NEW SAFE HARBOR FOR TENANCIES-IN-COMMON

On March 19, 2002, the Internal Revenue Service (the "IRS") issued Revenue Procedure 2002-22, 2002-14 IRB 733 (the "Rev. Proc."), which sets forth the conditions for considering a request for a ruling from the IRS that an undivided fractional interest in real property is not an interest in a business entity.

The "like-kind exchange" rules of Internal Revenue Code ("IRC") Section 1031 provide that tax-free exchange treatment is not available to an exchange of interests in a partnership. In contrast, property held by co-owners in a tenancy-in-common arrangement is eligible for like-kind treatment. Prior to the issuance of the Rev. Proc., the IRS would not issue advance rulings or determination letters on the question of whether an undivided fractional interest in real property is an interest in an entity that would not be eligible for tax-free exchange treatment.

The Rev. Proc. provides that the IRS will generally not consider a request for a ruling regarding an undivided fractional interest in property unless the following conditions are satisfied:

- *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.
- *Number of Co-Owners.* The number of co-owners must be limited to 35 persons. For this purpose, "person" is defined as an individual, trust, estate, partnership, association, company or corporation, 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.
- *No Treatment of Co-Ownership as an Entity.* The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The IRS generally will not issue a ruling under this revenue procedure if the co-owners held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership.
- *Co-Ownership Agreement.* The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition; or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the property.

- *Voting.* The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases of a portion or all of the property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the property.
- *Restrictions on Alienation.* In general, each co-owner must have the right to transfer, partition and encumber the co-owner's undivided interest in the property without the agreement or approval of any person. However, restrictions on the right to transfer, partition or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. Moreover, the co-owners, the sponsor or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor or the lessee at fair market value before exercising any right to partition.
- *Sharing Proceeds and Liabilities upon Sale of Property.* If the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.
- *Proportionate Sharing of Profits and Losses.* Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property. None of the other co-owners, or the sponsor, or 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 is not for a period exceeding 31 days.
- *Proportionate Sharing of Debt.* The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.
- *Options.* A co-owner may issue a call option to purchase the co-owner's undivided interest, 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 equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire a put option to sell the co-owner's undivided interest to the sponsor, the lessee, another co-owner, the lender, or any related party.
- *No Business Activities.* The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property. Activities will be treated as customary activities for this purpose if the activities would

cause the rent to be treated as unrelated business taxable income under IRC Section 512(b)(3)(A) and the Treasury regulations thereunder. In determining the co-owners' activities, 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, whether or not those activities are performed by the co-owners in their capacities as co-owners. However, activities of a co-owner or a related person with respect to the property will not be taken into account if the co-owner owns an undivided interest in the property for less than six months.

- *Management and Brokerage Agreements.* The co-owners may 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 to the sponsor or a co-owner), but who may not be a lessee. The determination of any fees paid by the co-ownership 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 by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.
- *Leasing Agreements.* All leasing agreements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for 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 property leased (other than an amount based on a fixed percentage or percentages of receipts or sales).
- *Loan Agreements.* 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.
- *Payments to Sponsor.* 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.

The Rev. Proc. provides that if the conditions described above are not satisfied, the Service may consider a request for a ruling if the facts and circumstances clearly establish that such a ruling is appropriate.

Although the Rev. Proc. specifically provides that the guidelines provided therein are not intended to be substantive rules and are not to be used for audit purposes, in practice, tax practitioners will no doubt interpret this ruling as creating “safe harbors” for the treatment of a joint-ownership arrangement as a tenancy in common rather than a partnership or other business entity.

The Rev Proc. gives taxpayers somewhat greater flexibility in performing like-kind exchanges. For example, a taxpayer may exchange wholly owned property for a tenancy-in-common interest in replacement real property. In addition, the limited number of taxpayers who currently own an interest in real estate through a tenancy-in-common arrangement with all of the conditions discussed above may exchange their tenancy-in-common interests for either wholly owned interests or tenancy-in-common interests in replacement property.

The Rev. Proc. does not provide guidance in the more common situation of taxpayers who currently own interests in partnerships that own real property. As discussed above, the Service will generally not issue a ruling under the Rev. Proc. if the co-owners hold interests in property through a partnership immediately prior to the formation of the co-ownership, although there is no technical reason for this no-ruling policy. In addition, IRC Section 1031(a) permits the tax-free exchange only of property "*held* for productive use in a trade or business or for investment" (emphasis added). The Service has ruled that property acquired for the purpose of an exchange does not meet this "holding" requirement. The transfer of real property from a partnership to a tenancy in common arrangement followed *immediately* by an (attempted) like-kind exchange would likely fail this "holding" requirement. If, however, the taxpayer holds the real estate in a tenancy-in-common arrangement for a sufficient period of time prior to engaging in a like-kind exchange, the transaction should qualify for tax-free, like-kind exchange treatment. (There are no clear guidelines on how long a holding period is required, the facts and circumstances of each particular situation will govern.)

The Rev. Proc. may present a variety of tax planning opportunities. If you would like to discuss any of the following in greater detail please do not hesitate to call Henry M. Cohn at 212 728-8209, Eugene Pinover at 212 728-8254 or Devorah I. Pomerantz at 212 728-8121.

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