Tax Free Exchanges Using Tenant in Common Interests: The IRS Clarifies an Otherwise Murky Area

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The Internal Revenue Service has provided some clarity in a recent Revenue Procedure as to how an owner of a tenants in common interest can sell or acquire an undivided interest in real property and qualify the transaction as a Tax-Free Exchange. However, as this article explains, owners of a tenants in common interest must keep in mind that the Revenue Procedure is not a substantive interpretation of the law but rather a guideline for such property owners to approach the IRS in seeking a ruling.

John Doe and Joe Black own as tenants in common a parcel of investment real property. When they acquired the property, a commercial building with several tenants already existed on the property. John and Joe agreed to share equally the costs of purchasing the building and any repair and maintenance work and they agreed to share equally the profits from the building. The leases are triple net leases and John and Joe alternate turns collecting the rent, paying the mortgage and coordinating the repair and maintenance work on the building and property. Over the years, John and Joe provide little to no oversight of the building and no material improvements are made to the building.

After several years, John and Joe decide to liquidate their investment and separately pursue other similar real estate investments in the area. In order to preserve the maximum amount of their gains from the sale of the property, they would like to each pursue a like-kind exchange and defer recognizing the taxable gain in accordance with Section 1031 of the Internal Revenue Code (the ''Code'').[1] Being the savvy investors that they are, John and Joe meet with an attorney to discuss structuring the sale of the property as a tax-deferred like-kind exchange. The attorney raises the question as to whether their co-ownership of the property is a partnership. The attorney then explains that if John and Joe have been operating as a partnership, they cannot sell their co-ownership interests in the property and each acquire a separate parcel of property as part of a tax-deferred like-kind exchange. However, if they merely co-owned the property as an investment, the attorney informs them, then they can sell their separate interests in the property and each acquire a separate parcel of property in a tax-deferred like-kind exchange.

This issue has been faced by many real estate investors over the years who have joined together to acquire real property or have inherited property as tenants in common. After several years of co-ownership the parties want to sell the property and go their separate ways investing the proceeds from the sale in different parcels of real property without recognizing taxable gain

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through the like-kind exchange rules under Section 1031 of the Code.

General Rule: Like-Kind Exchanges

In general, an owner of any property used in a trade or business or held for investment may sell the property and defer any tax on the gain realized if the owner acquires ''like-kind'' property within a prescribed period of time (''Tax-Free Exchange'').[2] If the owner receives money or other property in the transaction which is not considered like-kind property, the owner will recognize gain on the Exchange but only to the extent of the sum of money received or the fair market value of the property received. Although Section 1031 of the Code permits the sale and exchange on a tax deferred basis of many types of like-kind properties, the sale or exchange of partnership interests does not qualify for Tax-Free Exchange treatment.[3] Thus, co-owners of real property who are deemed by the IRS to own real property as a partnership and who then attempt to sell their interests and acquire separate individual parcels of real estate will be deemed to have sold partnership interests in a taxable transaction and not as part of a Tax-Free Exchange.

How then do co-owners of real property know whether or not they own property as tenants in common or as partners in a partnership for federal income tax purposes? The courts and the IRS have addressed this question on numerous occasions. While both the courts and the IRS state seemingly objective tests to determine whether co-owners of real property are acting as a partnership or as merely co-owners, the application of these tests to similar factual scenarios is often not consistent.

Tenancy-In-Common Interests Versus Partnership Interests

First and foremost, whether a partnership exists for federal income tax purposes is a matter of federal law and not state law. Thus, the question as to whether John and Joe's co-ownership of the property in the above example constitutes a partnership will be determined under the Code and underlying case law regardless of whether they formally created a partnership for state law purposes. The question as to whether a partnership existed under the applicable state law will be of some value to the court and the IRS but ultimately the question is a matter of federal law.[4]

For purposes of the Code, the term partnership can include ''a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a corporation, trust or estate.''[5] Thus, the term ''partnership'' as used in the Code is broader in scope than its traditional common law meaning and may include groups not traditionally considered to be partnerships.[6]

When persons combine their skills, labor, capital or goods to conduct a business enterprise, trade or profession and they each take an interest in the profits and losses they have effectively created a partnership. Whether a partnership exists or not is a question of fact based on all of the facts and circumstances surrounding their arrangement with the essential issue being whether the parties intended to and did indeed operate as a partnership. To answer this question, the courts will look at any agreements between the parties (written or oral), the parties' conduct and statements to third parties, their respective abilities and amount of capital contributed to the operation. The mere co-ownership of property and an agreement to share expenses does not in and of itself create a partnership. However, if the co-owners carry out the requisite degree of business activity, they will be deemed to be a partnership.[7]

Conversely, the following serves as a generally accepted definition of a tenancy in common: ''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.''[8] Each tenant in common is entitled to possession of the entire parcel of real estate along with each of the other tenants in common. As such, each tenant in common is entitled to a share of the rents or profits from the property and each is entitled to transfer their interest and to demand partition of the property. A tenant in common possesses the benefits of ownership in the property with the condition that such rights may not be exercised to the detriment of the other tenants in common.

The courts and IRS frequently reiterate the above tests in determining whether co-ownership of property constitutes a partnership. Yet, despite the apparent objectivity of the tests, the application of the tests is often subjective and less uniform. For instance, two individuals who acquired investment property were deemed to have created a partnership when they informally agreed to share all profits and expenses and did a minimal amount of maintenance (the main tenant to the property was responsible for its own maintenance of the property), they had not entered into a formal partnership arrangement. Proceeds from the sale of the investment property were deposited into their individual bank accounts. Based on these facts, the court concluded that their arrangement was indeed a partnership for federal income tax purposes.[9]

In another case, the taxpayer and several other individuals co-owned rental property and had agreed to share equally the income and expenses of the property. Although they had not formerly created a partnership, each year they filed a partnership tax return with the IRS reporting the income, expenses and allocations from the property. Each year they collected rent from the property and paid all of the expenses for the property. In one year, the taxpayer elected to pay all of the real estate taxes on the property and claimed the entire payment as a deduction. The IRS sought to disallow the deduction believing that the co-owners

were engaged in a partnership and that the expense should be shared equally among them as partners. The court disagreed and held that the taxpayer and the other owners were merely co-owners of the property and were not engaged in a partnership.[10]

Although the tests for whether the co-ownership of real property constitutes a partnership appear to be objective, they leave much to be desired in providing a clear sense as to whether or not the co-owners have inadvertently become a partnership for tax purposes. The result could be disastrous if the parties sold their interests in the property and acquired other property believing that the transaction qualified as a Tax-Free Exchange only to have the IRS disqualify the transaction from such treatment because they were deemed to own the property as partners in a partnership.

Revenue Procedure 2002-22

Fortunately, the IRS has provided a level of certainty to co-owners of real property as to whether their ownership arrangement constitutes a partnership. In March 2002, the IRS issued Revenue Procedure 2002-22 to provide guidance on when it would consider ruling requests to determine whether co-ownership of real property constituted a partnership for purposes of a Tax- Free Exchange. Although the Revenue Procedure was primarily targeted to dealers who sell undivided tenant in common interests in real estate as a Tax-Free Exchange investment vehicle, the Revenue Procedure does provide helpful guidance to co-owners of real property who need to properly structure their investment arrangement so as not to be deemed a partnership for federal income tax purposes.[11]

In the Revenue Procedure, the IRS sets forth certain minimum guidelines pursuant to which it will rule with respect to whether the relationship among co-owners of property as tenants in common constitutes a partnership for federal income tax purposes. These guidelines provide co-owners of investment property a helpful guide in structuring their investment arrangement so they can maximize the development potential of the property and their relationship as tenants in common without being deemed a partnership and jeopardizing the opportunity to participate in a Tax-Free Exchange in the future.

Identity Of The Owners

The first several guidelines are fairly straightforward and merit little discussion. Each of the co-owners must hold title to the real property as a tenant in common under local law and the co-owners cannot collectively hold their interests in any form of a partnership or other entity.[12] Each of the co-owners must be an individual rather than a business entity and there can be no more than 35 individuals as co-owners of the property.

Transfer Of Interests

Although the co-owners of the property cannot operate together in the same manner as a partnership, they can enter into agreements that run with the land with respect to the maintenance and management of the property. Thus, the co-owners can enter into an agreement which provides that any co-owner who seeks to exercise their right of partition must first offer their tenant in common interest to the other co-owners for its fair market value (determined as of the date of exercise).[13] In addition, the co-owners can enter into an agreement to have a right of first offer with respect to any co-owner's exercise of the right to transfer their interest in the property.[14] These rights also apply to the lessee of the property as well.[15]

Each co-owner may also grant a call option for the sale of their tenant in common interest in the property. The exercise price of the call option must reflect the fair market value of the property at the time the option is exercised. However, a co-owner cannot acquire a put option to sell their undivided interest to any other co-owner, lender or sponsor of the property or any person related to the aforementioned persons.[16]

Notwithstanding these rights, each co-owner must still have the right to transfer, partition and encumber their undivided interest in the property without the agreement or approval of the other co-owners or any other person. However, each co-owner may agree to restrict their rights to transfer their interest or partition the property as may be required by an un-related lender whose loan is secured by the underlying property.[17]

Property Management

The co-owners must retain the right to approve the following matters by unanimous consent:

(1) the hiring of any manager and the management agreement,

(2) the sale or other disposition of the entire property,

(3) any leases of a portion or all of the property, or

(4) the creation or modification of a blanket lien (*i.e.,* a mortgage which is secured by the entire property).

Any other actions to be voted on or approved by the co-owners may be by co-owners holding at least 50 percent of the undivided interests in the property.[18]

Upon the sale of the property by the tenants in common, the proceeds from the sale must first satisfy any existing mortgages secured by the entire property. The remaining net proceeds must then be distributed to the co-owners.[19] Accordingly, the co-owners must also share in any indebtedness secured by the entire property in the same proportion as their undivided interests.[20] Clearly, the intent behind the proportionate share of net proceeds and liabilities is to ensure that the economic arrangement among the owners reflects their common interests as tenants in common and not as a partnership. Thus, there is no real means of specially allocating net proceeds, liabilities or profits

and losses among the co-owners in a manner different from their ownership interests.

Not surprisingly, each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to their undivided interests in the property. The co-owners, a dealer or promoter, or manager may not advance funds to a co-owner to meet expenses associated with the operation of the property. A co-owner may make a loan to another co-owner provided that the loan is fully recourse to the borrowing co-owner and the term of the loan does not exceed 31 days.[21]

In keeping with the concept that the co-owners are not a partnership, the Revenue Procedure further provides that the co-owners' activities must be limited to those activities customarily performed in connection with the repair and maintenance of rental real property. However, the co-owners may hire a management agent to provide additional services to the property provided that the management agent is an independent contractor and is responsible for determining the manner in which it will provide the services, will bear all of the expenses for providing the services and retains for its own use all of the income from the services.[22]

Notwithstanding the prohibition of the co-owners engaging in business activities with respect to the real property, the co-owners may enter into a management agreement with a related person and avoid their management activities being imputed to the co-owners. The management agreement must be renewable on at least an annual basis. Under the terms of the agreement, the manager may maintain a single bank account for collecting and depositing rents and paying expenses before making disbursements to each co-owner. The manager must disburse net revenues to the co-owners within three months from the date the manager collects the revenues. The manager may also prepare periodic statements showing each co-owners' share of profits and expenses from the property and the manager may obtain or modify the insurance on the property, negotiate modifications to the terms of any lease and negotiate modifications to the terms of any indebtedness encumbering the property. Notwithstanding the manager's right to modify the terms of any lease or indebtedness, the manager must still obtain the approval of the co-owners as discussed previously. The manager's fees cannot depend either completely or partially on the income or profits earned by any person from the property.[23]

Lastly, the lease agreements entered into by the tenants must also satisfy certain criteria in order for the co-owners to avoid being treated as a partnership. The rent under any lease must be for fair market value and cannot be based on the income or profits earned by the tenant unless it is based on a fixed percentage of gross receipts or gross sales.[24] Thus, a lease under which rent is calculated on the basis of net income or cash flow would not satisfy the provisions of the Revenue Procedure.

Planning Opportunities

Section 6.03 of the Revenue Procedure provides that partners who become co-owners of real property through a liquidation of a partnership and then immediately sell their interests and acquire other like-kind property will not qualify for a Tax-Free Exchange. The immediate liquidation and sale of the co-ownership interests will be deemed to be a sale of partnership interests. However, this rule is predicated on the liquidation and sale happening within a relatively short period of time, thus, the Revenue Procedure appears to leave open the possibility that under certain circumstances a partnership could liquidate and the partners' sell their co-ownership interests as part of a Tax-Free Exchange. Because of the various provisions in the Revenue Procedure with respect to management, co-ownership, transfer of interests, rents and the like, it is conceivable that a partnership could liquidate and transfer its real property to the partners as co-owners. Those co-owners could continue to hold the property as tenants in common for a period of time before selling their interests in the property as part of a Tax-Free exchange. Most likely, such a transaction would only succeed if the partnership liquidation is not predicated on the prior agreement of the parties involved to sell their co-ownership interests in the property acquired in the liquidation.

Conclusion

Although the Revenue Procedure provides some clarity as to how an owner of a tenants in common interest can sell or acquire an undivided interest in real property and qualify the transaction as a Tax-Free Exchange, owners of a tenants in common interest must keep in mind that the Revenue Procedure is not a substantive interpretation of the law but rather a guideline for such property owners to approach the IRS in seeking a ruling. The Revenue Procedure does not overrule existing case law regarding the Tax-Free Exchange of a tenant in common interest. Thus, if the Revenue Procedure seemingly conflicts with existing law, the property owners should deem the case law as still controlling authority and consult their professional advisors in the structuring of the purchase or sale of a tenant in common interest in real property.

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[1] All references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended from time to time.

[2] Code § 1031(a)(1).

[3] Code § 1031(a)(2)(D).

[4] *Commissioner v. Culbertson,* 337 US 733 (1949); *Cusick v. Commissioner,* TC Memo 1998-286.

[5] Code § 761(a).

[6] *Cusick v. Commissioner,* TC Memo 1998-286.

[7] *Cusick v. Commissioner,* TC Memo 1998-286.

[8] § 2 Rev. Proc. 2002-22, 2002-1 C.B. 733 (March 19, 2002).

[9] *Cusick v. Commissioner,* TC Memo 1998-286. Of note in the court's decision, is that the decision was in favor of the taxpayer as the Internal Revenue Service was seeking to disallow an allocation of expenses claimed by the taxpayer. If the taxpayer had not been found to be a partner in a partnership, the allocation of expenses would have been disallowed.

[10] *Powell v. Commissioner,* TC Memo 1967-32. Interestingly enough, again the court's decision was in favor of the taxpayer.

[11] § 2 Rev. Proc. 2002-22, 2002-1 C.B. 733 (March 19, 2002).

[12] Rev. Proc. 2002-22, *Section 6.02.*

[13] Rev. Proc. 2002-22, *Section 6.04.*

[14] Rev. Proc. 2002-22, *Section 6.06.*

[15] Rev. Proc. 2002-22, *Section 4.*

[16] Rev. Proc. 2002-22, *Section 6.10.*

[17] Rev. Proc. 2002-22, *Section 6.06.*

[18] Rev. Proc. 2002-22, *Section 6.05.*

[19] Rev. Proc. 2002-22, *Section 6.07.*

[20] Rev. Proc. 2002-22, *Section 6.09.*

[21] Rev. Proc. 2002-22, *Section 6.08.*

[22] Rev. Proc. 2002-22, *Sec. 6.11. See* Rev. Rul. 75-374, 1975-2 C.B. 261.

[23] Rev. Proc. 2002-22, *Sec. 6.12.*

[24] Rev. Proc. 2002-22, *Sec. 6.13.*