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Section 1031 Exchanges and Tenancy in Common Interests

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I. Introduction

A popular way of acquiring real estate today is through use of Tenancies in Common (TICs). TICs allow small investors to exchange their smaller properties for a fractional interest in a much larger property. The issuance by the Internal Revenue Service (IRS) in March 2002 of Rev Proc 2002–22, 2002–1 Cum Bull 733, clarifying the steps that investors in a TIC should take in order to make their investment eligible for tax deferral under the Internal Revenue Code (26 USC §1031) when participating in like-kind exchanges, adds to the appeal of these arrangements and has created a huge growth in the TIC market.

II. Background

Real estate investors who have held properties for a long time generally have low taxable bases and have exhausted their ability to further depreciate them. They seek to (a) realize the value of their assets without incurring significant taxable gains and (b) reinvest their equity in new property with higher returns, more depreciation, and greater appreciation potential.

In the past, such investors would avail themselves of tax deferral under §1031 by simply locating, and then exchanging into, suitable replacement properties. However, prices in many areas of the country are so high that investors are unable to find appropriate replacements. It is often hard, for example, to find a triple-net-leased property occupied by a creditworthy tenant for less than $5 million. Thus, many investors are forced to exchange for more expensive property, causing significant negative cash flow. Exchanging for a TIC can avoid that problem and also enable investors to find the necessary replacement within the narrow time period allowed by §1031.

To respond to varying investor needs, “sponsors” have devised a variety of TIC arrangements for investors to acquire. Some sponsors will purchase a large piece of property, directly or through a controlled entity, under a long term triple-net lease with a high-credit, stable tenant (*e.g.*, Walgreen’s or Home Depot), arrange appropriate financing, divide title into tenancy in common interests (TIC units), and offer these units to exchangers and other investors. See Wamstad, *Feature A Boost From the IRS: On Tax-Deferred Exchanges and Tenancy-In-Common*, 13 Bus Law Today 41 (Mar./Apr. 2004). An exchanger can then acquire as many units as it needs to avoid having a taxable gain from the disposition of its former property.

Other sponsors purchase property with an existing loan already in place to be assumed by the investors, or enter into a contract of purchase and assign that contract right to the investors, who then simultaneously close on the property. The sponsors may also master lease the property from the TIC or manage it for the investors. See Borden & Wyatt, *Syndicated Tenancy-in-Common Arrangements: How Tax-Motivated Real Estate Transactions Raise Serious Nontax Issues*, 18 Prob & Prop 18 (2004).

In sum, there is a huge variety of prepackaged TIC interests that include different kinds of property and different kinds of financing arrangements. Investors may choose based on the kind of property offered to them, the rate of return, and the financing arrangements that they prefer.

A. The Legal Nature of a TIC Interest

To create a TIC that qualifies under §1031, it is necessary to satisfy the tenancy in common laws of the state. A tenancy in common is not an independent entity like a partnership, a corporation, or an LLC. No formal writing is necessary for its creation, nor is any filing required. A TIC is a way of holding title whereby each participant individually owns a physically undivided interest in an entire parcel of the property. CC §686; *Wilson v S.L. Rey, Inc.* (1993) 17 CA4th 234, 242, 21 CR2d 552.

Each cotenant in common is entitled to:

Share with the other tenants the possession of the whole;
Receive a prorata share of rents or profits from the property;

Transfer or lease the interest; and
Demand a partition of the property.

There is no rent liability from one cotenant to another for possession. *Tom v City & County of San Francisco* (2004) 120 CA4th 674, 16 CR3d 13. Typically, each cotenant's share is expressed in the instrument of conveyance as a percentage interest in the whole; otherwise, all cotenants are presumed to have equal interests.

B. TIC Arrangements

A TIC property may involve a triple-net lease with a single tenant and no management by the owners. It may also involve multiple tenants subject to a master lease, with the sponsor as master lessee or manager, having in turn subleased the property to the actual tenants. This removes the investors from management functions. Alternatively, a separate entity may be a manager, but not a sponsor. See Stein, *Tax-Free Exchanges and Fractional Interests: TICs, Tax, Go!,* 45 Orange County Law 18 (Aug. 2003).

After the sponsor (often a large real estate investment company) has acquired the property and has a TIC agreement or agreements ready, it will require each of its potential investors to form single-member LLCs that will execute the tenancy in common agreement. The reasons for single-member LLCs are:

Lenders prefer borrowing from entities that are legally separate and more remote from the risk of bankruptcy; and
If the LLC files bankruptcy, its nature as a single-asset entity will facilitate an early dismissal or relief from the automatic stay, and it is not likely to have major creditors besides the lender.

Sponsors who choose to participate in TICs may do so at different stages of the project, *e.g.*, offering, organizational, operating, liquidation. Some TIC agreements give the sponsor discretion to remain or become a tenant in common with the investors, and thus participate in the profits from operations or the profits from the resale of a TIC interest. Other agreements also require that the sponsor be used as broker on any later sale of an interest. Others provide for the sponsor, or an affiliated entity, to, *e.g.*, manage the property, collect the rents, pay the mortgage, deal with tenant defaults, re-lease the property when tenants leave. The sponsor may also have the power to finance or refinance. All of these additional activities, of course, will generate additional fees to the sponsor. Cuff, *Revenue Procedure 2002–22 and Section 1031 Exchanges Involving Tenancies In Common*, Creative Tax Planning for Real Estate Transactions (ALI-ABA Course of Study, Sept. 26–28, 2002); Cuff, *Section 1031 Exchanges Involving Tenancies-In-Common*, Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (PLI Course Handbook June 2003).

III. Advantages and Disadvantages of TIC Arrangements

A. Advantages

1. Ease of identification

Too often, an investor waits until after closing the sale of its current property to identify a replacement property and finds itself 44 days later scrambling for any property it can find. A TIC can eliminate this problem, since the sponsor does all the work, eliminating the need to spend that time within the 45-day identification period or the 180-day closing period. The sponsor's website, which shows all properties currently available and their projected returns, allows an investor to perfectly match up a replacement with the cash received from the earlier disposition. The exchanger/investor can then make its selection based on the characteristics of the property—*e.g.*, its size and nature, the amount required to invest, and the projected returns.

2. Due Diligence by Sponsor

Large projects will involve the evaluation of complex leases and the generation of income projections and loan documents. Sponsors also have to prequalify or accredit investors by doing necessary credit checks to ensure that potential investors satisfy minimum net worth requirements. When sponsors are experienced real estate dealers who have already analyzed the project and prepackaged it, it is easy for investors to purchase units within their §1031 deadlines. Sponsors will predraft the necessary documents (purchase agreement, escrow

instructions, tenancy in common agreement, property and asset management agreement, assignment and assumption agreement, tax opinion letter, and private placement memorandum containing information regarding the due diligence of the sponsor and all disclosures related to the property), thereby relieving each investor from additional hassles and costs. The USA Patriot Act (Pub L 107–56, 115 Stat 272) has further increased the sponsors' burden by adding new due diligence requirements on lenders; now, loan agreements contain language that each TIC member, any guarantor, or any affiliate of either shall not become a person restricted from doing business under the regulations of the Office of Foreign Asset Control (OFAC) of the Department of the Treasury. Some lenders also require ongoing covenants and indemnities relating to OFAC to ensure ongoing compliance. In anticipation of these lenders' requirements and policies, sponsors are taking additional steps to screen their prospective investors more carefully and accredit them ahead of time.

3. No Management Responsibilities

The property and the assets (*e.g.*, leases, bank accounts) are professionally managed by the sponsor itself or by a management company arranged by the sponsor. This feature is one of the main advantages of TICs because investors often do not want to have property management duties or headaches; they like the passive nature of these TIC investments and the fact that they will be professionally managed. See Aiken, *Evaluating Co-Ownership of Real Estate (CORE) or Tenant in Common (TIC) Interests in Real Estate* (Exeter 1031 Exchange Services) (available at http://www.exeterco.com/pdfs/Article_CORE_TIC.pdf). This may make it particularly attractive to older investors who prefer truly passive investments.

4. Diversification and Sizeable Returns on Investment

TICs allow investors to diversify their portfolios both geographically and through different kinds of properties, *e.g.*, office buildings, medical buildings, energy replacement properties, retirement homes. Investors can acquire not only higher grade, institutional-type properties, but also those having a stable level of return over many years.

5. Easy Financing

The sponsor will often put the investor in touch with a lender or mortgage broker already familiar with the project, one who may have already committed to loan on the property—perhaps with preset rates, reserve requirements, nonrecourse carve-outs (see below), default provisions, and transfer requirements—thus avoiding delays and the need to shop and negotiate terms.

6. Nonrecourse Loans

Sponsors often arrange for nonrecourse financing to make these TICs even more attractive to exchangers/investors. This does not mean that lenders like them; that is why, even though the loans may be nonrecourse, lenders (1) include their customary carve-outs to protect themselves from the intentional misbehavior of a TIC co-owner and (2) may still require personal guaranties. See Swenson & Dickson, *The Recent Trend Toward Financing Tenancies in Common Poses Substantial Challenges to Lenders*, 28 Los Angeles Law 40 (Sept. 2005).

7. "Parking" Arrangements

An investor confronting the 45-day property identification deadline—who does not want to commit to a long term investment and desires no management duties and a return on its investment—may decide "to park" its exchange money in one of these TICs until an alternative investment materializes. This can only be done if the TIC is structured so that there is a fixed termination date or an exit strategy is in place.

B. Disadvantages

1. Fear of Recharacterization

Despite an investor's best laid plans, a TIC arrangement may nevertheless be treated as a partnership by the IRS. For a historical analysis, see Levine, Exchanging Real Estate (Professional Publications & Education, Inc., Denver, 2005). See also Levine, Real Estate Transactions, Tax Planning, chap 29 (Thomson-West, St. Paul, 2005).

Exchanges of interests in partnerships and other business entities are not eligible for §1031 treatment (see McKee, Neslon, & Whitmire, Federal Taxation of Partnerships and Partners ¶3.03[5] ("Partnerships Distinguished from Co-Ownership of Property") (3d ed 1997)); therefore, an investor needing to complete a §1031 transaction must be sure that its acquired TIC interest will be treated as an interest in real property and not as an interest in the entity that owns it. Rev Rul 75–374, 1975–2 Cum Bull 261. The Revenue Ruling further provides that the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership; however, tenants in common may become partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. *Commissioner v Tower* (1946) 327 US 280, 90 L Ed 670, 66 S Ct 532; Allen, Section 1031: When Exchanges and Partnerships Collide (PLI Course Handbook June 2006).

Customary services performed by co-owners or their managers do not automatically lead to a TIC being recharacterized as a partnership; however, "additional services" could have that effect. Cuff, *Section 1031 Exchanges Involving Tenancies-In-Common*, Tax Planning For Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2004 at 867 (PLI Course Handbook June 2004). The line between the two is very fine; therefore, careful structuring and drafting of the TIC documents becomes absolutely crucial.

Revenue Procedure 2002–22 has clarified some of these concerns, but it is neither a law nor even an IRS ruling. It is merely an invitation to taxpayers to request an IRS ruling on the taxability of a transaction or event, with the suggestion that if it satisfies the criteria outlined in the procedure, then the actual ruling *may* be favorable. Rev Proc 2002–22, §3. It is not surprising that most TIC offering materials stress this risk.

2. Liquidity and the Difficulty of Finding an Exit Strategy

An undivided interest in real estate may be difficult to market. See Borden & Wyatt, *Syndicated Tenancy-in-Common Arrangements: How Tax-Motivated Real Estate Transactions Raise Serious Nontax Issues*, 18 Prob & Prop 18 (2004). In fact, some authors claim that the National Association of Securities Dealers (NASD) believes that TIC interests are illiquid, that there is no secondary market for them, and that a subsequent sale of one may only be possible at a significant discount. The only perceived benefit of the lack of liquidity, if there can be one, for the investor is that if the TIC is part of the decedent's estate, the investment can be significantly discounted. This, in turn, will present some estate planning strategy advantages. Nevertheless, for most investors, the need for liquidity is crucial; it is for this reason that many TIC investors need the assurance that they have an exit plan. That is why most sponsors, such as RealtyNet Advisors (a brokerage specializing in TICs for exchange purposes), advertise using language such as:

> Liquidity. RealtyNet maintains a secondary market for ownership interest in RealtyNet sponsored properties. On a best efforts basis, we can find a buyer to acquire your partial ownership interest. The longest it has taken us to find a buyer for an existing TIC client has been two months.

Adding to illiquidity concerns, lenders often require prepayment penalties or lock-in provisions specifically intended to prevent an early exit by the investor. TIC agreements invariably require the selling or trading co-owner to first offer the interest to other co-owners, the sponsor, or lessee at market value. Although this makes the marketability of TIC interests more cumbersome, it gives rise to a market for these TICs and simplifies the financing of these transfers.

3. Volatility and Risk Factors

TIC investments are often volatile and risky, since they depend on the expected stream of rental income from the underlying property. If there is only one tenant, rather than multiple tenants, the risk is increased, since everything depends on the financial health of that tenant. Other factors, such as fluctuations in interest rates and changes in market prices for similar properties, will affect the underlying value. In fact, many private placement memorandums specifically list all of the real estate, financing, and tax risks related to TICs.

4. Due Diligence Still Required

Despite the fact that TIC sponsors perform the due diligence, investors and their agents nevertheless are generally advised to make their own investigation of the credibility and track record of the sponsor and its management company. TIC brokers are advised by the NASD and the California Department of Real Estate

not to automatically rely on the sponsors, but to investigate to ensure that a sponsor's offering document does not contain false or misleading information. The investigation should include:

Background checks of the sponsor's principals, their track record, their structure, and their compliance with Rev Proc 2002–22; and
Review of the agreements and the fundamental bases for all projections.

Berkeley, *Real Estate Interests In Securities: TICs/DSTs* (ALI-ABA Course of Study, Mar. 16–18, 2006). TIC projects are typically offered as Regulation D offerings, one of the exemptions to the Securities and Exchange Act of 1933, which requires that a private placement memorandum be generated covering all aspects of the sponsor, the property, and necessary disclosures. Investors, their brokers, and their lawyers should therefore be careful to review the documents to ensure that the particular investment is suitable to that particular exchanger/investor.

5. Forced Sale

In certain circumstances, a TIC can be forced to sell its underlying property, either by the bankruptcy trustee under 11 USC §363(h) (in case one of the co-owners declares bankruptcy) or by the IRS under IRC §7403 (if the IRS holds a lien against a co-owner for unpaid taxes).

6. Bankruptcy

The filing of bankruptcy by any one co-owner may affect the other co-owners—and the project—if the trustee in bankruptcy seeks to reject and terminate any of the TIC agreements in order to manage the bankrupt estate. In addition, the bankruptcy of one co-owner may force the others to cover that share of expenses and stay them from seeking to recoup what they are paying, thus increasing the risk that the entire project may go bankrupt.

Lenders protect themselves against co-owner defaults by demanding bankruptcy-remote entities, such as single-member LLCs; but a bankruptcy filing by an investor's LLC could make the bankruptcy trustee a new tenant in common subject to the rules of the TIC agreement. Thus, a lender may also require that its nominee sit on the board of each LLC and that all operating documents require unanimous consent for filing bankruptcy. See Krabacher, *Tenancy-in-Common: Financing and Legal Issues*, 33 Colo Law 89 (June 2004); see also Weissburg & Trott, *Special Purpose Bankruptcy Remote Entities*, 26 Los Angeles Law 12 (Jan. 2004) (available at http://www.lacba.org/Files/LAL/Vol26No10/1475.pdf). Investors may also have to supply lenders with personal guaranties and other assurances. There may be "lockbox" restrictions on cash transfers. (A lockbox arrangement requires all cash receipts to be deposited into a separate bank account, jointly controlled by the lender and the borrower, that allows the lender to closely monitor cash disbursements.) Krabacher, *Tenancy-in-Common: Financing and Legal Issues*, 33 Colo Law 89 (June 2004). See also Fletcher & Tarkenton, *Protecting the Lender: Lockbox and Bankruptcy Remote Entities*, 5th Annual Mortgage Financing Program, Real Property Probate and Trust Law Section (ABA 1999); Senecker, *How to Document Securitized Commercial Real Estate Mortgage Loans*, 15 Prac Real Est Law 41 (May 1999).

In the near future, lenders may begin requiring investors to use Delaware Statutory Trusts (DSTs) instead of TICs because they give lenders even greater protection, since creditors of the beneficial owners of a DST cannot assert claims directly against the property held in the DST. A DST is a trust established to hold title to property in which a trustee acts as a fiduciary and beneficial interests in the trust are sold to investors. With careful structuring and drafting of the trust documents, beneficial interests in a DST have been determined to qualify for tax deferral under §1031. On July 20, 2004, the IRS clarified the use and tax consequences of DSTs in the context of §1031 exchanges by releasing Rev Rul 2004–86, 2004–2-Cum Bull 191. Many authors believe that the use of DSTs is superior to TICs since, among other things, the financing is easier and the 35-member limitation does not apply. There are, however, other limitations that may make their use more cumbersome. See Berkeley, *Real Estate Interests in Securities: TICS/DSTS* (ALI-ABA Course of Study, Mar. 16–18, 2006), and Lipton, *The "State of the Art" in Like-Kind Exchanges*, 19 Prac Real Est Law 31, 34 (May 2003); see also Pederson, *The Rejuvenation of the Tenancy-in-Common Form for Like-Kind Exchanges and Its Impact on Lenders*, 24 Ann Rev Banking & Fin L 467 (2005). Nevertheless, investors should consider DSTs because, like TICs, they are eligible for §1031 exchange benefits.

7. Fears of Foreclosure

If the gross cash flow is not sufficient to cover the TIC's debts, all the TIC owners may have to respond to cash calls to avoid foreclosure, since financing is aggregate rather than individual. While lenders do sometimes make individual loans to individual TIC owners according to the amount of their investment, they generally make all co-owners jointly and severally liable for the entire loan, with a blanket lien on the entire property. Gordon, *CMBS: Tenants-in-Common Becoming More Common*, Commercial Securitization for Real Estate Lawyers; Real Estate Finance in The Capital Markets: Risks and Rewards 217, 220 (ALI-ABA Course of Study, Apr. 1–2, 2004).

8. Liability

There is no assurance that all of the tenants in common will perform their obligations under the TIC documents. A concern of every investor and the lender is that a creditor of one co-owner may reach or affect the interests of the other co-owners. A lien on one cotenant's interest could adversely affect the marketability of the entire property. TIC investors expect the sponsor to do in-depth financial due diligence on the other investors before putting them into a common pool. Most TIC agreements include covenants of contribution, indemnities, representations, and warranties. In addition, while most property managers seek to maintain adequate liability insurance coverage, it may turn out to be insufficient or unavailable, making the other tenants in common personally liable for certain losses.

9. Death

The death of one co-owner will not affect the others, as would be the case for joint tenancy, but the heir may not be as creditworthy and may have different goals or investment needs than the remaining co-owners.

10. Divorce

In California, a spouse cannot shield the property from being included in the divorce, thereby exposing the property to judicial proceedings. Sponsors seek spousal consent from married investors in community property states, but these may not be effective.

11. Limited Number of Investors

TICs are often limited to 35 investors in order to meet the requirements of Rev Proc 2002–22. This may make it difficult to acquire expensive, high grade, or unique property that needs the funding base of a greater number of investors.

12. Fear of Partition

TIC co-owners must retain the right to partition the property in order to comply with the requirements of Rev Proc 2002–22, since a fundamental principle of tenancy in common interests is the freedom to alienate one's interest. However, partitioning property may lead to a forced sale. While the procedure permits lenders to place restrictions on co-owners' right to partition that are consistent with "customary commercial lending practices," lenders are very cautious in waiving the right to partition and employ numerous methods to avoid it, *e.g.*, requiring that a co-owner offer the property to the other co-owners before selling it to an outsider. See IRS Letter Ruling 200513010; see also Pederson, *The Rejuvenation of the Tenancy-In-Common Form For Like-Kind Exchanges and Its Impact On Lenders*, 24 Ann Rev Banking & Fin L 467 (2005).

13. Tenant Credit Risk

Only a limited number of high-credit tenants exist, and even they may present a credit risk. The failure of a major triple-net tenant, or of several smaller ones, can jeopardize the entire project. Since investors in TICs have no management duties to begin with, these risks are less controllable by them. They must rely on the sponsor and the lender to have enough motivation to monitor the property and its management properly.

14. No Fiduciary Duty?

It is not clear to what extent cotenants have any fiduciary duties to each other. One cotenant could take an action that is not in the best interest of the others, thereby exposing its cotenants to litigation. Sponsors and property managers, or their affiliates, claim that they have no fiduciary duties towards the cotenants; while this claim is dubious, it is nevertheless crucial for the investors in these TICs to investigate the sponsor and

property manager of any project to ensure that they have good reputations, expertise, stability, and track records.

15. Securities or Real Estate?

Property that constitutes a "security" (as defined in §1031(a)(2)(C)) will not qualify for like-kind exchange protection. Many securities attorneys believe that TICs constitute "securities" under state and federal securities law. Even if a TIC is a security, it may still be real estate under state real estate law, and thus escape the §1031(a)(2)(C) exclusion. See Borden & Wyatt, *Syndicated Tenancy-in-Common Arrangements: How Tax-Motivated Real Estate Transactions Raise Serious Nontax Issues*, 18 Prob & Prop 18 (Sept./Oct. 2004).
The TIC industry has recognized that these arrangements generally fall within the scope of securities laws. Sponsors generally use a real estate broker in the syndication and also hire securities brokers to sell TIC interests. Investors need to understand the implications of TIC interests being viewed as securities, especially with regard to the limitations on their ability to later dispose of them. (Sponsors should also be mindful of rules against the sharing of commissions under real estate and securities laws.) Due to these concerns, TICs are sold with a formal offering memorandum, which includes formal budgets, tax opinions, indemnity agreements for payments made under recourse provisions of the mortgage loans, and other documents to create structures to cap liability.
In March 2005, the NASD issued Notice to Members 05–18, in which it concluded that TICs generally constitute investment contracts and therefore are securities for purposes of the federal securities laws and NASD rules.
In sum, for tax purposes, TICs are deemed to be real estate and thus eligible for treatment under IRC §1031 if executed and structured properly, as prescribed by Rev Proc 2002–22. However, for securities law purposes, TICs are considered securities, and therefore must comply with all federal securities laws. That is often why most sponsors advertise their product by claiming that they have obtained a legal opinion from a reputable law firm attesting to the fact that they have complied with the rules and Rev Proc 2002–22. Berkeley, *Real Estate Interests in Securities: TICS/DSTS* (ALI-ABA Course of Study, Mar. 16–18, 2006). See Aiken, *Evaluating Co-Ownership of Real Estate (CORE) or Tenant-in-Common (TIC) Interests in Real Estate* (Exeter 1031 Exchange Services) (available at http://www.exeterco.com/pdfs/Article_CORE_TIC.pdf).

16. Bonds or Real Estate?

If an investment is characterized as a bond, §1031 is not available. A long term triple-net-leased property with a creditworthy lessee can look quite bondlike to an investor, especially when the tenant has an absolute obligation to pay rent, unrelieved by condemnation or destruction of the property, and bears all operating expenses, taxes, maintenance, and insurance—and the lessor merely collects rent checks. Sponsors may be tempted to enter into such arrangements in order to make their product more attractive to investors since the investors are relying on a secured flow of rental income.
However, because of the threat that the IRS may say that this arrangement is no longer a typical triple-net lease (lacking credit risk), but is truly bondlike, it is safer for most planners and tax advisors to stay away from such structures if they want to preserve their §1031 nonrecognition feature. Borden & Wyatt, *Syndicated Tenancy-in-Common Arrangements: How Tax-Motivated Real Estate Transactions Raise Serious Nontax Issues*, 18 Prob & Prop 18 (2004).

17. Referral Fees to Real Estate Brokers

It is questionable whether a broker/sponsor can pay referral fees to third parties for any business they refer. If TICs are viewed as investment contracts under securities laws, such fees can be paid only to registered brokers dealers (NASD Rule 2420). This requirement disqualifies real estate brokers who are not also broker/dealers. Consequently, many brokers involved in the sale of TICs secure both a securities license as well as a real estate brokers' license. Brokers who do not have a securities license often view TIC interests as competition to their business and therefore are more hesitant to steer clients to such investments. Aiken, *Evaluating Co-Ownership of Real Estate (CORE) or Tenant-in-Common (TIC) Interests in Real Estate* (Exeter 1031 Exchange Services) (available at http://www.exeterco.com/pdfs/Article_CORE_TIC.pdf). Needless to say, in most deals that are clearly structured as a real estate transaction, this issue does not come up.

IV. Revenue Procedure 2002–22

A. Purpose

Revenue Procedure 2002–22 made tenancy in common ownership deals very attractive by allowing tenancy in common interests to be exchanged for other real estate. This opened up huge markets of exchange alternatives for individual investors.

At the heart of the procedure is the concern that the investor be truly an owner of real estate, rather than in a business venture or partnership. Section 3 (Scope) of Rev Proc 2002–22 provides:

> This revenue procedure applies to co-ownership of rental real property (other than mineral interests) ... in an arrangement classified under local law as a tenancy-in-common.

It is not clear what happens to community property, joint tenancy, and similar co-ownership arrangements. The procedure, by its terms, does not apply to property not held as a tenancy in common.

The procedure provides guidelines for requesting advance rulings. The guidelines are not substantive rules. The procedure does not create a safe harbor, although most practitioners treat it as such and believe that the IRS will only issue a ruling when some of the conditions are not satisfied.

Recently, however, sponsors have stopped requesting revenue rulings. Most sponsors are asking their attorneys, or attorneys associated with reputable firms, to issue tax opinion letters with many caveats instead. Most opinion writers take the position that, if all the conditions set forth in the procedure are met, their clients may go forward.

The procedure, however, has made lawyers, accountants, and taxpayers cautious when cotenancy arrangements violate one or more of the guidelines. Although TIC arrangements have not yet been tested in the courts, most authors believe that courts reviewing them will take a more liberal approach than the requirements set forth in the procedure. Today, sponsored TICs are being marketed either as having received favorable advance opinions from attorneys specializing in the area or as being "ruling eligible" under the revenue procedure; those that do not receive such opinions, or are not ruling eligible, may soon be at a competitive marketing disadvantage. See Tuchman, *Swap Till You Drop—Structuring Co-Ownerships Under Code Section 1031 After Revenue Procedure 2002–22* (Mar. 25, 2002) (available online at http://www.lplegal.com/mjt_co_ownership).

B. Conditions

There are 15 conditions to receiving an advance ruling from the IRS u nder Rev Proc 2002–22:

1. *Tenancy in Common Ownership*. Co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law. Title to the property may not be held by an entity.

2. *Limited Number of Owners*. Owners must not exceed 35 persons. Husband and wife are treated as one person, as are persons acquiring an interest from a co-owner by inheritance.

3. *No Treatment of Co-Ownership as an Entity*. This condition addresses co-owners doing business under a common name. Thus, using a fictitious business name may violate this condition. The owners also should not identify themselves as "partners" or "members." The IRS has reservations about any technique whereby co-owners who were in a partnership dissolve it and form a TIC in anticipation of a §1031 exchange. This liquidate-and-exchange device is quite popular, but it risks recharacterization as a sale by the partnership.

4. *Co-Ownership Agreement*. The parties may enter into a limited co-ownership agree ment that runs with the land and binds subsequent purchasers. Most agreements require that a selling co-owner first offer the interest to the other co-owners or the sponsor at fair market value.

5. *Voting*. Certain actions require unanimous approval by the owners:

Any sale, lease, or re-lease of any part or all of the property;
Negotiation or renegotiation of any debt secured by a blanket lien;
Hiring of any manager; and
Negotiation of any management contract (or any extension or renewal).

This requirement is difficult to meet because it is often impossible to get all owners to vote unanimously. Devices used to finesse this requirement—*e.g.*, master leases and profit sharing—can easily lead to recharacterization as a partnership and defeat the ability to exchange. Fickes, *An Uncommon 1031 Deal*, Nat'l

Real Est Investor (Aug. 1, 2003) (available online at http://www.nreionline.com/finance/netlease/real_estate_uncommon_deal).

The guideline permits other cotenancy decisions to be made by a simple majority vote of the owners. See IRS Letter Ruling 200327003 and Allen, Section 1031: When Exchanges and Partnerships Collide (PLI Course Handbook June 2006).

6. *Restrictions on Alienation*. For reasons already stated, cotenants and lenders usually want to control the transfer of interests. This guideline requires that each co-owner must be able to transfer, partition, and encumber its interest without the approval of anyone else. Restrictions required by a lender consistent with customary commercial lending practices are not prohibited.

7. *Split on Property Sale*. If the property is sold, all debts secured by any blanket lien must be satisfied and the remaining sale proceeds must be distributed to the co-owners. This bars arrangements designed to survive the disposition of the property, as is often the case with partnerships. This requirement, however, has no basis in economic reality because it ties up the flexibility of the owners and the needs of lenders, and is not legally justified. See Weller, *Selected Like-Kind Exchange Issues*, Fifth Annual Real Estate Tax Forum (PLI Course Handbook Feb. 2003); see also Weller, *Current Developments in Like Kind Exchange Transaction Planning*, Creative Tax Planning for Real Estate Transactions (ALI-ABA Course Handbook Oct. 7–9, 2004).

8. *Proportionate Sharing of Profits and Losses*. Each co-owner must share in all revenues and costs associated with the property in proportion to its interest. Special allocations of profits or losses are usually indicative of a partnership arrangement. There may be some situations in which a nonprorata arrangement might make sense. A cotenant could be required to indemnify the other cotenants if the first cotenant damages the property, *e.g.*, by discharging hazardous waste on the property. The ownership interest of a cotenant might be separately assessed for purposes of property in a state, such as California, that limits property tax revaluations except in case of changes of ownership. This ruling guideline apparently prohibits such an indemnification or a requirement that a cotenant bear excess property taxes imposed as a result of a change of ownership.

9. *Proportionate Sharing of Certain Debt*. The co-owners must share in any debt secured by a blanket lien in proportion to their interests, and any blanket lien must be recorded. This prohibits many creative financing arrangements and TIC arrangements responsive to different debt/equity ratio needs of different co-owners.

10. *Options*. A co-owner may grant others—other co-owners, lessees, or third parties—an option to purchase a co-owner's interest (call option), provided that the exercise price for the call option reflects the fair market value of the property as of the time the option is exercised. Therefore, an exercise price at a predetermined price may not meet the guideline. Absolutely prohibited by the revenue procedure are "put" options, in which a co-owner holds a right to sell the co-owner's undivided interest to the sponsor, the lessee, another co-owner, or the lender, or any related person. The effect is to make such an interest unattractive to those who want only to extend their 180-day exchange period; therefore, such investors will be disinclined to acquire a TIC interest because it gives them no guaranteed exit strategy.

11. *Customary Nonbusiness Activities*. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property. See Rev Rul 75–374, 1975–2 Cum Bull 261. However, activities of a co-owner or a related person with respect to the property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the property for less than six months.

12. *Management and Brokerage Agreements*. To qualify under the guideline, the management or brokerage agreements cannot exceed one year.

The manager may be the sponsor of the cotenancy or a co-owner, but may not be a lessee. The management agreement may authorize the manager to perform certain simple tasks, such as:

Maintaining 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;

Preparing statements showing the co-owners' shares of revenue and costs from the property;

Obtaining or modifying insurance on the property; and

Negotiating modifications of the terms of any lease or any indebtedness encumbering the property, subject to the approval of the co-owners.

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 from the property, since it may be indicative of a partnership between co-owners and manager 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. See Cuff, *Section 1031 Exchanges Involving Tenancies-In-Common*, Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2004 at 867 (PLI Course Handbook June 2004).

13. *Leases*. All leasing agreements must be bona fide leases for federal tax purposes. Rents must reflect the fair market value for the use of the property, which means that they must not depend on income or profits of the tenant unless based on a percentage of receipts or sales. See IRC §856(d)(2)(A). The co-owners should not share in the profits of the tenant.

14. *Loan Agreements*. The lender cannot be related to any co-owner, the sponsor, the manager, or any lessee. This absolute limitation on related party loans will force careful checking of the identity of co-owners and lessees.

15. *Payments to Sponsor*. Payment to the sponsor for (a) the acquisition of the co-ownership interest and (b) any other services must reflect the fair market value of the interest or the services, and may not depend on income or profits from the property. Thus, the sponsor is prohibited from sharing in the net profits derived from the property.

V. Conclusion

The proliferation of TICs in the marketplace presents new opportunities and challenges to lenders, sponsors, and investors.

The lenders' challenge is to structure the financing so as to minimize their risks and at the same time allow borrowers to comply with the guidelines of Rev Proc 2002–22. Lenders must carefully analyze the credit risk posed by their borrowers and take a conservative approach toward qualifying the property and the borrower. Attorneys and tax advisors must analyze the bankruptcy, foreclosure, and priority issues their clients face in these types of arrangements and accompanying documents. The lender's watch list in Swenson & Dickson, *The Recent Trend Toward Financing Tenancies in Common Poses Substantial Challenges to Lenders*, 28 Los Angeles Law 40 (Sept. 2005), is a good guideline for lenders.

Sponsors should take care in structuring their own involvement in these TICs. They should realize that the success of TICs is market driven. Sponsors should find ways to ensure that their investors' fractional interests will remain marketable and valuable with readily available exit strategies. Finally, sponsors should be mindful of their disclosure duties since, despite their beliefs, fiduciary duties toward the investors may attach. Sponsors who want to remain competitive in this market will have to seek and receive advance rulings from the IRS and more reassuring tax opinions from reputable attorneys in the field.

Investors should thoroughly investigate the sponsor, the property, and the asset manager of a particular TIC and study their track records. They should not rely solely on the information provided to them by the sponsors. Investors should analyze all risks associated with any given TIC and consult their tax advisors, estate planners, and accountants before entering into any TIC arrangement.

While Rev Proc 2002–22 was enacted to address the need for clarity on these prepackaged TIC arrangements, it is believed that the guidelines are not limited to prepackaged TICs. Indeed, the procedure has greater impact in regular typical nonsyndicated, nonprepackaged TICs, since those are more common.

Many practitioners may view Rev Proc 2002–22 as a major break with the IRS's past position, since there are now guidelines to ensure that TIC arrangements will not be treated as interests in partnerships rather than interests in real estate. However, the guidelines spelled out in the procedure do not guarantee anyone involved that the IRS will provide an advance ruling, much less a favorable one. The procedure will undoubtedly have great significance in audits, but should not cause taxpayers to fully rely on them. For the time being, the guidelines set forth in Rev Proc 2002–22, in many respects, have become major hurdles for taxpayers to overcome. The IRS is still in a study stage, and the fact that the procedure has gone far beyond the existing

case law in this area will give no comfort to most lawyers and tax advisors. Thus, for the moment, all that can be done is to proceed with extreme caution.