

# Real Estate *Update*

## 1031 Exchanges

### *Tenancy-in-Common in Complex Property Ownership*

**T**he Section 1031 exchange is a mechanism set up by the Internal Revenue Code to defer recognition of gain on transfers of property held for productive use in a trade or business or for investment where the real estate is exchanged for "like-kind" property. The ability of real estate investors to take advantage of this provision is limited by narrow definitions of what constitutes "property" qualifying for the deferral treatment.

In particular, Section 1031 (a)(2)(D) excludes the exchange of interests in a partnership. The partnership exclusion has been broadly construed under the Internal Revenue Code and Regulations to include not just partnerships organized as such under state law, but any entity, whether or not incorporated, through which "any business, financial operation, or venture is carried on."<sup>1</sup>

In various court cases and Revenue Rulings based on the code and regulations, the IRS has broadly established that an interest in real estate held in a joint venture of any sort, except where the form of ownership is a tenancy-in-common having certain specified characteristics of co-ownership, does not qualify for Section 1031 treatment.<sup>2</sup>

In March 2002, the IRS issued Revenue Procedure 2002-22, 2002-14 IRB 733, setting forth guidelines for submitting ruling requests as to whether rental real property held in the form of a tenancy-in-common under local law constituted a co-ownership arrangement qualifying for like-kind exchange treatment under Section 1031. While the procedure expressly states that it is not intended to constitute a substantive rule, it does prescribe in substantial detail at least 15 characteristics that a co-ownership arrangement must meet as a condition to submitting a ruling request to the IRS for Section 1031 qualification.

#### **Distinguishing Characteristics**

In general, the revenue procedure distinguishes a 1031-qualifying tenancy-in-common from a non-qualifying partnership or other joint venture arrangement by identifying the

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tenancy-in-common as a "traditional concurrent estate in land ... [in which] each owner is deemed to own individually a physically undivided part of the entire parcel of property."<sup>3</sup>

Citing Powell on Real Property<sup>4</sup> as its authority, the revenue procedure identifies the key characteristics of a qualifying arrangement as one in which each co-owner holds rights to undivided possession of the whole property, a proportionate economic interest in rents and profits, and rights to transfer the interest and demand a partition of the property.

Beyond these general principles, the revenue procedure identifies the following specific conditions, among others, as ones that ordinarily must be satisfied before the IRS will rule that a co-ownership arrangement is not a disqualified partnership for purposes of Section 1031.

#### **Tenancy-in-Common**

The ownership arrangement must be a tenancy-in-common under local law, with no more than 35 co-owners, and may not file a partnership tax return, conduct business under a common name, hold itself out

as a form of business entity or conduct business operations other than those customarily performed in connection with the maintenance and repair of rental real property.

#### **Voting Rights**

Each co-owner must have a proportionate vote, with a unanimous vote required to hire a manager, sell, dispose or lease all or a portion of the property and mortgage the property, and with a vote of at least 50 percent in interest required for all other decisions.

#### **Restrictions on Alienation of Interest**

Each co-owner must have the right to transfer, partition, and encumber the co-owner's interest in the property, subject only to a right of first offer in the other co-owners prior to a sale of interest and a fair market purchase option in the other co-owners prior to an action for partition. An owner may acquire a fair market option to purchase the interest of another owner, but an

owner may not have an option to put its interest to another owner.

#### **Proportionate Economic Interest; Capital Contributions**

Each co-owner must have a proportionate share of any debt secured by a mortgage on the property, and must share proportionately in all profits, losses, and capital proceeds from the property. No owner or

#### TAXATION



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manager may advance capital on behalf of another co-owner except by a recourse loan to the non-funding co-owner, for a period not to exceed 31 days.

#### Management and Brokerage Agreements

The co-owners may enter into management and brokerage agreements, including with sponsors or co-owners (but not with lessees), renewable at least annually, with fair market compensation which may not depend on income or profits derived by any person from the property.

#### Leases

All leases must be bona fide leases with fair market rents, which may not depend on income or profits derived by any person from the property, or be based on net income, cash flow or increases in equity in or from the property.

In short, the scheme of co-ownership envisioned by the revenue procedure is one in which all owners have an active voice in the management and decision-making regarding the asset, hold proportional economic interests based on proportional economic contributions, and have freely transferable interests.

Such a scheme of co-ownership is undoubtedly well-suited to certain types of assets and property holdings: for example, a commercial property net-leased to a credit tenant and fully financed, which requires very little active management, or an occupied residential rental property owned by a group of family members claiming under a will, where no party has disproportionately contributed capital or services. Such types of properties and co-ownerships have typically benefited from the 1031 exchange rules, and the revenue procedure gives added assurance that such co-ownerships will continue to qualify for exchange treatment.

But a more flexible, creative approach is required to adapt such a co-ownership scheme to large, multi-tenanted commercial properties that are owned by investor groups typically consisting of active and passive investors.

### Organizational Aspects

The revenue procedure either expressly prohibits, or does not expressly permit, a number of key organizational aspects of the typical joint ownership arrangement for such investor groups. Among the issues which must be structured around are:

- Ownership must be held in multiple entities as tenants-in-common, rather than in a single special purpose limited liability entity, creating administrative issues and multiple bankruptcy risks.
- Lack of centralized management in the active investors or deal promoters, typically embodied in the general partner or managing member of an entity.
- Prohibition against grant of promoted and carried interests to deal sponsors, typically earned after a hurdle return is distributed to other investors.
- Lack of workable mechanism for providing for additional capital to property, typically provided through default loans and squeeze downs of interests of non-funding parties.
- Lack of sufficient controls over membership in ownership group, typically provided through rights of first refusal, buy-sells, and consents to additional members, in addition to rights of first offer.

Each of these issues is important not just to the investors in a property as time-honored reward and control mechanisms, but also to

commercial lenders who are concerned with the efficient and uninterrupted operation of the borrower and the asset, and have the added constraint of ensuring that borrower and deal structures comply with requirements of rating agencies and norms and standards of the commercial mortgage-backed securities market.

Structuring a deal that provides both for the protection of these principles yet complies with the revenue procedure to give the owners substantial assurance that they should be entitled to the benefits of a 1031 exchange is an evolving challenge.

Several mechanisms have been utilized in deals that attempt to bridge these challenges. The IRS has not yet issued rulings on transactions employing these mechanisms, so they must be evaluated by each practitioner independently based on a thorough review of the revenue procedure and the IRS reasoning behind it.

The "bridging" mechanisms include:

- Utilizing a common special member across all co-tenants, whose vote is required across all entities in connection with bankruptcy and other extraordinary decisions. Such a mechanism responds to lender concerns that a tenancy-in-common poses a risk of sequential bankruptcy filings by each co-tenant, in frustration of the lender's remedies. A common special member can ensure unanimity of bankruptcy decisions across all co-tenants.
- Utilizing a common managing member for all decisions which are required to be made by the tenants-in-common, with representatives of each tenant-in-common given a proportionate vote within such managing member, but with certain decisions delegated to the manager of the managing member. Such a mechanism allows for more streamlined decision-making on the management of the asset, an important factor where multiple leasing transactions are contemplated, and allows the active investor parties to serve in a more substantial decision-making capacity.
- Use of a master lease structure, where the property is net-leased to a master lessee for a fixed rent that provides a market rate of return to the fee owners, but where property operating responsibilities and all residual economics are at the lessee level. Since the lessee is not bound to operate under the tenancy-in-common strictures, this allows for financial mechanisms, such as promoted interests and additional capital, to occur at the lessee level. Care must be taken in this structure that the lessee is not a related party or otherwise deemed an alter-ego of the co-tenants. Underscoring this need for separateness, the revenue procedure cautions, in determining whether the business activity of the tenants-in-common is customary, that the activities of a lessee which is also a co-owner will be taken into account as the activities of the co-owners.



(1) I.R.C. Section 761(a); Procedure and Administration Regulations Section 301.7701-2(a).

(2) See *Bergford v. Commissioner*, 12 F.3d 166 (9th Cir. 1993), *Bussing v. Commissioner*, 88 T.C. 449 (1987), aff'd on rehearing, 89 T.C. 1050 (1987).

(3) Rev. Proc. 2002-22, 2002-14 IRB 733, Section 2.

(4) 7 Powell on Real Property, Section 50.01-50.07.