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## 1031 Transactions and Tenancy-in-Common Exchanges



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**A** tenancy-in-common (“TIC”) is a type of property ownership in which each owner is deemed to individually own an entire parcel of property. A fundamental characteristic of a TIC is that each owner is entitled to possess the entire property, has rights to the rents and profits in their proportional share of ownership, has the right to transfer the interest, and has the right to demand partition of the property.

In Revenue Procedure 2002-22 (the “Rev. Proc.”), the Internal Revenue

Service (“IRS”) decided to issue advance rulings and determinations on whether a property held through a TIC investment may be exchanged for an interest in real property tax-free under Section 1031 of the Internal Revenue Code. To date, only two private letter rulings have been issued: PLR 200327003 and PLR 200513010. Since the issuance of Rev. Proc., an entire industry related to 1031 exchanges of TIC interests has developed, including syndicators, professional real estate companies, REITS, securities brokers and intermediaries. In the absence of further guidelines from the IRS, tax practitioners must interpret the Rev. Proc. and advise taxpayers whether in any particular transaction, the investment would be considered either: (i) a TIC for federal income tax purposes, (in which case the investment would qualify for a 1031 exchange); or (ii) a partnership interest (in which case the investment would not qualify for a 1031 exchange).

To the authors knowledge, no transaction will satisfy all the requirements of the Rev. Proc. nor is it nec-

essary to do so (even according to the Rev. Proc.) in order to be considered a TIC. Nonetheless, taxpayers should be aware that certain considerations are more important than others in determining whether an investment constitutes a TIC. In order for an exchange to qualify as a valid 1031 exchange and, thus, avoid gain recognition, it is crucial that the initial investment be considered a TIC and not a partnership interest.

#### Requirements

The Rev. Proc. sets forth a myriad of requirements. For example, the co-owners must hold title as tenants-in-common (directly or through a disregarded entity). Also, there can be no more than 35 co-owners and in determining the number of co-owners, husbands and wives and all persons who acquire a TIC interest through inheritance are treated as a single person. Although not a dispositive factor, a taxpayer should be cautious in investing in any TIC with more than 35 co-owners.

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Other important factors: (i) the TIC is prohibited from filing a partnership or business entity return, and cannot hold itself out as a partnership or other business entity; (ii) net sales proceeds must be distributed pro rata, revenues and costs must be shared pro rata, and mortgage debt must be allocated pro rata; (iii) advances for expenses must be recourse and repaid within 31 days; (iv) with respect to the management of the TIC, unanimous votes are required for sales or leases (or lease renewals) of the property; negotiating (or renegotiating) mortgage debt; and, (v) hiring a manager or negotiating a management agreement, or extension or renewal thereof.

The sine qua non of a TIC is the ability to sell, refinance, and transfer. Accordingly, the unanimous consent of the co-owners is required for any sale, lease or financing of the underlying property. In addition, each of the co-owner's agents, and any persons related to the co-owners with respect to the property, will be taken into account. Co-owners must be free to transfer, partition or encumber their interests without approval, subject to customary commercial lending restrictions. Co-owners (and others) shall also have the right of first offer, and co-owners may agree to offer their interests to other co-owners at fair market value prior to the partition. The co-owners activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property.

Finally, co-owners may enter into brokerage and management agreements with sponsors, co-owners (or related persons), but not lessees, if such agreement(s) provide for certain terms. The agreement must not be renewable more frequently than annually nor provide for fees based on profits/income or fees that exceed the value of the services or comparable broker fees. The agreement may provide for a common bank account to be used for the deposit of rent, payment of expenses and disbursement of net proceeds (within 3 months of receipt). The agreement may also provide for the preparation of financial statements for the co-owners, obtaining or modifying insurance, and the negotiation of lease and loan modifications.

### **Private Letter Rulings**

The two PLRs issued pursuant to the Rev. Proc. demonstrate when a TIC interest may be treated as an investment in real property for purposes of transacting a tax-free exchange under Section 1031. Pursuant to PLR 2003277003, written notice of the renewal of a management agreement may be sent to the co-tenants. According to the facts, the co-tenants were given 60 days to reject renewal of the management agreement. This falls short of the unanimous affirmative consent required by the Rev. Proc., but the IRS concluded that the notice of renewal and the co-owners failure to object to the renewal was sufficient. Additionally, the ruling allows a sponsor to continue to own an interest in the property for up to 18 months without violating the customary activity (no business activity) provision of the Rev. Proc.

A 1031 TIC transaction typically involves a sponsor. The sponsor customarily oversees the management of the property (leasing, collecting rents, maintenance, etc.) or will contract with an affiliate company to manage the property, with the agreement of the TIC interest holders. If the sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, courts may assess the sponsor's relationship with the co-owners to determine whether it gives rise to a partnership. The conclusion that there is a partnership, either among the co-owners or between the co-owners and the sponsor, is fatal to the tax-free benefit of a 1031 exchange.

In evaluating a sponsor, an investor should be certain to ascertain certain key elements of the potential investment. First, determine who the sponsor is and how long it has been in the TIC business. The IRS's characterization of the transaction will be more certain if the sponsor has received a legal opinion and/or private letter ruling. If the sponsor retains an interest in the property there may be an issue of whether the business activities of the sponsor are attributed to the co-tenancy. If such attribution exists, the sponsor's activities may violate the Rev. Proc.'s requirement that the tenancy engage only in customary activities

and not business activities. Finally consider whether the sponsor (or an affiliate) is acting as a property manager. If so, is it through unanimous vote of the co-owners and does the renewal of the management agreement require unanimous consent?

### **1031 Exchange Considerations**

In connection with a 1031 Exchange, in which a TIC interest is designated as a replacement property, special care should be given to identifying that particular property. In other words, given that many TIC investments are somewhat fluid, depending upon the amount of debt required, an investor may have to purchase between X% and Y% of an undivided interest in real property known as 123 Main Street, Anywhere, USA. In order to properly identify the particular undivided interest an investor may have to choose three different targets such as X%, Y% and Z% of 123 Main Street, Anywhere, USA and have each individual percentage designated as one of the three safe-harbor choices.

A single member LLC is also a possible vehicle to hold the exchange property in a 1031 transaction and is often required by lenders. A wholly-owned, single member LLC is disregarded and the taxpayer will still be considered the direct owner of the properties for federal income tax purposes. It is important to note that the owner of the single-member LLC must be the same person that owned the property that was transferred in the 1031 exchange.

In conclusion, TICs offer taxpayers, an opportunity to acquire undivided interest in real property without any managed responsibility. Taxpayers must, however, be careful to ensure that the investment will qualify as a TIC and not be excluded as partnership interest. In this unregulated area, it is caveat emptor (buyer beware) and taxpayer may want to consult their own tax advisor to ensure that the transaction will qualify for purposes of section 1031 of the Code.