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IRS Issues Guidance for Co-Tenancies Used in Like-Kind Exchange

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The Internal Revenue Service (IRS) recently issued guidelines regarding the growing practice of using of co-tenancies in connection with like-kind tax deferred exchanges. The new rules do not go so far as to create any true safe havens, although they give a good indication as to how the IRS views this investment vehicle. Unfortunately, with these new rules, interested investors will be faced with a more difficult time finding, organizing, and holding on to appropriate replacement properties if they wish to pool resources with other like-minded investors.

The new IRS guidance, published as Revenue Procedure 2002-22, technically addresses only the conditions that must exist for the IRS to consider issuance of a favorable advance ruling that a group of co-tenants does not constitute a separate business entity. But, guidance of this type is generally considered a strong indication of the IRS' view of governing law.

The guidance was prompted by the growing use of co-tenancies in the area of like-kind exchange. Federal tax law permits an owner of real estate to exchange one property for another of equal or greater value, without having to recognize any capital gain on the property being exchanged. A real estate investor can take advantage of this unique tax benefit under the following scenario: Investor acquires an investment property *A* for $10. After several years, property *A* appreciates in value and is now worth $30; therefore, Investor sells property *A* for $30. Ordinarily, Investor would have to recognize a gain of $20. But, if Investor structures the transaction correctly and instead reinvests the $30 in a new replacement property *B*, the transaction is treated as an exchange of property *A* for property *B* and no gain is recognized on the transaction. Instead, Investor's tax basis in property *A* is carried over to property *B*.

REQUIRED CONDITIONS

Several conditions, some of which are highly technical, must be satisfied in order for these so-called like-kind exchanges to qualify for this beneficial tax treatment. One such condition is that both the property being "sold" or "relinquished" and the replacement property must be real estate held for trade or business. So, if Investor sold property *A* and, instead of buying property *B*, joined with a partner and each of them invested $30 in a partnership that

acquired property *C*, then the Investor would be required to recognize gain, because in this case real estate was exchanged for an interest in the partnership that was not real estate.

Real estate investors, eager to take full advantage of the unique benefits of like-kind exchange, have been utilizing a form of property ownership known as co-tenancy as a way of expanding the opportunities for like-kind exchange. "Co-tenancy" is a widely recognized creature of common law whereby a group collectively owns a parcel of real property and each member of the group is deemed to own an undivided fractional interest of the whole. As a general rule, co-tenancy interests are deemed to constitute real property interests and thus would be eligible under the like-kind exchange rules to be used as either "relinquished" property or "replacement" property. Therefore, if Investor bought a 50 percent undivided interest in property *C* as a co-tenant rather than a 50 percent partnership interest, Investor could still treat the transaction as a tax-deferred, like-kind exchange.

The advantages of combining co-tenancy and like-kind exchange have proven to be quite attractive. A real estate investor can get greater diversity; invest in larger, perhaps more stable, properties; and take advantage of the expertise and experience of professional managers and other real estate investors, all on a tax-deferred basis. The technique has had particular appeal to investors looking to transition their real estate investments into properties requiring less management, often in connection with estate planning.

To meet growing demand for this type of investment opportunity, entrepreneurs have been actively promoting, organizing, and sponsoring such arrangements. Such sponsors might organize a group of investors looking to complete an exchange, find appropriate replacement properties, structure the co-tenancy, structure the replacement property, and manage the replacement property. Typically, such sponsors or organizers have been compensated with fees or promoted ownership interests (*i.e.,* returns disproportionate to the sponsor's equity investment, if any) that tended to reward better investment performance.

As sponsors, investors and practitioners tried to adapt co-tenancy arrangements to more complex and sophisticated real estate investments, the co-tenancies could take on attributes of a partnership or other business entity. These attributes could include centralized, professional management; increased liquidity; and compensation for sponsors or managers based on performance of the investment. Any co-tenancy designed as such to take advantage of the like-kind exchange rules would, of course, fail in its essential purpose if the IRS later determined that the arrangement actually constituted a partnership or other business entity. Revenue Procedure 2002-22 details the most important considerations that will apply to a co-tenancy structured to meet the like-kind exchange rules.

CONDITIONS OF OWNING REAL PROPERTY INTERESTS

According to the IRS guidance, for a group of property owners to be deemed to own real property interests rather than interests in a business entity, 15 conditions must be satisfied.

1. *Ownership*. Each of the owners in the group must be considered a co-tenant under applicable state law and title to the subject property cannot be held in the name of any separate entity. While this determination is primarily a question of applicable state law, the IRS describes several attributes that it deems material. Some of these fundamental attributes include:

   - Each co-tenant is deemed to own an undivided, fractional interest in the entire property;
   - Each co-tenant is deemed to have a right to partition, meaning a right to have the property physically divided with the smaller pieces being allocated to each of the owners on a pro-rata basis;
   - No co-owner has the right to bind any other co-owner to any agreement or contract, including a lease or mortgage, affecting the subject property; and
   - Each co-owner has the right to freely assign, transfer, mortgage, or convey all or any fractional part of his or her interest.

A co-tenancy that varies from any of these basic attributes would, in the eyes of the IRS, presumably not qualify as a true co-tenancy.

2. *Size.* The group of co-owners cannot exceed 35 persons.
3. *No treatment as an entity*. The group must not have taken any action as an entity, such as filing a partnership tax return, conducting business under a common name, or executing any document identifying any co-owner as

a shareholder, partner or other member of a business entity. The IRS also frowns on any arrangement whereby co-owners held title to the property to be relinquished via a partnership or corporation immediately prior to creation of the co-tenancy.

4. *Terms of co-ownership agreement*. While the co-owners may enter into an agreement governing their activities as co-owners, the Revenue Procedure merely states that such agreement must be "limited."
5. *Voting*. The co-owners must retain voting rights over the critical issues of hiring any property manager, the sale or other disposition of the subject property, any leasing and any negotiation or renegotiation of any blanket lien covering the property and these issues must be decided by the unanimous vote of all co-owners. In all other cases, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided property interests.
6. *Alienation*. Generally, each co-owner must have the rights to transfer, partition, and encumber the co-owner's interest in the subject property without the agreement or approval of any person. But, restrictions on such rights that are required by a lender and are consistent with customary commercial lending practices are not prohibited, and the co-owners may give each other rights of first refusal or rights of first offer.
7. *Sharing proceeds and liabilities upon sale of property*. If the subject property is sold, any debt secured by a blanket lien must be satisfied and the remaining proceeds must be distributed to the co-owners.
8. *Proportionate share of profits and losses*. Profits and losses must be allocated to the co-owners in proportion to their respective undivided property interests. Loans among co-owners are prohibited unless they are full recourse and for a term not to exceed 31 days.
9. *Proportionate sharing of debt*. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.
10. *Options*. Options to buy the interest of another co-owner (calls) are permitted provided the option price reflects the fair market value of the property determined as of the date the option is exercised. For this purpose the value of an undivided interest is a strict fraction of the value of the property as a whole and no discounting may be done to account for illiquidity, lack of control, etc. Options to sell (puts) to any sponsor, co-owner, lessee, lender or any related person are prohibited.
11. *No business activities*. The co-owners can only engage in activities that are "customarily performed in connection with the maintenance and repair of rental real property." For this condition, the IRS will take an expansive view of the activities of all co-owners and their affiliates or related entities and intends to ignore any distinctions based on activities undertaken by a co-owner, whether purportedly in the capacity of sponsor, lessee or otherwise.
12. *Management and brokerage agreements*. While management and brokerage agreements are permitted, such agreements must have the following elements: such agreements must be renewable not less frequently than annually, net revenues must be distributed to the co-owners at least quarterly, and fees cannot be incentive or performance based and must not exceed the fair market value of the services provided.
13. *Leases*. All leasing arrangements must be *bona fide* leases for federal tax purposes. Rents must reflect the fair market value for the use of the subject property and may not depend on the income or profits derived by any co-owner from the subject property.
14. *Loan agreements*. The lender holding debt secured by the property cannot be related to any co-owner, sponsor, manager or lessee.
15. *Sponsors*. Any payments to a sponsor must reflect the fair market value of the acquired co-ownership interest and may not depend on the income or profits generated by the property.

EFFECT OF THESE GUIDELINES

What will be the effect of these guidelines? Several of the IRS criteria are probably materially more restrictive than what the investing public has been using. The nascent marketplace for co-tenancy interests will probably be significantly impaired. At a minimum, co-tenancy arrangements organized as such to accommodate like-kind exchanges likely will consist of smaller, more cohesive groups bound more by personal relationships and shared investment objectives than by formal agreements or other kinds of central management and control. Finally, the universe of replacement properties that will be appropriate for ownership by co-tenancy will likely be greatly reduced.

The new guidelines appear to be aimed at curtailing all but the most basic forms of compensation to sponsors. Sponsors can only charge a fair market price for services and are

essentially prohibited from receiving any type of performance-based compensation or promoted interest. The guidelines even contemplate, and prohibit, an arrangement whereby the sponsor receives compensation based on a lease or a management contract. These limitations are certain to curb the enthusiasm not only of the sponsors, but also that of potential investors who generally like to know that a sponsor is financially very interested in the ongoing success of the venture.

Other requirements also will make the task of organizing co-tenancies more difficult. Under the new guidelines co-tenants must be organized as relatively small groups of not more than 35 investors and, for the most part, they cannot agree to be centrally managed or controlled. Each of the owners has to retain voting rights over the most important managerial and operational aspects of the property, *i.e.* regarding financing, management, sale and leasing. Because these decisions require unanimous consent and cannot be delegated, there will be many opportunities for deadlocks. The guidelines appear to prohibit many of the techniques for avoiding deadlocks, such as central management, majority voting or buy-sell arrangements. Thus any person contemplating a co-tenancy arrangement will need to find some other means of getting comfortable so that deadlocks won't impair the investment. In such an environment, one would expect that potential investors will seek out those with whom they already have some type of personal or professional relationship, whose judgment they trust and in whom they have faith that investment objectives will be shared.

Finally, all of these factors will likely result in fewer replacement properties that investors will consider appropriate for ownership in a co-tenancy arrangement. Because all of the most important management decisions require unanimous approval of all of the co-tenants, such groups will prefer properties for which management decisions are unlikely to arise. Properties under long-term, triple net leases to credit tenants will continue to meet this criteria. But properties with multiple tenancies or short-term tenancies, properties that may require capital investment or that are in need of redevelopment or repositioning would all present challenges to a group of like-kind investors looking to organize as co-tenants.

CONCLUSION

Although the opportunities to combine co-tenancy with like-kind exchange will diminish, when appropriate, the combination can still offer very attractive benefits. While it is clear from the Revenue Procedure that the IRS intended to limit the use of the co-tenancies, it also is clear that the vehicle has not been completely eliminated and indeed may offer something tantamount to a safe haven for a structure that meets all of the factors. The guidelines published under Revenue Procedure 2002-22 will be better defined as practitioners apply them to real situations. The challenge for practitioners will be to organize co-tenancies in a way that maximizes the benefits but still meets the requirements established by this Revenue Procedure.

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