See *supra* note 29 and accompanying text.

period has elapsed.<sup>86</sup> Others become TIC investors when they fail to find other options for replacement property or when options they thought were available disappear. Therefore, by the time the investor and the broker-dealer's registered representative meet, there is little time to establish the necessary substantial pre-existing relationship before deciding whether to invest.

Under NTM 05-18, even if the broker-dealer establishes a substantial pre-existing relationship before expiration of the investor's 45-day identification period, the broker-dealer cannot sell the investor any offering that was known or contemplated at the time that relationship was established.<sup>87</sup> This can dramatically limit the variety of TICs a broker-dealer can sell to an investor. For instance, if the investor establishes a substantial relationship with the broker-dealer on day 30 of the investor's 45-day identification period, the broker-dealer can only sell that investor the TIC offerings that were not contemplated or being offered at that time. If the broker-dealer sells that investor TIC offerings that were first offered during the last 15 days of the investor's identification period, there may be only a dozen or fewer different TIC offerings from which the investor may choose.

NTM 05-18 not only prohibits the broker-dealer from selling TICs offered at the time the substantial relationship was formed, but also prohibits the broker-dealer from selling TICs contemplated at the time such relationship was formed.<sup>88</sup> The TICA Best Practices divides the timing of information flow from sponsors to the broker-dealer network into five periods: the "Sponsor Evaluation Period,"<sup>89</sup> the

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86. See Raitz, *supra* note 50 ("Because they are packaged deals, TICs may appeal to clients who are short on time."); Shawn R. Wamstad, *A Boost from the IRS – On Tax-Deferred Exchanges and Tenants-in-Common*, 13 BUS. L. TODAY No. 4 (Mar./Apr. 2004) ("A specialized industry has developed to meet the need for last-minute or back-up replacement properties."); see also Peter Coy, *Getting a Slice of the Commercial Market – Unusual Property Plays May Look Promising but Beware of High Fees and Lack of Liquidity*, BUS. WEEK (Feb. 13, 2006).

87. NASD NTM 05-18, *supra* note 78.

88. *Id.* at 7.

89. TICA Best Practices describes the Sponsor Evaluation Period as follows:

While a sponsor is initially evaluating a property and beginning the initial stages of preparing the offering documents, no information should be shared outside of the sponsor company and its advisors (including outside due diligence reviews). . . . To prevent the premature disclosure of information to broker-dealers and registered representatives, no pre-marketing or announcements of any kind are to be made during this time period.

TICA Alert 06-01, *supra* note 83.

“Contemplation Period,”<sup>90</sup> the “Broker-Dealer Due Diligence Cooling Off Period,”<sup>91</sup> the “Marketing Cooling Off Period,”<sup>92</sup> and the “Order Acceptance Period,”<sup>93</sup> which are summarized in the following table:

| PERIOD                        | COMMENCEMENT  | DURATION                   |
|-------------------------------|---|----------------------------|
| Sponsor Evaluation            | When sponsor starts evaluating a property   | Variable                   |
| Contemplation                 | With uniform announcement of the offering to the marketplace                        | Variable                   |
| B/D Due Diligence Cooling Off | When final PPM and due diligence package is sent to B/D                             | Minimum five business days |
| Marketing Cooling Off         | When PPMs are distributed to potential investors and B/D registered representatives | Minimum five business days |
| Order Acceptance              | When orders are first accepted from investors                                       | Variable                   |

TICA Best Practices concludes that an offering will be “contemplated” for purposes of the general solicitation and general advertising rules upon commencement of the Contemplation Period.<sup>94</sup>

90. *See id.* § 10(b).

91. TICA Best Practices state:

This time period begins when the *final* PPM and *complete* due diligence package is sent to the broker/dealers. During this time period, sponsors should not accept any subscription documents and should not provide specific property information to registered representatives . . . . The same limitations on providing information to the registered representative applicable in the Contemplation Period also apply in the Due Diligence Cooling Off Period.

*Id.* § 10(c) (emphasis in original).

92. “[T]he distribution of PPMs to potential investors and registered representatives is the beginning of the Marketing Cooling Off Period . . . . No investor paperwork should be accepted and considered “received” during this time period.” *Id.* § 10(d).

93. “A sponsor may accept investor paperwork for an offering only during the Order Acceptance Period, which begins on the day after conclusion of the Marketing Cooling Off Period.” *Id.* § 10(e) (emphasis in original).

94. TICA Best Practices describes the Contemplation Period as follows:

A Contemplation Period would commence upon the uniform announcement of the offering to the marketplace. Such announcement should be made to all firms on the same day in order to maintain a level playing field and establish a consistent date which contemplation of the offering began. This is necessary to determine when and to what investors offers may be made under the general solicitation rules . . . .

The Contemplation Period is of variable duration, but the Broker-Dealer Due Diligence Cooling Off Period and Marketing Cooling Off Period are a minimum of five business days each.<sup>95</sup> Registered Representatives are not to accept orders for TIC offerings until the Order Acceptance Period, which also is of variable duration.<sup>96</sup> Assuming an aggressive, two-week Contemplation Period, TICs could be “contemplated” for purposes of the general solicitation rules for 28 days before they could be sold to an investor, as follows:

| PERIOD                               | DAYS ELAPSED SINCE<br>SUBSTANTIAL RELATIONSHIP<br>FORMED |
|--------------------------------------|--|
| Contemplation Period                 | Days 1-14 (two weeks)                                    |
| B/D Due Diligence Cooling Off Period | Days 15-21 (five business days)                          |
| Marketing Cooling Off Period         | Days 22-28 (five business days)                          |
| Order Acceptance Period Commences    | Day 29   |

Under NTM 05-18, the broker-dealer must form a substantial relationship with an investor before there is any available TIC inventory for that investor.<sup>97</sup> Considering that 28 days may elapse between commencement of the Contemplation Period and acceptance of orders, if the broker-dealer is to conduct a suitability analysis and offer as many options to the investor as possible, the registered representative must form a substantial relationship with the investor at or before the time the investors relinquished property. Development of a substantial relationship with investors before the investors have an urgent need for replacement property is complicated by the fact that TICs are not sold through major securities brokerage houses, but instead are sold through lower tier broker-dealers, many of whom specialize in TICs or direct participation securities generally. Due to broker-dealer specialization, unless an investor previously invested in TICs or other direct participation securities, the investor is unlikely to have formed a relationship with the broker-dealer before sale of the relinquished property. Barring a referral from a friend, relative, attorney, accountant, or financial planner, the investor needing replacement property may

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*Id.* § 10(b).

95. *Id.* §§ 10(c)-(d).

96. *Id.* §10(e).

97. NASD NTM 05-18, *supra* note 78, at 7.

flounder for days or even weeks before finding a registered representative who is familiar with TICs. By then, it could be too late for the investor to be placed in an investment without running afoul of the general solicitation rules.

The consequences for failure to comply with the general solicitation and general advertising rules are potentially dire for the sponsor, the broker-dealer, and the registered representative. Since the prohibition of general solicitation and general advertising are requirements not only for the safe harbor in Rule 506 but also for the exemption in Section 4(2) of the 1933 Act, violation of those requirements will result in loss of the exemption from registration of the securities.<sup>98</sup> A single violation by one registered representative in connection with the sale of one interest in a TIC offering will have far-reaching effects beyond that one TIC interest and will result in the entire offering being required to be registered in accordance with the 1933 Act.<sup>99</sup> Therefore, all persons involved in sale of the securities, including the sponsor, broker-dealer and registered representatives who fully complied with the general solicitation rules, could end up being involved in the unlawful sale of unregistered securities due to the actions of one registered representative.

All parties involved in the sale of the unregistered securities could be subject to an SEC enforcement action or, in the case of a broker-dealer or registered representative, proceedings by the NASD.<sup>100</sup> In addition, disgruntled investors could sue the sponsor for rescission of their purchases of the unregistered securities under Section 11 of the 1933 Act.<sup>101</sup> Further, although state securities commissions are preempted from regulating securities sold in compliance with Rule 506,<sup>102</sup> if the Rule 506 exemption is lost, every state in which the securities are sold could bring an enforcement action for failure to have the securities qualified in that state.<sup>103</sup>

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98. 15 U.S.C. § 77d, *supra* note 52.

99. *Id.*

100. *See, e.g.*, Capital Growth Fin., LLC., Case No. E072003099001, at \*1 (NASD Apr. 2006).

101. 15 U.S.C. § 771 (1995).

102. The National Securities Markets Improvement Act ("NSMIA") preempts state substantive regulation of Rule 506 offerings, but permits states to require a notice-filing in connection with those offerings. NSMIA also does not preempt state anti-fraud actions in connection with Rule 506 offerings. 15 U.S.C. 77r (1933).

103. *Id.*

VI. SOLUTIONS TO THE TENSION BETWEEN THE REQUIREMENTS OF  
SECTION 1031 AND RULE 506*A. Developing Substantial Relationships before Sale of the Relinquished Property*

In the current sale structure in which TICs are sold under Rule 506 by securities broker-dealers, the tension between the 45-day identification period for replacement property and the NTM 05-18 substantial pre-existing relationship requirement can only be resolved either by: (1) broker-dealers developing relationships with potential investors early, preferably before their relinquished properties are sold; or (2) broker-dealers finding potential investors through means that do not involve general solicitation or general advertising.

Although the requirements of a substantial pre-existing relationship and the prohibition of selling securities contemplated when that relationship is created creates tension in the TIC marketplace, these requirements also provide bright-line tests to assist broker-dealers and their registered representatives in determining which securities they can sell to which investors. In effect, NTM 05-18 and the no-action letters on which it is based, create a presumption that the general solicitation or general advertising was not in connection with the sale of a particular privately placed security if the security was not contemplated when the substantial relationship with the investor was formed.<sup>104</sup> Therefore, it is key that broker-dealers develop relationships with investors well before they need to purchase replacement property.

*B. When Broker-Dealers Can Engage in General Advertising*

It is important to note that broker-dealers may engage in general solicitation or general advertising if that advertising is not in connection with the sale of privately-placed securities. TICA Best Practices states:

The following items . . . may be included in a general solicitation or advertisement:

- Discussion of the Internal Revenue Code
- Discussion of regulations and other tax authorities

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104. Although the TICA Best Practices are not law, they establish an industry standard that is consistent with federal securities laws as to when an offering is contemplated. In this respect, the TICA Best Practices should be followed uniformly by all broker-dealers selling TICs.

- Discussion of TIC fractional ownership concepts that do not mention an offering or sponsor
- Reference materials that do not refer to a specific offering or sponsor
- Other items not specific to a particular offering or sponsor<sup>105</sup>

Broker-dealers, therefore, may advertise about TICs generally and the tax benefits of investing in TICs, as long as they do not sell to a person responding to that advertising any TIC that was contemplated when the broker-dealer formed a substantial relationship with that person.<sup>106</sup> Broker-dealers also may conduct generally advertised educational seminars to which potential investors or attorneys, accountants, and real estate brokers assisting potential investors are invited.<sup>107</sup> For such general advertising or general solicitation not to be construed as being in connection with the sale of a privately placed TIC, however, it must be focused on attracting persons who have not yet sold their relinquished property and who, therefore, do not yet have a need to purchase a TIC.

If broker-dealers selling TICs do engage in general advertising or general solicitation for prospective investors, it is critical that the broker-dealers or their registered representatives not only find the prospective investor but also take the critical step of forming a substantial relationship with the prospective investor as soon as possible. Attendance at a broker-dealer seminar or making a phone call to a broker-dealer or registered representative does not appear to be sufficient to form a substantial relationship between the broker-dealer and the prospective investor. However, the SEC has stated in no-action letters that they have found a substantial relationship to have been formed when an investor filled out a questionnaire providing the broker-dealer with "sufficient information to evaluate the prospective [investors'] sophistication and financial circumstances"<sup>108</sup> and establishing them as accredited investors.<sup>109</sup> Therefore, if broker-dealers

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105. TICA Alert 06-01, *supra* note 89, § 8. TICA Best Practices goes on to say: "However, even the foregoing, when deemed connected to an offering, will not be permissible." *Id.*

106. The discussion in this section is limited to activities of broker-dealers and their registered representatives. It appears that the rules applicable to issuers may be more stringent. *See id.*; TICA Alert 05-02, *supra* note 82 (citing Agristar Global Networks, Ltd., SEC No-Action Letter (Feb. 9, 2004)).

107. TICA Alert 05-02, *supra* note 82.

108. *See* Bateman Eichler, Hill Richards, Inc., *supra* note 76, at \*1.

109. *See* Lamp Technologies, Inc., SEC No-Action Letter, 1997 SEC No-Act.

are engaging in general advertising or general solicitation, it is critical that they not only find prospective investors but also obtain the necessary information so as to form a substantial relationship with that prospective investor.

C. Obtaining Investors Through Means that do not Involve Solicitation

In addition to developing substantial relationships with prospective investors early, broker-dealers can avoid violating the prohibition on general solicitation by obtaining prospective investors through means that do not involve general solicitation or general advertising. The most obvious way to do this is for broker-dealers and registered representatives to develop relationships with professionals—such as attorneys, accountants, financial planners, qualified intermediaries, and real estate brokers<sup>110</sup>—who counsel persons engaged in a 1031 exchange. If, after a professional and registered representative form a relationship, the professional refers a prospective investor to the registered representative for possible placement in the TIC, the investor has not been obtained through any type of advertising or solicitation.<sup>111</sup>

The problem with this approach, particularly insofar as it involves real estate brokers, is that the referring professional may desire a commission or finder's fee for making the referral. Unlike attorneys, accountants, qualified intermediaries, and financial planners, real estate brokers typically receive all of their compensation from commissions, and a real estate broker can expect a one or two percent commission on the purchase price if the broker's client purchases non-TIC real estate. Without providing the real estate broker with comparable compensation for sale of a TIC interest, the broker has no incentive to encourage clients to invest in TICs, rather than in real estate investments for which the broker can receive a commission. It violates NASD rules, however, for a securities broker-dealer to pay a commission to a person who is not affiliated with a securities broker-dealer,<sup>112</sup> and finder's fees are permitted only under limited circumstances, if they are permitted at

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LEXIS 638 (May 29, 1997); IPONET, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 642 (July 26, 1996); see also TICA Alert 05-02, *supra* note 82; see also NTM 05-18, *supra* note 78.

110. See *infra* Sections VI.E. & VI.F.

111. *Id.*

112. See NASD Rule 2420.

all.<sup>113</sup> Therefore, real estate brokers in particular, after making a referral only to find out that they cannot receive any compensation in return, may not make further referrals.

#### D. Dual Licensing

Dual licensing may be another way to avoid violating the prohibition on general solicitation. Since TICs are both real estate and securities, many registered representatives and broker-dealers are also licensed as real estate brokers. With an active real estate brokerage, a broker-dealer could develop a substantial relationship with prospective TIC investors by listing the relinquished property for sale. Moreover, since the general solicitation rules do not apply to real estate brokers, the broker-dealer or real estate broker could engage in general advertising for the real estate brokerage portion of its business (but, of course, could not mention TICs in such advertising).

TICs are by definition "real estate" for federal tax and state law purposes, but generally are "securities" for both federal and state securities law purposes. Although sale of TICs by securities broker-dealers is required by federal and state securities laws, since TICs are also real estate, sale by securities broker-dealers creates tension with the real estate industry and real estate regulators. In some states, a real estate broker must be involved in the sale of a TIC,<sup>114</sup> which makes dual licensing as a real estate broker and securities registered representative or broker-dealer especially attractive to those in the TIC industry.

#### E. Payment of Real Estate Commissions

The National Association of Realtors ("NAR") "is working with the SEC to develop a means by which real estate licensees may participate in and derive compensation from the brokerage of securitized TIC interests."<sup>115</sup> Although the SEC has not addressed compensation of real estate brokers for sale of TIC interests, the SEC has addressed this issue in similar circumstances. Specifically, the SEC has set forth rules for commission-sharing in connection with the sale of condominiums that

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113. See *infra* Section VI.F.

114. Nat'l Ass'n of Realtors, *Hot Topics – Answers to Current Business Issues* "Tenants-in-Common Interests," 3-4 (Issue 1: 4th qtr, 2005).

115. *Id.* at 3. The NAR takes the position that some of the TICs being sold are not securities and therefore, refers to TICs that are securities as "securitized TICs." *Id.*

are tied to rent-pooling arrangements. In these rent-pooling arrangements, the condominium owners share expenses and rents generated from the rental of all condominium units, regardless of whether the expenses and rents were attributable to their particular unit.<sup>116</sup>

Like TICs, condominiums tied to rent-pooling arrangements are securities for purposes of the 1933 Act.<sup>117</sup> Since condominiums are real estate, many states' laws require that they must be sold by licensed real estate brokers.<sup>118</sup> Since, however, condominiums sold using rent-pooling arrangements are securities, they must, under federal securities laws, be sold by a broker-dealer. In the 1980s the SEC issued two no-action letters permitting real estate brokers and securities broker-dealers to share commissions in connection with the sale of condominiums tied to rent-pooling arrangements.<sup>119</sup> In *Roland University Properties* there was a specific and coordinated procedure for sale of the condominium units through the joint efforts of the real estate broker and the securities broker-dealer:

- (1) The initial contact could be made either by the real estate broker or the securities registered representative.
- (2) After the initial contact, the prospective investor would receive a prospectus.
- (3) Thereafter, there would be an interview by either the real estate broker or the registered representative. If the real estate broker conducted the interview, the broker would limit discussion to real estate matters, would make only representations set forth in the prospectus, and would inform the prospective investor that the offering involved a security and that a registered representative would be explaining the securities aspect of the transaction.

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116. See *infra* note 117.

117. SEC Release No. 5347, 38 Fed. Reg. 1735 (Jan. 18, 1973). One difference between this condominium structure and TICs is that theoretically, an investor could purchase a condominium and decide to manage it or could simply live in it. Unlike condominium owners, TIC investors have no right to use any particular portion of the real estate, nor under the current TIC structures do individual TIC investors have the ability to manage any portion of the real estate.

118. *Roland University Properties*, SEC No-Action Letter, 1984 SEC No-Act. LEXIS 2461 (Apr. 9, 1984); *Gunnar & Associates*, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2890 (Sept. 19, 1983).

119. See *Gunnar & Associates*, *supra* note 118; *Roland University Properties*, *supra* note 118.

(4) The securities registered representative would review the prospectus with the prospective investor, would confirm that the real estate broker had made no representations outside of the prospectus, and would conduct a suitability analysis.<sup>120</sup>

A year later, in *Gunnar & Associates*,<sup>121</sup> the SEC issued a second no-action letter involving a similar arrangement. In *Gunnar & Associates*, compensation between the real estate broker and securities broker-dealer was split with the proviso that the aggregate commission would not exceed ten percent of the offering price of a unit.<sup>122</sup>

In the 1980s, the SEC permitted real estate brokers to participate with securities broker-dealers in the sale of condominiums tied to a rent-pooling arrangement that constituted a security as long as the real estate brokers were subject to and trained in securities antifraud laws, the participants followed a strict protocol designed to assure that the securities broker-dealer made a suitability determination, and the total compensation was shared, rather than doubled.<sup>123</sup> In 1992, however, the SEC declined to issue a no-action letter in *The Snowy Owl Inn Condominium Unit Owners' Association*,<sup>124</sup> where the applicant proposed to have only real estate brokers involved in the sale of

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120. *Roland University Properties*, *supra* note 118, at \*5-6. In addition, [i]n order to assure this coordinated [sic] effort, the terms of the selling agreement to be entered into between the Issuer and the Real Estate Broker (the "Selling Agreement") will include the following provisions: (1) at the time an offer of a Unit is made, the Real Estate Broker will supply, or cause its salesmen to supply, to each prospective purchaser, a copy of the prospectus, including any amendments or supplements thereto; (2) the Real Estate Broker will not make, nor permit any of its salesmen to make, any representation which is not set forth in the prospectus; (3) the Real Estate Broker will identify itself, and cause each of its salesmen to identify himself or herself, as a real estate broker and will advise each prospective purchaser that: (a) the transaction involves the sale of a security, and (b) the Registered Representative will be contacting the prospective purchaser to discuss the securities aspects of the transaction; (4) the Real Estate Broker will not use, and will not permit any of its salesmen to use, any sales material which has not been approved by the Securities Broker; (5) the Real Estate Broker will be fully subject to the antifraud provisions of the federal securities laws in connection with its participation in the offer and sale of the Units; and (6) salesmen of the Real Estate Broker participating in sales of the Units will be trained in the antifraud provisions of the federal securities laws, the use of a prospectus and limitations on advertising and promotion of the Units.

*Id.* at \*4-5.

121. *See Gunnar & Associates*, *supra* note 118.

122. *Id.*

123. *See id.*

124. SEC No-Action Letter, 1992 SEC No-Act. LEXIS 1215, at \*4 (Nov. 17, 1992).

condominium units tied to a mandatory agency agreement for rental of the units as hotel rooms.<sup>125</sup> It appears likely that the SEC denied issuance of a no-action letter for *Snowy Owl Inn* because of the absence of securities broker-dealer involvement in the proposed sale. However, the SEC has yet to extend the rationale used in the condominium rent-pooling arrangements to TICs. The NASD recently settled a case against Rance King Securities Corporation (“Rance King Securities”), a broker-dealer that paid \$294,000 in commissions to real estate brokers in connection with the sale of TICs.<sup>126</sup>

In light of the NASD action against Rance King Securities, it is likely that the NASD would disapprove of real estate broker involvement in TICs in the manner previously permitted by the SEC for condominiums tied to rent-pooling arrangements. Yet, based upon the *Roland* and *Gunnar* no-action letters, there appears to be room for limited real estate broker involvement in the sale of TICs, provided that the real estate brokers were trained in and subject to securities antifraud laws, and provided the broker-dealer obtained a no-action letter from the SEC (which would operate as a safeguard against a NASD enforcement action). In addition, it would be advisable to train any real estate brokers involved in the sale of TICs in the general solicitation and general advertising rules applicable to private placements. Since the current broker-dealer compensation structure in TICs involves a 9% commission to securities broker-dealers, real estate brokers could receive a 1% commission without total compensation exceeding the 10% amount permitted in *Gunnar*. If commissions were paid to real estate brokers in this fashion, sponsors would likely need to increase their offering price to pay the additional commissions. Therefore, functionally, this additional commission would come from investors. This raises questions about whether the investors would be gaining any additional benefit for the additional compensation to real estate brokers or whether the real estate brokerage commission costs should not be passed on to investors but instead should come from the nine percent total commission that currently is paid to the broker-dealer.

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125. *Id.*

126. Rance King Sec. Corp., Case No. E0220040124-01 (NASD Apr. 2006); see also Morris Newman, *Regulators to TIC Industry: Expect Investigations, Prosecution*, Nat'l Real Estate Investor (Apr. 3, 2006), available at [http://nreionline.com/news/TIC\\_industry/](http://nreionline.com/news/TIC_industry/); cf. John Yasushi Hasegawa, Case No. 2005000435802 (NASD Dec. 2005) (accepting a settlement from a registered representative who, among other things, was accused of paying a referral fee to an unregistered person).

Real estate brokers claim that for this additional commission, investors would gain the expertise of a real estate professional uniquely qualified to advise them on the real estate aspects of the transaction and to "identify the most suitable property, of which a TIC interest may be an option."<sup>127</sup> Moreover, real estate brokers may have more incentive than broker-dealers to assist investors in evaluating whether to invest in a TIC or to purchase real estate of which they would be the sole owner. The reality is, however, that most registered representatives involved in the sale of TICs are experienced in evaluating real estate securities, and TICs in particular.<sup>128</sup> In the *Roland* no-action letter, the suitability determination was made by the securities broker-dealer, not by the real estate broker.<sup>129</sup> Furthermore, securities broker-dealers have an obligation not to sell an investor a TIC if another investment, such as pure real estate, is more suitable for that particular investor. Without more, it is unclear whether the added value of having a real estate broker involved in the process would justify the additional cost of paying real estate broker's commissions.

The added value of real estate brokers comes into play when dealing with the prohibition on general solicitation. Involvement of real estate brokers in TIC transactions may, under some circumstances, assist securities broker-dealers seeking compliance with the general solicitation prohibition. As discussed earlier, a real estate broker involved in the sale of an investor's relinquished property will have developed a substantial relationship with that investor far earlier than most securities broker-dealers under the current marketing structure.<sup>130</sup> If real estate brokers could expect to receive compensation for their participation, they would have an incentive to refer investors to securities broker-dealers involved in sale of TICs prior to the sale of the investor's relinquished property, thus enabling the broker-dealers to provide the investor with a greater selection of TIC offerings from which to choose.<sup>131</sup> If payment of a real estate commission helped broker-dealers to better serve their customers by providing more suitable investment options, then it might make sense for the broker-dealers to

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127. See *supra* note 114, at 3; see generally Stephen A. Wayner, *The TIC Drawback – Involving Real Estate Brokers in TIC Transactions Would be a Win-Win Situation*, SE REAL EST. BUS. (Mar. 2005).

128. But see Raitz, *supra* note 50.

129. See *supra* note 118 and accompanying text.

130. See *supra* Section VI.

131. *Id.*

pay some or all of the real estate brokerage commission.

*F. Finder's Fees*

In addition to combining the efforts of real estate brokers and securities broker-dealers in the sale of TICs, securities broker-dealers may be able to address the challenges presented by the general solicitation rules through the payment of finder's fees. In addition to real estate brokers, other real estate and tax professionals—including attorneys, accountants, and financial planners—may come into contact with a person needing replacement property. Broker-dealers and registered representatives can attempt to cultivate relationships with such professionals and encourage them to refer clients interested in TICs to them.<sup>132</sup> Some of these professionals will be compensated for their participation on an hourly basis by the investors; others may or may not even expect compensation from the broker-dealer for the referral. Real estate brokers, on the other hand, will generally have no potential source for compensation other than referral fees or commissions.

Payment of finder's fees by securities broker-dealers, if permitted, could provide some compensation for these referring parties while giving the securities broker-dealers access to a larger pool of prospective TIC investors at that critical early point before sale of their relinquished property. SEC no-action letters provide little guidance on the permissibility of finder's fees in TIC transactions. In *Colonial Equities Corp.*,<sup>133</sup> the SEC Division of Market Regulation issued a no-action letter where an issuer of real estate limited partnerships sold as private placements proposed to pay a flat fee to insurance agencies for referring potential investors.<sup>134</sup> In *Paul Anka*,<sup>135</sup> the SEC issued a no-action letter where Mr. Anka proposed to provide the Ottawa Senators, a hockey team, with names and contact information for persons with whom he had

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132. See *supra* Part VI.C.

133. SEC No-Action Letter, 1988 SEC No-Act. LEXIS 862, at \*11-12 (June 28, 1988).

134. Although the Divisions of Market Regulation and Investment Management issued no-action letters with respect to the plan of distribution, in a subsequent letter the Division of Corporation Finance declined to issue a no-action letter on grounds not directly relevant to the considerations here. There, the SEC found the plan of distribution could constitute an impermissible general solicitation. *Colonial Equities Corp.*, SEC No-Action Letter, 1988 SEC No-Act. LEXIS 1291, at \*4-5 (Sept. 2, 1988).

135. SEC No-Action Letter, 1991 SEC No-Act. LEXIS 925 (Jul. 24, 1991).

a relationship so that the Senators could contact those persons about the purchase of limited partnership interests. Mr. Anka would not contact any prospective investors or otherwise promote the limited partnership interests but would receive, as compensation, ten percent of the sales price of any interests purchased by persons he recommended.<sup>136</sup> Earlier, in *Mona/Kauai Corporation*,<sup>137</sup> the SEC issued a no-action letter where an issuer proposed payment of a compensation to real estate brokers whose activity was limited to providing names of prospective purchasers for the condominiums, with the referral fee being two to three percent of the sale price, payable only if the issuer actually sold a condominium to the prospective purchaser.<sup>138</sup>

More recently, however, in *John R. Wirthlin*,<sup>139</sup> the SEC declined to issue a no-action letter where Mr. Wirthlin proposed to make introductions between accountants and other professionals who had clients seeking Section 1031 replacement property and registered representatives selling real estate limited partnership interests.<sup>140</sup> Mr. Wirthlin was to be paid a percentage of the sales price by the issuer of the limited partnership interests if a sale was consummated.<sup>141</sup> The SEC distinguished finders for issuers from finders for broker-dealers and also expressed concern about Mr. Wirthlin's intention to solicit accountants and other professionals, attend the meeting between those professionals and the broker-dealer, and receive transaction-based compensation.<sup>142</sup> In 2000, the SEC revoked its prior no-action letter in *Dominion Resources, Inc.*<sup>143</sup> For many years, Dominion Resources had, under SEC sanction through a no-action letter, been assisting issuers with structuring securities transactions in exchange for a negotiated fee payable only if the transactions were consummated.<sup>144</sup>

Moreover, the NASD has indicated disapproval of finder's fee arrangements. NASD Conduct Rule 2460 provides that the NASD

consistently has taken the position . . . that it is improper for a member or a person associated with a member to make payments of

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136. *Id.*

137. SEC No-Action Letter, 1974 SEC No-Act. LEXIS 412, at \*1 (Aug. 25, 1974).

138. *Id.* at \*2-3.

139. SEC No-Action Letter, 1999 SEC No-Act. LEXIS 83 (Jan. 19, 1999).

140. *Id.* at \*2.

141. *Id.* at \*6.

142. *Id.* at \*2.

143. SEC No-Action Letter, 2000 SEC No-Act. LEXIS 304 (Mar. 7, 2000).

144. *Id.*

'finders' or referral fees to third parties who introduce or refer prospective brokerage customers to the firm, unless the recipient is registered as a representative of an NASD member firm.<sup>145</sup>

Furthermore, the NASD has precluded most, if not all, payments of finder's fees to real estate brokers in TIC transactions. In NTM 05-18, the NASD stated:

It is our understanding that the SEC staff would deem a real estate agent's receipt of a referral fee from a broker-dealer in connection with the sale of a TIC interest to be the type of activity that would render the real estate agent an unregistered broker-dealer. Therefore under [NASD] Rule 2420, a member may not pay a real estate agent who is not registered as a broker-dealer for participating in the transfer of a TIC interest that is structured as a security, nor may a member pay such real estate agent for referring TIC business that involves securities.<sup>146</sup>

Therefore, although it is unclear whether the SEC currently would countenance payment of finder's fees generally, in light of the NASD's position, it is inadvisable for a broker-dealer to pay finder's fees to real estate brokers or other real estate or tax professionals who refer prospective TIC investors to the broker-dealer until such time as the SEC expressly countenances such payments.<sup>147</sup>

### G. Websites

Another way that broker-dealers and registered representatives might be able to develop substantial relationships with prospective investors before sale of their relinquished property is through Internet websites. Although the SEC has required that offering materials on the Internet be placed behind a password and be accessible only to qualified investors,<sup>148</sup> the SEC has, in two no-action letters, permitted broker-dealer websites to establish a substantial relationship with the broker-dealer where the website provided an online form through which visitors

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145. See Report and Recommendations of the Task Force on Private Placement Broker-Dealers, 60 BUS. LAW. 959, 983-84 (2005); see also Raitz, *supra* note 50.

146. NTM 05-18, *supra* note 78.

147. See John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 ARIZ. ST. L.J. 861 (2005).

148. See SEC Release 33-7233, Question 20 (Oct. 6, 1995).

were qualified as accredited investors.<sup>149</sup> There is, however, little NASD or SEC guidance as to what constitutes general advertising or general solicitation on an Internet website.

Websites differ from other types of advertising in that, unlike traditional advertising, it is actively thrust upon its target. In contrast, Internet websites typically consist of passive media. Indeed, Internet websites are only viewed when someone makes a decision to visit that website by typing the URL into the web browser or clicking on a link. Therefore, with the exception of advertisements that invite prospective investors to visit a particular website, the viewing of a website by a prospective investor is more closely analogous to an investor's unsolicited visit to a broker-dealer's office than to a *Wall Street Journal* advertisement that invites prospective investors to contact the broker-dealer about purchasing securities. Absent SEC guidance on this issue, however, websites are being regulated by the NASD and broker-dealers as well as TIC issuers would be well advised to apply the substance of those no-action letters as well as other guidance geared towards traditional print advertising.

#### H. Alternatives to the Private Placement Exemption

TICs are subject to the general solicitation rules when they are sold pursuant to the Rule 506 safe harbor—the private placement exemption from registration. TICs need not, however, be sold pursuant to Rule 506. Where TICs are either registered or sold pursuant to an exemption from registration other than the private placement exemption, the general prohibition against solicitation and general advertising does not apply. Indeed, in those cases, TIC offerings may be advertised to prospective investors. Furthermore, TICs need not be structured as securities to qualify as replacement property under Section 1031. TICs that are not structured as securities are not required to comply with the general solicitation rules or any other federal securities laws.<sup>150</sup> Beyond the private placement exemption, the federal exemptions from registration that can be applied to TICs include the small issue

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149. *Lamp Technologies*, *supra* note 109; *IPONET*, *supra* note 109.

150. Although most investments that are not securities for purposes of federal securities laws will not constitute securities for purposes of state securities laws, the laws vary from state to state. Therefore, issuers should not sell TICs unless they confirm that the sale is in compliance with both federal and state securities laws.

exemption in Section 3(b) of the 1933 Act;<sup>151</sup> the safe harbor under Rule 504;<sup>152</sup> the intrastate exemption in Section 3(a)(11)<sup>153</sup> of the 1933 Act; and the safe harbor in Rule 147.<sup>154</sup> Therefore, the private placement exemption is not the only way to get around the registration requirement.

Section 3(b) permits the SEC to promulgate rules granting exemptions from registration for issues of less than \$5 million.<sup>155</sup> The safe harbor in Rule 504, promulgated under the small issue exemption, grants issuers exemption from registration as long as the offering is \$1 million or less.<sup>156</sup> To assure that issuers do not split an offering up to qualify for this exemption, certain offerings will be integrated to determine the dollar amount of an offering for purposes of the small issue exemption.<sup>157</sup> Rule 502(a)<sup>158</sup> contains a safe harbor whereby offerings made more than six months before and more than six months after an offering are not considered integrated for purposes of the exemption in Rule 504. Although an issuer can make additional offerings during the six month period,<sup>159</sup> the issuer does so at the risk of the offering not being exempt from registration. Further, unlike the Rule 506 exemption, offerings under Rule 504 are not exempt from state securities regulation.<sup>160</sup> Therefore, any issuer selling TICs pursuant to the exemption in Rule 504 will either have to find an exemption under the state law of every state in which the TICs are re-sold, or will have to qualify the offering in those states.

The \$1 million limit on offerings in Rule 504 is not practical for TICs. The average TIC investor invests between \$400,000 and \$500,000, so a TIC offered under Rule 504 could have only two or three investors. Additionally, with the six-month integration rule, a TIC sponsor could issue only \$2 million in TICs per year under Rule 504.

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151. 17 C.F.R. § 230.251

152. While the safe harbor in Rule 505 also was promulgated under the small issue exemption, it is subject to the prohibition on general solicitation and general advertising in Rule 502(c). *See* 17 C.F.R. § 230.502(c) (2006).

153. 15 U.S.C. § 77c(a)(11).

154. 17 C.F.R. § 230.147 (2006).

155. *See supra* note 151, § (b).

156. 17 C.F.R. § 230.504(b)(2).

157. *Id.*

158. 17 C.F.R. § 230.502(a).

159. If Rule 502(a) does not apply, then the criteria set forth in SEC Release 33-4552 would be used to determine whether the offerings would be integrated. *See supra* note 55 and accompanying text.

160. *See* 15 U.S.C. § 77r.

Considering the costs associated with maintaining a TIC program and performing sponsor duties under the master lease or property management agreement, this structure is not economically feasible for TIC sponsors at those low dollar amounts.

The intrastate exemption, contained in Section 3(a)(11) of the 1933 Act, as well as Rule 147<sup>161</sup> promulgated thereunder, contains no dollar limits on the offering and therefore may be useful for small, local TIC sponsors. As with the Rule 504 exemption, offerings in reliance on Rule 147 are subject to state securities regulation. Therefore any offering under Rule 147 either must be subject to an exemption or qualified under applicable state securities laws.<sup>162</sup>

Rule 147 requires both that the TIC sponsor be doing business in the state and also be a state resident.<sup>163</sup> Rule 147 also requires that all purchasers and offerees be a resident of the state, and that the proceeds from the offering primarily be utilized in the state.<sup>164</sup> For a sponsor to be considered a resident of a state for purposes of Rule 147, it must have derived eighty percent of its gross revenues on a consolidated basis from inside that state.<sup>165</sup> Entities formed for the specific purpose of acquiring part of an issue are not deemed to be a resident of the state.<sup>166</sup> Therefore, a national TIC sponsor cannot avoid the Rule 147 requirement that purchasers be residents of a particular state by forming entities in the state to acquire the TIC interests.

Rule 147 also requires that the issuer use at least 80% of the net proceeds from the offering for the purchase of real property located in the state in which the sponsor is doing business and the purchasers and offerees reside.<sup>167</sup> This is a problem in the TIC industry since most of the equity comes from the East and West coasts where investors have realized huge gains from appreciation on real estate. Properties on the coasts, however, generally do not produce the net operating income or internal rates of return desired by TIC investors, so most of the properties in TIC offerings are in the middle of the country.

Finally, Rule 147 contains integration provisions such that, should

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161. 17 C.F.R. § 230.147.

162. One possible exemption from state qualification is the accredited investor exemption, which is recognized in 32 states.

163. *Supra* note 161.

164. *Id.*

165. 17 C.F.R. § 230.147(c)(2).

166. *Id.* § 230.147(d)(3).

167. *Id.* § 230.147(c)(2)(iii).

the sponsor issue securities under Section 4(2) (and therefore also under Rule 506) or under Section 3 of the 1933 Act within six months of the Rule 147 offering, such securities will be considered part of the same offering when determining whether the offering is truly intrastate.<sup>168</sup> Therefore, the Rule 147 exemption will not be available for national TIC sponsors. It may, however, be useful for small, local TIC sponsors who are both familiar with the real estate and have access to prospective investors in the same region.

S.B. 64,<sup>169</sup> adopted by Utah in 2005, modifies the Utah Uniform Securities Act by removing from the definition of securities certain TIC offerings that involve a management agreement, and by providing that Utah-licensed real estate professionals may sell such TIC offerings. In addition, S.B. 64 gives the state Real Estate Commission enforcement power over these particular TIC offerings; requires the Utah Real Estate Commission to adopt rules governing disclosures made by real estate professionals selling TICs; imposes requirements for the TIC management agreement; and establishes disclosure, management, and structural requirements for TICs that involve a master lease.<sup>170</sup> This type of statute could be used along with the intrastate exemption in Rule 147 such that TICs could be sold in a single state through general advertising.<sup>171</sup>

### I. Structuring TICs as Real Estate and Not Securities

Although most TIC offerings are securities,<sup>172</sup> Rev. Proc. 2002-22 does not require that TICs be structured so that they constitute securities. Indeed, there are a number of TIC sponsors which claim that their TIC offerings are purely real estate and who, therefore, generally advertise and sell their offerings through real estate brokers.<sup>173</sup> If a TIC offering does not constitute a security, then the sponsor is free to generally advertise the offering like any real estate being sold, and is not required to have a pre-existing relationship with investors before the offering is contemplated. Therefore, TIC sponsors could avoid the general

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168. *Id.* § 230.147(b)(2).

169. 2005 UTAH LAWS 257.

170. *Id.* at § 4.

171. See Gary Beynon, Elizabeth Ayres Whitman, Daniel S. Rosefelt, *What Does Utah Senate Bill 64 Really Do?*, 3 W. REAL ESTATE BUS. 10 (2005).

172. See *supra* Section III.

173. See EFFORTLESS CASH FLOW, *supra* note 2, at 33.

solicitation prohibition in Rule 502(c) if they could structure TIC offerings such that they are not securities.

Under *Howey*,<sup>174</sup> there are three requirements for an investment contract: (1) investment in a common enterprise; (2) the expectation of profits; and (3) the efforts of others—usually a sponsor.<sup>175</sup> Since, by definition, TICs involve multiple investors who hope to save taxes, investment in a common enterprise with the expectation of profits<sup>176</sup> is inherent in the TIC structure. It may be possible, however, to eliminate the third *Howey* criterion—derivation of profits from the efforts of the sponsor—from the TIC structure.

TIC sponsors who claim their TIC offerings are not securities generally attempt to eliminate this third criterion by not entering into either a management agreement or a master lease for the property after closing.<sup>177</sup> If a TIC sponsor structures the TIC offering and, after sale of all of the TICs, has no further involvement in the property as property manager, lessee, owner, or guarantor, the TIC offering is likely pure real estate and not a security for federal securities law purposes. In *Schultz v. Dain Corp.*, the Eighth Circuit held that there was no security where the real estate investor created a closely held tenancy in common in the complex and retained the seller as manager.<sup>178</sup> The *Schultz* court concluded that the transaction involved nothing more than the sale of an apartment complex coupled with management services. *Schultz* further held that there was no investment contract because the investor retained

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174. See *supra* note 45.

175. *Id.* at 299.

176. Mere tax benefits to an investor will not qualify as a profit for these purposes. *United Housing Foundation v. Forman*, 421 U.S. 837, 855 (1975) (“We know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes constitutes income or profits.”); see also *Sunshine Kitchens v. Alanthus Corp.*, 403 F. Supp. 719, 721-22 (S.D. Fla. 1975). The *Forman* Court added that if tax deductions were considered profits, they still would not result from the managerial efforts of others. *United Housing Foundation*, 421 U.S. at 855 n.20. However, most TIC investors, in addition to expecting tax benefits, also expect to receive a return on their equity investment, not only through appreciation of the property, but also through net revenues from the property during their ownership. The latter certainly constitutes a “profit” within the meaning of *Howey*.

177. However, most of these “real estate TIC sponsors” retain a TIC interest in the property after the offering is completed. This gives the TIC sponsor some level of control over the property after sale of the TICs and may call into question whether those particular TICs are in fact securities under the *Howey* test.

178. 568 F.2d 612, 613-15 (8th Cir. 1978).

ultimate control over the complex, had considerable business expertise, and did not rely on the seller's efforts.<sup>179</sup> Likewise, in *Elson v. Geiger*, the United States District Court for the Eastern District of Michigan noted that where a lessee is obligated to pay an agreed rent, the rent is totally independent of any profits or managerial expertise.

Although the Plaintiffs argued that seller-lessee's managerial ability was requisite to a continuation of the timely rental payments, this contention alone does not meet the *Howey* test. Every lessor, in some measure, is reliant upon his commercial lessee's ability to manage the business profitably; however, such reliance will not render every commercial lease a security.<sup>180</sup>

In *Triple Net Leasing, LLC*,<sup>181</sup> however, the SEC denied issuance of a no-action letter for the traditional master lease TIC structure. The SEC thus regards TICs as securities, at least when tied to a master lease or to a TIC sponsor affiliate.<sup>182</sup>

Although the SEC did not give any reason for its denial of a no-action letter in *Triple Net Leasing*, it is likely that the SEC found the sponsor's continued involvement with the real estate after the closing to be determinative. The SEC may have distinguished the situation in *Schultz*, in which the real estate purchaser organized his own tenancy in common,<sup>183</sup> from that in *Triple Net Leasing* where the purchasers were depending upon the sponsor to structure the tenancy in common.<sup>184</sup> Also, in *Schultz* the seller presumably had been managing the property prior to its sale. Therefore, the court may have regarded the sale as not disrupting the status quo that existed before creation of the tenancy in common. In *Triple Net Leasing*, on the other hand, the sponsor's management of the property was part of the tenancy in common structure, and thus was not to commence until after creation of the tenancy in common.<sup>185</sup> Therefore, to be certain that a TIC is not a security, the TIC sponsor must have no further involvement in the real

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179. *Id.* at 615-16.

180. 506 F. Supp. 238, 243 (E.D. Mich. 1980), *aff'd without opinion*, 701 F.2d 176 (6th Cir. 1982); *see also Commander's Place Park Assoc. v. Girard & Pastel Corp.*, 572 F.2d 1084, 1086 (5th Cir. 1978).

181. *See supra* note 51.

182. *Id.* at \*12-13.

183. *See supra* note 178.

184. *See supra* note 51.

185. *Id.*

estate after its sale to investors.

While this is possible in theory, it is not practical in the current TIC market-conditions. TIC investors are generally looking to defer taxes while avoiding the need to manage their investment real estate. TIC investors selecting a master lease structure may also be looking for a predictable return on their investment. TIC sponsors make a profit not only from the spread between their purchase price plus syndication costs and the price at which the TIC offering is sold to investors, but also from management fees (or the spread between master lease payments and the property net operating income) as well as a disposition fee. Further complicating the structure are lender requirements that the sponsor remain involved with the property as either manager, master lessee, or co-owner<sup>186</sup> and that the sponsor or an affiliate guarantee certain potential liabilities associated with the property. Although TIC sponsors may otherwise be willing to part with the lucrative management fees or master lease spread and the disposition fee, TIC sponsors may be unwilling or unable to walk away from a property when lenders effectively tie the TIC sponsors to the property during the term of the loan. Indeed, the mere fact that the lender has tied the TIC sponsor to the property during the term of the loan could erode the claim that the TICs are not securities under the *Howey* test.

#### J. Registration of TICs

Finally, TIC sponsors could eliminate the need for complying with the general solicitation rule in Rule 502(c) by registering their TIC offerings with the SEC. Issuers and broker-dealers involved in public TIC offerings would be able to engage in general advertising and general solicitation in connection with the sale of TICs once they register the security.

Although registration may sound like a panacea for the tensions between the general solicitation rule in Rule 506 and the 45-day identification period under Section 1031, registration is not without difficulties. An initial obstacle to registration is that the existing SEC registration forms do not fit TIC offerings well. Form S-11, applicable to REITs and "securities issued by other issuers whose business is primarily that of acquiring and holding for investment real estate or interests in other issuers whose business is primarily that of acquiring

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186. Branscome, *supra* note 2.

and holding real estate or interests in real estate for investment” is the existing form that most closely applies to the TIC structure.<sup>187</sup> However, this language describes a real estate limited partnership or other real estate securities where title to the real estate is held by an entity.<sup>188</sup> Rev. Proc. 2002-22 requires that, in a TIC, title to the real estate be held directly by the tenants in common and not through any entity.<sup>189</sup> In order for TICs to be registered, therefore, the SEC would either have to establish a new registration form for TICs or permit adaptation of Form S-11 for TIC offerings.

Timing poses another obstacle to registration of TICs. Most TIC sponsors do not acquire the real estate before creating the TIC offering. Rather, the TIC sponsors enter into a purchase agreement for the real estate, conduct due diligence, prepare the private placement, sell TIC interests, and close on the sale of the TIC interest to investors on the same day the TIC sponsor acquires the real estate.<sup>190</sup> In a booming real estate market, TIC sponsors must compete with real estate investors, including institutional investors, for high quality properties with net operating incomes and internal rates of return that will be attractive to TIC investors. This places TIC sponsors under ever increasing pressure from sellers of real estate to truncate the time between execution of the purchase agreement and closing on the acquisition if those TIC sponsors want to be selected by the sellers to acquire the real estate. Therefore, TIC sponsors are forced to agree to very short time periods—sometimes only 60 or 75 days from entering into a letter of intent—until the closing in order to be selected by the seller to acquire the property. This leaves very little time within which to conduct due diligence on the real estate, negotiate a mortgage loan, and prepare an offering document (whether it be a private placement memorandum or a registration statement) before the TIC sponsor needs to begin marketing the TIC offering.

Registration of an offering typically takes several months using the conventional process. Thus, under the conventional process, the time between when the TIC sponsor identifies both the real estate and the

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187. For an example Form S-11, see U.S. Securities and Exchange Commission, available at <http://www.sec.gov/about/forms/forms-11.pdf>.

188. *Id.*

189. Rev. Proc. 2002-22, *supra* note 12, § 6.01.

190. Rev. Proc. 2002-22, *supra* note 12; *C.f.* Raitz, *supra* note 50. In some cases, TIC sponsors do not even acquire the real estate, but rather, assign their interests in the purchase agreements for the real estate to the TIC investors and direct the seller of the real estate to deed it direct to the TIC investors.

lender to the time when the TIC sponsor must close on the purchase is insufficient to allow the TIC sponsor to register the offering. The typical TIC sponsor, however, generally has an acquisition and offering plan that would enable the TIC sponsor to prepare and file a skeleton registration statement well in advance of identifying the real estate involved. A skeleton registration statement would contain a description of the TIC offering structure, the risks generally associated with the offering, and information about the TIC sponsor, but would omit information about the property and property-driven or market-driven details about the loan (such as the loan amount and interest rate). The SEC, then, could establish a procedure, much like a shelf registration under Rule 415, under which TIC issuers could file a skeleton registration statement before identifying the property. Once the property and loan terms are determined, the TIC issuer could amend or supplement the registration statement to include those items, after which the SEC could accelerate the effective date of the registration statement so that the TIC offering could be timely marketed.

Even if the SEC were to establish a registration procedure applicable to TICs, the use of that registration procedure would be limited by the cost of that procedure as well as by the time and the cost associated with obtaining qualification of the TIC offerings under state securities laws. As discussed earlier, under NSMIA, Congress exempted Rule 506 offerings from state regulation. This is the only self-executing exemption from state regulation in NSMIA, but there is another exemption from state regulation in NSMIA—for securities sold to “qualified purchasers.”<sup>191</sup> In NSMIA, Congress authorized the SEC

to define the term “qualified purchaser” under the Securities Act to include “sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary,” thus preempting securities transactions with these persons from state “blue sky” law. Although the states may not require registration of offers and sales of securities to qualified purchasers, offers and sales to those persons must be registered with [the SEC] under the [1933] Act, unless a federal registration exemption is available.<sup>192</sup>

On December 19, 2001, the SEC issued Release 33-8041, in which it proposed that “qualified purchaser” be given the same meaning as

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191. 15 U.S.C. 77r(b)(3).

192. SEC Release No. 33-8041, 2001 SEC LEXIS 2620 (Dec. 19, 2001).

“accredited investor” in Rule 501(a) of Regulation D.<sup>193</sup> However, no rule defining “qualified purchaser” was ever adopted. By adopting the rule proposed in Release 33-8041, and establishing a streamlined procedure that works for registration of TICs, the SEC could create a viable alternative to Rule 506 for the sale of TICs that would help TIC investors gain access to more suitable offerings within their 45-day identification period.

## VII. CONCLUSION

The tension between the general solicitation rules under Rule 506 and the 45-day identification period under Section 1031 is not easily resolved using current TIC structures and the current securities regulatory scheme. Broker-dealers and their registered representatives, however, can alleviate some of this tension by taking steps to form substantial relationships with prospective investors before they sell their relinquished properties. Broker-dealers and registered representatives can also address these issues by forming relationships with tax and real estate professionals who advise individuals in connection with Section 1031 exchange so that the broker-dealers receive unsolicited referrals of prospective TIC investors. Another option would be for broker-dealers to become dually licensed as real estate brokers. This would enable the broker-dealers to develop a substantial relationship with prospective TIC investors earlier, perhaps even through listing and selling the relinquished properties.

The status of the SEC’s position on payment by broker-dealers of finder’s fees for referrals of prospective investors is unsettled, and the NASD prohibits such practices. NAR is working to obtain SEC approval for payment of real estate brokerage commissions, as well as broker-dealer commissions in connection with the sale of TICs. Since the NASD takes the position that payment of such real estate commissions by broker-dealers would violate its rules, broker-dealers may not directly or indirectly pay commissions to real estate brokers in connection with the sale of TICs unless the SEC officially approves them.

Ultimately, the SEC should take action to adopt a qualified investor exemption, as required by NSMIA, and to create a streamlined registration process applicable to TICs. TICs serve a valuable function

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193. *Id.*

in supplying needed Section 1031 replacement real estate to retirees and others who no longer desire to manage their investment real estate. By establishing a procedure whereby prospective TIC investors gain access to the maximum possible number of available TIC offerings before expiration of their 45-day identification periods, the SEC can assure that TIC investors are in the best possible position to select TIC replacement properties that are suitable for their needs, while also assuring that those investors are given full and fair disclosure of the risks of these investments.