

SECTION 1031 EXCHANGES AND UNDIVIDED FRACTIONAL INTERESTS: THE HOTTEST NEW PAIRING ON THE TAX MENU

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**Materials Prepared for California Society of Tax Consultants
October 6, 2004 Program Outline**

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Program Outline

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I. Introduction to Section 1031 and UFI

A. A Section 1031 or like-kind exchange is a way to postpone the recognition (taxation) of gain essentially by shifting the basis of old property to new property. The transaction must be properly structured as an exchange (usually involving a qualified intermediary). Under Section 1031 the owner cannot simply sell the old property, receive the proceeds, buy new property and roll over the gain. A sale and reinvestment is taxable and is marked by the owner's actual or constructive receipt of cash. In a deferred exchange (also know as a "delayed" or "forward" exchange), the owner has 45 days to identify and 180 days to receive new property after transferring the old property. The proceeds are usually held by a qualified intermediary until the new property is acquired.

B. Under Section 1031, the owner's equity is fully reinvested in replacement property without having to pay current income tax. The equity earns a return, and there is no interest charge on the tax deferral. Some owners are "chronic exchangers" of investment property and receive cash through cash flow and refinancing proceeds and not taxable sales. In this way, Section 1031 exchanges can be a powerful wealth-building tool.

C. Section 1031 exchanges are also an estate planning tool. Gain recognition may be permanently avoided when the owner dies. The heirs receive a basis in the property equal to fair market value at death, eliminating the tax gain. Bequests are not subject to income tax but the estate may be subject to estate tax if the taxable estate exceeds the exempt amount (\$1.5 million for 2004).

D. Section 1031 applies only to business or investment property, not the owner's current personal residence. Section 121 provides a limited exclusion of gain for property owned and used as the taxpayer's principal residence for 2 of the last 5 years (\$250,000 for an individual and \$500,000 for certain married persons filing jointly). Property may be converted from investment property to a personal residence (or vice versa) before or after

an exchange. However, there are unanswered questions and legislative and administrative proposals relating to such conversions.

E. Undivided fractional interests (UFIs) also known as tenancy in common (TIC) interests have become a favored and highly promoted form of ownership because of the ability to exchange into and out of such interests under Section 1031. See, e.g., Rev. Rul. 73-476; Rev. Rul. 79-44; PLRs 200019014-200019019 (allowing the exchange of TIC interests under Section 1031). UFI ownership can be very attractive when faced with the time pressures of a delayed exchange (45 days to identify and 180 days to receive new property). Many TIC properties are sponsored and come prepackaged with financing, due diligence, title commitments and other necessary items in place.

F. Stock, partnership and LLC interests, and other interests in entities (including interests in a REIT) cannot be exchanged tax-free under Section 1031. Section 1031(a)(2) specifically excludes interests in corporations and partnerships (as well as notes, securities and dealer property) from nonrecognition treatment under Section 1031.

G. TIC ownership offers many of the same legal and investment advantages as group ownership through a separate entity, including centralized management, pooling of capital, leverage, monthly cash flow, low minimum equity requirements, quality properties and diversification. Limited liability can also be obtained by owning the TIC interest through an entity that is recognized for legal purposes but disregarded for tax purposes, such as a single-member LLC.

H. Section 1031 and UFIs have become a hot new pairing on the tax menu because owners can exchange tax-free into and out of UFIs (unlike interests in corporations, partnerships and LLCs) while enjoying the legal and investment benefits of group ownership. However, an investment in a TIC property should be a sound and suitable investment standing alone and free of income tax considerations. A fine wine should not be paired with substandard food. But if the cake itself is good, the “frosting” of the tax benefits of Section 1031 may make it irresistible. Bon Appétit!

II. What is a UFI?

A. A UFI is a direct co-ownership interest in property. The transfer of a UFI conveys an interest in the property itself, not merely an intangible interest in an entity that owns the property. A UFI is separately alienable (capable of being transferred or encumbered) and descendible (capable of being passed by inheritance). Under state law, the owner of a UFI typically has the right to partition and force a sale of the entire property. UFIs need not be equal (e.g., the UFIs could be 65%, 30% and 5% co-ownership interests). A direct co-ownership interest in property may be exchanged just like a 100% fee interest under Section 1031.

B. A joint tenancy interest is a special and limited kind of UFI. A joint tenancy interest must be equal (e.g., three joint tenants each own an equal 1/3 interest) and passes by right

of survivorship upon death to the surviving joint tenants. Owners of UFIs, especially if they are unrelated, usually want varying percentages of ownership and do not want their interests to pass upon death by right of survivorship to the surviving owners.

C. An interest in a corporation, partnership, LLC or other entity is not a direct interest in the underlying property owned by the entity. Such interests may not be transferred or received tax-free in a Section 1031 exchange. The sale, exchange or other disposition of an interest in a separate entity is generally taxable under the rules of Section 1001. However, contributions of property to and distributions of property from a separate entity may not be taxable. See, e.g., Sections 351 (tax-free incorporations), 355 (tax-free corporate spin-offs), 721 (tax-free contributions to a partnership), and 731 (tax-free distributions from a partnership).

D. A legal co-ownership may be treated as a tax partnership if the co-owners engage in sufficient business activity, file partnership returns or otherwise hold themselves out as a partnership. This “trap for the unwary” greatly complicates the issue of exchanges into or out of such interests under Section 1031. An owner will be unexpectedly taxed if, in an otherwise qualified exchange, the owner transfers or receives a legal co-ownership interest that is treated as an interest in a tax partnership. Part III of the outline analyzes the very thorny issue of a tax partnership versus a valid TIC arrangement.

E. The IRS provided advance ruling guidelines for certain sponsored TIC programs in Rev. Proc. 2002-22, 2002-14 IRB 733. If the TIC program obtains a ruling, owners will be assured that the interest qualifies as a valid co-ownership interest for Section 1031 and other tax purposes. The requirements for an advance ruling are detailed in Part IV of the outline. Other advantages, disadvantages and issues relating to sponsored TIC programs are discussed in Part V of the outline.

F. A fundamental distinction between a co-ownership interest and an interest in a separate entity is the ability of co-owners to partition the property. Practitioners often confuse the tax treatment of a partition of one property (not a “realization event” for tax purposes) with the sale or exchange of interests in different parcels (a “realization event”). The IRS recently issued further guidance on the issue of non-taxable partitions. This is examined in Part VI of the outline.

G. If a tax partnership was created (even though legal co-ownership interests are owned), what can the owners do? The techniques involve “drop and swap” transactions (distributions out of a partnership, subsequently followed by separate exchanges by one or more of the co-owners/former partners) and “swap and drop” transactions (exchanges at the partnership level, subsequently followed by distributions of the new properties to the partners). These techniques are discussed in Part VII of the outline.

H. Section 1031 allows for the exchange of an interest in a partnership if a valid election out of all of Subchapter K (the partnership tax rules) is in effect. See Section 1031(a)(2) (flush language). The exchange of such an interest is treated as an exchange of an interest in the underlying assets of the partnership. However, it remains unclear when a

partnership can make a valid election out of Subchapter K under the Section 761 regulations. The IRS recently issued Notice 2004-53, 2004-33 IRB 209, requesting comments on whether, and under what circumstances, individuals who own property through state law entities, including a limited partnership or LLC, should be able to make an election out of Subchapter K. This issue is addressed in Part VIII of the outline.

III. Tax Partnership versus valid TIC Arrangement

A. Authorities. Reg. Section 301.7701-1(a)(2) provides that a joint undertaking or other contractual arrangement 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. “For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent” under this regulation. But “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.” This determination is made as a matter of federal tax law and does not depend on whether the arrangement is recognized as an entity under local law. If the arrangement creates a business entity with two or more members, the entity will be classified as a partnership or corporation. See also Reg. Section 1.761-1(a) broadly defining a tax partnership by reference to these regulations. An exchange into or out of an interest in such a tax entity does not qualify under Section 1031. Section 1031(a)(2) specifically excludes stock, securities and partnership interests from nonrecognition treatment under Section 1031.

1. Under common law, the central characteristic of a tenancy in common is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. 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 rents or profits from the property, to transfer the interest, and to demand a partition of the property. A tenant in common has the benefits of direct ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common.

2. Rev. Rul. 75-374, 1975-2 C.B. 261, held that a two-person co-ownership of an apartment building 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 concluded 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. Similarly, in Rev. Rul. 79-77, 1979-1 C.B. 448, the IRS held that a business entity was not formed where three individuals transferred ownership of a commercial building subject to a net lease to a trust with the three individuals as beneficiaries.

3. Certain cases specifically address sponsored UFI arrangements. Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among the co-owners, but also between the sponsor and the co-owners in determining whether the co-ownership gives rise to a partnership. In Bergford v. Commissioner, 12 F.3d 166 (9th Cir. 1993), seventy-eight investors purchased “co-ownership” interests in computer equipment that was subject to a 7-year net lease. The co-owners 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 co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. 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 a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager’s consent.

4. The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court’s decision were the limitations on the co-owners’ ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager’s effective participation in both profits (through the remarketing fee) and losses (through the advances). Bergford, 12 F.3d at 169-180. See also Bussing v. Commissioner, 88 T.C. 449 (1987), aff’d on reh’g, 89 T.C. 1050 (1987); Alhouse v. Commissioner, T.C. Memo 1991-652.

5. Under Reg. Sections 1.761-1(a) and 301.7701-1 through 301-7701-3, a federal tax partnership does not include mere co-ownership of property where the owners’ activities are limited to maintaining, repairing, and renting or leasing the property. However, “a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships.” Bergford, 12 F.3d at 169. Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. Bussing, 88 T.C. at 460. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement may be characterized as a partnership (or other business entity) for federal tax purposes. Bergford, 12 F.2d at 169. But these statements do not provide “bright line” tests and the dividing line between co-ownerships and partnerships remains unclear.

6. As a matter of federal tax law, and without an advance ruling from the IRS, no one can say with great assurance that a sponsored UFI arrangement is not a tax

partnership. The answer may depend upon the exact terms of the arrangement. Is there a trade, business, financial operation or venture? If so, who carries it on? Should the activities of the sponsor, manager or lessee be attributed to the holders of the UFIs? Are any "additional services" provided to tenants? Is there a sharing of profits and losses or other shared economic interest between the lessors and lessee or owners and manager? See, e.g., Bergford, supra; Bussing, supra; PLR 8330093; PLR 8046064. Simply because they are sponsored, should sponsored UFI arrangements be treated differently than traditional co-ownership of property that has long been recognized as not creating a separate entity for tax purposes? See Estate of Appleby v. Commissioner, 41 B.T.A. 18 (1940), affd 123 F.2d 700 (2d Cir. 1941); Gilford v. Commissioner, 210 F.2d 735 (2d Cir. 1953); Powell v. Commissioner, T.C. Memo 1967-32; McShaine v. Commissioner, 68 T.C. 154 (1977).

B. Allowable Services. Rev. Rul. 75-374, 1975-2 C.B. 261, limits the type of services that give rise to an active business and partnership status. Under this ruling, co-owners or their agent may provide "customary tenant services" in connection with the maintenance and repair of an apartment building, such as heat, air conditioning, hot and cold water, normal repairs, trash removal, unattended parking, and common area cleaning and maintenance. The ruling states that furnishing such customary services will not create an active business and render a co-ownership a partnership. Similarly, co-owners or their agent may collect rent and other payments from tenants, and pay taxes, insurance and normal operating expenses without creating a partnership. See also PLR 200019014 (2/10/00) (corporate general partner of six partnerships that will own apartment complexes as tenants in common will manager the apartment complexes but furnish only customary services to tenants). In PLR 200019014, the IRS ruled that a new partnership will not be formed as a result of the six partnerships owning the apartment complexes as tenants in common, and that the exchange of mobile home parks for TIC interests in the apartment complexes qualified under Section 1031.

However, Rev. Rul. 75-374 states that furnishing additional services, such as attendant parking, other utilities for a separate charge, restaurants, cabanas, recreational facilities, maid service and similar hotel-like services imply the active conduct of a business. In Rev. Rul. 75-374, an unrelated company provided additional services for which tenants paid a separate charge to the company. The company determined the time and manner of performing these services, paid the expenses, and kept all of the income from these services. None of the profits arising from additional services were divided between the co-owners. The ruling holds that the separate provision of additional services did not taint the co-ownership and create a partnership because the company alone furnished the services and kept the profits therefrom.

In a number of private letter rulings, the Service has followed Rev. Rul. 75-374 in respecting co-ownership arrangements that limit themselves to customary tenant services. See, e.g., PLRs 20019014, 8330093, 8048064, 8117040, 7832007, and 7826012. Co-owners may own rental property, including apartment and office buildings, without creating a tax partnership by following the arrangements described in the above rulings.

Co-owners or their agents must not furnish additional services to tenants or other persons. If additional services are to be furnished, they must be provided by an unrelated and independent operator who will be responsible for the services, pay the expenses and keep the income.

In most small rental properties, such additional services are usually not provided. Thus, co-ownership of such properties may not be reclassified as a tax partnership as long as Rev. Rul. 75-374 applies. However, Rev. Rul. 75-374 has limited facts. All management of the property was conducted by an unrelated company. Further, other facts may have caused the IRS to rule differently and find a tax partnership. It is unclear whether the result in Rev. Rul. 75-374 would be the same if the co-ownership pooled income and expenses in a common bank account, had a co-ownership agreement, had a common trade name, inadvertently filed a partnership return one year, or was a continuation of a prior enterprise operated as a corporation or state law partnership. See, e.g., TAM 199907029 (9/30/98) (tax partnership existed based on long-standing partnership agreement, partnership bank account and filing of partnership returns, despite holding title as tenants in common and providing only customary services to tenants of an apartment building); PLR 8413003 (11/30/83) (pooling of rents for benefit of homeowner's association created tax partnership); PLR 8002111 (co-ownership was tax partnership following liquidation of personal holding company due to agreement to jointly sell property and restrictions of the transfer of co-ownership interests).

C. Additional Services. The line separating customary and additional services to tenants is not clear. The provision of gas, electricity and unspecified other utilities for a separate charge was listed as an "additional service" in Rev. Rul. 75-374. Presumably, the problem may be avoided by having separate meters with tenants paying such utilities, or by including a standard utility charge in the basic rent and making adjustments thereto. However, utilities such as gas and electricity are usually and customarily provided by a lessor of an apartment building. Separate charges or reimbursements for such utilities, without other "additional services," should not render a co-ownership a partnership. On the other end of the spectrum, it is clear that services furnished in connection with a hotel or resort are additional services that create an active business. See, e.g., Reg. Sections 1.512(b)-1(c)(5) and 1.1402(a)-1(c)(1)(iii); Rev. Rul. 57-108, 1957-1, C.B. 273 (maid service, instruction in swimming, boating and fishing, delivering messages and mail, etc.) Additional services may also include laundry facilities, vending machines, special security, recreational facilities and similar services that are furnished primarily for the convenience and comfort of tenants. In other words, such services are unlikely to be "customary" services relating to the maintenance and repair of the property. See, e.g., G.C.M. 36251 (recreational facilities may be an additional service depending on facts); PLR 8117040 (laundry facilities "may constitute additional service").

The factors used to distinguish between customary and additional services include: (1) whether the service is furnished primarily for the personal convenience and comfort of tenants and their guests (additional service); (2) whether the service is usually and customarily rendered by a lesser of property (customary service); (3) whether the service

relates to the maintenance and repair of the property (customary service); (4) whether a service or a facility is an integral part of the property (customary service); (5) whether the activity itself constitutes a trade of business under other Code provisions (additional service); (6) whether the service or facility requires significant time, effort, personnel or capital (additional services); and (7) whether a separate charge is imposed or a profit is earned (additional service). If co-owners are in doubt about whether a service is customary or additional and they desire to avoid partnership status, such services either should not be provided to tenants or should be contracted out to an independent firm. If additional services are contracted out, the co-owners may be able to receive payments from the operator for the privilege of conducting business on the property that are not based on the operator's net profits. See PLR 8117040 (co-owners received a percentage of gross receipts from the operator of laundry facilities that were installed and maintained by the operator).

D. Improvements. Capital improvements made to a property, beyond deductible maintenance and repair expenses, may imply the active conduct of a business, depending on the nature, extent and purpose of the improvements. Under the rules above, such improvements may constitute an additional service to tenants or other persons that is not customarily performed by a lessor. In the case of new rental units, the construction itself may involve active conduct of a business. However, at least one case holds that improvements made merely to make a property more productive should not render a co-ownership a partnership for tax purposes. See Estate of Appleby, 14 B.T.A. 18 (1940), aff'd 123 F.2d 700 (2d Cir. 1941). In Estate of Appleby, a building on land was demolished to construct a garage at a cost of over \$143,000 (1917 dollars). The garage was constructed to pay taxes and produce income at the suggestion of two auto dealers who became the first tenants, and was later improved with an inside mezzanine floor at a cost of over \$8,000 (1925 dollars). The court stated that the co-owners did not "operate" the garage and "were merely the owners of the property, which was improved and rented primarily to defray the taxes."

E. Uncertain Case Law. A plethora of cases have addressed the question of whether a partnership exists in connection with jointly-owned real estate. The cases differ somewhat on the level of business activity necessary to create a tax partnership. The deciding factor in most of these cases is whether the parties intended to create a partnership, as evidenced by their agreement, actions, use of a common name, holding of title, partnership bank accounts, filing of partnership tax returns, level of business activity, manner of operation, pooling of income and expenses, degree of individual or joint control, and continuation of a business enterprise in another form. The courts find that if a co-ownership has operated like a partnership, it is a partnership. In these cases, the fact that title to property was taken as tenants in common is not determinative and "may be considered neutral evidence." McManus v. Commissioner, 583 F.2d 443, 447 (9th Cir. 1978).

1. The filing of Forms 1065, and the reporting of a partner's distributive share on his own tax return, may conclusively establish partnership status against claims by

a co-owner to the contrary. See McManus, *supra* at 447 (“A taxpayer is estopped from later denying the [partner] status he claimed on his tax returns”); PLR 8916034 (filing a partnership tax return and opening a partnership bank account evidenced an intent by co-owners to form a partnership, despite no significant services to tenants and prior co-ownership status). However, earlier cases have held that filing a partnership return is not determinative of partnership status. Needless to say, co-ownerships desiring to avoid partnership status should not file Form 1065, unless they are required to do so in order to make an election out of Subchapter K. See Madison Gas and Electric Company v. Commissioner, 72 T.C. 521, 558, *aff’d* 633 F.2d 512 (7th Cir. 1980) (the filing of a partnership return and election-out under Section 761(a) are not “admissions” of partnership status).

2. With the significant exception of Rev. Rul. 75-374 and some private letter rulings that followed it, the trend of the cases and rulings is to find a tax partnership in co-ownership cases upon a showing of minimal business activity and joint conduct. See, e.g., Cusick v. Commissioner, T.C.M. 1998-286; Estate of Aaron Levine v. Commissioner, 72 T.C. 780 (1979). See also Baker v. Commissioner, T.C. Memo 1997-442; Winkler v. Commissioner, T.C. Memo 1997-4; Marinos v. Commissioner, T.C. Memo 1989-492; Bergford, *supra*. Compare Gabriel v. Commissioner, T.C. Memo 1993-524; Lattin v. Commissioner, T.C. Memo 1995-233; Clifton v. Commissioner, T.C. Memo 1995-528.

3. The recent case of Cusick is a case of “man bites dog.” The IRS argued that the rental property was owned by co-owners, while the taxpayer claimed to be a partners in a tax partnership in order to deduct expenses that had accrued and were unpaid or paid by others. The court held that despite the lack of any formalities evidencing a partnership, the co-owners met the definition of a tax partnership because they were engaged in a business activity and shared profits and losses. At different times, each co-owner in Cusick managed a commercial property where office space was rented to a variety of month-to-month tenants. The management of the property “was difficult and required a significant amount of time.” The co-owners “not only maintained books and records and collected rent, but also performed maintenance tasks such as fixing backed-up toilets and assisting tenants who were locked out of their offices.” The court held that the “degree of business activity” exhibited by the co-owners in conducting their rental real estate activities caused the relationship to be characterized as a tax partnership.

4. Cases that have upheld co-ownership arrangements are older cases or usually involve property inherited by family members (persons who had co-ownership “thrust upon them”). Moreover, the courts have literally applied a very broad statute, and found co-owners to be partners if they or their agents carry on the requisite “degree of business activities,” regardless of whether or not they intended to form a partnership or share in a joint cash profit. In Madison Gas and

Electric Company, *supra*, 633 F.2d at 514-15, the court stated: “At bottom MGE’s position is that it is not sound policy to treat the [co-ownership] entity here as a partnership. But we are not free to rewrite th tax laws, whatever the merits of MGE’s position.”

5. As one commentator stated in 1961, “a twilight zone separates co-ownership of property from joint ventures or partnerships. The boundaries in this area were reasonably well-established prior to the 1954 Code, but the provisions of the Section 761(a) election seem to have moved the partnership line well over into the area that was previously mere co-ownership.” Cruikshank, “Are Co-owners Partners? Code Raises Doubts; Electing Exclusion Urged,” 15 Journal of Taxation 166 (September 1961). See also Note, “The Fine Line Between Partnership and Co-ownership.” Utah Law Review 495 (Summer 1975). Given the enactment of Section 1031(a)(2)(D), the issue of tax status as a co-ownership or a partnership has been revitalized, and the stakes of the outcome have been raised. In the absence of a ruling under Rev. Proc. 2002-22 or a valid Section 761(a) election, nonrecognition treatment under Section 1031 will depend on uncertain case law determining whether or not a co-ownership is a partnership for tax purposes. The burden of proof will be on co-owners of rental real estate to prove that they are not partners. See Rothenberg v. Commissioner, 48 T.C. 369 (1967).

F. Trap for the Unwary. The inadvertent creation of a tax partnership by a co-ownership remains one huge trap for the unwary under Section 1031, and the Service is well aware of it. See, e.g., TAM 199907029 (9/30/98) (co-ownership was tax partnership and had to exchange as a partnership); FSA 199951004 (9/3/99) (substance of transaction was exchange of partnership interest); PLR 9818003 (12/24/97) (replacement properties conveyed directly to partners in liquidation of their interests disqualified partnership’s exchange); PLR 9741017 (7/10/97) (exchange of interests in rental properties did not qualify under Section 1031 because the interests were deemed to be interests in a tax partnership); PLR 9645005 (7/32/96) (partner cannot individually defer gain on property distributed one day before closing of condemnation sale; replacement property had to be purchased by joint venture under Section 1033). Compare PLR 9022037 (3/5/90) (partnership conveyed property to partners as tenants in common, 18 days later partners sold property under threat of condemnation, and partners individually were eligible to purchase replacement property under Section 1033 since they were tenants in common at the time of the sale). See generally, Phillips & Rocca, “Exchanges By ‘Partners’ under Section 1031” (5th Annual NRDC Conference) (May 4, 1992).

IV. IRS Revenue Procedure 2002-22

A. Conditions for Ruling. Section 5 of the revenue procedure outlines the information required as part of a ruling request. The request must contain a complete statement of all facts relating to the UFI arrangements, including those relating to promoting, financing,

and managing the property. The information must include all promotional documents relating to the sale of the UFI, and all agreements relating to the property, including lending, co-ownership, lease, purchase and sale, management, brokerage, indemnity, guaranty and option agreements. All items of information and the conditions set forth in Section 6 must be accounted for. When multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt is secured by all of the parcels, the IRS will generally treat all of the parcels as a single property. In such a case, the IRS will generally not consider a ruling request unless (1) each co-owner's percentage interest is the same in all parcels, (2) each co-owner's interest cannot be separated and traded independently, and (3) the parcels are properly viewed a single business unit.

B. Section 6 of the revenue procedure details 15 conditions for obtaining a favorable ruling, and states that "ordinarily" the IRS will not consider a ruling request unless each one of these 15 conditions is satisfied.

1. TIC Ownership. Each of the co-owners must hold title, either directly or indirectly or through a disregarded entity, as a tenant in common under local law. Title may not be held by an entity recognized under local law (other than a disregarded entity). This title requirement also applies for purposes of electing out of Subchapter K as an "investing partnership." See Reg. Section 1.761-2(a)(2) (investment property must be "owned as co-owners"). So far, so good. Almost all UFI arrangements, by definition, should meet this requirement.

2. Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons (as defined in Section 7701(a)(1)). Under Section 7701(a)(1), a person includes an individual, trust, estate, partnership, association, company or corporation. A husband and wife are treated as a single person and all heirs are treated as a single person. This requirement, on its face, might be circumvented by using an entity to consolidate an unlimited number of cash purchasers as one co-owner. Up to 34 exchangers could then directly own the remaining interests in the property. But for purposes of a ruling request, the IRS may decide to "look through" the entity in determining the number of persons.

3. No Treatment as Entity. The co-ownership may not file a partnership or corporate tax return. It is unclear whether it may do so even for purposes of electing out of Subchapter K but that may be superfluous if the co-ownership is seeking a ruling. The co-ownership may not 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 business entity. A common bank account is permitted but the co-ownership should be careful about how it titles the account. The IRS generally will not issue a ruling if the co-owners held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership. This rules out many situations in which a ruling would be the most

useful, including liquidation of a tax partnership and holding property as co-owners before an exchange. Apparently, the IRS does not want the serious problem of attempting to terminate a tax partnership and become a co-ownership to muddy the waters.

4. Limited Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that runs with the land. The agreement may provide that a co-owner must offer the interest for sale to the other owners, the sponsor or the lessee at fair market value before exercising any right to partition. The agreement may provide voting rights as described in Section 6.05. These are the only two examples given of what may be included in a co-ownership agreement. Presumably, the agreement may contain other provisions that are not in conflict with any of the other conditions of Section 6.

5. Voting. Each co-owner must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases, or the creation or modification of a blanket lien, including the negotiation, renegotiation, extension, or renewal of such agreements or re-leasing of the property (“major actions”). These major actions must be decided by unanimous approval of the co-owners. For all other actions, the co-owners may agree to be bound by the vote of a majority-in-interest. A co-owner who has consented to an action may provide a power of attorney to execute documents for that action but may not give a global power of attorney. The requirement of unanimous approval for major actions may create practical problems and allows a small dissenting owner to block and stalemate the co-ownership. Section 6.10 allows a co-owner to issue an option to purchase his interest (call option). If minority owners dissent, could a co-ownership agreement trigger the call option in the case of deadlock? Would such a provision be consistent with each co-owner retaining the right to approve major actions, or would it make such rights illusory? Compare PLR 8117040 (1/27/81) (no tax partnership where co-owners could approve management decisions by majority vote, but any decision to sell or mortgage the property required approval of 75% of the owners in interest and would be binding on all co-owners); PLR 8048064 (decisions made by co-owners of a majority-in-interest); PLR 8002011 (10/22/79) (co-ownership was tax partnership where co-owners agreed to jointly sell the property by majority vote, could not transfer their interest to third parties with the prior written consent of all other owners and waived right to partition during term of agreement).

6. Alienation. In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner’s interest in the property without the agreement or approval of any person. Restrictions are not prohibited if they are required by a third-party lender (as provided in Section 6.14) and are consistent with customary commercial lending practices. Further, the other co-owners, the sponsor, or the lessee may have a right of first offer to purchase the interest with respect to any co-owner’s exercise of the right to transfer his interest, and a co-

owner may agree to offer his interest for sale before exercising any right to partition as provided above. These allowable restrictions may be sufficient to address most concerns over the right to transfer, partition, or encumber a co-owner's interest. If a judgment or other lien attached to a co-owner's interest and the creditor attempted to foreclose on the property, the right of first offer may be triggered with respect to the co-owner's or his creditor's attempt to transfer the interest. Compare PLR 8048064 (grant of right of first refusal to other co-owners and limited waiver of right of partition were allowed); PLR 7832007 (similar to PLR 8048064 and right of first refusal granted to manager if property is sold).

7. Sharing Net Proceeds. 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 is straightforward and distinguishes a co-ownership from, for example, a limited partnership where the general partner may decide to reinvest the proceeds rather than distribute them to the partners.

8. Proportionate Sharing of Profits and Losses. Each co-owner must share in all revenues and costs in proportion to his undivided interest. The other co-owners, the sponsor and the manager may not advance funds to a co-owner to meet expenses unless the advance is recourse to the co-owner and not for a period exceeding 31 days. See Bergford, supra (manager's advances to co-owners was a form of sharing in losses).

9. Proportionate Sharing of Debts. The co-owners must share in any debt secured by a blanket lien in proportion to their undivided interests. Compare PLR 20019014 (2/10/00) (allowing disproportionate sharing of debt among co-owners in accordance with the terms of their debt-sharing agreement).

10. Options. A co-owner may issue a call option provided that the exercise price reflects the fair market value of the property at the time the option is exercised (without any discount for a fractional interest). A co-owner may not acquire an option to sell the co-owner's interest (put option) to the sponsor, the lessee, another co-owner, the lender, or any person related to them. The rationale behind the prohibition of put options is not entirely clear since such an option enhances the free alienability of the interest, a distinguishing feature of TIC ownership. The IRS may have been concerned that put options make the interests akin to marketable securities.

11. No Business Activities. The co-owner's activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities) as described in Rev. Rul. 75-374, supra. Activities will be treated as customary activities if they would not prevent an amount received by a tax-exempt organization from qualifying as rent under Section 512 (b)(3)(A) and the regulations thereunder. All activities of the co-owners, their agents and any persons related to the co-owners are taken into

account, whether or not the activities are performed in their capacities as co-owners (e.g., all activities of a sponsor or lessee are taken into account if the sponsor or lessee is a co-owner). However, activities of a co-owner or related person are not taken into account if the co-owner owns an interest in the property for less than 6 months.

The rents that are excluded from unrelated business income under Section 512(b)(3)(A) and Reg. Section 1.512(b)-1(c) are all rents from real property and all rents from personal property leased with real property if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease. Rents attributable to personal property generally are not an incidental amount of the total rents if such rents exceed 10 percent of the total rents from all the property leased. However, such rent is not excluded if either (a) more than 50 percent of the total rents are attributable to personal property, or (b) the determination of the amount of such rents depends 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 the gross receipts or sales. The rules contained in paragraph (b)(3) and (6) (other than paragraph (b)(6)(ii)) of Reg. Section 1.856.4 apply for this purpose. Under Reg. Section 1.856(b)(6)(i), if real property is leased to a tenant under terms other than solely on a fixed sum rental (for example, a percentage of the tenant's gross receipts), and the tenant subleases all or a part of such property under an agreement which provides for a rental based in whole or in part on the income or profits of the sublessee, the entire amount of the rent received from the prime tenant with respect to such property is disqualified as "rents from real property."

Further, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally rent from real property. See Reg. Section 1.512(b)-1(c)(5).

12. Management and Brokerage Accounts. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually. The manager may be the sponsor or a co-owner (or any

person related to the sponsor or a co-owner), but 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. The manager may negotiate modifications of the terms of any lease or any indebtedness encumbering the property, subject to the unanimous approval of the co-owners as provided in Section 6.05. 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.

13. Leasing Agreements. All leasing arrangements must be bona fide 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). The rules for REITs under Section 856(d)(2)(A) and the regulations there under apply for this purpose. 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. Loan Agreements. The lender with respect to any debt that encumbers the property or that is 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. A related person is defined by reference to Sections 267(b) and 707(b)(1) as if the co-ownership were a partnership and each co-owner was a partner.

15. 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.

C. Recent Private Letter Ruling. In PLR 200327003, the IRS ruled that an undivided fractional interest (UFI) in rental real property will not be an interest in a partnership or

other business entity and the UFI will qualify as eligible replacement property under Section 1031. The sponsor of the UFI program received a favorable ruling under Rev. Proc. 2002-22, even though it could not comply with all of the information requirements of the revenue procedure, the management agreement provided for automatic annual renewals (absent written notice of termination by any co-owner), and the sponsor would own some interests in the property and the sales of the interests may take 18 months or longer to complete. PLR 200327003 indicates that the IRS may take a practical and flexible approach in granting rulings under Rev. Proc. 2002-22 as long as there is substantial compliance with the substantive requirements of the revenue procedure.

D. Interest in DST. The IRS recently ruled that a beneficial interest in a Delaware statutory trust (DST) may be considered an interest in the real property held by the DST and therefore eligible as relinquished property or replacement property in an exchange. In Revenue Ruling 2004-86, the DST held real property, and multiple persons held beneficial interests in the DST. The trustee's duties were limited to the collection and distribution of income to the beneficial owners. The beneficial interests in the DST represented interests in a grantor trust and thus the beneficial owners were considered to own undivided fractional interests in the real property for federal tax and Section 1031 purposes. The trustee could not exchange the property for other property, purchase assets other than short-term investment assets, or accept additional contributions of assets, renegotiate the terms of the debt used to acquire the property, renegotiate the lease with the tenant of the property or enter into new leases, except in the case of bankruptcy. Further, the trustee could make only minor nonstructural modifications to the property. If the trustee had any of these additional powers, then the ruling holds that the DST would be a business entity classified as a partnership or corporation and the beneficial interests would not be valid relinquished property or replacement property in an exchange.

E. Conclusion. Most of the conditions set forth in Section 6 of the revenue procedure are not surprising and are consistent with prior authorities addressing the co-ownership/partnership issue. Sponsored UFI arrangements that are "vanilla programs" should be able to meet these conditions. For example, if the co-owners enter into a net lease of their property to a third party lessee, who in turn re-leases the property to tenants, the UFI arrangement should satisfy the conditions for a ruling provided that (1) the number of co-owners does not exceed 35 persons; (2) the lessee is not the taxpayer's agent, a co-owner or a person related to a co-owner (so that the activities of the lessee are not attributed to the co-owners); (3) the lease meets the requirements of Section 6 and there is no sharing of profits and losses or other "shared economic interest" between the co-owners and the lessee; and (4) a sponsor's compensation does not exceed fair market value or depend, in whole or in part, on the income or profits of any person in the property. In these arrangements, the co-owners may not even enter into any type of co-ownership or management agreement involving the property, although limited agreements are allowed under the revenue procedure. Instead, the rights of the co-owners concerning the property are set forth in the lease with the lessee. These arrangements are the most likely to qualify as "RETICs" (or ruling-eligible tenancy-in-common interests).

These arrangements may be contrasted with situations in which the co-owners enter into both a co-ownership agreement and hire a manager to actively manage the property on their behalf. Even if the property generates only rental income, there is a significant risk that such an arrangement would be treated as a tax partnership depending on the activities of the manager (which will be attributed to the co-owners) and whether any additional services are provided to tenants. Similarly, many sponsored UFI arrangements that provide for enhanced returns to sponsors, including any type of cash flow or equity participation, will not be eligible to obtain a ruling under Section 6.15 of the revenue procedure.

Is compliance with all of the requirements in Rev. Proc. 2002-22, 2002-14 IRB 733, required for a tenancy-in-common interest to be treated as an interest in real estate (and not as an interest in a partnership)? If not, which requirements are the most important ones? The most important elements are (1) not holding title in a legal entity, although title to a TIC interest may be held in a disregarded entity, such as a grantor trust or single-member LLC; (2) avoiding the appearance of a partnership; (3) complying with the approval rights of Section 6.05 of the revenue procedure; (4) limited restrictions on alienation; and (5) proportionate distributions and sharing. Rev. Proc. 2002-22 provides a set of rules that are practical in most situations. Most sponsors and co-owners should be able to substantially comply with these rules.

Rev. Proc. 2002-22 also has implications for traditional co-ownerships that do not involve any sponsors. Traditional co-ownerships of rental real property may also request rulings under the revenue procedure. The requests would simply state that there are no promotional documents and there is no sponsor. Even if traditional co-ownerships desire to avoid the expense of a ruling request, they can use the conditions set forth in Section 6 (most of which are consistent with prior authorities) to avoid reclassification as a partnership. While the revenue procedure states that these conditions “are not intended to be substantive rules and are not to be used for audit purposes,” an arrangement that satisfies these conditions (and thus is “ruling eligible”) is very unlikely to be recharacterized by the IRS as a tax partnership. At least in this respect, the conditions in the revenue procedure are like having a pink elephant in the room that everyone sees but is told to ignore.

V. Sponsored TIC Programs

A. The advantages of TIC programs cited by sponsors include the following:

1. Fractional ownership allows an investor to diversify into more than one property and to participate in potentially larger, institutional quality properties. Thus, small investors in one area of the country may participate in large industrial, commercial, and residential property investments all around the country with professional management.

2. TIC investments provide simplicity by eliminating active property management headaches. Individuals who are tired of the day-to-day burdens of being a landlord or who own land and would like an income-producing property may appreciate the benefits of a TIC investment. A TIC program may provide a "coupon clipper" or "mailbox management" investment that can save time and money.
3. Cash flow is generally paid monthly and is tax-sheltered via depreciation deductions. Owners also share in the appreciation of the property when sold.
4. Minimum equity requirements may be as low as \$50,000 and allow the owner to invest in high quality, institutional grade properties. Otherwise, it may be prohibitive to acquire property with a billion-dollar credit-worthy tenant guaranteeing a long-term lease. These low minimums also allow an owner to investments in different locations, with various property types, tenants, industries, etc.
5. National real estate companies structure these TIC programs. They acquire (identify and locate, evaluate, arrange financing, etc.), manage (maintain, lease, collect rent, service mortgage), and sell the TIC properties. They have a vested interest in the performance of the property. These companies may have strong track records extensive experience in all sectors, types, and locations of real estate.
6. TICs may enable the owner to replace the required debt on the exchange. Accredited investors assume non-recourse (no personal guarantee) financing existing on the property. Owners can invest in properties that have no debt or in ones with very high leverage.
7. TICs may provide the flexibility to avoid the taxable boot if other real estate doesn't allow the owner to meet the full debt and equity requirements.
8. A ready inventory of TIC properties allows individuals to easily identify properties within the 45-day identification period, acquire the property within the 180 days, or have a "back-up" property in case their preferred real estate falls through.

B. The following is a laundry list of some of the items that each party to a TIC transaction should consider.

1. Sponsor. Does the transaction satisfy all provisions of Revenue Procedure 2002-22 and if not which of the requirements does the transaction fail? Further, is the sponsor interested in obtaining a private letter ruling?
2. Lender's requirements. Often the structure and the leverage ratios are dictated by lenders and underwriting criteria. Typically, most TIC deals have lower

leverage ratios than most real estate transactions. Further, lenders often require that the sponsor either guarantee all the non-recourse carve-outs or guarantee the performance of property managers or other affiliates. All parties should consider how non-recourse carve-outs are treated in the loan documents.

3. Master Lease vs. straight TIC structure. The sponsor must consider whether or not they will serve as the master tenant in the transaction. A master lease structure allows the sponsor to participate in the upside appreciation of the property but requires a level of financial commitment in the event that the property fails to perform.

4. Potential Mark Ups. Typically the sponsor has to purchase the property at one price, increase it by the sponsor's expenses ("load") and sell it at a price that will be supported by an appraisal that can be used to finance the property. This generally limits the sponsor's ability to mark up the property when being syndicated.

5. Buyers. Most TIC transactions are designed for accredited investors only.

6. Issues for the Investors.

a) Satisfaction of Revenue Procedure 2002-22.

b) Legal Opinion. What is the standard that is applied and who does the opinion run to?

c) Load and leverage ratios.

d) Reputation of the sponsor and the major tenants.

e) Reserves. Are there any?

f) Exit Strategies. When will the property be sold? When will the debt be due? Is there any secondary market for the interest?

g) Non-recourse Carve-Outs and Guarantees. What obligations are either non-recourse to the investors or subject to a guarantee? Common examples include bankruptcies with other tenants, death, environmental problems, waste, fraud and prohibited transfers.

h) Does the investor understand the legal and financial structure of the deal?

i) Master lease vs. straight tenancy in common.

j) What is the structure of the debt? Is there an amortizing loan balance and a balloon payment? Is the interest rate fixed or variable?

k) Diversification. Is the investor diversified in the type of property being held, geographical location and other investments?

C. Links to Sponsored TIC Programs

www.netleasecapital.com
www.omni1031.com
www.1031america.com
www.1031ex.com
www.for1031.com
www.1031ticinvest.com
www.tic-agreements.com
www.1031tax.com
www.ticinternational.com
www.legacynnn.com
www.safeharborproperties.com
www.1031street.com
www.1031nnn.com
www.1031exc.com/1031tic.htm

VI. **Partition of Jointly-Owned Property Is Not an “Exchange.”**

A. In PLRs 200328034 and 200303023, the IRS ruled that a partition by tenant-in-common owners of one contiguous tract of property is not an exchange or other taxable disposition. Thus, the owners will not “realize” any gain or loss under Section 1001 as a result of the partition.

1. The jointly-owned property was owned as tenants-in-common by A and B, C, and T. A and B are the parents of C, and T is a trust for the benefit of D, another child of A and B. A and B, as joint tenants, own an undivided fee interest in three-sixths of the jointly-owned property and a life estate for the life of the survivor of A and B in one-sixth of the jointly-owned property. C owns an undivided fee interest in two-sixths of the jointly-owned property. T owns a remainder interest in the one-sixth interest in which A and B own a life estate. A and B hold a mortgage on a portion of the property. The obligors on the mortgage are C and another child of A and B who formerly owned an interest in the property.

2. The one contiguous property will be partitioned into four separate parcels of property that will not be owned jointly by A and B, C, and T. Rather, the four parcels will be owned separately as follows: (1) A and B will own one parcel as joint tenants in fee simple; (2) A and B will also own a life estate for the life of the survivor in a second parcel; (3) T will own the remainder interest in the parcel in which A and B own a life estate; and (4) C will own the third and fourth parcels in fee simple. The taxpayers represented that each parcel of property will be approximately equal in value to the value of the taxpayers' respective undivided interests in the jointly-owned property immediately prior to the partition. Further, none of the taxpayers will benefit disproportionately as a result of the partition, and no gift will be made or received as a result of the partition. Finally, no interest in the jointly-owned property that is subject to a mortgage will be transferred or assumed by any of the taxpayers as a result of the partition. The mortgage obligors will remain indebted to A and B in the same amounts.

3. The IRS began its analysis with Reg. Section 1.1001-1(a). This regulation provides generally that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained (a "realization event"). The IRS stated that, for purposes of Section 1001, in an "exchange" of property, each party to the exchange gives up a property interest in return for a "new or additional" property interest. Such an exchange of property is a realization event under Section 1001(a). In a partition, however, the IRS held that the parties do not acquire a "new or additional" property interest. The IRS cited a case under applicable state law.

4. Thus, the IRS ruled that the partition of jointly-owned property is not a sale, exchange or other realization event, but merely the severance of joint ownership. The IRS relied on Rev. Rul. 56-437, 1956-2 C.B. 507, which holds that the conversion of a joint tenancy in corporate stock into a tenancy in common for the purpose of eliminating the survivorship feature is not a realization event. Similarly, the severance of a joint tenancy in stock, pursuant to an action under state law to compel partition, and the issuance of two separate stock certificates in the names of each joint tenant, is a nontaxable transaction. Rev. Rul. 56-437 concludes that in both cases there was no sale or exchange, and the taxpayers neither realized a taxable gain nor sustained a deductible loss.

B. In the above rulings, the IRS distinguished Rev. Rul. 73-476, 1973-2 C.B. 301. Rev. Rul. 73-476 holds that if three unrelated tenants-in-common who owned undivided interests in three separate parcels transfer their interests so that each party becomes the sole owner of one of the parcels, an exchange occurs so that gain or loss is realized. Rev. Rul. 79-44, 1979-2 C.B. 265, reaches the same conclusion on similar facts. In both these rulings, the IRS determined that an exchange of a "new or additional" property interest occurred but Section 1031 applied to avoid recognition of part or all of the realized gain.

In the above PLRs, the jointly-owned property was simply partitioned, and no exchange of interests in separate parcels occurred. The IRS concluded that the result in Rev. Rul. 56-437, rather than in Rev. Rul. 73-476, applies, and no gain or loss is realized under Section 1001 as a result of the partition. The IRS reached the same result that the partition of jointly-owned property is a mere realignment of interests and not an “exchange” in two other recent rulings. See PLRs 200411022 and 200411023. The key fact is that the owners begin with one contiguous property rather than with interests in separate parcels as in Rev. Rul. 73-476. One may question whether these taxpayers, in substance, received “new or additional” property interests. New and separate parcels were created as a result of the partition, presumably as a result of a subdivision of the land. The taxpayers ended up with different interests in separate parcels. However, the IRS analogized the partition to the conversion of a joint tenancy into a tenancy in common to eliminate the survivorship feature. In one of the situations noted in Rev. Rul. 56-437, two separate stock certificates were issued to each of the prior joint tenants. This result was viewed by the IRS as comparable to a subdivision of land.

C. In Rev. Rul. 55-77, 1955-1 C.B. 339, the taxpayer desired to purchase the undivided interest of one of the other tenants in common, but no price could be agreed upon. In accordance with state law, a partition action was filed, thus forcing a sale of the property. The taxpayer, together with four other tenants in common, purchased the property at the partition sale. The proceeds of the sale were distributed among all of the tenants in common in accordance with their respective undivided interests. The entire title to the property was then conveyed to the taxpayer and the four other purchasing tenants in common. The IRS held that the partition proceedings constituted a nontaxable transaction as to the purchasing owners. The taxpayer neither realized a taxable gain nor sustained a deductible loss on the sale of the undivided interest in the property because the taxpayer still owned the interest which he owned prior to the sale. Hence, the taxpayer sold nothing. The effect of the sale was to establish a price at which the taxpayer could purchase the undivided interest of one of the other tenants in common. Compare Mary L. Hunnicutt v. Commissioner, 10 B.T.A. 1004, acq. C.B. VII-2, 19 (1928). See also Rev. Rul. 55-179, 1955-1 C.B. 240 (sale and repurchase of taxpayer’s own interest in property to perfect title is not a taxable disposition).

VII. Exchanges Involving Partnerships

A. Handling Cash-Out Partners. If relinquished property is held by a tax partnership, how can some of the partners receive cash while other partners receive replacement property? There are three alternatives that are used:

1. Special allocations to the partners receiving cash, but such allocations may lack substantial economic effect (further, if there is depreciation recapture, the cash-out partners may not offset ordinary income with capital losses);

2. Distribute undivided interests and then the cash-out partners sell their interests and the other partners exchange (this is the most frequently used methodology, although there are “holding” and “continuing partnership” issues); and
3. A partnership-level exchange with a buyer’s installment note (the installment note is subsequently distributed to the cash-out partners), which works but may not be practical unless the buyer is very creditworthy.

B. “Drop and Swap” and “Swap and Drop” Transactions. Can a taxpayer exchange property received in a distribution from a partnership (a “drop and swap” transaction)? Can a taxpayer who receives replacement property in an exchange immediately transfer the property to a partnership (a “swap and drop” transaction)?” Many leading tax commentators believe that these transactions “should be” allowed. The weight of the law and Congressional intent appear to support such transactions. Most practitioners simply provide warnings but neither try to prevent such transactions nor disclose them on tax returns. Authorities in support of such transactions include Bolker v. Commissioner, 81 TC 782, aff’d 760 F.2d 1039 (9th Cir. 1985); Mason v. Commissioner, TC Memo 1988-273, aff’d without pub. opin. 880 F.2d 420 (11th Cir. 1989); Magneson v. Commissioner, 81 TC 767 (1983) , aff’d 753 F.2d 1490 (9th Cir. 1985); Maloney v. Commissioner, 93 TC 89 (1989). But see Chase v. Commissioner, 92 TC 874 (1989); Rev. Rul. 75-291, 1975-2 C.B. 332; Rev. Rul. 77-297, 1977-2 C.B. 304.

C. Netting of Partnership Liabilities. In Rev. Rul. 2003-56, 2003-23 IRB 985, the IRS concluded that liabilities are netted for purposes of Section 1031 and Section 752 when a partnership enters into a deferred like-kind exchange that straddles tax years. Thus, when a partnership transfers relinquished property subject to liabilities in one year and receives replacement property subject to liabilities in the next year, the partnership liabilities are netted both for purposes of Section 1031 and Section 752. Any net decrease in a partner’s share of partnership liabilities is taken into account under Section 752(b) in the first year of the partnership, and any net increase in a partner’s share of partnership liabilities is taken into account under Section 752(a) in the second year of the partnership.

1. The IRS presented two fact patterns. In the first, a general partnership, with two equal partners, owns relinquished property with a fair market value (FMV) of \$300. That property is subject to a liability of \$100 and the partnership has an adjusted basis of \$80. The partnership enters into a deferred like-kind exchange under Section 1031. The partnership transfers the relinquished property subject to the liability in the first year. In the following year, the partnership receives replacement property, which has a FMV of \$260 and a liability of \$60. This results in a net decrease in partnership liabilities of \$40. In the second situation, the replacement property received has a FMV of \$340 and is subject to a liability of \$140. Hence, the partnership has a net increase in partnership liabilities of \$40.
2. In the first situation, the partnership’s amount realized was \$300 (the FMV of the replacement property was \$260, increased by the surrendered liability of \$100,

and decreased by the replacement liability of \$60). The partnership's adjusted basis was \$80, resulting in a realized gain of \$220. Under Section 1031(b), the partnership recognizes gain only to the extent of money or other property received in the exchange. The IRS noted that the surrendered liability of \$100 is offset by the replacement liability in determining the amount of money or other property that the partnership is treated as receiving. Accordingly, under Section 1031(b), the partnership is treated as receiving and recognizing gain on \$40 in the first year. That gain is allocated to the two equal partners \$20 each. The IRS then held that, under Section 752(b), each partner is treated as receiving a deemed distribution from the partnership of \$20 in the first year. The deemed distribution is treated as an advance or drawing of money to the extent of each partner's distributive share of the partnership's income for the first year, including the gain recognized from the exchange. The deemed distribution is effective as of the end of the first year.

3. In the second situation, the IRS ruled that the partnership did not recognize gain in the first year because the surrendered liability of \$100 is offset by the replacement liability of \$140 in determining the amount of money or other property the partnership is treated as having received. Thus, the partnership didn't receive any money or other property under Section 1031(b). The partnership had a net increase in partnership liabilities of \$40 after receiving the replacement property. The net increase in partnership liabilities is allocated to the two equal partners \$20 each. The IRS then held that, under Section 752(a), each partner is treated as having made a contribution to the partnership of \$20 in the second year.

4. The ruling cites Example 5 of Section 1.1031(k)-1(j)(3) which generally allows for netting of liabilities in a deferred exchange. However, that example does not specifically apply to deferred exchanges that straddle tax years and does not consider the provisions of Section 752 applicable to partnerships. The IRS reasoned that, if the exchange straddles two taxable years of the partnership, the amount of the relinquished liability that exceeds the amount of the replacement liability is treated as money or other property received in the first taxable year of the partnership, since the excess is attributable to the transfer of the relinquished property subject to the relinquished liability in that year. In addition, any gain resulting from the receipt of money or other property in the first taxable year of the partnership must be recognized and reported by the partnership in that year.

5. Some commentators have argued that the IRS could have been even more lenient to partnerships and partners in the first situation by permitting the partnership to defer gain recognized on the deferred exchange under Section 1031, as well as the decrease in a partner's basis in his partnership interest under Section 752(b), until the second year in which the partnership received the replacement property. However, any deferral of gain recognition by the partnership under Section 1031 would favor partnerships over other exchanging

taxpayers that would have to recognize gain upon the transfer of the relinquished property. Any deferral under Section 752(b) to the second year could allow a partner to deduct partnership losses, receive tax-free distributions of money, or receive distributed property with an inflated basis. The adjusted basis of the partner's interest should be reduced at the end of the first year by partnership liabilities that no longer exist (i.e., the net decrease in liabilities after completion of the deferred exchange). Some commentators also argued that the IRS could have been more lenient by allowing the basis increase in the second situation to occur at the end of the first year. But since the net increase in liabilities does not in fact occur until the second year, a more lenient approach would allow partners to retroactively inflate their basis in their partnership interests.

6. In summary, Rev. Rul. 2003-56 is very generous in that it violates the annual accounting principle by deferring some or all of the relief of partnership liabilities in a deferred exchange by a partnership. The IRS could have treated each year as a separate accounting period and held that the partnership was relieved of the total amount of the relinquished property liabilities in the first year (i.e., the year in which the relinquished property was transferred). See Rev. Rul. 81-242, 1981-2 C.B. 147 (applicable to involuntary conversions under Section 1033). But the IRS correctly recognized that deferred exchanges should be treated as integrated transactions, and extended the Section 1031 netting rules to Section 752. Rev. Rul. 2003-56 seems to strike exactly the right balance, and the criticism that it isn't "generous enough" is misplaced.

VIII. Election out of Subchapter K

A. In FSAs 199923017 and 200216005, the IRS opined that an entity formed under state law, such as a limited partnership or LLC, could not make a valid Section 761 election. In FSA 199923017, the IRS reiterated its position that "generally, the Service does not allow entities formed under a state's limited partnership laws to elect out of Subchapter K." The IRS based its position on a technical analysis of Reg. 1.761-2(a), which states the requirements that must be met for an election out of Subchapter K. These requirements include three conditions that the participants in the joint purchase, retention, sale, or exchange of investment property must meet:

1. The participants must own the property as co-owners.
2. The participants must reserve the right separately to take or dispose of their shares of any property acquired or retained.
3. The participants must 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 the 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.

These conditions to elect out of Subchapter K may not be met by entities formed under state law (i.e., general partnership, limited partnership or LLC laws) since ownership of the underlying property is by an entity and not directly as “co-owners.”

B. A election out of Subchapter K may be desirable for several reasons, including the following:

1. Partnership tax returns are avoided, which can reduce both administrative costs and the risk of “winning” the audit lottery.
2. Ownership interests may be exchanged tax-free, but partnership interests are excluded from like-kind exchange treatment.
3. The Section 183 limitation on the deductibility of losses will apply at the owner (i.e., “partner”) level rather than at the entity (“partnership”) level.
4. Unlike partners, co-owners can make separate depreciation, depletion and other tax elections.
5. The sale of a partnership interest would be subject to capital gain and loss treatment under Section 741 and Section 1221 while the sale of an ownership interest will be a deemed sale of a proportionate interest in each of the partnership assets subject to Section 1231 gain and loss treatment.
6. State and local income taxes imposed on entities may be avoided or reduced if the state imposes an entity-level tax and respects the federal election out under Section 761.

C. An election out also may have its disadvantages. For example, Section 721 will no longer apply. Contributions to capital of anything other than cash may trigger gain to the extent of any disproportion in contributions or in the value of the interests received in the exchange. Moreover, a purported election out that is not respected by the IRS may have adverse consequences when the entity fails to act as a partnership. Tax elections that a partnership or LLC otherwise might have made (e.g., Section 754 elections and methods of accounting elections) will be forgone. There may be penalties under Section 6698 for failure to file partnership tax returns.

D. In Notice 2004-53, 2004-33 IRB 209, the IRS signaled its willingness to reconsider whether individuals who own investment property through a state law entity (including a limited partnership or LLC) should be eligible to elect to be excluded from the application of Subchapter K. In the Notice, the IRS solicited comments from the public regarding the application of Reg. 1.761-2(a)(2) and whether those conditions should be revised, modified or clarified. Among other things, comments were requested on the circumstances under which participants in the joint purchase, retention, sale, or exchange

of investment property should be treated as owning the property as “co-owners” for purposes of the election out of Subchapter K. Comments also were requested by the IRS on the facts that should be considered in determining whether such participants have reserved the right to separately to take or dispose of their underlying shares in the property. For example, comments were requested as to whether an agreement with a third party, such as a lender, that limits the rights of the co-owners to take or dispose of their underlying shares in the investment property will prohibit the group from making an election out. Finally, comments were requested on the meaning of “investment property” for purposes of Reg. 1.761-2(a)(2). For example, can rental real estate be property treated as investment property for these purposes? The due date for all comments is November 15, 2004. If the IRS provides an expanded ability to elect out of Subchapter K, it would facilitate Section 1031 exchanges into or out of such interests. See Section 1031(a)(2) (flush language) which allows tax-free exchanges of interests in a partnership with a valid election in effect.

IX. Conclusion

A. By exchanging directly-owned investment property under Section 1031, an owner can defer the income taxes normally paid on a gain. Section 1031 exchanges are also an estate planning tool. Upon death the income tax basis is adjusted to the property’s current market value eliminating the income tax gain.

B. In IRS Revenue Procedure 2002-22, the IRS provided ruling request guidelines for TIC investments. In order to ensure that investors get the benefits of a Section 1031 exchange, it is crucial that the structure be a valid TIC ownership arrangement and not considered a tax partnership. An interest in a “partnership” may not be received tax-free under Section 1031.

C. TIC investments are usually offered by professional sponsors that purchase or already own attractive, high quality, commercial properties. The sponsor puts the owner into a TIC ownership structure, which allows for up to 35 investors. The property is then re-sold at a marked-up, retail price to TIC investors. Once the available equity is sold out, the sponsor usually stays in place as the asset and/or property manager. Since an owner can invest in several TICs simultaneously, the owner can obtain the benefits of diversification. Some TIC sponsors offer several property types, such as retail, office, industrial and multi-family in various and diverse locations. Such programs can act like a real estate stock mutual fund for the conservative or passive investor.

D. Both for tax and investment reasons, TIC ownership structures have become very popular and highly promoted. Combined with Section 1031 exchanges, these TIC ownership structures have become the hottest new pairing on the tax menu.