NEW RULES LIKELY TO INCREASE USE OF TENANCY-IN-COMMON OWNERSHIP IN LIKE-KIND EXCHANGES

BY RICHARD M. LIPTON

The new IRS Procedure generally tracks the practices already being used by the real estate industry that matches undivided interests in property with buyers in order to make nontaxable exchanges possible. To be sure, there are restrictions designed to prevent an arrangement from operating anything like a tax partnership, and there are other limitations that will require careful drafting of co-ownership agreements. Nevertheless, the overall impact of the guidance should be seen as quite favorable.

RICHARD M. LIPTON is a partner in the Chicago office of the law firm of McDermott, Will & Emery, and is Chair of the ABA Tax Section. He also is a co-author, along with John S. Pennell, Philip F. Postlewaite, and the late Arthur B. Willis, of the Seventh Edition of Partnership Taxation *(Warren, Gorham & Lamont, 2002). A member of THE JOURNAL's editorial board, he is also a regular contributor. The views expressed in this article are those of Mr. Lipton in his individual capacity, and do not necessarily reflect those of the ABA Tax Section.*

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In Rev. Proc. 2002-22, 2002-14 IRB 733, the Service followed up on its intention, stated in Rev. Proc. 2000-46, 2000-2 CB 438, to issue guidance concerning whether an undivided fractional interest or tenancy-in-common (TIC) interest in real estate will be treated as giving rise to a separate business entity for federal income tax purposes. The new Procedure sets forth detailed conditions under which the IRS will consider a request for a ruling that a TIC interest is not an interest in a business entity.

Rev. Proc. 2000-46 was issued in response to several requests for private rulings filed on behalf of "promoters" that were selling TIC interests in real estate as replacement property for like-kind exchanges.[1] The Service announced at that time that it would not issue advance rulings or determination letters on (1) whether a TIC interest in real property is an interest in an entity (i.e., a partnership interest) that is not eligible for a tax-free exchange under Section 1031(a)(2)(D), or (2) whether arrangements in which taxpayers acquire a TIC interest in real property constitute separate entities for federal tax purposes.

Rev. Proc. 2002-22 is likely to be viewed as a significant milestone in the growth of like-kind exchanges of real property. Prior to the issuance of this new guidance, a taxpayer who sold real estate (relinquished property) would have to search for other real estate (replacement property) that cost about the same as the proceeds from the prior sale. It often was not possible to find the appropriate replacement property at the right cost in a timely manner (i.e., within the 45 days provided by Section 1031(a)(3) for identifying replacement property), notwithstanding that there were several reputable companies engaged in marketing replacement properties for like-kind exchanges.[2]

The purchase of a TIC interest as replacement property makes economic sense because the size of the TIC interest can be tailored to the taxpayer's needs. Rev. Proc. 2002-22 sets forth guidelines under which a taxpayer can acquire a TIC interest as replacement property without fear that the Service will attempt to recharacterize the TIC interest as an interest in a partnership. This guidance should help taxpayers locate suitable replacement property. Moreover, as a practical matter, the criteria set forth in Rev. Proc. 2002-22 probably will become the "norm" that will be applied with respect to most TIC interests that are sold commercially by sponsors or promoters to taxpayers.

THE CODE, THE CASES, AND THE PROBLEM

Section 1031(a) provides for the nonrecognition of gain or loss if a taxpayer engages in a like-kind exchange. This treatment applies if the taxpayer exchanges property held for use in a trade or

business or for investment for other property of a like-kind that will be held for use in a trade or business or for investment.[3] Section 1031(a)(2)(D) provides that an interest in a partnership is not of like-kind to any other property.

A well-established body of law concerns the definition of "partnership" for tax purposes. At the heart of these rules is the Supreme Court's decision in *Culbertson,* 337 U.S. 733, 37 AFTR 1391 (1949), 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 or losses or both. This determination is a question of fact, to be determined by the partners' testimony, their agreement, and their conduct.

Culbertson set forth a general rule; more specific guidance concerning the existence of a partnership can be found in the Tax Court's decision in *Luna,* 42 TC 1067 (1964). There, the court emphasized that the existence of a partnership does not depend on the name given to the arrangement but, rather, on the presence or absence of a variety of factors:

- The agreement of the parties.
- Their conduct in executing its terms.
- The contributions, if any, which each party has made to the venture.
- The parties' control over income and capital.
- The right of each party to make withdrawals of income and capital.
- Whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income.
- Whether the business was conducted in the joint names of the parties.
- Whether the parties filed federal partnership returns or otherwise represented to the Service or to persons with whom they dealt that they were joint venturers.
- Whether separate books of account were maintained for the venture.
- Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

The check-the-box Regulations contained new rules for determining whether a partnership (or, more accurately, a business entity taxable as a partnership) exists. Under these rules, the determination of whether a TIC interest constitutes an interest in a partnership depends on whether a "business entity" has been created. Reg. 301.7701-1(a)(2) provides that a joint venture or other contractual 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 business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.[4] 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.[5]

Rev. Proc. 2002-22 addresses the difficult theoretical question of when a tenancy-in-common ownership of real property should be treated as a separate business entity. A tenancy-in-common is one of the traditional concurrent estates in land.[6] Each owner of a TIC interest 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 the rents or profits from the property, to transfer the tenancy-in-common interest, and to demand a partition of the property. These rights generally provide the holder of a TIC interest with the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other co-tenants.

The IRS previously had considered the treatment of TIC interests in Rev. Rul. 75-374, 1975-2 CB 261, which concluded that a two-person co-ownership of an apartment building rented to tenants did not constitute 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.[7]

The conclusion reached by the IRS in Rev. Rul. 75-374 has to be contrasted with several court decisions in which a co-ownership arrangement was found to be a tax partnership. For example, in *Bergford,* 12 F.3d 166, 73 AFTR2d 94-498 (CA-9, 1993), 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

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1 Two such ruling requests were filed by the author.

2 The availability of reverse like-kind exchanges under Rev. Proc. 2000-37 has somewhat alleviated this concern, but in many cases taxpayers are unwilling (or unable) to acquire replacement property until they have received the proceeds from the sale of the relinquished property. See generally Lipton, "New Revenue Procedure on Reverse Like-Kind Exchanges Replaces Tax Risk With Tax Certainty," 93 JTAX 327 (December 2000).

3 The many separate requirements that must be satisfied to obtain like-kind exchange treatment are beyond the scope of this article. See generally Lipton, *supra* note 2, and Lipton, "The State of the Art in Like-Kind Exchanges," 91 JTAX 78 (August 1999).

4 Reg. 301.7701-2(a).

5 Reg. 301.7701-1(a)(2). Section 761(a) provides that "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate.

6 See Wolf, ed., *Powell on Real Property* (Matthew Bender, 2000), ¶ 50.01.

7 See also Rev. Rul. 79-77, 1979-1 CB 448, which did not find a business entity where three individuals transferred ownership of a commercial building subject to a net lease to a trust of which the three individuals were the beneficiaries.

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.

The *Bergford* court held that the co-ownership arrangement was a partnership for tax purposes.[8] 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.[9] In one other important decision, *Madison Gas & Electric Company*, 633 F.2d 512, 46 AFTR2d 80-5955 (CA-7, 1980), *aff'g* 72 TC 521 (1979), 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.

The final piece of this legal jigsaw puzzle is provided by Section 761, which provides an election under which certain co-ownership arrangements are not treated as a partnership for tax purposes. Under Reg. 1.761-2(a)(2), this election may be made if the participants in the joint purchase, retention, sale, or exchange of investment property meet all of the following conditions:

1. They own the property as co-owners.

2. They reserve the right separately to take or dispose of their shares of any property acquired or retained.

3. They do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the benefit of his account, but not for a period of more than one year.

Although this election appears to be relatively broad, it has been narrowly interpreted by the Service, which generally has been unwilling to issue any favorable guidance to taxpayers who desire to elect out of partnership status under these Regulations.

In summary, the distinction between a partnership on the one hand and a tenancy-in-common on the other is relatively tenuous. In both, there is co-ownership of property, and in both there is a sharing of the income derived from the property. A co-tenancy exists where the owners' activities are limited to keeping the property maintained, in repair, and rented or leased, whereas a partnership arises when the parties to the venture join together capital or services with the intent of conducting a business or enterprise and sharing the profits and losses from the venture. In a partnership there frequently will be situations in which one of the partners can act on behalf of, or otherwise bind, the other partners, whereas in a co-tenancy each co-owner can act on behalf of and bind only herself. Likewise, in a partnership there may be non-pro-rata sharing of the income from the venture, whereas a co-tenancy always will feature pro-rata sharing of the income from the property. Finally, and perhaps most important, a partnership frequently will engage in business operations, whereas a co-tenancy in real estate usually involves the passive ownership of property in which the co-owners benefit from rent and appreciation in the value of the property.

THE NEED FOR TIC INTERESTS

It was in this legal quagmire that an industry that sold TIC interests in real estate was born out of necessity. Although it was possible to acquire as replacement property vacant land, a store, or a building that was net leased to a high-quality tenant, in many cases the cost of the property was greater than the taxpayer desired. Two or more taxpayers could each acquire, however, an interest in the same property, thereby reducing the cost for the co-owners.

Example: John and Brian, two unrelated taxpayers, each sold a relinquished property for $1 million. A new store that was leased to a tenant with a solid credit rating cost $2 million; neither John nor Brian could afford to acquire the store on his own. If, however, John and Brian could combine their funds and acquire the building as co-tenants, they would both be better off. The difficult problem was for John and Brian to find each other; an industry has developed to acquire properties and sell them to buyers such as John and Brian.

The foregoing example involves a single property leased to a credit tenant (a "CT lease"); it would be relatively easy for John and Brian to acquire an interest as co-tenants in a single property.[10] As a result, the taxpayer-investor is essentially buying into the credit rating of a single lessee. Although this is fine if the tenant has a strong credit rating (say, Wal-Mart), it could result in adverse tax and economic consequences if the tenant floundered (say, K-Mart). Moreover, until Rev. Proc. 2002-22 was issued, there was still some uncertainty about

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[8] This conclusion was important because, unless a partnership existed, the statute of limitations might have expired for any determination with respect to the tax consequences of the equipment leases, which were part of a 1980s-type tax shelter.

[9] Bussing, 88 TC 449 (1987), reconsideration denied 89 TC 1050 (1987); Alhouse, TCM 1991-652.

[10] Several companies are engaged in the business of regularly offering for sale stores or similar property that is triple-net-leased to tenants with good credit ratings; these properties are commonly referred to as "credit tenant lease properties." The asking price for the properties depends primarily on the tenant's credit rating (instead of the intrinsic value of the underlying real estate), because the buyer is effectively acquiring a long-term bond issued by the tenant.

whether the IRS could take the position that a CT lease should be recharacterized as a partnership for tax purposes. No authority treated these simple situations as co-tenancies (rather than as partnerships), although most practitioners would be comfortable arranging such co-ownerships on the basis of Rev. Rul. 75-374. To be safe, the co-owners also would file an election under Section 761 to make sure that their co-ownership arrangement would not be treated as a partnership.

Although most practitioners were comfortable that a limited co-ownership of property that was subject to a CT lease did not give rise to a partnership, in many other situations the property is leased to more than one tenant, or the tenant that leases all or a portion of the property does not have a favorable credit rating. In those situations, the taxpayer-investor would need a different arrangement in order to acquire an interest that makes economic sense but that is not treated as part of a partnership. Also, as a practical matter, some taxpayers were reluctant to take the economic risk that goes with looking to the credit of one lessee for the payment of rent.

From a practical standpoint, a TIC interest in real property offers a means for a taxpayer to acquire an interest in real estate that is more closely matched to the taxpayer's needs. This is particularly true in the CT lease situation, in which the taxpayer may want to be one of several co-owners of a property that will be leased to a single tenant. In addition, in order to diversify risk, some taxpayers would prefer to rent to multiple tenants, but it was not clear whether this could be arranged as a co-ownership without giving rise to a partnership.[11] If the property had multiple tenants, however, the taxpayer would not be as dependent on the financial performance of a single tenant, so such co-ownerships were desirable.

THE NEW PROCEDURE

Rev. Proc. 2002-22 provides guidelines for requesting rulings on whether the co-ownership of rental real property (other than mineral interests), in an arrangement classified under local law as a tenancy-in-common, will be treated as a partnership for tax purposes. The Procedure states that these guidelines are solely to assist 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 such conditions are all 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.

The Service's disavowal to the contrary notwithstanding, as a practical matter the guidelines in Rev. Proc. 2002-22 *will* effectively become a safe harbor for structuring TIC interests that can be acquired as replacement property in like-kind exchanges. It can be anticipated that tax practitioners will be comfortable issuing a favorable opinion to taxpayers with respect to TIC interests that satisfy the requirements of the guidelines, whereas practitioners will be less comfortable issuing favorable opinions if the TIC interests are not described in these guidelines. Indeed, because the taxpayers who acquire replacement property in like-kind exchanges generally want to take little tax risk,[12] it is likely that most TIC interests will be structured in the future to conform to the guidelines in Rev. Proc. 2002-22.

Like all guidelines for rulings, Rev. Proc. 2002-22 provides a lengthy list of the information to be submitted in connection with a ruling request, such as a complete statement of all facts relating to the co-ownership, including all of the facts relating to the promoting, financing, and managing of the property.[13] The names, taxpayer identification numbers, and percentage fractional interests of all of the co-owners of the property must be included, as well as similar information for all persons involved in the acquisition, sale, lease, and other use of the property, including any sponsor, lessee, manager, or lender. (The person who sells TIC interests to various taxpayers is referred to herein as the "promoter" or "sponsor.") All agreements concerning the property must be included with the ruling request, including any promotional materials, lending agreements, agreements among the co-owners, leases, purchase and sale agreements, property management or brokerage agreements, option agreements, and any other agreements relating to the property. There also must be included a representation that each of the co-owners holds title to the property as a tenant-in-common under local law.

Multiple Properties

One of the issues on which the Service requested comments in Rev. Proc. 2000-46 was whether TIC interests should be treated as a partnership for tax purposes if they related to multiple properties. Rev. Proc. 2002-22, section 4, states that where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the IRS generally will treat all of the parcels as a single "property." In this situation, the Service generally will not consider a ruling request unless all of the following conditions are met:

1. Each co-owner's percentage interest in each parcel is identical to that co-owner's percentage interest in every other parcel.

2. Each co-owner's percentage interests in the parcels cannot be separated and traded independently.

3. The parcels of property are properly viewed as a single business unit.

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[11] If a property with multiple tenants were actively managed (such as a shopping mall or office building), there was concern that the IRS could argue that a partnership existed due to the level of activity of either the "co-owners" or their designated manager for the property.

[12] If the taxpayer who acquires replacement property has not engaged in a valid like-kind exchange, the taxpayer will owe tax on the disposition of the relinquished property *and* will have used the proceeds of the sale to purchase the replacement property, thereby depriving the taxpayer of the liquidity needed to pay the tax. For this reason, most taxpayers require a high degree of assurance that a like-kind exchange is valid.

[13] Rev. Proc. 2002-22, 2002-14 IRB 733, section 5.

Although the IRS generally will treat contiguous parcels as comprising a single business unit, even if parcels are not contiguous the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. One example given in the Procedure is an office building and a noncontiguous garage that services the tenants of the building.

The IRS disavowal to the contrary notwithstanding, as a practical matter the guidelines will effectively become a safe harbor for structuring TIC interests.

Although not expressly stated in Rev. Proc. 2002-22, it appears that the IRS would take the position that a TIC interest in multiple properties is a partnership interest except in the rare instance in which the parcels are properly treated as a single business unit. This position appears to be in response to the sale by some promoters of so-called "silos" of TIC interests, in which a taxpayer would acquire as replacement property a "silo" that consisted of varying percentage interests in multiple, unrelated properties. Although there is a theoretical basis for treating each TIC interest separately (without regard to the manner in which they are sold), the Service apparently is concerned that packages of interests in multiple properties provide risk sharing that is more akin to a partnership than direct ownership of the underlying real estate.

As a practical matter, therefore, it will be more difficult for promoters or sponsors to market TIC interests in multiple properties after Rev. Proc. 2002-22. Most sponsors are likely to sell TIC interests in one property (or contiguous properties that constitute a single business unit) at a time.

Tenancy-in-Common Ownership

The first of the conditions for obtaining a ruling under Rev. Proc. 2002-22 is set forth in section 6.01, which provides that "[e]ach of the co-owners must hold title to the [p]roperty (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the [p]roperty as a whole may not be held by an entity recognized under local law." This seemingly innocuous statement has two key components.

First, by rejecting any ruling requests if title to the property is held by an entity, the IRS is stating that it will not view favorably attempts by taxpayers to elect out of partnership status under Section 761. That is, even if all of the requirements of Reg. 1.761-2(a)(2) are satisfied, the mere ownership of title by a legal entity is sufficient to prevent a ruling that a partnership is not present. Some promoters have attempted to sell TIC interests where title to the property is held by a legal entity such as a Delaware business trust or a grantor trust; Rev. Proc. 2002-22 specifically rejects this approach.

On the other hand, Rev. Proc. 2002-22 specifically endorses the use of disregarded entities to hold title to the TIC interests. This provision is critical because, as a practical matter, each of the co-owners frequently will be required by the other co-owners (or the sponsor) to place his or her TIC interest into a disregarded entity (usually a single-member limited liability company, or SMLLC) in order to avoid legal risks arising from the death or bankruptcy of a co-owner. If a TIC interest is held by an SMLLC, the death or bankruptcy of the owner of the SMLLC will not directly affect the other owners of interests in the property.[14] In contrast, if the TIC interest were owned directly, each of the other co-owners could find their economic position subject to judicial control as a result of the death or bankruptcy of a co-owner of the property. Thus, section 6.01 provides an important sanction for the holding of TIC interests through SMLLCs, which is an essential aspect of any well-constructed ownership structure.

This rule does create several practical issues, however, that do not appear to be justified from a policy perspective. For example, replacement property in a Section 1031 exchange could include a leasehold interest in real estate. It is not clear whether a co-tenancy in a long-term leasehold "qualifies" (because the co-tenants would not hold legal title to the leased property[15]), even though such legal title is not a prerequisite to a valid exchange. Likewise, in some situations the co-tenants might be able to acquire all of the benefits and burdens of ownership of the property but not legal title; this would occur in the event of a contract for deed or an installment sale in which legal title was retained as collateral for future payments. Rev. Proc. 2002-22 appears to prohibit such arrangements even though the co-owners otherwise would be treated as the owners of the property for federal income tax purposes. The IRS may want to reconsider whether this limitation makes sense in these situations.

Number of Co-Owners

The limit on the number of co-owners is set at 35 persons, by section 6.02. For this purpose, a "person" is defined by reference to Section 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

This rule appears to be a favorable response to the requests from many commentators to allow up to 35 co-owners of TIC interests.[16] The number relates to the limitations in the securities laws as to offerings to unaccredited investors; any investment offered to 35 or fewer unaccredited investors is not

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14 There is a possibility, however, that the liability shield generally provided by an LLC may not be available in some jurisdictions for an SMLLC because a court might characterize this entity as the alter ego of the single owner, and impose liability.

15 In some jurisdictions long-term leases would qualify as interests in real property for purposes of a Section 1031 nonrecognition transaction. A detailed consideration of such interests and the impact of a TIC interest therein is beyond the scope of this paper.

16 See Lipton, "Like-Kind Exchanges of Undivided Fractional Interests in Real Estate: Wrestling With the Issues," 43 Tax Mgt. Memo. 35 (2/11/02).

subject to registration.[17] Some promoters had used this limitation in their offerings to avoid registration of the offering as a security.[18] Furthermore, as a practical matter few co-ownership arrangements involve more than 35 co-owners of a single property, although such widespread co-ownership is theoretically possible.[19]

No Entity Treatment

According to section 6.03 of the Procedure, 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. Similarly, the co-owners may not hold themselves out as partners, shareholders, or members of a business entity. In addition, the co-owners generally cannot have held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership.

The Service's position that the co-owners cannot hold themselves out as a partnership or a business entity was to be expected. More interesting is the prohibition against the co-owners holding interests in the property through a partnership immediately prior to the formation of the co-ownership. This rule could adversely affect situations in which real property is held by a partnership and some partners want to sell whereas others desire to engage in a like-kind exchange. A common planning technique (albeit of uncertain validity) was to have the partnership distribute TIC interests in the property to the partners who want to sell, while the partnership would engage in a like-kind exchange with the remaining TIC interest that it held. Rev. Proc. 2002-22 calls this technique into question by implying that the co-ownership arrangement might be recharacterized as a partnership, thereby imperiling the like-kind exchange.

Co-Ownership Agreement

Under section 6.04, the co-owners may enter into a limited co-ownership agreement that may run with the land. This co-ownership agreement may contain a mechanism to enforce the other rights and privileges of the co-owners that are permissible under Rev. Proc. 2002-22.

For example, a co-ownership agreement may provide that a co-owner must offer its TIC interest for sale to the other co-owners, the sponsor, or the lessee at FMV before exercising any right of partition (see section 6.06), or that certain actions on behalf of the co-owners will require a more-than-50% majority vote (see section 6.05).

Prior to the issuance of Rev. Proc. 2002-22, some promoters who sold TIC interests would avoid using co-ownership agreements out of fear that the mere existence of such an agreement could support the government's argument that the co-ownership arrangement was a partnership. This provision eliminates that fear, and also allows restrictions on the use of the property to be recorded. More important, there are some arrangements between the co-owners that are best set forth in writing, such as a right of first offer or a right of first refusal. The new guidance permits such arrangements without "tainting" the like-kind exchange.

Voting

According to section 6.05 of the Procedure, 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, the co-owners may agree to be bound by the vote of those holding more than 50% of the undivided interests in the property. A co-owner who has consented to an action may provide the property manager or some other person a power of attorney to execute specific documents with respect to that action, but not a global power of appointment.

This provision contains both good and bad news for the holders of TIC interests. The good news is that voting agreements are permissible, and that some actions can be approved by a majority vote; this will make it simpler for the co-owners to operate a rental property. The bad news is that there is a lengthy list of actions that require the approval of all of the co-owners, including particularly any lease of the property or the selection of a manager. Thus, in the case of TIC interests with respect to a multi-tenant property (whether residential or commercial), the approval of all of the co-owners would be needed to fill any vacancy in the property.[20] Likewise, the selection of a manager of the property will require unanimous approval, which may be difficult to obtain in some situations.

A likely consequence of this rule will be an increase in the use of long-term, triple-net leases of property to be sold through TIC interests. For example, a promoter could enter into a long-term lease for the property with an affiliate before the promoter sells any TIC interests.[21] Although unani-

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[17] Regulation D, Securities Act of 1933, 17 C.F.R. sections 230.501-08.

[18] Section 1031(a)(2)(C) provides that "securities or other evidences of indebtedness" are not like-kind property. Based on the legislative history of this provision, it appears unlikely that the Service could argue that a TIC interest constitutes a "security" even if the sale was registered with the SEC; "securities" as used in Section 1031(a)(2)(C) appears to refer to bonds, notes, and other debt instruments.

[19] The standard used in Rev. Proc. 2002-22 is narrower than the exception from publicly traded partnership (PTP) status in Reg. 1.7704-1(h)(1), which applies if there are fewer than 100 partners in a partnership. By definition, any co-ownership arrangement with fewer than 35 co-owners could never be treated as a PTP. For more on the Section 7704(b) rules, see Lipton, Loffman, and Presant, "Final PTP Regs. Abandon Restrictive Conditions and Adopt Workable New Exemptions," 84 JTAX 279 (May 1996).

[20] Although not expressly stated in Rev. Proc. 2002-22, it is likely that the Service would permit the manager to approve a short-term lease of de minimis space in the property, e.g., a kiosk in a shopping mall. There is no policy reason for such limited leases to require approval of the co-owners.

[21] Assuming that the co-owner does not retain an ownership interest in the property for more than six months, the promoter (or an affiliate thereof) could lease the property from the co-tenants. See section 6.11 of Rev. Proc. 2002-22.

mous agreement of the co-owners would be required to renew the lease, if the initial lease has a term of 20 or more years, as a practical matter this would not be a significant problem. Moreover, the selection of the manager of the property then could be the prerogative of the lessee (an affiliate of the promoter), which will further isolate the co-owners from active management of the property. The co-owners' right to vote would be limited to ministerial matters, such as cosmetic changes to the property or the selection of a bank through which rents will be collected and expenses paid.

Query whether the co-owners of property could grant their advance consent with respect to a sale of the property or a refinancing of indebtedness that encumbers the property. Although such an arrangement is theoretically possible, Rev. Proc. 2002-22 appears to require that the co-owners approve any sale or refinancing on a contemporaneous basis. This may create a practical problem if one of the co-owners takes an obstructionist attitude; in such situations, the only recourse available to the other co-owners may be to bring a partition action with respect to the property. Although this result is a harsh one, it is consistent with the theory that the co-owners must unanimously agree on all major matters affecting the property.

Restrictions on Alienation

In general, each co-owner must have the right to transfer, partition, and encumber the co-owner's TIC interest in the property without the agreement or approval of any person (see section 6.06). Nevertheless, 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 (i.e., the right to have the first opportunity to offer to purchase the TIC interest). In addition, a co-owner may agree to offer its TIC interest for sale to the other co-owners, the sponsor or the lessee at FMV before exercising any right of partition, with the FMV to be determined as of the time the partition right is exercised.

This aspect of Rev. Proc. 2002-22 authorizes a common commercial technique, in which the co-owners of property (or the partners in a partnership, or the shareholders in a corporation) provide a right of first offer to their fellow co-owners before selling it to a third party. The guidance is not completely clear, however, in distinguishing between a right of first offer (commonly referred to as a ROFO) and a right of first refusal (a ROFR). A ROFO is clearly permissible in the case of any sale of a TIC interest, whereas a ROFR is allowed if any co-owner desires to exercise its right of partition. Logically, the inverse would also be true, i.e., the co-owners also could have a ROFO in the case of a potential partition action and a ROFR on any attempt to sell a TIC interest.

This distinction is not merely an academic one. In a ROFO, the co-owner must allow the other co-owners to bid for the property, but if no bid is acceptable the selling co-owner may sell the property to anyone else for a higher price. In a ROFR, in contrast, the selling co-owner must name her price for the property and accept a bid at that price from any other co-owner; the property may be sold to third parties (at a higher price) only if none of the co-owners agrees to buy at the stated price. The difference comes down to who must name the price for the property, the selling co-owner or the other (buying) co-owners.

Buyers generally prefer that property be subject to a ROFR (so that the seller must first name a price), but it is not completely clear that a ROFR is permissible. In light of the arm's-length negotiations that generally occur when the sale of a property is subject to a ROFR, however, it seems likely that the Service's fundamental goal of maintaining the co-owners' right to obtain full value for their property would not be damaged by a ROFR or a ROFO.

Sharing Proceeds and Liabilities on Sale

Under section 6.07 of Rev. Proc. 2002-22, if the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners. This provision prevents the retention of profit or debt by one of the co-owners on the sale of the property, which would be indicative of a partnership (through the non-pro-rata sharing of profits and liabilities).

This rule also appears to prohibit the owners from unanimously agreeing to allow the property to be sold or transferred subject to indebtedness. Doing so would be economically beneficial if the property is subject to an assumable mortgage; this should not be troublesome from a policy standpoint. The Service may want to reconsider whether this limitation makes sense if there is unanimity among the co-owners as to the proposed transaction.

Sharing Profits and Losses

Each co-owner 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 (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 that all profits and costs related to the property be shared pro rata was to be expected; non-pro-rata sharing of the costs or benefits of operation of the property would be evidence of a partnership arrangement. More unusual, however, is the requirement that one co-owner cannot advance funds for the benefit of another for any period in excess of 31 days. Thus, for example, if there is an operating cash-flow shortfall, one co-owner can cover the shortfall for only a limited period. On the expiration of this 31-day period, either all co-owners would have to contribute their pro-rata share of the cash needs of the property or, in the alternative, the property (or the TIC interests of the defaulting co-owners) would have to be sold.

Moreover, this situation would not be limited to operating cash-flow shortages. Suppose that the five co-owners of a property disagree with respect to whether the roof should be replaced. Under section 6.05, that determination could be made by a majority of the co-owners. If four of the five co-owners vote to replace the roof, and the final co-owner defaulted on his obligation to contribute a share of the money, the other co-owners could "cover" the shortfall for only a limited period. In a partnership, it would be common to reduce the distributions to the defaulting partner, but under Rev. Proc. 2002-22 the only remedies available to the other co-owners would be to sell the property or purchase the interest of the defaulting co-owner. Each co-ownership agreement will have to be carefully drafted to address the situation in which a co-owner fails to advance funds as required.

Proportionate Sharing of Debt

The Procedure, in section 6.09, provides that the co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests. Some commentators had argued that debt was not the same as profit and loss, so that debt could be shared by co-owners non pro rata, but the Service rejected this notion. Instead, Rev. Proc. 2002-22 recognizes that if debt that encumbers property is not shared pro rata, the economic interest of each of the co-owners also will vary in a manner that is not pro rata. Such varying interests are contrary to the concept of TIC interests, in which the interests of all of the co-owners are essentially the same.

Options

Under section 6.10 of Rev. Proc. 2002-22, a co-owner may issue an option to purchase the co-owner's TIC interest (a call option), provided that the exercise price for the call option reflects the FMV of the property determined as of the time the option is exercised. For this purpose, the FMV of an undivided interest in the property is the co-owner's percentage interest in the property multiplied by the FMV of the property as a whole. Thus, no discount is permitted for a "minority interest," and a "control premium" cannot be paid in connection with a greater-than-50% TIC interest. The call option can run in favor of anyone—the sponsor, the lessee, other co-owners, or unrelated third parties can have a call option with respect to a co-owner's TIC interest.

By contrast, Rev. Proc. 2002-22 does not permit most put options. Specifically, a co-owner may not acquire an option to sell the co-owner's interest to the sponsor, the lessee, another co-owner, or the lender, or any person related to the foregoing. A put option to a third party, however, would be permissible. As a practical matter, the person who would be most likely to issue a put option to a co-owner would be the sponsor, who would issue such options as a means to guarantee a "floor value" for a TIC interest. Such arrangements are not sanctioned, and as a practical matter will likely be avoided, even though it is difficult to determine theoretically how an out-of-the-money put option creates a partnership between the co-owner and a sponsor.

No Business Activities

One of the most important aspects of Rev. Proc. 2002-22 is found in section 6.11, which provides that the co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). Activities will be customary for this purpose if they would not yield income that is not treated as rent under Section 512(b)(3)(A), i.e., the income would not be unrelated business taxable income. The practical effect of this requirement is that rent cannot be based on the net income of any tenant, although participating rent is permitted if it varies on the basis of a fixed percentage of the gross receipts of a tenant.

Even more important is an "activity attribution rule," under which all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the property will be taken into account in determining the co-owners' activities, regardless of whether those activities are performed by the co-owners in their capacities as such. The Procedure gives an example where the sponsor or a lessee is a co-owner of the property, and states that all of the activities of the sponsor or lessee (or any related person) with respect to the property will be taken into account in determining whether the co-owners' activities are customary activities. The activities taken into account could include, for example, the sponsor's efforts to sell TIC interests in the property. A useful exception applies, however, to activities of a co-owner or related person with respect to the property (other than in the co-owner's capacity as a co-owner): these will not be taken into account if the co-owner owns an undivided interest in the property for less than six months.

The practical effect of this requirement is that neither the sponsor nor the lessee (or a person related to either of them) can be a co-owner of the property for more than six months. In many situations, a sponsor will acquire a rental property and, over time, either the sponsor or its affiliate will sell off TIC interests in that property or act as a manager of the property. This rule effectively mandates that all interests be sold by the sponsor within six months so as to avoid "tainting" the customary activities conducted by the co-owners with the sales activity of the sponsor. Moreover, if the sale of all of the sponsor's interests does not occur within six months, it is possible that the IRS could argue that all of the TIC interests represented partnership interests from inception. For this reason, it is likely that this rule will effectively cause sponsors to covenant to sell all of their co-ownership interests in a property within six months in all events.

Management and Brokerage Agreements

Although the co-owners are limited to engaging in customary activities with respect to the property, section 6.12 allows the co-owners to 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

thereto), but who may not be a lessee. As noted previously, under section 6.05 the appointment of a manager or broker for the property must be made unanimously by all of the co-owners. The determination of any fees paid by the co-owners to the manager must not depend in whole or in part on the income or profits derived by any person from the property and may not exceed the FMV of the manager's services. Any fee paid to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

A management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within three months of receipt. The manager may prepare statements for the co-owners showing their shares of revenue and costs from the property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the property and to negotiate the modifications of the terms of any lease or any indebtedness encumbering the property, subject to the unanimous approval of the co-owners under section 6.05.

One question that is not squarely addressed by this section is whether the manager can maintain a reserve to cover unanticipated expenses. The requirement that net revenues be disbursed within three months arguably would not prohibit the manager from setting aside a reasonable amount of rental income into an account (owned pro rata by the owners) as a reserve. Alternatively, the manager could distribute all rental income as received, but the agreement among the co-tenants could require them to make pro rata contributions to a fund to be used to pay capital and unanticipated expenditures. It is hoped the IRS will interpret this provision so as to allow reasonable, pro rata reserves.

The limitations on what a manager can do for the co-owners, when combined with the requirement that all leases be unanimously approved, will have little effect on CT leases in which the property is leased to a single tenant. This rule, however, will effectively cause many sponsors and co-owners in multi-tenant properties to prefer TIC interests with respect to property that is investor-leased to a single person (usually the sponsor or a related person) who then can sublease the property and retain a manager. The lease between the co-owners and the master lessee can be for a long term, and the lessee/sublessor then will have the flexibility to retain reserves for the property and deal with the actual users (tenants) of the property.

Leasing Agreements

Under section 6.13, all leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the FMV of the use of the property. 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 leased property (other than an amount based on a fixed percentage or percentages of receipts of sales). For purposes of making this determination, the rules under Section 856(d)(2), which determine whether rent is permissible for a real estate investment trust (REIT), are used to determine whether the leasing arrangement is permissible. 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.

Lenders

According to section 6.14, the lender with respect to any debt that encumbers the property or with respect to any debt incurred to acquire an undivided interest in the property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the property. In other words, seller financing from the sponsor is not permitted, and one co-owner cannot borrow money from another co-owner to finance an acquisition of a TIC interest. This rule effectively prevents debt from being shared by the co-owners in

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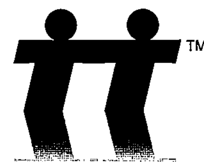

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a non-pro-rata manner (see section 6.09) and also prevents the sponsor from obtaining an additional return through seller financing.

Payments to Sponsor

Under section 6.15, except as otherwise provided in Rev. Proc. 2002-22, 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 FMV 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. This provision is yet another back-stop to the fundamental principle underlying Rev. Proc. 2002-22, i.e., sponsors, although permitted, should not be in a position to share (directly or indirectly) in the results of operation of the property.[22]

Practice Notes

The practical effect of the "activity attribution rule" is that neither the sponsor nor the lessee (or a person related to either of them) can be a co-owner of the property for more than six months. Typically, before Rev. Proc. 2002-22 a sponsor would acquire a rental property and, over time, either the sponsor or its affiliate would sell off TIC interests in that property or act as a manager of the property. This rule effectively mandates that all interests be sold by the sponsor within six months so as to avoid "tainting" the customary activities conducted by the co-owners with the sales activity of the sponsor. Moreover, if the sale of all of the sponsor's interests does not occur within six months, it is possible that the IRS could argue that all of the TIC interests represented partnership interests from inception. For this reason, it is likely that this rule will effectively cause sponsors to covenant to sell all of their co-ownership interests in a property within six months in all events.

CONCLUSION

Rev. Proc. 2002-22 provides relatively clear rules for determining whether the Service would attempt to classify a TIC interest in real estate as an interest in a partnership for federal income tax purposes. The guidance reflects pre-existing industry practice by incorporating some of the techniques that were being used by some of the existing sponsors, but restricts arrangements that were viewed by the IRS as giving rise to the potential for income or risk-sharing among the co-owners or between the co-owners and the sponsor. Moreover, by allowing co-ownership agreements and ROFOs and ROFRs in certain situations, the Procedure will allow the co-owners to clearly define their relationship and protect themselves against inappropriate actions by their co-owners.

The part of the guidance that will create the greatest difficulty for the co-owners of TIC interests is the unanimous consent requirements for leases and management agreements. As a practical matter, these requirements are likely to cause the co-owners of multi-tenant property to use a master lease structure, in which the entire property is net leased to a single tenant, who can then sublease the property and hire a manager; this would effectively eliminate the need to obtain co-owners' approval. This aspect of the guidance will have no effect, however, on CT leases, which generally involve the lease of a large property to a single tenant; there frequently will be no need to retain a manager for such properties, and the lease usually will be for a very long term. Thus, there will be practical solutions to these problems.

Another significant problem involves the limitation on the co-owners or manager with respect to advancing funds on behalf of a defaulting co-owner for more than 31 days. As a practical matter, this provision will make it important to draft a clear, tightly worded co-ownership agreement to address these situations. In addition, prospective co-owners may need to determine the financial capability of the other co-owners of the property.

For sponsors selling TIC interests, the most significant problem is created by the rule requiring that their activities be imputed to the co-owners if they own any interest as co-owners for more than six months. If the entire property is sold to a group of co-owners as TIC interests in a single closing, this rule will have no impact. In many situations, however, a sponsor will have difficulty in disposing of its TIC interests in a property; this new rule will mandate a six-month disposition. Indeed, this requirement is likely to result in a covenant that the sponsor sell or otherwise dispose of its interests in a property within six months, which may make for some buying opportunities. This rule also will prevent the sponsor from retaining an interest in the property; previously the investor co-owners may have wanted the sponsor to keep such an interest to demonstrate that the sponsor shares their economic concerns.

Notwithstanding these limitations, it can be anticipated that the sponsors who sell TIC interests, as well as the individuals and businesses that buy them, will view Rev. Proc. 2002-22 as a step in the right direction. The guidance provides clear rules for structuring CT leases to single tenants as well as securitized master leases for multi-tenant properties. Certainly this guidance will permit the industry to continue to flourish and, by removing the cloud created by Rev. Proc. 2000-46, allow tax practitioners to give favorable opinions to sponsors. As a result, it seems likely that there will be a continuing growth in the availability of TIC interests as replacement property. ■

NOTES

[22] This is consistent with the decisions in Bergford, 12 F.3d 166, 73 AFTR2d 94-498 (CA-9, 1993), and Bussing, *supra* note 9.