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FAQs (frequently asked questions) | Tenancy In Common in San Francisco

May 22, 2006 Edition, by David R. Gellman

Breaking News The San Francisco Board of Supervisors has passed new legislation permanently blocking condominium conversions of TIC properties where "protected" (elderly, disabled, or catastrophically ill) tenants have been recently evicted. A further provision of the new law blocks conversions if two or more recent evictions of non-"protected" tenants have occurred. Details within.

Individual Tenancy-In-Common (TIC) mortgages are now being offered by lenders in San Francisco, allowing TIC owners to sidestep the two biggest problems associated with a TIC group mortgage, i.e., the risk of default by one member of the TIC group, and re-financing complications when one TIC member wishes to sell his or her "unit." The replacement of a group TIC mortgage with individual TIC mortgages largely eliminates the distinction between condominium and TIC ownership. G3MH offers current information regarding availability of individual TIC mortgage loans in a recorded hotline message, which you can access by dialing: 415/673-5610 and then pressing *302 after the prompt.

What is a Tenancy In Common (TIC)?

While the legal term "Tenancy in Common" simply refers to a form of group ownership, the residential TIC popular in San Francisco can best be understood through comparison with condominiums. In a condominium, the portions of the property within the dwelling unit walls are owned by individuals (unit owners), and everything else is owned by a group (the homeowners' association). In a TIC, the *entire property* is owned by the TIC group (the tenants in common) in percentage shares, and a detailed written agreement describes each TIC member's rights and duties, including exclusive rights to use and occupy particular dwelling units, along with assigned parking, storage and deck areas.

Why are TICs so Popular in San Francisco?

Over the past decade, TICs have become the primary source of entry-level housing in San Francisco. This is due to factors unique to San Francisco combining in a "perfect storm": i) stratospheric prices of single-family residences; ii) City restrictions which strangle new construction of houses and condos; iii) Rent Control rules which discourage investment ownership of multi-unit properties; and iv) restrictive City limits on condominium conversions of existing multi-unit properties. Often, the combined values of the separate TIC shares of a building exceed the value of the building as an undivided property. The potential for certain TICs to convert to condominiums is also attractive to home buyers.

This article summarizes the rules understood to be in effect on its publication date. Buyers and Owners should check with the author for recent developments before making commitments based on information in this article. Updated versions of this article may appear on the firm's website at www.g3mh.com.

Are TICs Legal?

Factions within San Francisco have tried on various occasions to outlaw or limit TIC formations. In each instance, restrictive local laws have either been rejected by voters or, when passed by the City Supervisors, thrown out by the courts. The most recent effort (in 2001) attempted to make the exclusive occupancy arrangements central to TIC formations illegal and unenforceable. The law was ruled unconstitutional by the San Francisco Superior Court in a decision affirmed by the California Court of Appeal in 2004. Meanwhile, TIC ownership has become an established part of the San Francisco real estate scene, where TIC interests are routinely advertised, bought and sold.

How are TICs Organized?

A lawyer experienced in TIC formation can guide potential tenants in common in developing an appropriate structure tailored to the requirements of their particular group and property, which will be documented in a written TIC Agreement. The primary goals should be eliminating friction among TIC owners, maximizing re-sale marketability of TIC shares and, where appropriate, facilitating condominium conversion. After purchase, each TIC owner occupies and maintains her/his assigned areas. The costs of maintaining common spaces, and most other building expenses, are divided equitably among the owners pursuant to the TIC Agreement. Each owner can sell his/her interest at any time; first refusal rights may apply. If the building is converted to condominiums, each owner receives his/her assigned areas as a deeded condominium unit.

How are TIC Percentage Interests Determined?

In most TICs, a "relative value percentage" is assigned to the areas (dwelling, parking, storage, deck, etc.) that each owner will occupy. Factors that affect relative value percentage include square footage, upper or lower floors, views, and general condition. The percentages are typically determined by the prospective co-owners, often with the assistance of a real estate agent. A common approach is to value each unit as if it were being sold separately. Recent sale prices for comparable condominium units can be used as a basis for this valuation, if TIC comparables are not available. Once the values are established, they are added together and each is divided into the total to yield the TIC percentages. Purchase prices and property taxes will be shared along these percentages.

How have TIC Mortgages Traditionally been Shared?

Many TIC groups share a common mortgage, usually in the same ratios as their TIC ownership percentages. Sometimes a prospective TIC owner may have a small down payment but ample income, or a large down payment but limited income. This can be dealt with by allowing each owner's percentage share of the group mortgage to be different from the owner's TIC ownership percentage. This arrangement is perfectly equitable if the total of a particular owner's down payment and loan share equal his or her share of the building cost; however, a particularly large disparity in debt and/or down payment suggests the need for special precautions.

What is Different about the New Individual TIC Mortgages?

With the new individual, or "fractional", TIC mortgages, each TIC owner obtains a separate, independent mortgage secured only by his or her ownership interest in the TIC property. With the elimination of a group mortgage, a late payment by one owner does not damage the credit history of the other TIC owners, and while a loan default by one owner may have some consequences to the TIC group, risk of foreclosure against the non-defaulting TIC owners is not among them. The considerable advantages offered by fractional TIC mortgages should make them the first choice for TICs; however, higher interest rates and less favorable mortgage terms have reduced the desirability of these new loans.

How are TIC Expenses Paid?

TIC expenses are divided into "individual expenses" and "common expenses". Individual expenses include maintenance and improvements to dwelling unit interiors, personal property insurance, and separately metered utilities, and are paid directly by the individual owners. Common expenses include insurance, property taxes, maintenance and improvements to common areas, and shared utilities like water and trash removal; they are paid through a TIC group bank account. Mortgage expenses will be either "individual", if fractional TIC mortgages are obtained by each owner, or "common", if a single shared mortgage is obtained by the TIC group. Most TIC groups require each owner to make a single monthly payment to the group bank account. The monthly payment is based upon the total of the owner's share of the anticipated common expenses.

How are TIC Group Decisions Made?

Generally, each TIC owner has one vote, with routine decision made by a majority. Major decisions, such as sale or refinancing of the property, building changes or improvements, and all group decisions in 2-unit buildings, typically require unanimity.

How are TICs Formed?

When a group of potential homebuyers gets together (or is brought together by their real estate agents) to purchase a multi-unit property, the first thing the potential TIC members should do is evaluate each other's abilities to sustain their individual shares of the common financial obligations the group will be undertaking. The TIC group should examine each other's financial statements, tax returns and other evidence needed to provide a satisfactory comfort level among all of the potential TIC members. This self-approval process should be as much a precondition to the group's obligation to purchase a property as are the normal property inspections and loan approvals.

What Should be Included in a TIC Agreement?

The following is a partial list of issues a well-drafted TIC agreement should cover:

- Description of which portions of the property are for the exclusive use of particular owners;
- Discussion of how common areas of the property are to be shared and maintained;
- Allocation of mortgage, property tax, common area maintenance, utilities, and other shared financial obligations;
- Rules for refinancing and condominium conversion;
- Consequences and remedies for default, including a default reserve fund;
- Rules governing use of the property, including limits on number of occupants, pets, quiet hours, and floor coverings;
- Polices addressing the death or bankruptcy of a member;
- Rules governing sale of individual interests, including approval of buyers and rights of first refusal; and,
- Dispute resolution via mediation and arbitration

How are TIC Agreements Prepared?

Each TIC agreement is unique; re-use of another group's agreement, or signing a "boiler plate" form does not allow the new TIC members the opportunity to engage in group discussion of what is appropriate for their group, and increases the odds of subsequent arguments within the TIC. Since a primary purpose of having a written TIC agreement is to forestall such disagreements, that purpose is defeated when the TIC group fails to take a professional approach to drafting their agreement. Typically a highly-qualified attorney represents the entire TIC group, starting with a face-to-face conference where the potential TIC members can meet and test their abilities to make group decisions and get along with each other. The attorney is responsible for suggesting alternatives, facilitating a discussion of advantages and disadvantages of various approaches to resolving potential future disputes, and preparing a comprehensive written agreement, specifically tailored to the group's personality and needs. It is entirely appropriate for individual members to seek separate review by their own accountants and attorneys, and incorporate their efforts into the final TIC agreement.

Can I Sell My TIC Interest?

Subject to any agreement to hold title for a specified period to facilitate condominium conversion, individual TIC interests can be sold at any time for market value, provided the TIC group approves of the qualifications of the buyer. Refinancing of the entire property may or may not be required (see below). TIC interests are marketed and sold throughout San Francisco under the Multiple Listing Service (MLS) in much the same way as are condominiums.

How are Fractional Mortgage TIC Re-Sales Financed?

Refinancing in connection with the sale of an individual TIC interest subject to a fractional TIC mortgage should be similar to condominium resales – the new buyer qualifies for and obtains a new fractional mortgage in his or her own name, and the seller uses the sale proceeds to pay off the original fractional mortgage loan. The other TIC owners are not involved in the refinancing at all. All of this assumes, however, that fractional TIC mortgages will continue to be offered by lenders. The current crop of fractional TIC loans are being offered by only a handful of lenders on a trial basis; future availability of these loans is not yet assured.

How are Group Mortgage TIC Re-Sales Financed?

In the initial years of TIC ownership, the members holding a group TIC mortgage will generally not need to refinance the property when a single owner sells. Instead, the buyer will join the other owners as a borrower on the existing loan, and will assume the seller's share of the outstanding loan balance under the TIC agreement. To facilitate this, it is important that the initial TIC mortgage be *assumable*. To minimize loan assumption fees, it is advantageous to obtain a loan that allows for "partial assumption" – substitution of the buyer of a TIC share for the selling owner without re-qualification by the entire TIC group. As the group TIC mortgage balance declines over the years, and/or if the TIC interest being sold significantly appreciates in value, there can be a large difference between the sale price and the seller's share of the outstanding loan balance. If the buyer cannot offer a large down payment, the seller will either need to offer private financing, or arrange for the entire TIC group to refinance the property. A well-drafted TIC agreement will include detailed rules governing these processes.

What are the Tax Benefits of TIC Home Ownership?

TIC ownership provides the same tax benefits as other forms of home ownership. Owner-occupants may deduct their mortgage interest and property taxes, and can take advantage of homeowner capital gains exclusions on resale. Persons considering acquiring a TIC interest strictly as investment property should consult a tax specialist concerning the application of tax laws to TIC ownership.

What San Francisco Laws Currently Affect TICs?

San Francisco Rent Control rules can affect the ability of TIC owners to occupy their new homes if tenant occupied. Only one "Owner Move-In" eviction is allowed per building, although an unlimited number of relatives may pursue their own evictions to accompany the owner. Evictions of "protected" (elderly, disabled or catastrophically ill) tenants are generally prohibited. Where more than one owner eviction is necessary, where tenants are protected, or where the owner doesn't qualify under Owner Move-In rules, all tenants in the building can be evicted under the state's Ellis Act, but subsequent rental of the property will be restricted (see our article entitled *Tenant Evictions in San Francisco* for information about evictions). San Francisco's eviction laws are complex and punitive. Anyone considering a TIC purchase of a tenant-occupied property should consult an experienced attorney.

What are the State Requirements for Larger TICs?

The California Department of Real Estate (DRE) now requires that TIC formations in buildings of five or more units apply for a "Public Report." The process of obtaining a Public Report from the DRE can take from 4–6 months, and will involve a professionally prepared budget and establishment of significant TIC reserve funds. The cost of obtaining a Public Report will vary depending on the size of the building. A Public Report is **not** required for the **resale** of an interest in an existing TIC, even if the TIC never had a Public Report.

How Can My TIC Property Become Eligible for Condominium Conversion?

San Francisco severely restricts residential condominium conversions. All 3–6 unit buildings, and all 2-unit buildings which are not 100% owner-occupied by separate individuals living in separate units, must compete in an annual lottery for the right to convert. A maximum of 200 residential units can win the right to convert each year through the lottery. Properties with *more than 6 residential units* cannot convert at all. A 2–6 unit building will qualify to convert only when it (1) meets occupancy requirements; (2) wins or bypasses the annual conversion lottery; and, (3) for lottery conversions only, satisfies "Tenant Intent to Purchase" requirements.

What Steps Should a TIC Group Take to Prepare for Condominium Conversion?

Your building need not be upgraded to meet current building codes, be seismically retrofitted, or even have parking. However, the City will require a building inspection as part of the conversion process. **Because the City Department of Building Inspection is taking up to 18 months to schedule inspections, we advise owners to initiate the City inspection process at least six months prior to submitting a conversion application.** If you decide not to proceed with your conversion, you may cancel a requested inspection. However, once your City inspection has actually taken place, you must perform the cited work whether or not you proceed with conversion. In some cases, pre-inspection by a private consultant familiar with conversion requirements may be beneficial. A consultant can provide advance warning of likely inspection issues, recommend steps to minimize remediation requirements, establish the legality of preexisting improvements, and help you obtain building permits. We can provide a list of knowledgeable inspectors to our clients when needed.

Do Evictions Affect Condominium Conversion?

Yes. Under laws recently enacted by the San Francisco Board of Supervisors, properties where "protected" (elderly, disabled, or catastrophically ill) tenants have been displaced ***after May 1, 2005*** will be denied condominium conversion. Conversion will also be blocked for ten years in buildings where two or more evictions of *non-protected tenants* have occurred. Also, owners who evicted protected tenants between November 16, 2004, and May 1, 2005, although not barred from converting, face significant restrictions on their ability to do so. **Evictions based on tenant fault (e.g., non-payment of rent, nuisance) do not interfere with condominium conversions.** Please see our article entitled *Condominium Conversion in San Francisco* for further information about conversion.

What are the Risks of TIC Ownership?

All co-ownership forms (TICs, condominiums, cooperatives, partnerships, etc.) involve risks associated with sharing use of property with others, and relying on each other to fulfill mutual obligations. The level of risk can depend on the portion of the property that is co-owned, as well as the size of the shared obligations. For example, condominium owners co-own only the structural elements, systems and common areas of their building, and therefore share relatively few obligations, such as maintenance and insurance of the co-owned areas, making their risks relatively low. Because TIC members co-own the entire property, the TIC group is collectively responsible for **all** obligations of property ownership. Thus, while condominium owners still need to worry about whether their neighbors will be effective group decision-maker, be considerate in use of common areas, and pay their home owners' association dues, they need not worry about whether their neighbors will make mortgage payments. If a TIC owner fails to pay his or her share of the monthly mortgage payment and a default results, the lender could foreclose on the entire building, causing all of the other owners to lose their homes. At the very least, owners could suffer damage to their credit histories. To help minimize these risks, potential TIC owners should:

- Thoroughly investigate the background and qualifications of co-owners;
- Exhaustively evaluate the property and financing;
- Create a customized TIC agreement that each group member fully understands;
- Establish a default reserve fund; and
- Observe and enforce the rules of their TIC agreement.

How Might I Become Involved in a TIC Group?

1. Participate in formation of a new TIC as one of the founding members by:

- Assembling your own group of family, friends or associates, and then working with a qualified Realtor® to locate a building the entire group likes; *or,*
- Joining an individual or group that is in the process of buying a building, but has an available unit. A Realtor® can help you find such an individual or group and then evaluate the qualifications and suitability of the potential co-owner(s); *or,*
- Working with a Realtor® to identify a suitable multi-unit building, creating an model TIC agreement, then locating qualified co-owners for the other unit(s).

2. Join an existing TIC group by buying a single TIC interest that is offered for sale. Joining an existing TIC group is usually more expensive but may involve less risk if the group has a history of successfully making decisions and satisfying its financial obligations. An existing group may also be farther along in the process of qualifying the building for conversion to condominiums.

3. Create a TIC framework for sale of all or part of a property you already own. With a model TIC agreement prepared for review by potential buyers, agreement on a TIC structure by the buyers will not be a contingency to the purchase contract. Consider offering the property with a financing package for the buyers already in place. It is also possible to market your property simultaneously as both TIC shares and a single investment property.

How do I Choose a Lawyer to Assist Me in Creating My TIC?

A Law Firm Specializing in Condominium Conversions Should Offer You:

- Experienced attorneys knowledgeable in all aspects of TIC creation and operation;
- A custom-drafted TIC agreement tailored to your group and building requirements;
- Substantial experience in converting TICs to condominiums;
- Expertise in landlord/tenant issues.

What Sets Goldstein, Gellman, Melbostad, Gibson & Harris, LLP ("G3MH") Apart in TICs?

TIC Experience:

G3MH has been a respected member of San Francisco's real estate community for over twenty years. Beginning in 1998, our attorneys have been preparing the legal framework for TICs throughout Northern California. We have provided guidance and prepared the legal framework for nearly four hundred Tenancy In Common groups, representing more than two thousand homeowners.

Condominium Conversion Experience:

When you are ready to begin your condominium conversion, a G3MH team which has successfully completed over 2,200 condominium conversions will be there for you. Over the past four years, G3MH has handled the majority of all San Francisco conversion applications, including more than half of all lottery winners (over 400 units), plus an additional 543 duplex units exempt from lottery requirements.

Flat-Fee:

G3MH provides Tenancy In Common formation services on a flat-fee basis. The scope of our work is clearly explained up front, and the costs laid out for you, so that there will be no surprises or "extras" down the road. Any additional hourly services are incurred only at your specific request. Our fees vary depending on property size, and are competitively priced; please call for details.

Service:

G3MH is a full-service law firm, which means that our attorneys and paralegals are available to offer additional guidance in landlord/tenant issues, condominium conversion, title transfer and vesting, trust and estate matters, easements, property tax issues, and all other matters related to TICs. We also offer skilled mediation services to TIC groups to help resolve internal disputes. No other firm in San Francisco offers the staffing and resources to meet your needs in every aspect of residential real estate co-ownership.

About the Authors:

David R. Gellman, managing partner of G3MH, has extensive experience in Tenancy In Common (TIC) formation, condominium conversion, landlord/tenant (rent control), real estate litigation, commercial leasing, like-kind exchanges, multifamily housing finance, construction, and estate planning. Mr. Gellman is an accredited instructor with the California Department of Real Estate, and frequently conducts co-ownership workshops for attorneys, real estate agents, and prospective home buyers. He has written a companion article to this one, entitled "Condominium Conversion in San Francisco" which can be found on the firm's website at www.g3mh.com. Mr. Gellman can be contacted via email at DGellman@g3mh.com or by phone at (415) 673-5600.

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