Tax Management Memorandum
March 7, 2005, Vol. 46 No. 05

Tax Management Memorandum

Vol. 46 No. 05 **March 7, 2005**

MEMORANDUM

Finally, IRS Issues Ruling Under Rev. Proc. 2002-22 Involving Multi-Tenant Building with Blanket Mortgage*

by Howard J. Levine
Roberts & Holland LLP
Washington, D.C.*

Major References:

I.R.C. §1031; Rev. Proc. 2002-22, 2002-14 I.R.B. 733.

INTRODUCTION

Rev. Proc. 2002-22[1] set forth conditions under which an undivided fractional interest in real estate would be treated as eligible replacement property in a §1031[2] exchange and not as an interest in a business entity, such as a partnership. Since the publication of Rev. Proc. 2002-22, the IRS had previously issued only one private letter ruling under the ruling guidelines of the revenue procedure.[3] That ruling involved a single tenant net leased property on which there was no blanket mortgage, i.e., each taxpayer who acquired an undivided tenancy in common (TIC) interest in the property obtained his own financing so that a default by one TIC owner could not result in a foreclosure of the underlying real estate.[4] On December 6, 2004, the IRS issued a second private letter ruling[5] (the "Ruling") which is the first and only ruling dealing with a multi-tenant building subject to a blanket mortgage.[6] Further, the ruling is significant because the sponsor will maintain a TIC interest in the property and stay in as a co-owner.

BACKGROUND

The IRS announced in Rev. Proc. 2000-46[7] that it would no longer issue rulings in connection with undivided fractional interests (UFIs) acquired as replacement property in §1031 exchanges. Instead, it began a study to determine under what circumstances undivided interests should be treated as partnership interests. This study culminated in Rev. Proc. 2002-22, in which guidelines (Guidelines) were issued under which an advance ruling could be obtained. In several ways, the Guidelines were very generous, and they may have permitted one to include provisions in documents that previously may have caused some concern. In other ways, the Guidelines were very conservative and, as explained below, most existing structures that were being offered by syndicators and promoters[8] could not fully comply with the revenue procedure.

Some of the Guidelines[9] and conditions for obtaining a ruling, which are relevant to the Ruling, are:

> 1. The Guidelines "are not intended to be substantive rules and are not to be used for audit purposes." [*However, from a practical viewpoint, taxpayers and IRS agents will undoubtedly both be looking to these Guidelines*.]
>
> 2. Each of the co-owners must hold title to the property as co-owners under local law (either directly or through a disregarded entity).
>
> 3. There cannot be more than 35 co-owners (for this purpose, a husband and wife, and all persons who acquire an interest by inheritance, are treated as one co-owner).
>
> 4. The co-owners "must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any lease of a portion or all of the property or the creation or modification of a blanket lien."
>
> 5. Any sale, lease or release of the Property, any negotiation or renegotiation of indebtedness secured by a blanket mortgage,

the hiring of any manger, and the negotiation (or renegotiation) of any management contract, must be "by unanimous approval of the co-owners."

6. For all other actions on behalf of the co-owners, the co-owners may agree to be bound by a vote of those holding more than 50% of the undivided interests in the Property.

7. Restrictions on the right to transfer, partition or encumber the co-owner's interest in the Property "that are required by a lender and that are consistent with customary commercial lending practices are not prohibited."

8. "Customary" type services (typically performed in connection with maintenance and repair of the property), including cleaning of public areas and the furnishing of heat and light, can be provided to the tenant by the co-owners or their agents. The revenue procedure states that activities will be treated as "customary" if the activities would qualify as rent under §512(b)(3)(A). This would include heat, air conditioning (although not mentioned in the ruling, it is mentioned in the Preamble to the revenue procedure), trash removal, unattended parking, and maintenance of public areas.

9. No business type activities (except perhaps, as discussed above, for "customary services") can be conducted with respect to the property. For this purpose, all activities of the co-owners, their agents and any person related to the co-owners "with respect to the property" will be taken into account and attributed to the other co-owners, except to the extent that a particular co-owner holds his interest for less than six months).

10. Management agreements must be renewable no less frequently than annually. [*When taken together with the requirement that management agreements must have unanimous approval, this requirement (which apparently was based on one of the conditions in Regs. §1.761-2(a)(2)) may, from a practical viewpoint, be impossible to meet in almost all situations. IRS representatives have said orally that neither an automatic renewal in the agreement nor merely giving the co-owners the right to "revoke" the appointment of the manager may be acceptable*.]

The deluge of rulings that may have been expected by the IRS to materialize from the publication of Rev. Proc. 2002-22 did not occur; probably because it was virtually impossible, as a practical matter, to meet all the literal conditions required under the revenue procedure to obtain a ruling. It was also not entirely clear which of the conditions the IRS considered essential from a substantive law viewpoint (and not just to obtain an advance ruling). While the issuance of PLR 200327003 did reflect flexibility on the part of the IRS in interpreting the revenue procedure, it did not involve a blanket mortgage or a multi-tenant building that would typically raise a number of practical concerns, including significant lender concerns. It is understood that several attempts were made by sponsors and their advisors to obtain rulings that would have addressed some of these issues and concerns, but no further ruling had actually been obtained (until the issuance of the Ruling discussed below).

The TIC industry has exploded[10] and the lack of rulings has caused sponsors to rely on tax opinions. Over time, a number of conditions of Rev. Proc. 2002-22 were treated by some sponsors and practitioners as generally not reflecting the law, despite the IRS's repeated statements at public forums to the contrary. Eventually, a few sponsors even became quite aggressive, which ultimately resulted in what would appear to be unwanted publicity for the industry.[11] All of this placed investors, and particularly attorneys advising investors, in a difficult position. Often a tax attorney would be asked by his client to review a number of possible TIC (and non-TIC) replacement property deals and advise which deals would be safe from a §1031 viewpoint. The client, of course, would then make the decision on how to proceed, taking into account, among other things, the overall costs, the expected returns, the type of property, whether there is a secondary market for the investment or an exit strategy, and the tax advice he receives from his tax lawyer. On the one hand, the transactional costs on some of these deals are high and sophisticated tax advisors and clients may also be concerned about the tax issues. On the other hand, taxpayers who are seriously considering these deals often have no other viable options for replacement property and the 45 day clock is ticking.

As stated, the IRS has now issued the Ruling, which is the first and only ruling dealing with a multi-tenant building subject to a blanket mortgage, and the first ruling where the sponsor intended to maintain a TIC interest in the property and stay in as a co-owner. While sponsors may want to continue to rely just on tax opinions, investors and their tax advisors should welcome this ruling as being helpful in evaluating the myriad number of syndication deals in the marketplace and the potential tax issues.

THE RULING

The following is a general summary of the facts involved in the new ruling:

The sponsor (Company) represented that it will acquire multi-tenant office buildings on contiguous properties (referred to herein simply as the "Property"). Under each lease, the tenant would be responsible for its pro-rata share of real estate taxes and operating expenses, as well as maintenance and repair of certain fixtures, equipment, and systems. In addition, each tenant would keep and maintain the Property and areas adjoining the Property in a clean and orderly condition, free of accumulation of dirt, rubbish, snow, and ice. The term of each lease would vary.

Following acquisition, Company would create and sell undivided fractional interests in the Property at fair market value to no more than 35 persons (Co-owners). Company would retain an undivided fractional interest in the Property. Each Co-owner would acquire its interest in the Property by paying cash and/or assuming a pro-rata share of the blanket debt on, the Property.

Each Co-owner would be required to enter into a co-tenancy ownership agreement (co-tenancy agreement). The co-tenancy agreement would provide that the unanimous consent of all Co-owners shall be required to enter into any amendments, consents to assignment, subleases, re-leases, or modifications of any lease of Property or guarantees of lease, the sale of the entire Property, the appointment or reappointment of a property manager for Property under the management agreement, or the incurrence of any indebtedness secured by Property. For all other actions, the approval by holders of more than 50% of the undivided fractional interests would be required.

Under the co-tenancy agreement, a Co-owner could, at any time, sell, finance, or otherwise create a lien upon the Co-owner's own interest, provided it did not create a lien on anyone else's interest. In addition, any Co-owner could freely sell, assign, or transfer all or a part of its interest in Property. Each Co-owner would also have the right, subject to any restrictions contained in any documents related to any loan on Property, to exercise a right of partition with respect to its interest in Property, and to file a complaint or institute any proceeding at law or in equity to have Property partitioned. However, before exercising any right to partition, each Co-Owner would agree to offer its interest for sale to the other Co-Owners at fair market value, as determined by an independent appraisal.

The co-tenancy agreement would further provide that each Co-owner would grant an option to the other Co-owners to acquire its interest at fair market value in the event: (1) there is a proposal to sell part or all of Property, or to incur indebtedness to be secured by Property, or to modify any lease (or guarantee of a lease) of Property; (2) the Co-owner votes not to proceed in circumstances where holders of more than 50% of the Co-Ownership interests vote to proceed with the proposed action; or (3) a Co-owner provides a notice of termination of the management agreement. If the proposed action were to sell part or all of Property to an unrelated third party who had made a bona fide offer, the fair market value would be determined by reference to the price proposed for the entire property multiplied by the Co-owner's percentage interest in Property. Otherwise, the fair market value would be determined by an independent appraisal of the total fair market value of the entire Property multiplied by the Co-owner's percentage interest in Property.

Following the purchase of an interest, each Co-owner would enter into a management agreement with Management Company. Management Company would be related to Company through a common parent. Under the management agreement, Management Company would agree to manage all administrative, operational, and management matters of Property, including but not limited to the management of all lease agreements.

The management agreement would also provide that each Co-owner agrees to be obligated for a proportionate share of all costs associated with Property, to the extent that the revenues from Property are insufficient to cover the costs. In addition, if Property operates at a loss or if capital improvements, repairs, or replacements are required, for which capital reserves do not exist, the Co-owners would, upon request, make necessary payments in proportion to their individual ownership interests in Property. Distributions of each Co-owner's share of net revenue would be made at least quarterly.

The term of the management agreement would be 12 months, renewable annually under certain procedures. At certain periods, but prior to the end of each 12-month term (renewal period), the Management Company would provide Co-owners with a notice of renewal of the management agreement. The notice would provide each Co-owner the opportunity to object to specific provisions of the agreement as well as to terminate the agreement as set forth in the notice of renewal. The notice of renewal would be sent to each Co-owner at the address provided by the Co-owner for this purpose using certified mail, return receipt requested (postage prepaid), or by using a nationally recognized courier service that guarantees overnight delivery, either alternative being an "approved notice method."

Any Co-owner (objecting Co-owner) could cause the management agreement not to be renewed by providing a notice of termination to the Manager and to the other Co-owners by the approved notice method within a certain period prior to the end of the renewal period, provided the objecting Co-owner set forth a substitute manager and the material terms under which the substitute manager would be engaged. The engagement of the substitute manager would be subject to the approval of each of the other Co-owners.

Each Co-owner would have a certain period after the date of the notice of termination to provide written notice by the approved notice method to the Objecting Co-owner and the other Co-owners that the substitute manager was unacceptable and the reasons therefore.

If any Co-owner provided notice that the substitute manager was unacceptable, the following procedures would apply:

1. The other non-objecting Co-owners could exercise the option

to acquire the ownership interest(s) of the objecting Co-owner at fair market value.

2. If the other non-objecting Co-owners did not exercise their option to acquire the ownership interest of the objecting Co-owner, the objecting Co-owner, within a certain period after being notified that the alternative management arrangements were not acceptable, on its own behalf and at its own expense, could retain the substitute management company. In this event, the objecting Co-owner must provide written notice to Management Company and the other non-objecting Co-owners. In such case, the managers must consult on all actions; however, except in cases in which unanimous approval of all Co-owners is required, the manager representing the controlling Co-owners would be able to act without the approval of the co-manager. The Co-owners who did not provide a notice of termination would be treated as consenting to a renewal of the Management Agreement.

In addition, a Co-owner could object to specific provisions in the Management Agreement by providing a notice of objection to the Management Company and to the other Co-owners within a certain period after receipt of the notice of renewal. The Management Company and the Co-owner(s) could negotiate to modify specific terms of the Management Agreement. If no agreement were reached, a Co-owner could provide a notice of termination as described above on or before a certain period. Subsequently, the procedures described above would then apply.

The management agreement would provide further that, notwithstanding the requirement that Management Company otherwise obtain unanimous consent for the lease or re-lease of all or any portion of Property, Management Company could, without obtaining consent of the Co-owners, lease (or re-lease) a certain minor amount of the total leaseable space. Any leases entered into by the Management Company pursuant to this provision must meet certain unanimously approved lease guidelines provided by the Co-owners annually. Such lease guidelines would include parameters relating to credit worthiness, type of tenants, rental ranges, and length of rental term. Once unanimously agreed to, the lease guidelines could not be altered or amended except upon the unanimous consent of all the Co-owners.

Issues Presented

The ruling request raised several issues under the revenue procedure, including: (1) whether Company's permanent retention of an ownership interest in the Property results in the Company's business activities being attributed to the other co-owners under the revenue procedure, and (2) whether the lack of an affirmative annual vote on retaining or hiring management violates the revenue procedure.

In connection with the first issue, it is helpful for potential investors to know that a particular sponsor also will be a permanent co-owner. It not only gives the investor comfort that the property will be managed continuously on a professional basis, but it also indicates to the investor that the sponsor thinks this is a good investment.

Rev. Proc. 2002-22 provides that all activities of the co-owners, their agents and any person related to the co-owners "with respect to the property" will be taken into account and attributed to the other co-owners, except to the extent that a particular co-owner holds his interest for less than six months. Therefore the activities of Sponsor and any person related to Sponsor "with respect to the Property" must be taken into account in determining whether the co-owner's activities are customary activities. *This raises the* *issue of whether the maintaining of a co-ownership interest by the sponsor should be a problem, where no services are provided with respect to the property or only customary services are provided. In other words, does the attribution of activities discussed in the prior paragraph mean that the business activities of the promoter in selling the co-ownership interests could somehow be attributed to the other co-owners?*

Some commentators had concluded that sponsors simply could not stay in as a co-owner for more than six months.[12] In PLR 200327003, the IRS approved the sponsor retaining a co-tenancy interest for up to 18 months in order for him to have time to sell all of his co-tenancy interests. Some practitioners may have read the ruling as providing only an extension of the six-month time period in §6.11 of the revenue procedure during which business activities of the sponsor would not be attributed. While that was not the intent of the ruling, it may be understandable that one could read the ruling that way, particularly if one had not reviewed the ruling request filed or had discussions with the IRS as to what was intended. In any event, the Ruling clearly permits permanent retention by the sponsor of a co-ownership interest. The rationale of the Ruling is that the business activities of the sponsor are not attributed to the other co-owners merely because the sponsor retains a co-ownership interest. These are not business activities "with respect to the property" which was the concern of the revenue procedure in §6.11.

While, as stated above, it can be helpful for the sponsor to retain an interest, it is unlikely that a sponsor will want to retain a majority interest. However, if that were to occur, it is unclear whether the IRS would approve such a transaction, at least with respect to an advance ruling.

In connection with the second issue referred to above, the facts in the ruling raised, for the first time, a true deemed consent procedure with regard to the annual renewal or hiring of the manager. Although PLR 200327003 did have a deemed consent type procedure, the facts of that ruling were that any co-owner could terminate his consent to the continued retention of the manager *at any time*, by giving 60 days notice.[13] That mechanism is unlikely to be workable where there is a blanket mortgage (and certainly not where there is a securitized loan). The lender will, at a minimum, want to be assured of continued management of the property and rental collection. The mechanism described in the facts of the Ruling provides for a true deemed consent provision and imposes a series of safeguards that should alleviate the concerns of many or most lenders about continuity of management.

Other Issues

The facts of the ruling potentially raised other issues as well including: (1) whether the multi-tenant nature of the building created a partnership because of necessary periodic leasing activities; (2) the impact of contiguous properties; (3) the ability of the manager to exercise discretion in leasing or releasing a limited amount of space without ownership approval; (4) the impact of the blanket mortgage; and (5) possible consequences in the event of a default or an action by the lender because of a breach of certain obligations. The resolution of these issues was the product of extensive discussions with the IRS. At this time, suffice it to say that the Ruling reflects the favorable outcome of all of these potential issues. The Ruling also reaffirms the willingness of the IRS to issue a ruling under Rev. Proc. 2002-22 that is not investor specific or property specific, despite the literal requirements of the revenue procedure.[14]

CONCLUSION

The IRS should be commended for taking a practical and helpful approach to both the procedural impediments that this ruling created and the substantive issues presented. The Ruling, which is the first of its kind (and only the second to be issued under the revenue procedure), should be of particular interest to investors and their advisors (although lenders and sponsors will obviously have an interest as well). There are so many deals (and sponsors) available in the current marketplace, that a taxpayer who is under pressure to identify replacement property often turns to his tax advisor for help in evaluating which deals are safe from a §1031 viewpoint. This ruling should help in such an evaluation. While other taxpayers or sponsors cannot, of course, rely on private letter rulings, it does give an indication of current IRS thinking.

Footnotes

[1] 2002-14 I.R.B. 733.

[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[3] PLR 2002327003, which was obtained by this author.

[4] For a more detailed discussion of this ruling, see Levine, "First IRS Ruling on Undivided Fractional Interests Under Rev. Proc. 2002-22: IRS takes Practical Approach in Interpreting Revenue Procedure," 44 *Tax Mgmt. Memo.*, No. 10, 171 (5/19/03).

[5] The official PLR number is 165157-02. However, the ruling will not be released to the public until Apr. 2005, at the earliest.

[6] The new ruling was obtained by this author on behalf of Geneva Real Estate Exchange, LLC.

[7] 2000-44 I.R.B. 438.

[8] Because of the 45-day identification requirement in §1031(a)(3), promoters and syndicators began packaging and structuring deals whereby a taxpayer could acquire a UFI as replacement property with relative ease. The Property Report section of the Wednesday edition of the *Wall Street Journal* has traditionally been an advertising haven for these deals.

[9] For a detailed discussion of the revenue procedure, see Levine, "Undivided Fractional Interests and §1031: Revenue Procedure Brings Clarification But With Some Confusion," 43 *Tax Mgmt. Memo*., No. 16, 331 (8/12/02).

[10] *See* Smith, "Real Estate Investors Become Adventurous," *Wall St. J*., Jan. 5, 2005, at B6.

[11] See, e.g., the transaction discussed in Smith, "Real Estate Investors Become Adventurous," *Wall St. J.*, Jan. 5, 2005, at B6.

[12] *See* Lipton, "New Rules Likely to Increase Use of Tenancy-In-Common Ownership in Like-Kind Exchanges," 96 *J. Tax'n*, No. 5, 303 (May 2002).

[13] Some practitioners apparently overlooked this ability in PLR 200327003 to terminate at any time, or just misread the ruling. See, e.g., the comment by Lou Weller in "Geneva TIC Program Receives Ruling From IRS; PLR Said To Approve Sponsor Retention," *TIC Monthly* (2/8/05), in which he compares PLR 200327003 to (his understanding of) the new ruling.

[14] *See* §5.02 of the revenue procedure. See also Levine, "First IRS Ruling on

Undivided Fractional Interests Under Rev. Proc. 2002-22: IRS takes Practical Approach in Interpreting Revenue Procedure," 44 *Tax Mgmt. Memo.*, No. 10, 171 (5/19/03), which discusses this point in the context of the earlier ruling issued.