EXCHANGING INSIGHTS

"A newsletter devoted to the education of those involved in section 1031 exchanges"

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Part and Parcel: Structuring Like Kind Exchanges Under Code Section 1031 after Revenue Procedure 2002-22

Many exchangors purchase as replacement property tenant-in-common interests in "TIC" programs that offer an undivided fractional interest in a large property with multiple owners. The perceived advantages of a TIC program are having partial ownership in a larger property with appreciation, cash flow, annual depreciation benefits all without many of the management problems associated with individually owned rental property.

The problem with purchasing a TIC interest, however, was whether a specific TIC interest would be considered a real estate interest suitable for an IRC Section 1031 exchange, or an interest in a partnership or other non-real estate interest.

The IRS recently issued guidelines that will help taxpayers to determine whether the purchase of an undivided fractional interest in real estate (i.e., a tenant-in-common interest) will be considered "like-kind" property eligible for a tax-free exchange under Section 1031 of the Internal Revenue Code. A taxpayer engaging in the purchase of an interest in a TIC program can now eliminate the risk of whether the property

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qualifies as like kind property by obtaining a private letter ruling pursuant to Revenue Procedure 2002-22. This will also be of interest to the promoters of TIC programs and persons that have purchased tenant-in-common interests in TIC programs prior to the issuance of the Revenue Procedure.

1. Tax Free Exchanges - Generally

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment. In general terms, the replacement property will be deemed to be of a "like kind" for purposes of Code Section 1031 if it is the same general type of property as the relinquished property. Accordingly, under the rules of Code Section 1031, a taxpayer is not required to replace a residential apartment building with another residential apartment building. Instead, the taxpayer can obtain like kind exchange treatment if he replaces the residential apartment building with an office complex or other types of developed real property.

2. Why Purchase a Fractional Interest in Real Property?

For the most part, the challenge facing property owners that are seeking to avail themselves of the tax benefits of the tax-free like kind exchange structure is the ability to identify and acquire suitable replacement property within the time frame required under Code Section 1031. A taxpayer has only 45 days from the date of the sale of the relinquished property to identify the property that will be acquired as the replacement property and only 180 days from the date of the sale of the relinquished property to actually acquire the identified property. In addition, there are limitations imposed on the number of properties that can be identified within the 45-day period.

Because of these restrictive timing rules, taxpayers wishing to engage in a tax-free like kind exchange are under great pressure to find and then actually acquire suitable property. Accordingly, many owners hoping to undertake a tax-free like kind exchange have failed to achieve their goal of tax-free treatment because they could not find suitable replacement property. With this problem in mind, the tenant-in-common TIC program was specifically designed to provide persons seeking to engage in a tax-free like kind exchange with a viable replacement property solution. In general terms, the tenant-in-common structure allows owners seeking to close out of a like kind exchange to purchase an undivided fractional interest in property that is subject to a triple net lease to a good credit tenant.

Promoters of TIC programs generally stress the following benefits that the structure provides. First, the property underlying the tenant-in-common structure is ready for sale and the promoter is in the business of closing quickly once the person seeking to close out the like kind exchange identifies the tenant-in-common interest as the replacement property. Second, the tenant-in-common structure provides the purchaser with the flexibility needed to match, on a dollar-for-dollar basis, the debt and equity that must be replaced to obtain tax-free treatment. Accordingly, in instances in which a person cannot find a suitable property within the 45-day replacement period, the tenant-in-common structure provides a possible opportunity to identify and acquire replacement property in a timely manner.

3. Conditions That Must Be Satisfied Before the IRS Will Issue a Ruling.

Tenancy in Common Ownership. Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law. The Internal Revenue Service will not consider a ruling request if title is held through a business entity organized pursuant to state law.

Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons.

No Treatment of Co-Ownership as an Entity. The co-ownership may not file a partnership or corporate tax return. Similarly, the co-owners cannot conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity. In addition, co-owners cannot hold themselves out as partners, shareholders, or members of a business entity.

Voting. The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases of a portion or all of the property, or the creation or modification of a blanket lien. In addition, the Internal Revenue Service will not consider a ruling request unless the unanimous approval of the owners is required for each of the foregoing.

Restrictions on Alienation. 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, the Internal Revenue Service will consider the ruling request notwithstanding the existence of such a restriction, but only if the restriction is on the right to transfer, partition, or encumber interests in the property or such restrictions are required by a lender and are consistent with customary commercial lending practices.

Proportionate Sharing. Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property and the co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests. In addition, the Internal Revenue Service will not consider a ruling request unless the transactional documents require that, upon the sale of the property any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

No Business Activities. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities).

Leasing Agreements. All leasing arrangements must be bona fide leases for federal tax purposes and rents paid by a lessee must reflect the fair market value for the lease of the property. In addition, the Internal Revenue Service will not consider a ruling request if the determination of the rent depends, in whole or in part on the income or profits derived by any person from the leased property.

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.

Co-Ownership Agreements. In general, the co-owners may enter into a limited co-ownership agreement that may run with the land.

Options. In general, 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. The Internal Revenue will not consider ruling requests if any co-owners acquire an option to sell the co-owner's interest (put option) to the sponsor, the lessee, another co-owner, the lender or a person related to any of the foregoing.

Management or Brokerage Agreements. In general, 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.

It may be evident upon review of these conditions that advance rulings under Revenue Procedure 2002-22 will be available only for the most simply structured co-ownership arrangements, ones that may not be attractive to program sponsors seeking enhanced economic returns.

Sophisticated structures sold through broker-dealer networks involving enhanced returns to program sponsors through master leases and similar arrangements generally will not be eligible for advance rulings under Revenue Procedure 2002-22.