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Avoiding Partnership Status
—*Reviewing New Guidance in Like-Kind Exchanges*

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The Internal Revenue Service recently issued Revenue Procedure 2002-22, providing ruling guidelines for the tax classification of undivided fractional interests in rental real property. Although we continue to find clients to whom this comes as a surprise, section 1031 of the Internal Revenue Code prominently provides that the tax-free treatment accorded to like-kind exchanges does not apply to the exchange of partnership interests. Therefore, partnership interests cannot constitute either relinquished property or replacement property in a like-kind exchange.

When confronted with this obstacle, real estate lawyers sometimes propose restructuring the partnership into a tenancy-in-common. For example, a taxpayer who transfers real property in a like-kind exchange may replace it with a 50% tenancy-in-common interest in a building, since the tenancy-in-common interest constitutes real property. Then, the tax lawyers "who always foul-up the deal" point out that for tax purposes a tenancy-in-common is often treated as a partnership, resulting in a disqualified exchange.

Whether a tenancy-in-common will be classified as a partnership for tax purposes is based on the facts and circumstances of each case. Typically, a real estate attorney begins drafting a tenancy-in-common agreement and asks what provisions will give rise to tax problems? From the tax perspective, an agreement which simply states that the parties intend that the tenancy-in-common not be a partnership is good; everything else the parties want to add is probably bad.

Treasury Regulation section 301.7701-1(a)(2), which deals expressly with this question, provides:

> A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owners, or tenants in common, of farm property lease it to a farmer for a cash

> rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

It emerges from this regulation and the other limited authority in this area that partnership characteristics pertaining to a tenancy-in-common weigh in on a cumulative basis. At a certain point enough partnership attributes accumulate such that the tenancy-in-common resembles a partnership.

We would like to think that the IRS issued Revenue Procedure 2002-22 (the "Rev. Proc.") to make our lives easier and clarify this mess, but the Rev. Proc was actually the result of a study announced in Revenue Procedure 2000-46 intended to address situations where co-ownership interests are prepackaged for sale as replacement properties in like-kind exchanges. To satisfy the needs of taxpayers seeking replacement property in like-kind exchanges, promoters (or in the words of the Rev. Proc. "sponsors") take large real estate assets and chop them up into tenancy-in-common interests which are then made available as replacement property. The tenants-in-common are usually strangers to each other and have no interest in operating the property. The sponsor, therefore, typically negotiates a lease of the property, arranges financing and hires a manager. The resulting arrangement is a far cry from the simple case of two people who buy a building as tenants-in-common and share the revenue.

The Rev. Proc. illustrates the Service's concerns in these cases with the following description of *Bergford v. Com'r*, 12 F.3d 166 (9th Cir. 1993):

> [S]eventy eight investors purchased "co-ownership" interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.
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> The court held that the co-ownership constituted a partnership for tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances).

In response to this perceived problem, Revenue Procedure 2000-46 announced a moratorium on private letter rulings in this context and a study which culminated in the Rev. Proc.

The Rev. Proc. consists primarily of a list of conditions which must be satisfied as a prerequisite to receiving a private letter ruling from the Internal Revenue Service. Here are some of the highlights:

- Each co-owner must hold title to the property as a tenant-in-common.
- The tenants-in-common may not number more than 35.

As reflected in this condition, the Service is targeting large prepackaged cases like *Bergford*. Yet, the Rev. Proc.'s conditions (to obtaining a tax ruling) apply equally to cases of two person tenancies-in-common where they may tend to be overly restrictive.

- The co-owners may not file a partnership or corporate tax return. The co-ownership may not conduct business under a common name or hold itself out as a partnership or other form of business entity. Moreover, if the co-owners own the property through a partnership or corporation immediately before the formation of the co-ownership, the Service will generally not issue a ruling.

These conditions show the importance of getting tax advice early, since it may not be possible to cure a wrong move.

- The co-owners may enter into a limited co-ownership agreement which may run with the land. (The Rev. Proc. then goes on to set forth guidelines relating to such an agreement.)

What is meant by the qualification "limited"? Does it allow the Service to deny a ruling on the grounds that it finds the agreement to be more than limited or does it simply mean that it complies with the restrictions set out in the Rev. Proc., which follow?

> **Voting.** Decisions to hire managers, sell property, lease property or incur debt secured by the property must have the unanimous consent of the co-owners. The co-owners may agree to be bound by a majority of the interests with respect to all other decisions.
>
> **Alienation.** Each co-owner must have the rights to transfer, partition and encumber his interest without the agreement or approval of any person. However, restrictions required by a lender which are consistent with commercial lending practices are not prohibited.

Query: Is it necessary to provide that such provisions become inoperative when the loan is repaid in order to establish that they were adopted only because of the lender's insistence?

> A right of first offer is also permissible and co-owners may be required to offer their interests at fair market value to other co-owners, the lessee of the property, or the promoter of the arrangement before exercising a right of partition.

The Rev. Proc. does not say whether a right of first refusal is permissible.

- If the property is sold, any debt secured by the property must be satisfied and the remaining sales proceeds distributed.

- Revenues, costs and any debt secured by the property must be shared in accordance with the percentage ownership of the property.
- Neither the sponsor nor any co-owner may advance funds to a co-owner to meet expenses associated with the co-ownership interest unless the advance is recourse to the co-owner and is not for a period exceeding 31 days.
- Options to purchase co-tenancy interests at fair market value are permissible, but options to "put" such interests are not.
- Management agreements entered into by the co-owners must be renewable no less frequently than annually.

Is an agreement which automatically renews annually (absent action by either party) permissible?

- The manager must disburse to the co-tenants their shares of net revenues within three months of the date of receipt of those revenues.
- The manager may have the authority to negotiate modifications of the terms of any lease, "subject to the approval of the co-owners."
- All leasing arrangements must be bona fide leases for federal tax purposes. The rent must be at fair market value and may not be based, in whole or in part, on the income or profits derived from the property, but may be based on fixed percentages of receipts or sales.
- Amounts paid to the sponsor to acquire tenancy-in-common interests and fees paid to the manager must reflect fair market value and may not be based in whole or in part on the income or profits derived from the property.
- The lender with respect to any debt that encumbers the property or with respect to any debt incurred to acquire an interest in the property may not be a related person to any co-owner, the sponsor, the manager or any lessee.

The Rev. Proc. provides that its ruling guidelines are not intended to be substantive rules and are not to be used for audit purposes. Moreover, the Rev. Proc. allows the Service to deny a ruling request even if it meets all of these requirements "whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration"—a pretty broad discretionary standard. On the other hand, if the conditions are not met "the Service may consider a request for a ruling under this revenue procedure where the facts and circumstances clearly establish that such a ruling is appropriate"—good luck.

On its face, the Rev. Proc. concedes very little to the taxpayer. In many cases the time constraints imposed by section 1031 preclude obtaining a private letter ruling, which often takes over 6 months. The restrictions in the Rev. Proc. are so tight that one wonders why this guidance did not take the form of a safe harbor. When you boil down the Rev. Proc., the IRS has merely agreed to accept ruling requests in a limited number of cases (at $5,000 a pop).

One substantive point arising from the Rev. Proc. is the Service's affirmation and interpretation of Revenue Ruling 75-374. Revenue Ruling 75-374, 1975-2 C.B. 261, held that a tenancy-in-common ownership of an apartment building was not a deemed partnership, where the co-owners (a life insurance company and a real estate investment trust) limited themselves to furnishing only the customary services that arise in connection with the maintenance and repair of the property. Such customary services included "heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning of public areas." Noncustomary services were provided by the manager who paid the costs and retained the income from providing such services.

The Rev. Proc. requires that the co-owners limit activities performed with respect to the property to those "customarily performed in connection with the maintenance and repair of rental real property." The Rev Proc. then cites Revenue Ruling 75-374 and states that activities will be treated as "customary" if the activities would not prevent amounts received by certain exempt organizations from qualifying as rent under section 512(b)(3)(A) of the Code. (If an exempt organization provides the wrong type of services to its tenants, the rent from those tenants will not qualify for certain favorable treatment.) The Rev. Proc. thus clarifies the term "customary" as used in Rev. Ruling 75-374 by reference to the section 512(b)(3)(A) standard, which would permit the provision of many services not mentioned in Revenue Ruling 75-374.

Previously, in cases not involving net leased property, taxpayers were often unsure whether the services they provided were "customary." Now, even without obtaining private letter rulings, practitioners may be able to rely on the Rev. Proc.'s interpretation of Revenue Ruling 75-374. Thus, a perhaps unintended aspect of the Rev. Proc. may be its most important long-term benefit to real estate co-owners.

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