The Florida Bar Tax Section

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Telephone CLE

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Tax Considerations for Tenancy in Common Ownership Structure

I. Common Law

A. Florida Law. *A tenancy in common is the default form of tenancy in that it is a very common form amongst non-married owners and is also the form of concurrent ownership that results when another form is attempted but fails for whatever reason. It is characterized by the owners having distinct and possibly different size ownership interests, yet each owner having an undivided interest in the whole.* West Florida Real Estate Law Handbook.

B. Black's. A tenancy by two or more persons, in equal or unequal undivided shares, each person having an equal right to possess the whole property but no right of survivorship. *"The central characteristic of a tenancy in common is simply that each tenant is deemed to own by himself, whit most of the attributes of independent ownership, a physically undivided part of the entire parcel."* Thomas F. Bergin & Paul G. Haskell, *Preface to Estates in Land and Future Interests* 54 (2d ed. 1984).

II. Usefulness as a Tax Vehicle

A. General. Section 1031 provides that the recognition of gains from the sale of interests in real property may be deferred. This tax deferral mechanism has played a historically significant role in the timing of the sale and acquisition of real property.

B. <u>Code</u>. 1031(a)(1) provides, “no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.”

C. <u>Exceptions</u>. Subpart (2) makes exception for, (i) property held primarily for sale, (ii) stock, bonds, (iii) other securities, (iv) partnership interests or other beneficial interests, or (v) choses in action.

III. Determination of Tax Treatment of Interests in Property

A. Popularity conflicted with Rise of Syndicated TICs.

B. Given the critical nature of distinguishing between partnership and tenancy in common, particularly in the area of 1031 exchanges, a taxpayer would be rightfully concerned to know whether or not a property interest qualifies as a “tenancy in common” and <u>not</u> as a security or partnership interest.

C. <u>When not a partnership</u>. Regulations Section 1.761-1(a) ***provides that*** where the participants in the joint purchase, retention, sale, or exchange of investment property:
   1. Own the property as co-owners,
   2. Reserve the right separately to take or dispose of their shares of any property acquired or retained, and
   3. 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 time being for his account, but not for a period of more than a year, ***then***

4. such group may be excluded from the application of the provisions of subchapter K under the rules set forth in paragraph (b) of this section

A. No Ruling. Until the IRS issued Rev. Proc. 2002-22, 2002-14 I.R.B. 733, superseding Rev. Proc. 2000-46, 2000-44 I.R.B. 438, and modifying Rev. Proc. 2002-3, 2002-1 I.R.B. 117, in Mar. 2002, it adhered to a "no ruling" policy on the questions of whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under §1031(a)(1) and whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes under §7701. Sec. 7701 sets forth the definitions of corporations and partnerships.

B. Advent of Rev Proc 2002-22. Rev. Proc. 2002-22 specifies the conditions under which the IRS will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in §614) is not an interest in a business entity within the meaning of Regs. §301.7701-2(a). Rev. Proc. 2003-3, 2003-1 I.R.B. 113, §1.02(8) states that Rev. Proc. 2002-22 was incorporated into the annual "no ruling area" revenue procedure by deleting old §§5.03 and 5.06 of Rev. Proc. 2002-3. In IRS Info. Letter 2005-0165, the IRS stated that Rev. Proc. 2002-22 does not address the question of whether tenancy in common interests (TICs) are securities under §1031(a)(2)(B) or (C).

C. Rev. Proc. 2002-22 provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth in Rev. Proc. 2002-22 are not intended to be substantive rules and are not to be used for audit purposes. The guidelines and conditions set forth in Rev. Proc.

2002-22 do not establish any particular "law" or "rule" for the treatment of TIC ownership arrangements, they merely set forth the circumstances under which the IRS is prepared to rule favorably when presented with a particular case. Cases that do not meet all the requirements and conditions of Rev. Proc. 2002-22 may nonetheless qualify as proper TICs for tax purposes under their particular facts and circumstances

IV. Revenue Procedure 2002-22

A. Purpose. To provide guidelines for how to obtain a PLR for a determination of whether a tenancy in common interest will be respect for federal income tax purposes.

B. Background.

1. Rev. Rul. 75-374 (1975-2 C.B. 261) concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the revenue ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership.

2. Rev. Rul. 79-77 (1979-1 C.B. 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 with the three individuals as beneficiaries.

C. Scope and Guidelines. Limited to co-ownership of rental real property. PLR to be offered only if all conditions of Section 6 are satisfied.

V. Conditions Precedent for PLR

A. Tenancy in Common Ownership. Each of the co-owners must hold title to the Property as a tenant in common under local law. Thus, title may not be held by an entity.

B. Number of Co-Owners. Must be limited to no more than 35 owners.

C. 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 the co-owners as partners, shareholders or members of a business entity. The Service will generally not issue a PLR if the co-owners held interests in the Property through partnership or corporation immediately prior to the formation of the co-ownership.

D. Co-Ownership Agreement. Co-owners may enter into a limited co-ownership agreement satisfying the following conditions:

1. It may run with the land.
2. It may require a co-owner to offer its interest to the other co-owners, sponsor or lessee before exercising a right of partition.
3. It may require certain actions of the co-owners to be approved by a vote of co-owners holding more than 50% of the undivided interests.

E. <u>Voting.</u> 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. A co-owner who has consented to an action in conformance with this section (voting) may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

F. <u>Restrictions on Alienation</u>. In general, each co-owner must have the rights 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. Lender may not be a co-owner, sponsor, manager or lessee. 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 (determined as of the time the partition right is exercised) before exercising any right to partition.

G. <u>Sharing Proceeds and Liabilities upon Sale of Property</u>. 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.

H. <u>Proportionate Sharing of Debt.</u> The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

I. <u>Options.</u> A co-owner may issue an option to purchase the co-owner's undivided interest (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 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 an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

J. <u>No Business Activities.</u> The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374 (1975-2 C.B. 261). Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in section 511(a)(2) from qualifying as rent under section 512(b)(3)(A) and the 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. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners’ activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

K. 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 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 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to 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 modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) 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.

L. Leasing Agreements. All leasing arrangements 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). See section 856(d)(2)(A) and the regulations thereunder. 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.

M. 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.

N. Payments to Sponsor. Except as otherwise provided in this revenue procedure, 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.

VI. Analysis

A. Tenancy in Common Ownership. Major financings may require that title be held in a bankruptcy remote entity (BRE) such as a state law grantor trust, which would be an entity for federal income tax purposes.

B. Number of Co-Owners. Some feared this number would be lower and some think it is too low. It is probably more than adequate for most deals.

C. No Treatment of Co-Ownership as an Entity. One caution here would be if partners distributed property to its members so that they could momentarily own the property as tenants in common, only to then sell the property as part of an intended 1031 exchange. In *Mason v. Commissioner*, 55 T.C.M. (CCH) 1134 (1988), the Tax Court addressed the issue directly, holding that former partners who exchanged real property interests immediately following a distribution of the property from a partnership exchanged interests in the underlying property, not partnership interests. Because courts have respected the form of ownership immediately following a distribution of property, the IRS's blanket disregard of such arrangements is inappropriate.

D. Co-Ownership Agreement. Co-owners may enter into a limited co-ownership agreement satisfying the following conditions:

   1. It may run with the land. – *Transferees to be bound by the co-ownership agreement.*

   2. Right to Partition - A significant benefit to the RevProc is the method for dealing with the challenge of the co-tenant's right to partition. Because this is such a fundamental common law element, removing or restricting this right too significantly would seem to undermine any TIC argument. But by forcing

the co-tenant to offer its interest for sale at fair market value to its co-tenants before exercising its right to partition.

3. It may require certain actions of the co-owners to be approved by a vote of co-owners holding more than 50% of the undivided interests.

E. Voting. Procedure sanctions voting by majority interest in all but certain instances (or their modification) : (i) hiring of any manager, (ii) sale or other disposition of the Property, (iii) any leases of a portion or all of the Property, or (iv) the creation or modification of a blanket lien.

F. Restrictions on Alienation. In a PLR issued to a two owner TIC, the IRS allowed a buy/sell style terms, and the requirement of approval of a co-owner before the other co-owner could encumber an interest. Further, 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.

G. Sharing Proceeds and Liabilities upon Sale of Property.

H. Proportionate Sharing of Debt.

I. Options. Similar to Restrictions on alienation. In PLR 200513010, IRS approved a co-tenant obligation to offer for sale to other co-tenants for FMV when (i) co-tenant dissented when unanimous consent was required and more than 50% voted in favor (e.g. sell the entire property, incur indebtedness, renew management contract, amend lease, etc.)

J. No Business Activities.

K. Management and Brokerage Agreements. Renewal periods may be governed by an evergreen clause, so that it renews annually unless terminated pursuant to its terms. PLR 200513010[1]**.** I

L. Leasing Agreements.

M. Loan Agreements.

N. Payments to Sponsor.

[1] The term of the management agreement will be 12 months (12-month term), renewable annually under the following procedures. At least days, but no more than [redacted data] days, prior to the end of each 12-month term (renewal period), the Management Company will provide Co-owners with a notice of renewal of the management agreement. Such notice will provide each Co-owner the opportunity to object to specific provisions of the agreement as well as to terminate the agreement as set forth in the notice of renewal. The notice of renewal will be sent to each Co- owner at the address provided by the Co-owner for this purpose using certified mail, return receipt requested (postage prepaid), or by using a nationally recognized courier service that guarantees overnight delivery, either alternative being an "approved notice method". The notice of renewal will set forth the following procedures and will include the names and addresses of each Co-owner.

Any Co-owner (objecting Co-owner) may cause the management agreement not to be renewed by providing a notice of termination to the Manager and to the other Co-owners by the approved notice method at least days prior to the end of the renewal period, provided the objecting Co- owner sets forth a substitute manager and the material terms under which the substitute manager will be engaged. The engagement of the substitute manager shall be subject to the approval of each of the other Co-owners.
Each Co-owner shall have days after the date of the notice of termination to provide written notice by the approved notice method to the Objecting Co-owner and the other Co-owners that the substitute manager is unacceptable and the reasons therefore.
If any Co-owner provides notice that the substitute manager is unacceptable, the following procedures apply.

1. The other non-objecting Co-owners may exercise the option to acquire the ownership interest(s) of the objecting Co-owner at fair market value.
2. If the other non-objecting Co-owners do not exercise their option to acquire the ownership interest of the objecting Co-owner, the objecting Co-owner, within days of being notified that the alternative management arrangements are not acceptable, on its own behalf and at its own expense, may retain the substitute management company. As a result, the objecting Co-owner will cease to be a party to the original management agreement and will no longer be responsible to Management Company for any fees or associated expenses. However, the objecting Co-owner will remain subject to the terms of the co-tenancy agreement. In this event the objecting Co- owner must provide written notice to Management Company and the other non-objecting Co- owners. In such case, the managers must consult on all actions; however, except in cases in which unanimous approval of all Co-owners is required, the manager representing the controlling Co-owners shall be able to act without the approval of the co-manager.
3. The Co-owners who did not provide a notice of termination will be treated as consenting to a renewal of the Management Agreement.

In addition, a Co-owner may object to specific provisions in the Management Agreement by providing a notice of objection to the Management Company and to the other Co-owners within days of the receipt of the notice of renewal. The Management Company and the Co-owner(s) may negotiate to modify specific terms of the Management Agreement. If no agreement is reached, a Co-owner may provide a notice of termination as described above on or before the day before the end of the renewal period. Subsequently, the procedures described above will apply.