New Rules Likely To Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges

Richard M. Lipton

All section references are to the Internal Revenue Code (“IRC”) unless otherwise indicated. “CT” refers to credit tenant; “FMV,” to fair market value; “LLC,” to limited liability company; “REIT,” to real estate investment trust; “PTP,” to publicly traded partnership; “TIC,” to tenancy-in-common; “ROFO,” to right of first offer; “ROFR,” to right of first refusal; and “SMLLC,” to single-member limited liability company.

A. Introduction

1. In Rev. Proc. 2002-22, 2002-14 I.R.B. 733, the IRS followed up on its intention, stated in Rev. Proc. 2000-46, 2000-2 C.B. 438, to issue guidance concerning whether an undivided fractional interest or TIC interest in real estate will be treated as giving rise to a separate business entity for Federal income tax purposes. The new Procedure sets forth detailed conditions under which the IRS will consider a request for a ruling that a TIC interest is not an interest in a business entity.
2. Rev. Proc. 2000-46 was issued in response to several requests for private rulings filed on behalf of “promoters” that were selling TIC interests in real estate as replacement property for like-kind exchanges. Rev. Proc. 2000-46 was superseded by Rev. Proc. 2002-22. Two such ruling requests were filed by the author.

3. The IRS announced at that time that it would not issue advance rulings or determination letters on:

   a. Whether a TIC interest in real property is an interest in an entity (i.e., a partnership interest) that is not eligible for a tax-free exchange under section 1031(a)(2)(D); or

   b. Whether arrangements in which taxpayers acquire a TIC interest in real property constitute separate entities for Federal tax purposes.

4. Rev. Proc. 2002-22 is likely to be viewed as a significant milestone in the growth of like-kind exchanges of real property. Before the issuance of this new guidance, a taxpayer who sold real estate (relinquished property) would have to search for other real estate (replacement property) that cost about the same as the proceeds from the prior sale. It often was not possible to find the appropriate replacement property at the right cost in a timely manner (i.e., within the 45 days provided by section 1031(a)(3) for identifying replacement property), notwithstanding that there were several reputable companies engaged in marketing replacement properties for like-kind exchanges. The availability of reverse like-kind exchanges under Rev. Proc. 2000-37, 2002-2 C.B. 308, has somewhat alleviated this concern, but in many cases taxpayers are unwilling (or unable) to acquire replacement property until they have received the proceeds from the sale of the relinquished property. See generally Richard M. Lipton, New Revenue Procedure on Reverse Like-Kind Exchanges Replaces Tax Risk With Tax Certainty, 93 J. Tax’n 327 (December 2000).

5. The purchase of a TIC interest as replacement property makes economic sense because the size of the TIC interest can be tailored to the taxpayer’s needs. Rev. Proc. 2002-22 sets forth guidelines under which a taxpayer can acquire a TIC interest as replacement property without fear that the IRS will attempt to recharacterize the TIC interest as an interest in a partnership. This guidance should help taxpayers locate suitable replacement property. Moreover, as a practical matter, the criteria set forth in Rev. Proc. 2002-22 probably will become the “norm” that will be applied for most TIC interests that are sold commercially by sponsors or promoters to taxpayers.
B. The IRC, the Cases, and the Problem

1. Section 1031(a) provides for the nonrecognition of gain or loss if a taxpayer engages in a like-kind exchange. This treatment applies if the taxpayer exchanges property held for use in a trade or business or for investment for other property of a like-kind that will be held for use in a trade or business or for investment. The many separate requirements that must be satisfied to obtain like-kind exchange treatment are beyond the scope of this article. See Richard M. Lipton, The 'State of the Art' in Like-Kind Exchanges, 91 J. Tax'n 78 (August 1999). Section 1031(a)(2)(D) provides that an interest in a partnership is not of like-kind to any other property.

2. A well-established body of law concerns the definition of “partnership” for tax purposes. At the heart of these rules is the Court’s decision in Commissioner v. Culbertson, 337 U.S. 733 (1949), in which the Court stated that whether a partnership is created depends on whether the alleged partners really and truly intended to join together for the purpose of carrying on business and sharing the profits or losses or both. This determination is a question of fact, to be determined by the partners’ testimony, their agreement, and their conduct.

   a. Culbertson set forth a general rule; more specific guidance concerning the existence of a partnership can be found in the Tax Court’s decision in Luna v. Commissioner, 42 T.C. 1067 (1964). There, the court emphasized that the existence of a partnership does not depend on the name given to the arrangement but, rather, on the presence or absence of a variety of factors:

      i. The agreement of the parties;
      ii. Their conduct in executing its terms;
      iii. The contributions, if any, which each party has made to the venture;
      iv. The parties’ control over income and capital;
      v. The right of each party to make withdrawals of income and capital;
      vi. Whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;
vii. Whether the business was conducted in the joint names of the parties;

viii. Whether the parties filed Federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint venturers;

ix. Whether separate books of account were maintained for the venture; and

x. Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

3. The Check-the-Box Regulations contained new rules for determining whether a partnership (or, more accurately, a business entity taxable as a partnership) exists. Under these rules, the determination of whether a TIC interest constitutes an interest in a partnership depends on whether a “business entity” has been created. Treas. Reg. §301.7701-1(a)(2) provides that 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. A business entity with two or more members is classified for Federal tax purposes as either a corporation or a partnership. Treas. Reg. §301.7701-2(a). The mere co-ownership of property that is maintained, kept in repair, and rented or leased does not, however, constitute a separate entity for Federal tax purposes. Treas. Reg. §301.7701-1(a)(2). Section 761(a) provides that “partnership” includes 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 or a trust or estate.

4. Rev. Proc. 2002-22 deals with the difficult theoretical question of when a tenancy-in-common ownership of real property should be treated as a separate business entity. A tenancy-in-common is one of the traditional concurrent estates in land. See 7 Richard R. Powell, Powell on Real Property ¶50.01 (Michael A. Wolf, ed., Matthew Bender, 2002). Each owner of a TIC interest is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant-in-common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of the rents or profits from the property, to transfer the tenancy-in-common interest, and to demand a partition of the property. These rights generally provide the holder of a TIC interest with the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other co-tenants.