Tenancy-in-Common Interests: A Valuable Addition to the Financial Planner's Toolkit

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Richard Lipton and Daniel Cullen discuss tenancy-in-common interests as part of a Code Sec. 1031 like-kind exchange.

Introduction

As predicted by a number of commentators,[1] the issuance of Rev. Proc. 2002-22 by the IRS has dramatically increased the use of tenancy-in-common (TIC) interests as part of a Code Sec. 1031 like-kind exchange.[2] Prior to Rev. Proc. 2002-22, TIC structures were primarily used by sophisticated real estate investors. In contrast, many of the taxpayers currently investing in private placement offerings of TIC interests as replacement property in their like-kind exchange transactions are high-net-worth individuals (*i.e.*, accredited investors) who may have less exposure to TIC structures and tax matters relating to real estate investments in general. Rev. Proc. 2002-22 has provided a sufficient level of comfort to taxpayers wishing to use TIC structures as replacement property in their like-kind exchanges. Accordingly, as these accredited investors continue to reposition their investments in commercial and other real estate, financial planners need to be familiar with the emerging use of TIC interests as replacement property in like-kind exchanges, and as an investment vehicle in general for the ownership, disposition and succession of real estate holdings.[3]

This article first describes the tax rules under Code Sec. 1031 which acted as an economic catalyst for the current TIC industry. Next, this article outlines the fundamental tax principles under Rev. Proc. 2002-22 that govern the creation

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and operation of a TIC structure, as well as recent developments impacting such structures. Then, with this backdrop in mind, this article contrasts the two primary structures currently used in the TIC offering marketplace—the "master lease" and the "property management" structures.

I. TIC Economics—Creating Supply to Meet the Demand for Replacement Property[4]

Code Sec. 1031(a) provides for the nonrecognition of gain or loss if a taxpayer engages in a like-kind exchange. This treatment only 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. Code Sec. 1031(a)(2)(D), however, provides that an interest in a partnership is not of like-kind to any other property.[5] Accordingly, the linchpin of a properly structured offering of TIC interests for use as replacement property in a Code Sec.1031 like-kind exchange is to ensure that the tenancy relationship is not considered a partnership for federal income tax purposes. If the relationship among the TIC investors is considered a partnership, the undivided fractional interests acquired by the TIC investors will not constitute qualified replacement property under Code Sec. 1031 and they will be subject to federal income tax on the gain inherent in their relinquished property.

The definition of a "partnership" for tax purposes is governed by a well established body of case law. The seminal case governing this issue is the Supreme Court's decision in *W.O. Culbertson Sr.*[6] in which the Court stated that whether a partnership is created depends on whether the alleged partners intended to join together for the purpose of carrying on business and sharing the profits or losses or both. This determination of federal tax status is a question of fact, to be determined by both the partners' agreement and conduct. More specific guidance concerning the existence of a partnership, however, is provided by the Tax Court's decision in *H.M. Luna.*[7] In that case, 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, including the following:

- The agreement among the parties
- Their conduct in executing the terms of their agreement
- The contributions, if any, made by the parties to the venture
- The parties' right to exercise control over income and capital
- The right of each party to make withdrawals of income and capital
- Whether each party shares a mutual proprietary interest in net profits and losses
- Whether the business was conducted in the joint names of the parties
- Whether the parties filed federal partnership returns or otherwise represented to the IRS or others 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 Treasury's issuance of the check-the-box (CTB) regulations greatly simplified this analysis. Under the CTB regulations, 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 (such as a tenancy-in-common agreement) 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. The CTB regulations provide a default rule: An eligible business entity with two or more members may be classified for federal tax purposes as either a corporation or a partnership. In contrast, the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.[8]

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. Under state real property law, a tenancy-in-common is classified as one of the traditional concurrent estates in land.[9] Each owner of a TIC interest is deemed to own individually a physically undivided part of the entire parcel of property. By law, 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 and 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 considered the treatment of TIC interests in Rev. Rul. 75-374,[10] which concluded that a two-person co-ownership of an apartment building rented to tenants did not constitute a partnership for federal income tax purposes. 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; in addition, the agent 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.[11]

The conclusion reached by the IRS in Rev. Rul. 75-374, however, must be contrasted with several court decisions in which a co-ownership arrangement was found to be a tax partnership. For example, in *G.W. Bergford*,[12] investors purchased "co-ownership" interests in computer equipment that were 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 percent 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 its 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. In reaching this conclusion, the court emphasized the limitations on each investor's ability to sell, lease or encumber either their interest or the underlying property (each a key indicia of ownership), 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.[13] In one other 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.

The final piece of this legal jigsaw puzzle is provided by Code Sec. 761, which provides an election under which certain co-ownership arrangements are not treated as a partnership for federal 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:

- They own the property as co-owners.
- They reserve the right separately to take or dispose of their shares of any property acquired or retained.
- 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 IRS, which generally has been unwilling to issue any favorable guidance to taxpayers who desire

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to elect out of partnership status under these regulations.[15]

In short, 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 itself. 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 importantly, 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. These deceptively simple distinctions can become somewhat blurred when applied to commercial finance structures and techniques for acquiring real estate.

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It was this legal quagmire that provided the genesis for the TIC offering industry. 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; the TIC 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. 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 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 Code Sec. 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.

II. Genesis of the TIC Industry

In Rev. Proc. 2002-22, the IRS issued guidance concerning whether an undivided fractional interest or tenancy-in-common interest in real estate will be treated as giving rise to a separate business entity for federal income tax purposes.[16] The guidance provided under Rev. Proc. 2002-22 is the ultimate outcome of several requests for private rulings filed on behalf of sponsors[17] that were selling TIC interests in real estate as replacement property for like-kind exchanges.[18]

As alluded to above, over the past two years, Rev. Proc. 2002-22 has provided greater flexibility, and therefore significant growth, in executing like-kind exchanges of real property. Prior to the issuance of the Rev. Proc. 2002-22, a taxpayer who sold real estate (the "relinquished property") would have to search for, identify and ultimately close on other real estate (the "replacement property") that cost about the same as the proceeds from the prior sale of the relinquished property. In many cases, taxpayers simply could not find appropriate replacement property at the right cost in a timely manner,[19] notwithstanding the existence of several reputable companies engaged in marketing replacement properties for like-kind exchanges.[20]

The purchase of a TIC interest as replacement property in a like-kind exchange is often advantageous for a taxpayer because the size of the TIC interest can be tailored to the taxpayer's needs. In short, Rev. Proc. 2002-22 provided taxpayers with sufficient guidelines under which a taxpayer can acquire a TIC interest as replacement property without significant risk that the IRS will attempt to recharacterize the TIC interest as an interest in a partnership that would be taxable under Code Sec. 1031(a)(2)(D).

III. Guidelines Provided Under Rev. Proc. 2002-22 and Recent Developments in the TIC Industry

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 federal income tax purposes. Rev. Proc. 2002-22 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 IRS 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.

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. 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.

The IRS's disavowal to the contrary notwithstanding, as a practical matter the guidelines in Rev. Proc. 2002-22 *will*, over time, effectively become a quasi-safe harbor by providing guideposts for structuring TIC interests that can be acquired as replacement property in like-kind exchanges. As described below, some of the requirements in Rev. Proc. 2002-22 are cumbersome, and in some cases, practically impossible to comply with from a commercial point of view.[21] Indeed, the commercial realities that make full compliance with the requirements of Rev. Proc. 2002-22 practically impossible have prevented TIC sponsors from seeking private letter ruling requests under Rev. Proc. 2002-

22. Instead, practically all of the deals currently being offered in the TIC marketplace are supported by the opinion of tax counsel that the TIC interests should be treated as interests in real estate (and not as interests in a partnership).

1. Tenancy-in-Common Ownership

The first requirement 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 appeared to be stating that it will not view favorably attempts by taxpayers to elect out of partnership status under Code Sec. 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 appeared to be sufficient to prevent a ruling that a partnership is not present. This position by the IRS caused concern to some promoters who structured their TIC interests so that title to the property is held by a legal entity such as a Delaware statutory trust (DST) or a grantor trust. The IRS recently issued guidance regarding DSTs providing that their use is permissible, but only in extremely limited circumstances.[22] 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 will be required by the lender (as well as 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. 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 TIC ownership structure.

2. 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 Code Sec. 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. The number 35 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 subject to registration.[23] Some promoters had used this limitation in their offerings to avoid registration of the offering as a security. Furthermore, as a practical matter, few co-ownership arrangements involve more than 35 co-owners of a single property. In fact, many lenders impose stricter limitations; often, a lender will limit the number of co-owners to somewhere between 25 and 30 investors.

3. No Entity Treatment

According to section 6.03 of Rev. Proc. 2002-22, 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 "no entity treatment" requirement can easily be met by the co-ownership; however, the prohibition against the co-owners holding interests in the property through a partnership immediately prior to the formation of the co-ownership may, at times, cause some difficulty. 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 re-characterized as

a partnership, thereby imperiling the like-kind exchange.

4. 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 fair market value 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-percent 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 in Rev. Proc. 2002-22 eliminated that fear. Indeed, a properly drafted co-ownership or tenants-in-common agreement ("TIC agreement") is now considered the keystone of a properly structured tenancy-in-common program. Clearly, 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. Moreover, use of a written agreement allows such restrictions to be recorded.

5. Voting

According to section 6.05 of Rev. Proc. 2002-22, certain actions with respect to the property are subject to the unanimous approval of the co-owners. Specifically, 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 percent 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 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, can create difficulties in administration of the property. For example, 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. Likewise, the selection of a manager of the property by unanimous approval may be difficult to obtain in some situations.

To a certain extent, two factors have mitigated some of the difficulties associated with obtaining unanimous approval of the TIC investors. First, most loan documents with respect to a TIC property now provide that an "event of default" under the loan will arise unless a replacement manager acceptable to the lender is promptly appointed by the TIC owners. As a practical matter, this risk of default under the loan prevents lengthy or unnecessary disputes among the TIC investors with respect to approving the property manager on an annual basis. Second, 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 re-appointment 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 object to the proposed action, it is deemed to have been approved. This type of "deemed consent" was approved by the IRS in Private Letter Ruling 200327003. In that ruling, the property management agreement required the manager to send a notice of renewal to each co-owner annually at which time each co-owner could exercise its right to terminate the management agreement at any time with just 60 days notice. The ruling stated that, "[a]lthough not an affirmative consent, the notice requirement ... containing the right of any co-owner to terminate the agreement at any time with just 60 days notice satisfies the conditions in ... Rev. Proc. 2002-22 regarding unanimous annual renewals of any management agreement."[24]

6. 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). These rights are viewed by the IRS as key indicia of property ownership. 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 fair market value before exercising any right of partition, with fair market value to be determined as of the time the partition right is exercised.

This aspect of Rev. Proc. 2002-22 permits 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 (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 contrast, under a ROFR 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 IRS'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.

7. 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).

8. 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 parenthetical clause in section 6.08 of Rev. Proc. 2002-22, quoted above, has become one of the most controversial aspects of Rev. Proc. 2002-22. This provision would mandate that the individuals who own the interests in the SMLLC that actually holds the TIC interest would be personally liable to contribute cash to the SMLLC 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. This result is simply unacceptable from a commercial perspective.

Moreover, most lenders require that the SMLLC be a "bankruptcy remote" entity, so that the SMLLC is not obligated for the debts of its owner, and *vice versa*. The individual liability imposed by this parenthetical in section 6.08 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.[25]

It also is difficult to understand why the IRS feels that personal liability for such obligations provides less indicia of a partnership. While it was true under the Kintner Regulations that unlimited liability was a partnership factor, the advent of the LLC and the CTB regulations indicate that unlimited liability may be more of a historic factor. The better view is that such a restriction in today's environment is not needed and is inconsistent with business

(*i.e.*, nontax) motives. Most, if not all, TIC structures involving debt financed property have complied with the lenders' requirements, so that this parenthetical is ignored in transactions in which there is debt financing.

9. Proportionate Sharing of Debt

Rev. Proc. 2002-22, 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 IRS 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.

Accordingly, in debt financed TIC structures, careful consideration must be given to the allocation of liability for the debt under the loan documents. For example, most lenders will require nonrecourse carve-outs for certain "bad-boy" acts committed by the sponsor or the TICs. As a general rule, these carve-outs should be reviewed to ensure they are properly divided among the sponsor and the TICs based upon which party controls the underlying action at issue.

10. 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 fair market value of the property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the property is the co-owner's percentage interest in the property multiplied by the fair market value 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-percent 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. The use of a call option has become an important practical element of most TIC arrangements. As noted previously, unanimous consent is required for most important actions involving the property, including sale, leasing, financing and appointment of the property manager. In order to avoid the possibility that one co-owner can prevent the other co-owners from undertaking necessary or appropriate actions, each of the co-owners is usually required to grant a call option and a limited power of attorney that provides that if a specified percentage of the co-owners agree to an action (often between 75 percent and 80 percent), the dissenting co-owners will have to sell their interests to the consenting co-owners for fair market value. Consider the following example:

> **Example.** Individuals A through L own equal TIC interests in Blackacre. Bigco offers to purchase Blackacre for $1 million, and A through K (but not L) desire to accept the offer. A through K cannot force L to accept the offer, but in order to complete the transaction, A through K (or any subset thereof, or the property manager) could exercise their rights under the call option and acquire L's TIC interest for its fair market value. All of the co-owners could then sell Blackacre to Bigco for $1 million.

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 should 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.

11. 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 Code Sec. 512(b)(3)(A), *i.e.*, the income

would not be unrelated business taxable income (the "512(b) standard"). 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 the "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. Rev. Proc. 2002-22 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.

Because of this restriction on business activities, the various activities conducted at the property in a TIC structure should be carefully reviewed. For example, the operation of parking facilities at the property should be carefully reviewed as the activities allowed in a TIC structure may, in some cases, be different than those allowed for a real estate investment trust (REIT). The IRS recently issued guidance in this area in Rev. Rul. 2004-24. In that ruling, the IRS identified circumstances in which a REIT's income from providing parking facilities at its rental real properties qualifies as "rents from real property" under Code Sec. 856(d), a fundamental requirement under the REIT rules (the "856(d) standard"). In contrast, such income from the use of a parking space may not be excluded from "unrelated business taxable income" under the 512(b) standard applicable to TICs. The difference between the 856(d) standard and the 512(b) standard is one of congressional intent, and the treatment of exempt organizations under Code Sec. 512(b)(3) reflects the differences between Code Secs. 856(d) and 512(b)(3), as well as differences between the regulations interpreting those sections.[26]

12. 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. As stated above, most TIC agreements now contain an "implied consent" provision under which each of the co-owners is given a specified period of time to object to the reappointment of the property manager.[27]

In addition, 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 fair market value 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. Also, 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.

13. Leasing Agreements

Under section 6.13 of Rev. Proc. 2002-22, all leasing arrangements must be *bona fide* leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value 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 Code Sec. 856(d)(2), which determine whether rent is permissible for a 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.

14. Lenders

According to section 6.14 of Rev. Proc. 2002-22, 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 to the TICs 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 a non-*pro rata* manner (*see* section 6.09) and also prevents the sponsor from obtaining an additional return through seller financing.

15. 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 fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property. This provision is yet another backstop 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.[28]

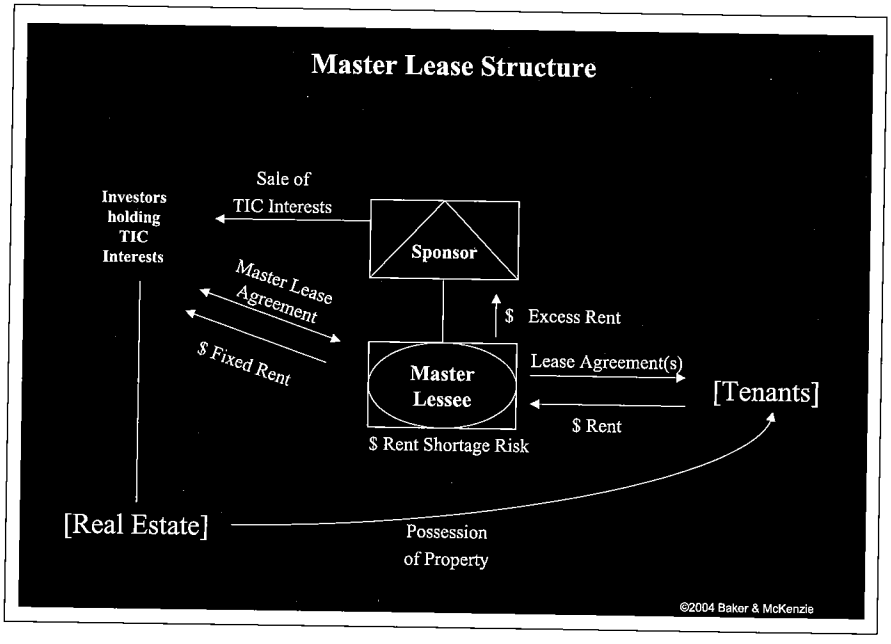
IV. Comparison of Master-Lease and Property Management Structures

Currently, almost every TIC offering in the marketplace is structured using either a "master-lease" or a "property management" structure. Each structure, of course, is subject to a variety of enhancements and modifications which will vary on a deal-by-deal basis.

Simply stated, the master-lease structure consists of a master lease over the entire property for a term equal to (or longer than) the anticipated holding period of the property. The master-lessee is typically a special purpose entity, set up by the sponsor specifically for the purpose of holding the master lease. The master-lease entity is usually capitalized in a nominal amount, so credit enhancement is not typically one of the attributes of the master lease.

In the typical master-lease structure, the master tenant pays a fixed base triple-net rent to the TIC owners of the property. The master-lease payments are typically net of all items (operating and capital) other than debt service and income taxes. In some cases, the master lease is net of debt service, and in some (infrequent) cases, it is gross of capital items. In many cases, the master-lease rent includes a percentage kicker of the gross income above some breakpoint (similar to many grocery store leases). In theory, this allows the TIC owners to receive a steady, predictable cash flow stream, without being subjected to the variances that often occur in income producing property. On the other hand, the TIC owners understand that they are foregoing a portion of the underlying rental income above the master lease payments. Diagram A shows the basic structure, contractual arrangements and cash flows for a typical master-lease structure. In

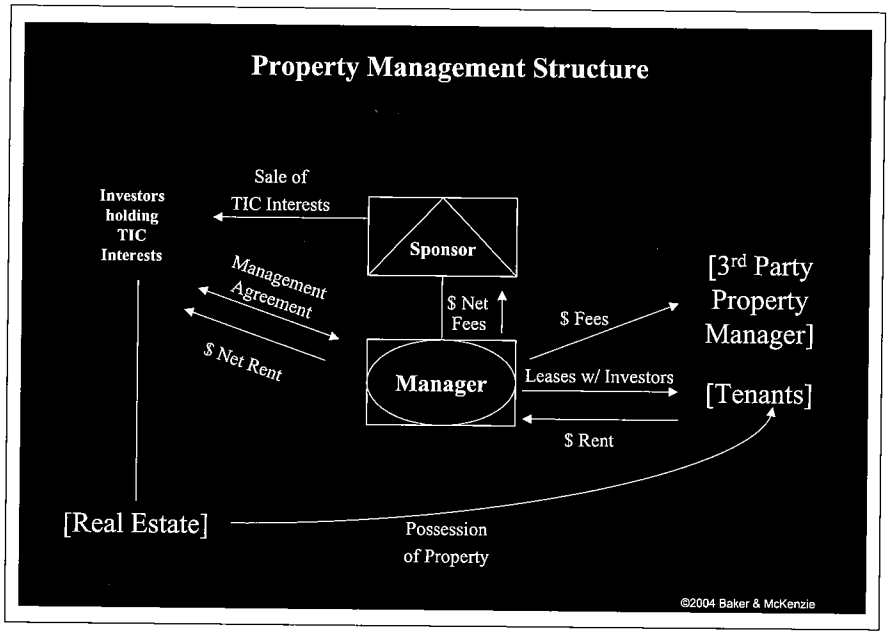
Diagram A



some cases, the master lease includes a master-lease termination payment or exit fee paid upon exit or a sale of the property and the termination of the master lease. This fee, if any, declines over the term of the master lease.

The primary alternative to the master-lease structure is the property-managed offering. Under a property management structure, the TIC investors acquire an interest in property that is subject to existing tenant leases (or lease if its a single-tenant property). Basically, the tenants in common "step into the shoes" of the previous property owner, and have a direct lessor/lessee relationship with the tenants. In this structure, the tenants in common will enter into an asset management agreement (usually with an affiliate of the sponsor (the "asset manager")), and the asset manager will often enter into a subcontract arrangement with a third-party property manager (who handles the day-to-day operations of the property). In this structure, the TIC owners are required to provide their approval (or disapproval) over both the major issues, such as new leases or capital expenditures, and (at least once per annum) the day-to-day management of the property by the property manager. In the property-managed structure, the TIC owners receive all of the income from the property, but only the income actually generated by the property. The sponsor, through its affiliate, benefits on the spread between the asset management fee it receives from the tenants in common and the fee it pays to the third-party property manager. Alternatively, if the sponsor (through its affiliate) is able to provide property management services directly, the TICs will enter into a property management agreement with a property manager, who is an affiliate of the sponsor, to manage the property.[29] Diagram B shows the basic structure, contractual arrangements and cash flows for a typical property-managed structure.

Diagram B



V. Practice Note/ Conclusion

When evaluating a TIC structure, taxpayer investors, as well as their financial planners, will be most concerned with the underlying economics of the investment, the allocation of risk, and the corresponding impact resulting from the limitations on centralized management required by Rev. Proc. 2002-22 and the supporting case law.

For example, it is important to acknowledge that pure co-ownership arrangements, without certain enhancements, are inherently limited structures through which to hold real estate. One of the greatest potential difficulties for co-owners of TIC interests is the unanimous consent requirements imposed on TIC structures by tax law. Failure to obtain the approval of a single co-owner in certain cases may prevent a sale, exchange, transfer, lease or refinancing deemed appropriate by the manager or the other co-owners. Consequently, a co-owner's return on investment could be adversely affected as the amount derived from a sale of its undivided interest in a property could be less than the comparable *pro rata* amount derived from a sale of a property as a whole. In addition, the failure of any co-owner to fulfill its obligations, or inhibit the retention or appointment of the property manager, could adversely affect a property. In light of this potential difficulty, many practitioners felt that as a practical matter, these requirements would cause the co-owners to use a master lease structure, in which the entire property is net leased to a single tenant, who

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can then sublease the property and hire a manager, thereby effectively eliminating the need to obtain co-owners' approval. Although the master lease structure remains the preferred structure for some TIC sponsors, a significant number of recent TIC offerings have adopted the property-managed structure—with each such TIC offering raising the desired equity investment in a relatively short period of time. This use of the property-managed structure may be due to the fact that the TIC industry has adopted a number of enhancements to their co-ownership structures that mitigate the dangers presented by the unanimous consent requirements. These enhancements include the use of call agreements, implied consent provisions, as well as ROFOs and call options in certain situations, each of which (if properly structured) allow the co-owners to more clearly define their relationship and protect themselves against inappropriate actions by other co-owners. As discussed above, many of these enhancements are expressly allowed by Rev. Proc. 2002-22, or under subsequent guidance issued by the IRS. A working knowledge of these enhancements, as well as any additional developments in this area going forward, will be essential to taxpayers and their financial planners when evaluating an investment in a particular TIC structure.

Although it is still too early to enumerate a complete list of "industry standards" in the TIC marketplace, many guideposts, as discussed herein, have emerged to evaluate TIC programs and their use as an investment vehicle for the ownership and succession of real estate holdings in connection with a like-kind exchange. Absent a change in tax law, the like-kind exchange under Code Sec. 1031 will continue to be the "500-pound gorilla" of real estate tax planning as it is one of the remaining shelters for taxable gains realized on real estate dispositions.[30] As the aging Baby Boomers continue to seek an exit from management-intensive property into more passive forms of real estate holdings,[31] a solid understanding of TIC programs, and their varying structures will become increasingly important to the well informed financial planner.

ENDNOTES

1 *See* Richard M. Lipton, *New Rules Likely to Increase Use of Tenancy-In-Common Ownership in Like-Kind Exchanges,* 96 J. TAX'N 303 (May 2002); *see also,* Louis S. Weller and Neal D. Sacon, *Real Estate Undivided Fractional Interest Programs and Rev. Proc. 2002-22: Birth of an Industry?* J. PASSTHROUGH ENTITIES, May–June 2002, at 23.

2 Industry projections prepared by Omni Brokerage estimate that in 2004 TIC sales will approach approximately $2 billion.

3 It's too early, as of yet, to determine whether TIC structures will also grow into a preferred means of investing in credit-tenant properties outside of a like-kind exchange transaction.

4 Portions of this article are based upon prior articles authored by Richard M. Lipton. *See generally,* Lipton, *supra* note 1; *see also,* Richard M. Lipton, *New Revenue Procedure on Reverse Like-Kind Exchanges Replaces Tax Risk With Tax Certainty,* 93 J. TAX'N 327 (Dec. 2000).

5 The requirements of a properly structured like-kind exchange under Code Sec. 1031 are beyond the scope of this article. For a discussion of structuring like-kind exchanges, *see generally,* Richard M. Lipton, *The State of the Art in Like-Kind Exchanges, Revisited,* 98 TAX'N 334 (June 2003).

6 *W.O. Culbertson Sr.,* SCt, 49-1 USTC ¶9323, 337 US 733, 69 SCt 1210. Note also that Code Sec. 761(a) provides that a 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.

7 *H.M. Luna,* 42 TC 1067, Dec. 26,967 (1964).

8 *See* Reg. §301.7701-1(a)(2).

9 *See* POWELL ON REAL PROPERTY, at ¶50.01 (Wolf ed., 2000).

10 Rev. Rul. 75-374, 1975-2 CB 261.

11 *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.

12 *G.W. Bergford,* CA-9, 94-1 USTC ¶50,004, 12 F3d 166.

13 *I.J. Bussing,* 88 TC 449, Dec. 43,722 (1987), *reconsideration denied,* 89 TC 1050, Dec. 44,342 (1987); *W.G. Alhouse,* 62 TCM 1678, Dec. 47,843(M), TC Memo. 1991-652.

14 *Madison Gas & Electric Co.,* CA-7, 80-2 USTC ¶9754, 633 F2d 512, *aff'g,* 72 TC 521, Dec. 36,142 (1979).

15 The IRS recently requested guidance regarding the application of the regulations under Code Sec. 761 to oil and gas ventures. *See* PS-103-90, 69 FR 11,709 (Mar. 11, 2004); *see also,* comments of the Chicago Bar Association regarding same, 2004 TAX NOTES TODAY 102-25 (May 26, 2004).

16 Rev. Proc. 2002-22 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 for federal income tax purposes.

17 Two of these ruling requests were filed by Mr. Lipton.

18 Rev. Proc. 2002-22 follows up on the IRS's stated intention to issue guidance in this area. In Rev. Proc. 2000-46 the IRS 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 Code Sec. 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.

19 Code Sec. 1031(a)(3) requires taxpayers to identify replacement property within 45 days of disposing of the relinquished property and to close on the replacement property within 180 days. Section references contained in this article are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

20 The IRS alleviated some of the difficulty of executing a like-kind exchange, in part, by providing a framework for reverse like-kind exchanges when it issued Rev. Proc. 2000-37. However, many 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, supra* note 4.

21 *See* Todd D. Golub and Matthew M. Nochowitz, *Tenancy in Common Interests and Current Developments Under Rev. Proc.*

2002-22, J. PASSTHROUGH ENTITIES, Mar.–Apr. 2004, at 29.

[22] *See* Rev. Rul. 2004-86, IRB 2004-33, 191. On July 20, 2004, the IRS issued guidance (Rev. Rul. 2004-86) concerning the tax treatment of a Delaware Statutory Trust (DST) for purposes of Code Sec. 1031 like-kind exchanges. Many tax practitioners had hoped that, in situations in which there were multiple owners of a single piece of real estate, DSTs could be utilized to hold title to the property instead of requiring direct ownership by the tenants in common. Those practitioners will likely be disappointed by the narrowness of Rev. Rul. 2004-86, which as a practical matter will restrict the usage of DSTs in like-kind exchanges. Indeed, Rev. Rul. 2004-86 may best be viewed as setting forth the very limited situations in which a DST can be structured to be treated as a trust for tax purposes and not as a business entity (taxable as a corporation or a partnership). These circumstances are very narrow and will, in most instances, be practical when debt-financed property is involved only for leased property where the lessee is responsible for capital improvements. (For a further discussion of Rev. Rul. 2004-86, *see* Lipton, Golub and Cullen, *DSTs and § 1031: A Marriage Made in Heaven, or Just a Pipe Dream?* 101 J. TAX'N 140 (Sept. 2004).

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

[24] LTR 200327003 (July 3, 2003).

[25] In addition, many lenders require the issuance of a "substantive non-consolidation" opinion, which means that the SMLLC would not be consolidated with its individual owner in the case of a bankruptcy filing by the individual owner; finance counsel have expressed concern that compliance with the parenthetical clause in section 6.08 of Rev. Proc. 2002-22 may prevent counsel from being able to issue a substantive nonconsolidation opinion.

[26] *See* Rev. Rul. 2004-24, IRB 2004-10, 550 (Mar. 5, 2004).

[27] *See* note 24 and its accompanying text.

[28] This rule is consistent with the case law governing this issue. *See* note 12 and its accompanying text.

[29] Some sponsors (*e.g.*, banks), might be required to use a third-party property manager as federal or state regulations may prohibit their participation in certain real estate activities.

[30] *See* Weller and Sacon, *supra* note 1.

[31] *Id.*

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original U.T.C. that was submitted to the Colorado legislature contained a $1 million fiscal note for the burden to the judiciary.

[49] *Davidson v. Davidson, supra* note 20.

[50] *See* Section II, C. of this article.

[51] *In re Balanson, supra* note 21.

[52] *Id.*

[53] For a further discussion of the issues of contingent or indefinite remainder interests please *see* Chapter 3 of the treatise MARK MERRIC, ASSET PROTECTION STRATEGIES, VOL. II (Alexander A. Bove, Jr., ed. 2004).

[54] U.T.C. §504(d).

[55] Citing SCOTT ON TRUSTS §130, at 409 (4th ed. 1989).

[56] Further §187.2 states, "Even though there is no standard by which it can be judged whether the trustee is acting reasonably or not, or though by the terms of the trust he is not required to act reasonably, the court will interfere where he acts dishonestly or in bad faith, or where he acts from an improper motive." Section 187.3 discusses when a trustee fails to use his judgment. Section 187.4 discusses where the trustee acts dishonestly, and §187.5 discusses when a trustee has an improper motive.

[57] Restatement (Second) of Trusts §187, at 409 (1959).

[58] It should be noted that the Restatement Third §50 comment c. holds out the promise that the grant of extended discretion might provide some relief. However, this comment makes clear that it will be a matter of judicial interpretation whether such discretions "manifests an intention to relieve the trustee of *normal judicial supervision and control* in the exercise of a discretionary power over trust distributions" (emphasis added).

[59] *Comins v. Comins,* 595 N.E.2d 804, 33 Mass. App. Ct. 28 (1992).

[60] *Id.,* 595 N.E.2d 804, at 806.

[61] *Lauricella v. Lauricella,* 565 N.E.2d 436, 409 Mass. 211 (1991).

[62] *Supra* note 60.

[63] *Lauricella v. Lauricella, supra* note 61, 565 N.E.2d, at 439.

[64] *D.L. v. G.L., supra* note 12.

[65] As noted in the text, it is uncertain whether the trust in *Lauricella* was a discretionary or a support trust under common law. In the event the trust was a support trust, then the beneficiary did in fact have a sufficient enforceable right under common law.

[66] *Davidson v. Davidson, supra* note 20.

[67] Even if a standard is omitted, the court will still apply a good-faith judgment, "based on the extent of the trustee's discretion, the various beneficial interests created, the beneficiaries' circumstances and the relationships to the settlor, and the general purposes of the trust" to created a standard for judicial interpretation. Restatement of Trusts (Third) §50, comment d., adopted on May 16, 2001, by the American Law Institute, published 2003.

[68] *Lauricella v. Lauricella, supra* note 61, 565 N.E.2d, at 439.

[69] *Lauricella v. Lauricella, supra* note 61.

[70] U.T.C. §504, comment—fourth paragraph thereunder, National Conference of Commissioners on Uniform State Laws 2001.

[71] Restatement of Trusts (Third) §60, comment e. and e.(1).

[72] *Bureau of Support in the Department of Mental Hygiene and Correction v. Kreitzer,* 243 N.E.2d 83, 16 Ohio St. 2d 147 (1968). *Also see* the following unreported appellate cases that follow the *Kreitzer* analysis: *Matter of Gantz,* 1986 WL 12960; *Samson v. Bertok,* 1986 WL 14819 (however, the creditor did not recover because it was not a governmental claim); *Matter of Trust of Stum,* 1987 WL 26246.

[73] *Metz v. Ohio Dept. of Human Services,* 762 N.E.2d 1032, 145 Ohio App. 3d 304 (2001).

[74] *Dwight v. Dwight,* 756 N.E.2d 17, 52 Mass. App. Ct. 739 (2001). *Dwight* references the Restatement Third §59 and *Gershaw v. Gershfield,* 751 N.E.2d 424, 52 Mass. App. Ct. 81 (2001). Section 59 contains the exceptions to spendthrift trusts. *Gershaw* is a support trust case. Therefore, under common law, the exception creditors of alimony and child support are appropriate to a support trust. However, *Dwight* is a discretionary trust. Prior to the U.T.C. and Restatement Third, there are no exception creditors to a discretionary trust.

[75] *Dwight v. Dwight, supra* note 74.

[76] U.T.C. §504.

[77] Restatement (Third) of Trusts §50, comment b.; U.T.C. §814(a).

[78] As previously noted, *Comins* was decided without reference to the U.T.C. and Restatement Third. Similar to *Dwight* it appears to fly in the face of common law. However, similar to *Dwight, Comins* makes perfect sense under the newly created continuum of discretionary trusts.

[79] *Dwight v. Dwight, supra* note 45.

[80] An interesting observation is made in *D.L. v. G.L., supra* note 12. When the court determined that the trust was a discretionary intergenerational trust and that it was not to be considered as marital property, the court cited as a favorable fact that the child beneficiary had no knowledge of the trust assets.

[81] For a further analysis of conflict of law issues regarding trusts, *see* ENGEL, LOCKWOOD AND MERRIC, THE ASSET PROTECTION PLANNING GUIDE—A STATE-OF-THE-ART APPROACH TO INTEGRATED ESTATE PLANNING, Ch. 10 (**CCH** 2000). However, it should be noted that again the U.T.C. adopts a minority view in trust law, by using a strong public policy argument to allow a judge to use the "most significant relationship" in determining choice of law. U.T.C. §107.

[82] Due to the Restatement Third creating trust law in the area of creditor recovery, Texas is currently drafting anti-Restatement Third legislation. Other estate planning attorneys have also noted that to retain the common law of the discretionary-support distinction as well as several other creditor recovery areas where the Restatement Third appears to adopt