I.R.S. Lends a Hand to the Tenants-in-common Exchange Market: The Basics and Impact of Revenue Procedure 2002-22

By Kent Davis Jones, Esq.

So...you want to play with the big boys. Do you want to turn away from your woes in the stock market and strike it rich in the world of investment grade real estate, but don't have a spare $5,000,000 lying around (See "woes in the stock market" above)? Or perhaps you are looking for an exit strategy for your most recent development, but can't find that investor with a spare $5,000,000 lying around.

From one of the most unlikely sources (the Internal Revenue Service) comes an answer that may hold serious promise both for real estate investors and developers. With the issuance of Revenue Procedure 2002- ____ the IRS has provided a new mechanism for receiving ruling on Co-tenancy arrangements as they impact exchanges of like-kind property. This article will discuss the significance of this revenue procedure and the potential benefit it offers for those seeking tax-deferral on real property transactions. This article will not focus on the technical aspects of the revenue Procedure, although it will provide the basics of the procedure's framework.

Background and 1031 Overview

Section 1031 of the Internal Revenue Code of 1986 (as amended, the "Code") provides that no gain or loss will be recognized on the disposition of property held for productive use in trade or business, or investment, if such property is exchanged for like-kind property. Seems simple enough, right? Well, if you put on your litigator's hat (or, more accurately, your IRS hat) for a minute you begin to see that the terms like "like-kind" and "productive use in trade or business" present ample for discussion or argument. Over the years much of the reported tax litigation has dealt with honing these concepts to a finer point.

While the concept of "exchanging" into and out of undivided co-tenancy interests is not new, the revenue procedure offers the potential to mainstream this product and to offer it with less risk to the "average" real estate investor. The problem with co-tenancy arrangement is that they look an awful lot like partnerships. And you cannot exchange partnership interests under Section 1031.[i] The line between valid co-tenancies and invalid partnerships has never been bright, but the IRS has successfully challenged such arrangements, arguing that they are in substance partnerships.[ii]

To boil it down further, the lack of specific guidance, left taxpayers to necessarily absorb some risk when trying to avail themselves of the benefit of an exchange involving co-tenancies. Their tax professionals (lawyers and accountants) were asked to be the arbiter of what would be acceptable to the I.R.S. without any definite ruling on the matter.

Issuance of Revenue Procedure 2002-22

After many years of refusing to promulgate any specific procedures pertaining to the acceptability of a tenants-in-common structure, on March 20,2002, the I.R.S. issued revenue Procedure 2002-22. The reader has to be aware that the Revenue Procedure does not create a "safe harbor" for co-tenancy exchanges, nor does it give the seal of approval to any particular deal structure that has found its way into the marketplace.

What the I.R.S. has done, however, is to open the door to information for taxpayers and co-tenancy sponsors seeking to effectuate tax-deferred exchanges of tenants-in-common interests. The ability to get a determination leads the way toward developing "standards" for these types of products. Once taxpayers and sponsors take advantage of this procedure, a body of "precedence" will develop, reducing the risk to taxpayers and increasing the marketability of this vehicle.[iii]

Framework of 2002-22

Revenue Procedure 2002-22 is structured essentially as a checklist for obtaining a ruling. It provides in Sections 5 and 6, laundry lists of information that must be included and conditions that must be met. Section 5 is more of a "housekeeping" provision; setting forth requirements for names, property descriptions and documentation necessary for the ruling. Section 6 should be of much more interest to taxpayers and tax practitioners, in that it gives general guidance as to the types of substantive provisions that the Service will be looking for. The following are the fifteen conditions that are required:[iv]

1. Tenancy in Common Ownership. Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

2. Number of Co-Owners. The number of co-owners is limited to thirty-five. Husband and wife are viewed as one owner for this purpose. This limitation should provide sufficient flexibility in structuring tenants-in-common arrangements, as most involve less than thirty-five owners to begin with.

3. No Treatment of Co-Ownership as an Entity. Basically, the co-owners cannot act as if they are part of a partnership or other organized business entity. This means that they can't operate under a common name or file partnership tax returns.

4. Co-Ownership Agreement. Fortunately, the procedure allows the co-owners to enter into an agreement that governs property. Prior to 2002-22, drafters had to walk the tight rope between "control" of the property and avoiding classification as a partnership. Many even believed that they could not risk formalizing the agreement of the co-tenants for fear of creating a partnership. Now, at the least, the I.R.S. deemed such agreements permissible. Such an agreement can run with the land and can contain alienation and voting provisions. The contents of such agreements are more particularly described in the other conditions of the revenue procedure.

5. Voting. Essentially, any significant action taken with respect to the tenants –in-common arrangement must meet with the approval of all of the members. Such actions include hiring a manager, leasing of the premises, sale of the property or obtaining any blanket financing. It is clear that such a requirement poses significant problem for the sponsor of such an arrangement, in that each member could essentially hold the project hostage. However, it is important to realize that this type of investment product will normally appeal to investors looking for "care-free", investment grade real property, and will be less likely to hold up management decisions. Still, the threat is real and structuring deals to minimize this risk is advised and doable.

6. Restrictions on Alienation. Fundamental to the ownership of real property is the right of the owner to transfer, encumber or otherwise dispose of such property. In the context of valid tenants-in-common arrangements the same principle applies; however, the I.R.S. has recognized the need among co-owners for some restriction on alienation. While no approval of the other members or the sponsor may be required, typical restrictions imposed by lenders are permissible Additionally, the co-tenancy agreement may grant a right of first offer in the non-selling owners or the sponsor. The co-owners may also agree that they will offer the interest to the other owners prior to exercising any right to partition. Currently, the Service takes the position that rights of first refusal are too much of a restriction on transfer. The author believes that this is an inconsistency in the procedure's guidelines and that carefully crafted rights of first refusal should be allowed. Such rights are commonly granted in real property transactions and afford certain protections to the non-selling co-owners.

7. Sharing Proceeds and Liabilities upon Sale of Property. All blanket financing on the property must be satisfied from the proceeds of sale. Any remaining amounts must be distributed to the co-owners in proportion to their ownership interest.

8. Proportionate Sharing of Profits and Losses. All expenses and revenue of the property will be shared by the owners in proportion to their ownership interest. Since funds cannot be advanced to a co-owner by a co-owner or sponsor to cover costs, it begs the question of what recourse is available against a co-tenant for failure to pay its respective share. Absent an action to collect such amounts, the co-owners only option may be to purchase the defaulting owner's interest at fair market value pursuant to a call option.

9. Proportionate Sharing of Debt. Any blanket lien on the property must be allocated to the owners in proportion to their interests. This does not prevent any outside financing secured only by an individual owner's interest.

10. Options. The revenue procedure allows for the owner's to issue call options at fair market value. It does not allow a co-owner to issue a put in favor of any co-owner, sponsor or related party. Effectively, this limits the ability of the co-owners to deal efficiently with a non-performing owner (e.g. an owner that fails to pay its share of expenses) and does not allow an out for an owner that needs to liquidate its interest. See

Tax Free Exchanges Under § 1031 § 9.08.50 ,Long and Foster 2002.

11. No Business Activities. While the I.R.S. intends that the valid co-ownership arrangement would be one that is predominantly passive, it has recognized that certain actions must be taken in connection with the use, operation and maintenance of the property. The revenue procedure allows the co-owner's to take such actions as are "customarily performed in connection with the maintenance and repair of rental real property". Rev. Pro. 2002-22 Sec. 6.11. Ancillary services outside of those that would normally be covered by rent, are prohibited activities and will likely cause the arrangement to fail.

12. Management and Brokerage Agreements. Assisting the co-owners in the operation of the property, the I.R.S. has approved the use of management and brokerage. The investor looking for a truly passive investment will benefit form this allowance. Any such agreement must be renewable no less than annually and can be made with another co-owner or the sponsor (but not a lessee). Permitted activities of the manager include: collecting rents, preparing operating statements, obtaining insurance, negotiating financing for the property, and negotiating leases. Fees to managers and brokers must reflect market value.

13. Leasing Agreements. Any lease of the property by the co-owners must be on terms that reflect market conditions and rental amounts must not be tied to the income or profits of the property. Percentage rents based on sales are acceptable. Since one of the major inducements to potential co-owners will be the income stream form high credit tenants, this condition should be met easily.

14. Loan Agreements. Neither the owners nor the sponsor may be the lender on any financing affecting the property. While not addressed in the revenue procedure, this presents a small problem when considering the transfer of an interest between members. The revenue procedure would suggest the sale must be for cash.

15. Payments to Sponsor. As with most of the provisions of the revenue procedure, the owners and sponsor are required to treat the deal like a typical real estate deal. Thus, the amount paid to the sponsor for the interest must reflect the market value of such real estate. The purchase price cannot be based, in whole or in part, on the income of the property. Simply stated, the distinction can be thought of in terms of a real property interest versus that of a security.

What is the net result of all this? At this point it is difficult to say. The fact that the Service says may consider applications for rulings that have not fulfilled all of the conditions, leaves the door ajar for some creativity, risk and abuse. In this author's opinion, Revenue Procedure is a road map to a safe place. But, it does not go far enough to be an actual safe harbor. As decisions are handed down, I think the road will get clearer and clearer. The I.R.S. will also have the chance to address some of the issues that the revenue procedure creates (e.g. puts v. calls; rights of first offer v. rights of first refusal) and to either explain or remedy the apparent inconsistencies.

One thing is for certain, those serious about taking advantage of tax-deferral on co-tenancy property now have a tool to help quantify if not eliminate risk. This should effect tremendous growth in a market that may prove to be a gold mine for exchange business and may open the door to a whole new class of real estate investor.