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Real Property Transactions

TAXING COMPLICATIONS

SORTING OUT TAX-DEFERRED EXCHANGES FOR TENANTS IN COMMON

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In recent years, many taxpayers and their counsel have become increasingly aware of the benefits of an IRC 1031 tax deferred exchange. Properly structured, a tax deferred exchange allows a taxpayer to defer the capital gain tax realized upon the sale of business or investment property if the taxpayer acquires property of like-kind which is also held for business or investment purposes.

Complexities and Benefits

To obtain the benefit of tax deferral, taxpayers must adhere to a strict schedule of identifying and purchasing replacement property. These requirements sometimes leave taxpayers scrambling and, on occasion, unable to complete an exchange. Taxpayers must identify potential replacement property (one or more) within 45 calendar days and acquire the replacement property within 180 calendar days, both periods running from the date of closing the relinquished property. IRC 1031(a)(3)(A)-(B). In addition, to obtain a complete deferral of the capital gain tax, the taxpayer must acquire replacement property of equal or greater value, obtain equal or greater debt on the replacement property, reinvest all the net proceeds realized from the sale of the relinquished property, and acquire only like-kind property. Treas. Reg. 1.1031(d)-2 and IRC 1031(a)(1).

The drive to satisfy both the statutory deadlines and reinvest all of the net proceeds in qualifying replacement property has spawned a boutique industry of companies that sell undivided tenant in common (TIC) interests in real property, most often triple net leased properties. Typically, a sponsor identifies and purchases a desirable property. The sponsor then determines the offering price and how many TIC interests (typically computed on a percentage basis, for example, a 5.5 percent interest) they will sell. The TIC sponsor may earn a commission or acquisition fee and typically manages the property for the TIC owners for a customary management fee. The TIC owners receive a distribution check monthly or quarterly, without having any management responsibilities.

TIC interests are desirable for a number of reasons. First, the investor is not responsible for any property management. Second, novice real estate investors can benefit from working with experienced national or regional real estate sponsors who handle the due diligence, acquisition, financing, leasing, management, etc. and provide the investors with a "net" return. Third, most TIC investors do not have sufficient net proceeds to acquire a first class building, with credit (or other quality) tenants and a nationally recognized property manager; by acquiring an undivided TIC interest, the investor can acquire a small portion of a bigger and better quality replacement property. Fourth, most TIC investors are able to reinvest all of their net proceeds because TIC interests are sold on a percentage basis (versus traditional replacement property that does not come in just the right size to permit the complete reinvestment of the taxpayer's net proceeds). Finally, a taxpayer may diversify by acquiring TIC interests in a number of properties.

Because TIC interests resemble partnership interests in some respects, it has been unclear whether TIC interests would qualify under Section 1031. This distinction is critical because, since 1984, interests in a partnership specifically do not qualify as replacement property in a tax deferred exchange. IRC 1031(a)(2)(D).

Like-kind property is defined as property held for productive use in a trade or business or for investment purposes that is exchanged solely for property to be held for productive use in a trade or business or for investment purposes. IRC 1031(a)(1). Like-kind refers to the "nature or character" of the property and not its grade or quality. Thus, "[t]he fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class." Treas. Reg. 1.1031(a)-1(b). Real property that conforms to this definition should be considered "like-kind" even though very different in a practical sense. For example, vacant land which is held for investment can be exchanged for industrial property held for business or investment purposes. There is no requirement that properties be similar in type or class.

Personal Property Swaps

In addition, personal property fitting the above definition of like-kind may also be exchanged. However, personal property and real property are not like kind. Therefore, real property must be exchanged for real property and personal property must be exchanged for personal property. The determination as to what is considered real property and what is considered personal property is generally determined by state law. Treas. Reg. 1.1031(a)-1(b), (c), Aquilino v. U.S., 363 U.S. 509, 80 S. Ct. 1277, 4 L.Ed.2d 1365, 5 A.F.T.R.2d 1698, 60-2 USTC P 9538 (U.S.N.Y., 1960); Coupe v. Commissioner of Internal Revenue, 52 TC 394 (Tax Ct., 1969), acq. in result, 1970-1; and Rev. Rul. 55-749.

The IRS has recently provided much needed guidance on the qualification of TIC interests in Revenue Procedure 2002-22 issued on May 19, 2002. Unlike the "safe harbor" that had been expected, the guidance takes the form of advance ruling requirements. While not a statement of substantive law, the advance ruling requirements are likely to become a litmus test for many sponsors of tenant in common replacement property programs.

Previously, in Revenue Procedure 2000-46 (Oct. 12, 2000), the IRS stated that it would no longer issue advance rulings on whether an undivided (fractional) tenant in common interest in real property is an interest in an entity that is eligible for tax-deferred exchange treatment under Section 1031. The IRS was concerned that taxpayers were taking the position that certain arrangements where they acquire tenant in common interests in real property may constitute an interest in an entity classified as a partnership for federal income tax purposes. Revenue Procedure 2000-46 has now been repealed. A copy of Revenue Procedure 2002-22 is attached.

The advance ruling guidelines are set forth in Section 5 and the conditions to issuance of a ruling are set forth in Section 6, which are set out below. The Revenue Procedure states that the IRS "ordinarily" will not consider a request for a ruling unless the information described in Section 5 is included and the conditions described in Section 6 are satisfied. However, even if Sections 5 and 6 are satisfied, the IRS 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." This will create fertile ground for creative sponsors of tenant in common programs and their able tax counsel.

Section 5 outlines the information to be submitted as part of a ruling request, including detailed information on each co-owner and the property. In addition, the ruling request must contain a complete statement of all the facts relating to the tenant in common ownership, including those relating to promoting, financing and managing the property. All of the following information must be included to the extent related to the property:

the name, taxpayer identification number and percentage interest of each co-owner;

the name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of the property, including the sponsor, lessee, manager, and lender;

a full description of the property;

a representation that each of the co-owners holds title as tenants in common under local law;

promotional documents relating to the sale of the tenant in common interests;

financing documents;

agreements among the co-owners;

any lease agreement;

purchase and sale agreement;

any property management or brokerage agreement; and

any other relevant information, for example, any call and put options.

All documents and supplementary materials submitted to the IRS must contain applicable exhibits, attachments and amendments. Keep in mind that rulings will only be granted for "real" (and not hypothetical) deals.

However, much of the required information may only be known at the end of an offering, when the sponsor is ready to acquire the property, close the loan and sell interests to the tenants in common. Accordingly, it is unlikely that many sponsors will be able to keep a deal open long enough to obtain a ruling.

Conditions for Rulings

The IRS "ordinarily" will not consider a request for a ruling unless the conditions described in Section 6 are satisfied. However, where the conditions in Section 6 are not satisfied, the IRS still may consider a ruling request "where the facts and circumstances clearly establish that such a ruling is appropriate." The conditions are summarized below.

1. Tenants In Common Ownership. Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law.

2. Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons (and husband and wife are treated as a single person for this purpose).

3. No Treatment of Co-Owners as an Entity. The co-owners may not file a partnership tax return or otherwise hold themselves out as a partnership or other form of entity.

4. Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. This agreement may provide that a co- owner must offer the interest for sale to the other co-owners or the sponsor at fair market value before exercising any right of partition. In addition, the agreement may provide for majority voting on certain issues.

5. Voting. The co-owners must retain their voting rights as described below. Unanimous approval is required for any sale, lease or re-lease of a portion or all of the property, any negotiations or re-negotiations of indebtedness secured by the

property, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract). However, for all other actions, the co-owners may agree to be bound by a vote of more than 50% of the co-owners. A co-owner who has consented to an action in this matter may provide the manager with a power of attorney to execute specific documents with respect to that action.

6. Restrictions on Alienation. In general, each co-owner must have the right to transfer, partition, and encumber their interest in the property without the agreement or approval of any person. However, restrictions that are required by a lender and that are consistent with customary commercial lending practice are not prohibited. Moreover, the co-owners or the sponsor may have a right of first refusal and a co-owner may agree to offer an interest for sale to the other co-owners or the sponsor at fair market value before exercising any right to partition.

7. Sharing Proceeds and Liabilities Upon Sale of Property. If the property is sold, any debt secured by the property must be satisfied and the remaining proceeds distributed to the co-owners.

8. Proportionate Sharing of 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 their interests in the property. Neither the other co-owners, the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the property, unless the advance is recourse and is not for a period exceeding 31 days.

9. Proportionate Sharing of Debt. The co-owners must share in any indebtedness secured by the property in proportion to their undivided interests in the property.

10. Options. A co-owner may issue an option to purchase his interest, provided the exercised price reflects fair market value of the property determined as of the time the option is exercised. A co-owner may not acquire an option to sell the interest (put option) to the sponsor, the lessee, another co-owner or the lender or any person related to such parties.

11. No Business Activities. The activities of the co-owners must be limited to those customarily performed in connection with the maintenance and repair of rental real estate. See Rev. Rul. 75-374, 1975-2 CB 261.

12. Management and Brokerage Agreements. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually. The manager or broker may be a sponsor or co-owner (or a related party), but may not be a lessee. The management agreement may authorize the manager to maintain common bank accounts for the collection and deposit of rents and to offset expenses associated with the property against any revenues before dispersing each co-owners' share of net revenues. In addition, the management agreement may authorize the manager to take certain actions on behalf of the owners (subject to the voting regime described above in Paragraph 5). The manager may not be paid a fee based in whole or in part on the income or profits derived from the property and the fees may not exceed the fair market value of the manager's service based upon comparable fees paid to unrelated parties for similar services.

13. Leasing Agreements. All leasing agreements must be bona fide leases for federal tax purposes.

14. Loan Agreements. The lender may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the property.

15. Payments to Sponsor. The amount of any payment to the sponsor for the acquisition of the co-ownership interest and services must reflect the fair market value of the interest acquired and the services rendered. This means that such payments and fees may not depend, in whole or in part, on the income or profits derived from the property (i.e., no back-end or carried interest is permitted).

Conclusion

In conclusion, the IRS may now render advance rulings on tenant in common programs. However, very little new guidance has been given on the difference between a qualifying tenant in common interest and a non-qualifying interest in an entity. Also, there is no mention of the much anticipated master lease programs.

The conditions stated above are understood and being followed by many sponsors of tenant in common programs. However, the IRS retains the authority under appropriate circumstances to decline to issue a ruling. The absence of a "safe harbor" or other bright line test will create fertile ground in the future for creatively structured tenant in common programs. Apparently, the IRS decided to defer the hard questions to the future, when ruling requests are received and considered.

Therefore, those interested in tenant in common programs will need to wait for guidance to follow from the IRS in future rulings and, possibly, announcements. Until then, sponsors of tenant in common programs are likely to adapt their programs to conform with most of the conditions stated in the Revenue Procedure. However, sponsors of other programs, for example, those that make use of a master lease or election out of Subchapter K, are free to continue offering their programs because the Revenue Procedure is not a statement of substantive law and not to be used for audit purposes.

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