Tax-Free Exchanges and Fractional Interests: TICs, Tax, Go!

by Jacob Stein

Jack was fast approaching his "golden" years, and following the advice of his attorney/CPA/financial planner was looking to diversify his only asset, a 30,000 square-foot shopping center. Having made his living off real estate, Jack was not interested in pork belly futures, blue-chip stocks or aircraft leases; he was looking to diversify into real estate. Jack was a happy man—he just received an eight digit offer for his 30,000 square foot shopping center. Jack was a self-made man, and he built the shopping center with his bare hands, over 30 years ago. In tax jargon, he had no basis in the shopping center, and on sale, his taxable gain would equal the eight digit offer. Jack became an unhappy man.

Then along came the neighborhood marketable tenancy-in-common promoter who explained to Jack how he could diversify his shopping center into high-grade office buildings, industrial parks and apartment complexes, without recognizing a taxable gain. Jack was again a happy man.

The marketable tenancy-in-common interests ("MTICs") have become a popular method to complete a tax-free exchange under the *Internal Revenue Code* [Code] §1031 (a "1031 exchange"). MTICs come in different shapes and flavors: a) it can be a single tenant, single lease arrangement, usually on a triple-net basis; b) it can be a multi-tenant, multi-lease arrangement managed by a third party; c) it can be a multi-tenant, single lease arrangement, also managed by a third party; or d) it may be a hybrid form of the above arrangements.

Whatever form an MTIC may take, it offers investors the advantages of hands-off ownership, an opportunity to invest in high-quality, high-rent real estate and ease of identification for 1031 exchange purposes. It is the ease of identification for 1031 exchange purposes that appeals to investors like Jack, who are contemplating selling their high-gain property, or who just sold their property and have only 45 days to identify replacement property. Because an MTIC is a fractional interest in real estate, with the fraction being whatever the investor needs it to be, MTICs can be perfectly tailored for each participant in a 1031 exchange to ensure that no recognition of gain results from the exchange.

From an investor's standpoint, while MTICs are generally a desirable 1031 exchange mechanism, MTICs have some pitfalls. There may be no secondary market for an MTIC, it may be difficult to compare-shop MTICs offered by different promoters, certain MTICs may be treated as securities for federal and California purposes, and most importantly, for the purposes of this article, some MTICs may be treated as partnerships for federal tax purposes.

Pursuant to Code §1031(a)(2)(D), MTICs that are treated as partnerships for federal tax purposes do not qualify for 1031 exchange treatment. This does not mean that partnerships cannot participate in 1031 exchanges. It means that a partnership interest itself can never qualify for 1031 exchange purposes. MTICs, while not partnership interests per se, may be re-chartered as partnerships for tax purposes if they have certain partnership-like characteristics.

A joint venture or other contractual arrangement may create a separate entity for federal tax purposes (which is likely to be classified as a tax partnership) if the participants carry on a trade, business, financial operation, or venture and divide profits. The same Treasury Regulations provide that mere co-ownership of property, sharing of expenses, maintaining or repairing, renting or leasing the property does not create a separate taxable entity. While intent to form a partnership or joint undertaking is often emphasized by the courts, this intent is determined objectively, by looking at such factors as the conduct of the parties, including participation in management and operations. (*Comm'r. v. Culbertson*, 337 U. S. 733 (1949).) Even when the parties specifically indicated in their agreement that they were not forming a partnership, the court found a partnership based on the conduct of the parties. (*Hubert Baughn*, T. C. Memo 1969-282.)

While the courts consider that sharing of profits and losses, and carrying on an activity with the goal of generating a profit, are requisites of characterizing the arrangement as a partnership; the courts will also look at whether:

a) a partnership agreement exists; b) the parties represented to others that they were partners; c) the parties had the right to control partnership's distributions and allocations; d) the parties filed partnership returns; e) the parties exercised mutual control and assumed mutual responsibility for the enterprise; and f) the parties contributed capital or services.

With respect to real estate, the courts concluded that mere joint ownership of undeveloped land, or paying agents to collect rent and make repairs, did not constitute a partnership. (*Frank v. U. S.*, 120 F. Supp 9 (1954); *Powell*, T. C. Memo 1967-32.) Additionally, the IRS ruled that it would not treat co-owners of rental real estate as partners if they furnished to tenants only "customary tenant services." (*Rev. Rul.* 75-374, 1975-2 C. B. 261; PLR 200019014 (May 15, 2000).) Customary tenant services include provision of heat, A/C, water, unattended parking, repairs, trash services, and the upkeep of public areas.

Because the above factors do not establish a bright line test, until last year investors in MTICs had no certainty as to whether an MTIC would qualify for 1031 exchange purposes, and attorneys were reluctant to issue opinion letters to that effect. Given the growing popularity of MTICs and the growing number of private letter ruling requests, the Service moved to resolve the MTIC tax classification uncertainty by issuing *Revenue Procedure* 2002-22 (2002-14 I.R.B. 733 (March 19, 2002)). *Revenue Procedure* 2002-22 sets forth the requirements for a transaction involving an undivided fractional interest (which includes an MTIC) in a 1031 exchange context that will need to be satisfied before the IRS will issue a private letter ruling.

Although, technically the *Revenue Procedure* only establishes the minimum requirements that need to be met to obtain a private ruling, without guaranteeing it, most practitioners rely on this type of *Revenue Procedure* and *Revenue Ruling* as a *de facto* safe harbor.

There are 15 conditions that an MTIC must satisfy under *Revenue Procedure* 2002-22. Each co-owner/investor must be a tenant-in-common under the applicable state law, which means that title to the property may not be held by one aggregate entity, but must be held by tenants-in-common. However, there is no requirement that individuals hold the tenant-in-common interests—the interests may be held through limited liability companies, or other types of pass-through entities. Many MTIC promoters violate the prohibition on one entity, because many lenders require that the underlying property be held by a single asset entity. Some promoters attempt to resolve this dilemma by bringing in an investor as a tenant-in-common, and then immediately flipping the investor into an entity interest. This may violate the "held for investment" requirement of Code §1031(a), although many attorneys find solace in the Ninth Circuit holding in *Bolker* (760 F.2d 1039 (9th Circuit, 1985)), which provides that "the intent to exchange property . . . satisfies the holding and use requirement, because it is not an intent to liquidate the investment or to use it for personal pursuits."

The number of the co-owners is limited to 35. For this purpose, husband and wife are treated as a single owner. While the IRS may not issue a letter ruling if an MTIC has more than 35 investors, it is difficult to see how the IRS would challenge an MTIC arrangement with more than 35 investors. What possible arguments may the IRS offer to support its position that an MTIC with 36 investors is more of a partnership for tax purposes than an MTIC with 34 investors?

The MTIC arrangement cannot be treated as an entity for tax purposes. This means that there can be no partnership or operating agreement among the investors (there can be a co-ownership agreement), no business may be conducted under the co-ownership name and no partnership returns may be filed. The requirement that business cannot be conducted under a common name can be problematic for many real estate developers, who often use names for shopping centers, office buildings and apartment buildings. Many promoters avoid this problem by having the investors lease the property to a single user, usually the promoter, who then subleases the property to subtenants under such lease (usually referred to as the "Master Lease"). The Master Lease to the promoter is usually long-term, 20 years or more, with the lease rents increasing slowly over time, allowing the promoter to create income on the spread.

The investors must retain certain voting rights, including the right to hire any manager, the sale or disposition of the underlying real estate, or the creation of a lien. Further, decisions involving hiring of managers, sale of real estate and creation of liens must be approved by a unanimous vote of the investors. The co-ownership agreement may specify the requisite percentage to approve all other decisions, with the *Revenue Procedure* implying the necessity of a 50% vote. The unanimous vote requirement can obviously be problematic, and may be avoided by utilizing the Master Lease arrangement, allowing the promoter to make all the leasing and management decisions.

Each investor must have the right to encumber, transfer or partition its undivided interest in the real estate, without prior approval of any other person. All profits and losses, excess proceeds on sale and debt must be shared by the investors proportionately.

Investors are allowed to issue call options with respect to their interests, but are not allowed to issue put options to the sponsor (promoter), another investor or the lender. The put option prohibition effectively eliminates a great deal of liquidity that MTICs could otherwise provide, limiting their usefulness as 1031 exchange parking arrangements.

The co-owners are not allowed to perform any activities, other than those customarily performed by owners of real estate, such as maintenance and repair. Any and all of the activities of the co-owners are taken into account under this test, with the sole exception that activities of a promoter/co-tenant will be disregarded if the promoter holds an ownership interest in the MTIC for fewer than six months. The six month safe harbor affords promoters a short window to sell MTIC interests, without violating this clause.

In the only private letter ruling issued by the Service under *Revenue Procedure* 2002-22, the taxpayer was substantially in compliance with the above requirements, but not entirely. In the private letter ruling, the promoter held an MTIC interest for 18 months, while the interests were being marketed and sold, and the management agreement did not require an annual reaffirmation. The Service, applying practical sense and reason, ruled that these departures were in compliance with the intent of the specific conditions departed from, and blessed the proposed MTIC.

Because the pre-*Revenue Procedure* 2002-22 co-ownership v. partnership tests do not offer a bright line, and because the *Revenue Procedure* incorporates a number of limitations which may not be acceptable to a real-world real estate developers, promoters and their attorneys rely more and more on the Master Lease arrangement discussed above.

To summarize, MTIC promoters and investors in MTICs should exercise caution and prudence. For arrangements that do not conform closely to the *Revenue Procedure*, a letter ruling should be sought from the IRS. The Master Lease arrangement should be used to avoid the prohibition on the use of a single name, and on the unanimous vote requirement. However, one should keep in mind that even reliance on the *Revenue Procedure* may not always be equated to a safe harbor, and an opinion letter should be obtained by the promoter to negate any possible tax penalties. Finally, the investors in MTICs should be just that, investors, who have no participation in management or operation of the enterprise.

Jacob Stein, is a partner in Boldra, Klueger & Stein, LLP with offices in Century City, CA. and Woodland Hills, CA. He can be reached at Lataxlawyers.com.