CHAPTER 11

A DEFENSE OF TICs AND DSTs

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In a recent article in the Journal of Real Estate Taxation, Terry Cuff highlighted a number of potential risks and considerations with respect to syndicated tenancy in common, or TIC transactions, and the TIC industry as a whole.[1] Terry is a well-know expert in the area of like-kind exchanges and the author of numerous articles on the subject. His article requires a response. In the authors' view, while Terry's intent to educate investors on the risks involved in TIC investments and to provide them with tools to make better investment decisions is laudatory, the article glosses over many of the important benefits that have contributed to the dramatic rise in demand for TIC offerings over

[1] Terence F. Cuff, "*Research Can Prevent an Investment in a Ticky Tacky TIC*," 33 Real Estate Tax'n 4 (Third Quarter 2006).

the past five years and that, barring regulatory changes, will continue to grow in the future.

As described in more detail below, in a typical TIC transaction, a sponsor will offer undivided interests in real estate to a group of accredited investors who will become co-owners with respect to the property. To date, the primary, though by no means exclusive, investors in TIC transactions have been individuals looking to acquire qualified replacement property in connection with a like-kind exchange under Section 1031.[2] When properly structured, the undivided interests acquired in a TIC offering ("TIC Interests") are treated as interests in real estate and therefore as qualified replacement property for taxpayers disposing of other real estate in a like-kind exchange. Most TIC offerings are structured as securities offerings, although some sponsors offer TIC Interests as real estate under a somewhat modified structure.

Terry's article is particularly concerned with what it terms "Ticky Tacky TICs". The article states that it is principally concerned with "bad TICs, not the good ones." Terry clearly states that "[g]ood TICs are sensibly constructed . . . offer acceptable investments for a like-kind exchange" and "are much to be encouraged." He also agrees that "[t]heir promoters provide a valuable service." By contrast, "Ticky Tacky TICs" are "just bad investments." Unfortunately, Mr. Cuff believes, Ticky Tacky TICs "infect the marketplace." In addition to potentially unscrupulous sponsors marketing poor investments, Mr. Cuff criticizes such TICs on the ground that they are burdened by heavy up-front fees, have weakly developed exit strategies, and may not qualify as good replacement property for investors participating in like-kind exchanges if the sponsor is cavalier about complying with IRS guidelines. Mr. Cuff urges potential investors to carefully investigate both particular TIC transactions and the sponsors offering them in order to distinguish good TIC transactions from bad ones and provides an extensive discussion of the principal risks and considerations investors may take into account. Ultimately, Mr. Cuff is concerned that TIC investors "are so intoxicated by TICs as replacement property for Section 1031 exchanges that they forget to undertake the normal investigation required for investing in real property."

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2 Unless stated otherwise, all Section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

None of this is objectionable as far as it goes. Bad investments are simply that, whether they are undivided interests in real estate or in dot-com stocks. One hopes that most investors, and their advisors, appreciate that tax savings alone are not a sufficient justification for trading a profitable investment for an unprofitable one. The potential for profit and loss depends on the characteristics of a particular piece of real estate and the experience of the persons managing it to a far greater degree than for many other types of investments; investors must therefore be careful in selecting a suitable property in which to invest. Unscrupulous or cavalier sponsors are a threat to both investors and the industries in which such sponsors operate.

Nevertheless, while there is no doubt that some Ticky Tacky TICs exist and investments must be chosen with care, the TIC industry has grown so significantly (to date more than $10 billion of TIC offerings have been made) because TIC investments offer a number of advantages, particularly to individual investors. Obviously, a TIC investment is not suitable for all investors, must be carefully evaluated, and must be weighed against alternative investments in real estate as well as other types of investments. For these reasons, the authors believe that with adequate due diligence and regard for pitfalls, TICs (and syndicated offerings of undivided interests in real estate offered through Delaware Statutory Trusts, or DSTs) can accomplish the needs of many taxpayers in the market for suitable replacement property for Section 1031 exchanges.

¶ 1101 BACKGROUND ON SECTION 1031(a), TICs AND DSTs

A tenancy in common is one of the traditional concurrent estates in land and has existed for hundreds of years. The laws of virtually all states recognize a tenancy in common (or its equivalent) as an estate in land. The essential feature of a tenancy in common is that each owner is deemed to own individually a physically undivided part of the entire parcel of property.[3]

By contrast, the syndicated TIC industry is approximately fifteen years old and has experienced its most rapid growth in the past five to six years. There is currently approximately more than $10 billion in

[3] Rev. Proc. 2002-22, 2002-1 CB 733.

equity invested in interests in TICs and DSTs. The TIC industry generally involves two basic types of syndicated real estate transactions. The first are syndicated offerings of undivided tenancy in common or TIC Interests from which the name of the industry is derived. The second are syndicated offerings of beneficial interests in DSTs. For historical reasons, the industry is often referred to as the TIC industry although this technically is not correct since ownership of an interest in a DST does not create a tenancy in common for state law purposes. For the sake of convenience, references to the TIC industry or TIC Interests in this article refer to both types of interests except where otherwise indicated.[4]

The primary, though by no means exclusive, investors in TIC Interests are individuals seeking to complete a like-kind exchange under Section 1031. Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment for property of like-kind which is to be held either for productive use in a trade or business or for investment. Under Section 1031, virtually all types of interests in domestic real estate qualify as like-kind with respect to other domestic real estate. However, certain types of property are statutorily excluded from qualifying for nonrecognition treatment under Section 1031, including interests in a partnership (even if the sole asset of the partnership is real estate), certificates of trust or beneficial interests, and securities.

When properly structured, an interest in a TIC or a DST may qualify as an interest in real property for purposes of Section 1031 and therefore can be exchanged for other real property in an otherwise qualifying Section 1031 exchange. However, that is where the similarities between TICs and DSTs end. The two forms of investment have little in common apart from the fact that either may constitute an interest in real property for purposes of Section 1031. The IRS has issued two separate authorities to provide guidelines for when an

[4] There is also wide variation between tenancy in common transactions. Tenancy in common transactions can be structured as asset managed deals in which an asset manager oversees the operation of the property on behalf of the investors or by having the investors master lease the property to a master lessee. In addition, as discussed below, tenancy in common offerings have been structured as securities offerings in some cases and as sales of real estate in others.

interest in a TIC or DST will be considered like-kind property in a Section 1031 exchange and it is the authors' view that the guidance issued by the Service with respect to TICs should only be applied to interests in a TIC, and likewise the guidance with respect to DSTs should only be applied to interests in a DST.[5] The two authorities are mutually exclusive and interests in TICs and DSTs should be analyzed separately under the specific guidance issued for each.

Rev. Proc. 2002-22[6] sets forth guidelines under which the Service will consider issuing a private letter ruling that an interest in a TIC constitutes an interest in real property, as opposed to an interest in a business entity (i.e., a partnership) under Treas. Reg. 1.7701-3. Rev. Rul. 2004-86[7] addresses whether a trust will be treated as a trust under Treas. Reg. 1.7701-3 or classified as a business entity under Treas. Reg. 1.7701-3. Beneficial interests in a DST that is classified as a trust which also satisfies the requirements of a grantor trust under Section 671 will be treated as interests in the property owned by the trust rather than as an interest in a partnership or a trust for purposes of Section 1031 exchanges. Although legal authorities discussing tenancy in common structures and the tax treatment of DSTs existed prior to the issuance of Rev. Proc. 2002-22 and Rev. Rul. 2004-86, and some transactions were undertaken based on those authorities, the substantial growth in the TIC Industry over the past several years is due principally to the additional certainty provided by the issuance of these rulings. Both Rev. Proc. 2002-22 and Rev. Rul. 2004-86 are discussed in greater detail below.

TICs and DSTs, much like Section 1031 exchanges in general, are here to stay for the foreseeable future. As the like-kind exchange industry continues to profit from the sale of TIC and DST interests, and as taxpayers continue to find tax deferral success with Section 1031 exchanges, more sophisticated and creative methods will continue to emerge. Taxpayers must at once be prepared to take advantage of these opportunities while at the same time being cautious of Ticky Tacky TICs and other pitfalls.

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[5] See Richard M. Lipton, Arnold Harrison & Todd D. Golub, "*The Intersection of Delaware Statutory Trusts and Tenancies in Common*", Real Estate Taxation (1st Qtr. 2006).

[6] Rev. Proc. 2002-22, 2002-1 CB 733.

[7] Rev. Rul. 2004-86, 2004-33 IRB 191.

¶ 1102 WHAT A TIC IS *NOT*

The popularity of TIC Interests is due in part to the fact that they provide a convenient source of replacement property for taxpayers desiring to obtain the benefits of tax deferral under Section 1031 and can be tailored to the size of the investment a potential investor desires to make. However, tax deferral alone is not a sufficient reason to purchase a TIC Interest. The decision to acquire a TIC Interest must be weighed against the benefits available from alternative real estate investment opportunities, including investment opportunities that may not provide any tax deferral. Moreover, even if a taxpayer has determined that a TIC investment is the best option, the taxpayer must still determine which TIC Interest to purchase. A TIC Interest is not a bond, CD, annuity or other investment providing a fixed and relatively certain return but an investment in real estate that is subject to the normal risks and benefits associated with real estate investments.

TIC investors need to conduct adequate due diligence with regard to the TIC property, much the same as they would if they were purchasing the property in fee. Merely because a property is a TIC does not preclude the possibility that the replacement property may have unforeseen problems. In evaluating TIC investments and alternatives, potential investors need to understand what a TIC is and what a TIC is not.

¶ 1102.1 Comparison to Fee Simple Ownership

At the outset, potential investors considering an investment in a TIC offering need to understand that a TIC Interest is not the same as a fee simple interest in property. The owner of a fee simple interest possesses the entire interest in the property and, subject to legal and regulatory restrictions, is entitled to all of the benefits of ownership of the property, and can develop, sell, encumber, lease or otherwise utilize the property as he or she sees fit. By contrast, the owner of a tenancy in common 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 in common 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 are exercised to the detriment of the other tenants in common.

An interest as a tenant in common affords the taxpayer less control over the property, since he must obtain the consent of the other tenants in common to sell, lease, encumber or otherwise utilize the property.

The purchase of a TIC Interest, as opposed to fee simple ownership, makes sense for many taxpayers, but not for all. A TIC Interest may give an investor the opportunity to invest in a larger property or provide diversification by allowing the investor to invest in a different property class that the investor lacks the resources to acquire as a fee owner. The size of a TIC Interest can be tailored to an individual taxpayer's needs, and the TIC industry can provide reduced hassle and a less time-consuming method for taxpayers to locate suitable replacement property within the requirements of Section 1031. TIC investors do not have to manage the property themselves and will generally have the benefit of professional management, while the owner of a fee simple interest must either manage the property themselves or hire their own professional property managers. On the other hand, syndicated TIC Interests are sold commercially by sponsors or promoters who receive significant fees for the risk they assume in structuring the offering and for undertaking the due diligence with respect to the property that an investor would otherwise have to conduct on its own. In some cases, these fees may be higher than an investor would incur to acquire fee ownership in a smaller property. In that respect, each potential investor must balance the cost of sponsor fees and their impact on the investor's return on (and return of) his or her investment capital in relation to the benefit obtained by the purchase of syndicated TIC Interests.

¶ 1102.2 Comparison to Real Estate Funds and REITs

A TIC Interest also differs substantially from other forms of real estate investments including real estate funds organized as partnerships and real estate investment trusts (REITs). Like TIC Interests, these types of investments free investors from the burden of being actively involved in property management. Because TIC offerings typically include a single property or at most a few properties, they provide significantly less diversification and may carry more risk than real estate funds or REITs that are heavily diversified (although the level of risk will depend significantly on the investment goals and risk profile of the particular real estate fund or REIT and on the performance of the specific properties held by the fund or REIT). While real estate funds

offered as private placements are relatively illiquid investments, public REITs offer significantly greater liquidity. Like TIC investments, the persons who organize and manage real estate funds and REITs receive substantial fees for their services. While the fee structures for real estate funds and REITs typically differ significantly from those charged in connection with TIC transactions, they can significantly impact the return on the investment.

Due in part to the fact that the TIC industry is relatively new and in part to restrictions imposed on TIC investments by the IRS guidelines discussed in more detail below, TIC offerings currently offer fewer opportunities for investors to make tradeoffs between risks and rewards (such as investing in turnaround or distressed properties in the hopes of realizing significantly higher capital appreciation in the value of their investments) than are available in various real estate funds and REITS. This may be less of a distinction between TIC offerings and investments in other syndicated real estate investments than it first appears. To date, anecdotal evidence suggests that TIC investors strongly favor the certainty of current income distributions over the potential for capital appreciation. In addition, creation of upfront reserves necessary for properties that are not producing sufficient cash flow to cover expenses creates potential boot issues that render such properties less attractive to TIC investors.

Despite these differences, TIC Interests provide an important and attractive alternative to other forms of syndicated real estate investments for many investors. Real estate funds often require minimum investments in excess of amounts that an investor is willing or able to invest. Thus, one of the advantages of TICs is that they enable smaller investors the opportunity to invest in professionally managed real estate that otherwise would be unavailable to them. The typical TIC investor will have to make his or her investment in a real estate fund or REIT with after-tax dollars. Because a TIC investor is able to defer the gain on the disposition of its relinquished property, it may make a larger equity investment and generate a return on that investment. In addition, a TIC investor may be able to structure its disposition of the TIC Interest as a like-kind exchange and obtain the benefits of additional tax deferral. Tax-deferred exit strategies typically are not available to investors in real estate funds and REITs. Management rights also differ substantially between TIC Interests and other syndicated real estate investments. In the case of a TIC Interest, the consent

of each of the investors is generally required for major decisions regarding the property such as a sale of the entire property, loans that encumber the property, and leases. These rights are beneficial in the sense that TICs have input into major decisions regarding the property, but can cause difficulties when unanimous consent cannot be obtained. In typical TIC transactions these difficulties are ameliorated to some degree by giving TICs the right to purchase the interests of dissenters when a specified percentage of investors have approved a particular course of action. By contrast, investors in other syndicated real estate transactions may have few, if any, voting rights.

A TIC Interest does not automatically qualify as an interest in real estate for purposes of Section 1031. As discussed in more detail below, the IRS has issued guidance discussing criteria for treating TIC Interests as interests in real property. While practitioners generally agree that satisfaction of all of these requirements is not necessary for a TIC Interest to qualify as real estate, certain of these requirements are critical, while other requirements are not. Taxpayers must ensure that their TIC Interests will qualify as like-kind exchange property. TIC Interests that deviate too far from the published guidance or that violate critical requirements may not qualify as real estate for purposes of Section 1031.

¶ 1102.3 Comparison to Partnerships

A TIC is not a partnership. Rather, a TIC specifically seeks to avoid partnership classification. Section 1031 specifically provides that it does not apply to an exchange of interests in a partnership.[8] Rev. Proc. 2002-22 sets forth advance ruling guidelines under which taxpayers can acquire TIC Interests as replacement property without fear that the Service will attempt to recharacterize the TIC Interest as an interest in a partnership. A TIC does share some similarities with a partnership. Both a TIC and a partnership could involve the co-ownership of property and sharing of the income derived from that property. A partnership arises when the parties to a venture join together capital or services with the intent of conducting a business or enterprise and sharing the profits and losses from that venture. A TIC, on the other hand, involves passive ownership of real estate in which the co-owners

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[8] Section 1031(a)(2)(D).

benefit from the rent and appreciation in the value of the property, as opposed to business operations.

There is a well-established body of case law that concerns the definition of "partnership" for tax purposes. One seminal case is the U.S. Supreme Court's decision in *Commissioner v. Culbertson*[9] in which the Court stated that whether a partnership is created depends on whether the alleged partners really and truly intended to join together for the purpose of carrying on business and sharing the profits and losses or both. This determination is a question of fact, to be determined by the partners' testimony, their agreement and their conduct. Post-*Culbertson* decisions, such as *Luna*,[10] set forth specific factors to be considered in determining whether an arrangement should be treated as a partnership for tax purposes.

¶ 1103 TICs, DSTs AND PARTNERSHIPS

Although TICs and DSTs are often referred to as TIC Interests, TICs and DSTs have little in common except that an interest in either may constitute an interest in real property for purposes of Section 1031. The rules concerning TICs and DSTs arise under separate provisions of the regulations. The IRS has issued two separate authorities to provide guidance for when an interest in a DST or TIC can be used as like-kind property in a Section 1031 exchange. Rev. Proc. 2002-22 sets out guidelines under which the IRS will consider issuing a private letter ruling that a TIC constitutes a direct interest in real property, and not an interest in a partnership under Treas. Reg. 1.7701-3. Rev. Rul. 2004-86 provides guidance regarding whether a trust will be treated as a trust under Treas. Reg. 1.7701-4 or will be classified as a partnership under Treas. Reg. 1.7701-3. Under Section 1031(d), an interest in a partnership does not qualify as good replacement property for purposes of Section 1031. Understanding the differences between a TIC, a DST and a partnership is therefore critical.

A TIC is a non-entity seeking to avoid entity classification. A TIC is a form of holding property which is based on state law (concurrent interests in land), and a TIC seeks to avoid treatment as a partnership.

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[9] 337 U.S. 733 (1949).

[10] 42 TC 1067 (1964).

If TIC Interests were treated as interests in a partnership, the like-kind exchange would fail. Because a TIC is not a legal entity, the relationship between the co-owners is governed by a contract. The advance ruling guidelines set forth in Rev. Proc. 2002-22 test whether the relationship between the parties (including co-owners, sponsors, lenders, etc.) resembles a partnership. Decision-making and sharing of profits that more closely resemble a partnership than a co-ownership of real estate may cause the arrangement to be classified as a partnership. The mere co-ownership of property that is maintained, kept in repair, and rented or leased does not, however, constitute a separate entity for federal tax purposes.[11]

A DST is an entity seeking investment trust classification. The most important distinction in analyzing the tax treatments of a DST and a TIC is that the latter involves a determination of whether the relationships and activities constitute a partnership for tax purposes, whereas with a DST, the existence of an entity is assumed, but the entity has to be classified.

The fundamental concept underlying Rev. Rul. 2004-86 is that a DST is an entity for federal income tax purposes that is recognized as separate from its owners. Creditors of the beneficial owners of the DST could not assert claims directly against the property held by the DST. A DST may sue or be sued, and the property of a DST is subject to attachment and execution as if it were a corporation. The beneficial owners of a DST are entitled to the same limitation on personal liability stemming from actions of a DST that is extended to shareholders of a Delaware corporation. A DST may merge or consolidate with or into one or more statutory entities or other entities, such as a partnership, and a DST can be formed for investment purposes. Based on the purpose of, and powers and privileges afforded to, a DST and the beneficial owners thereof, the IRS concluded in Rev. Rul. 2004-86 that the trust was an entity that could not be disregarded for federal income tax purposes. Thus, it was necessary to classify it as either a business entity or a trust.

A partnership is an entity taxed as an entity. It is another means by which individuals can collectively own an interest in real estate. Treas. Reg. 301.7701-1(a)(2) provides that a joint venture or other contractual

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[11] Treas. Reg. § 301.7701-1(a)(2).

arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation or venture and divide the profits therefrom. A partnership, therefore, is an entity seeking to be taxed as an entity for federal income tax purposes. DSTs and TICs both seek to avoid treatment as a partnership.

¶ 1104 FEDERAL INCOME TAX TREATMENT OF TENANCY IN COMMON ARRANGEMENTS

Prior to 2002, the IRS had considered the treatment of TIC Interests in Rev. Rul. 75-374,[12] which concluded that a two-person co-ownership of an apartment building rented to tenants was not a federal tax partnership. In that Ruling, the co-owners employed an agent to manage the apartments on their behalf. The agent collected rents; paid property taxes, insurance premiums, and repair and maintenance expenses; and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The Ruling concluded that the agent's activities were not sufficiently extensive to cause the co-ownership to be characterized as a partnership for federal income tax purposes.

In contrast to Rev. Rul. 75-374 were several court decisions in which a co-ownership arrangement was found to be a tax partnership. For example, in *Bergford,*[13] 78 investors purchased "co-ownership" interests in computer equipment that was subject to a seven-year net lease. The investors authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the investors to decide by majority vote whether to sell or lease the equipment at the end of the initial lease term; absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10% of the equipment's selling price or lease rental whether or not an investor terminated the agreement or the manager performed any remarketing. An investor could assign her interest in the property only after fulfilling numerous conditions and obtaining the manager's consent.

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[12] 1975-1 CB 261.

[13] 12 F.3d. 166 (9th Cir. 1993).

The *Bergford* court held that the co-ownership arrangement was a partnership for tax purposes. In reaching this conclusion, the court emphasized the limitations on each investor's ability to sell, lease, or encumber either her interest or the underlying property, as well as the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Two other courts reached similar conclusions where a promoter/manager maintained a significant economic interest in the property that was sold to co-owning investors.

In another important decision, *Madison Gas & Electric Company,*[14] the court held that a co-generation operation conducted by three utilities as tenants in common was a partnership for tax purposes because the parties shared expenses and divided the jointly produced property among themselves.

In Rev. Proc. 2002-22, the IRS set forth new ruling guidelines for purposes of determining whether a TIC arrangement involving rental real estate which is treated as a tenancy in common for local law purposes would be treated as the ownership of real estate or a partnership for tax purposes. Rev. Proc. 2002-22 states that these guidelines are to be used solely in assisting taxpayers in preparing ruling requests, and the IRS in issuing rulings, and that they are not intended to be substantive rules or used for audit purposes. The Service ordinarily will not consider a request for a ruling if the conditions provided in Rev. Proc. 2002-22 are not satisfied, although even if all such conditions are met the IRS still may decline to issue a ruling whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration. Investors should recognize that Rev. Proc. 2002-22 does not establish a safe harbor for taxpayers that do not elect to request a ruling. Because most sponsors do not request a ruling, a TIC offering should always include an opinion from reputable tax counsel stating that the TIC Interests should be treated as interests in real property and not as interests in a partnership or a security for federal income tax purposes.[15] Investors and their independent tax advisors should carefully

[14] 633 F.2d 512 (7th Cir. 1980), *aff'g* 72 TC 521 (1979).

[15] Investors should be aware, however, that in accordance with the requirements of Circular 230, most tax opinions bear a legend stating that (i) the opinion of tax counsel is not intended or written to be used, and it cannot be used by any taxpayer for the

review this opinion. Every TIC structure must be closely scrutinized and variations from Rev. Proc. 2002-22 should be carefully analyzed to determine whether the IRS would have a strong argument for classifying the arrangement as a partnership.

A detailed discussion of all of the requirements in Rev. Proc. 2002-22 is beyond the scope of this article.[16] Practitioners, however, are rapidly becoming comfortable with the idea that while several of the requirements in Rev. Proc. 2002-22 are "essential elements" of a TIC arrangement, other requirements are not as critical or can be modified to a certain degree. As a result, sponsors are obtaining favorable opinions from counsel for TIC transactions that satisfy the most essential elements of Rev. Proc. 2002-22 but that may contain variations on minor points.

The key requirements listed in Rev. Proc. 2002-22 are as follows:

1. Tenancy in Common Ownership. Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law.[17] Thus, title to the property as a whole may not be held by an entity recognized under local law. As a practical matter, this means that the IRS will not issue a ruling if the property is held in a state law partnership, even if the partnership elects out of partnership status for tax purposes under Section 761. In a typical TIC offering each investor will hold his or her interest in the property through a single member limited liability company ("SMLLC").

   If state law treats limited partnerships more favorably than limited liability companies, most practitioners are comfortable with having interests held by a limited partnership in which 99% of the limited partnership interests are held by the investor and a 1% general partnership interest is held by a

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purpose of avoiding penalties that may be imposed under the Code; (ii) the opinion was written to support the promotion or marketing of this transaction, and (iii) each prospective investor should seek advice based on such investor's particular circumstances from an independent tax advisor.

[16] See Richard M. Lipton, "*New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges*," 96 J. Taxation 303 (May 2002).

[17] Rev. Proc. 2002-22, 2002-1 CB 733.

single member limited liability company that is 100% owned by the investor.

For purposes of determining whether a limited liability company is treated as a disregarded entity or as a partnership for federal income tax purposes, a husband and wife who own property as community property can elect to treat the limited liability company as a disregarded entity under Rev. Proc. 2002-69.[18] The investors must take care to ensure they comply with all of the requirements under Rev. Proc. 2002-69. It is particularly important to determine whether the property is or will actually be held as community property under state law (it is not sufficient that the spouses are from a community property state).

2. Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons.[19]

3. No Treatment of Co-Ownership as an Entity. The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). Most TIC agreements contain a specific provision under which an investor covenants not to take such actions. Although not explicitly permitted by Rev. Proc. 2002-22, most practitioners are comfortable that operating the property under a trade name by the tenants in common as tenants in common is permissible.

4. Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. A co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the company, or the lessee at fair market value before

[18] 2002-2 CB 831.

[19] Rev. Proc. 2002-22, 2002-1 CB 733.

exercising any right to partition; or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the property. Co-owners agreements should comply with these requirements in all material respects.

5. Voting. 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 or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the property.[20]

Most TIC agreements now contain an "implied consent" provision under which each of the co-owners is provided notice of an event (a sale, lease, financing, or reappointment of the property manager), and each co-owner is then given a specified period of time to object (usually 72 hours for a lease, and much longer for a sale, financing, or reappointment of the property manager). If none of the co-owners objects to the proposed action, it is deemed to have been approved. This type of "implied consent" was approved by the IRS in Priv. Ltr. Rul. 200327003. However, it is unclear whether a deemed consent would satisfy the provisions in Rev. Proc. 2002-22.[21] In addition, there is no certainty as to whether the time periods provided under the deemed consent provisions would be acceptable to the IRS.

In addition, although not specifically permitted under Rev. Proc. 2002-22, a number of practitioners are comfortable with the use of leasing guidelines that are narrowly tailored and

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[20] Id.

[21] The IRS has issued Priv. Ltr. Rul. 200327003 which permitted a negative consent, (i.e., the provision is approved unless the provision is affirmatively rejected).

approved annually by the tenants in common. Leases entered into in accordance with the leasing guidelines would not require the unanimous consent of the tenants in common. Leasing guidelines are most commonly used in connection with residential rental property where lease terms are likely to be more uniform and predictable (and where unanimous consent to each lease may be difficult to obtain based on the sheer number of leases to be approved). They may also be used in connection with commercial or retail property, but practically it may be difficult to develop sufficiently narrow guidelines for commercial properties in advance because commercial or retail leases are often more heavily negotiated and exhibit greater variation than residential leases. The argument that such leasing guidelines are not inconsistent with the lease approval requirements under Revenue Procedure 2002-22 is that there is no material distinction to an investor approving every lease and having the investor approve leases in advance as long as the criteria for approval are narrow, specific and subject to review and revocation annually.

6. Restrictions on Alienation. Each co-owner must have the right to transfer, partition, and encumber the co-owner's undivided interest in the property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value before exercising any right to partition.[22]

7. Sharing Proceeds and Liabilities upon Sale of Property. If the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed

[22] Rev. Proc. 2002-22, 2002-1 CB 733.

to the co-owners.[23]

8. Proportionate Sharing of Profits and Losses. Each co-owner also must share in all revenue generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property, under section 6.08. In addition, "[n]either the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days."

   The requirement is that the investor that owns a TIC must have recourse liability for any amounts advanced by another TIC or its owner. This provision effectively would mandate that the individuals who own the interests in the single member limited liability company that actually holds the TIC Interest would be personally liable to contribute cash to the single member limited liability company in the event that any other co-owner made an advance to cover operating deficits. As a practical matter, the effect of this provision would be to convert potentially nonrecourse liabilities into recourse obligations. Moreover, most lenders require that the single member limited liability company be a "bankruptcy remote" entity, so that the single member limited liability company is not obligated for the debts of its owner, and vice versa. The individual liability of the owner of the single member LLC would be contrary to the covenants required in most loan documents, so that a choice would need to be made between compliance with Rev. Proc. 2002-22 or compliance with the loan covenants. Because transactions need to comply with lender requirements, this parenthetical is ignored in most TIC transactions in which there is debt financing, particularly if the debt is securitized.

9. Proportionate Sharing of Debt. The co-owners must share in any indebtedness secured by a blanket lien in proportion to

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[23] Id.