



# First American Exchange

A QUALIFIED 1031 EXCHANGE INTERMEDIARY

## Tenancy in Common Revenue Procedure Issued by IRS

A tenancy-in-common interest, unlike a partnership interest, can be exchanged in a tax-deferred exchange. As a result, the tenancy-in-common has become a popular method of holding title to property. However, tenants-in-common must be careful not to go beyond the mere co-ownership of property and engage in business together, like partners do, or the IRS may recharacterize the tenancy-in-common as a business entity (either a partnership or corporation) and disallow an exchange of the tenant-in-common's interest. To address this issue, several sponsors of tenant-in-common (TIC) programs approached the IRS and requested advance rulings to approve their particular TIC ownership as a non-business entity. In late 2000 the IRS issued Revenue Procedure 2000-46 stating that it would no longer accept requests for revenue rulings on this issue. On March 20, 2002 the IRS issued Revenue Procedure 2002-22, which superseded Revenue Procedure 2000-46 and set forth conditions under which the IRS will once again consider requests for advance rulings dealing with TIC interests in rental real property (other than certain mineral property).

The Revenue Procedure sets forth a comprehensive list of items that must be submitted to obtain a ruling and sets forth the following conditions that must be met to receive one:

- 1. Tenancy in Common Ownership.** Each co-owner must hold title (either directly or through a disregarded entity) as a tenant in common under local law.
- 2. Number of Co-Owners.** No more than 35 persons (husband and wife and all persons who acquire interests from a co-owner by inheritance treated as a single person)
- 3. Treatment of Co-Ownership as an Entity.** The co-ownership may not:
  - file a partnership or corporate tax return,
  - conduct business under a common name,
  - execute an agreement identifying the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as such). If the co-owners held

interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership a ruling will be denied.

- 4. Co-Ownership Agreement.** The co-owners may enter into a limited co-ownership agreement that may run with the land.
- 5. Voting.** The co-owners must unanimously approve:
  - the hiring of any manager (including contract negotiation, extension or renewal),
  - the sale or other disposition of the Property,
  - any leases of a portion or all of the Property, or
  - the creation or modification of a blanket lien.For all other actions, the vote of those holding more than 50 percent of the undivided interests in the Property is acceptable. Powers of attorney may be used only to execute specific documents after the co-owner has consented to the action.
- 6. Restrictions on Alienation.** In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest without the agreement or approval of any person. However, restrictions on these rights required by a lender (consistent with customary commercial lending practices) are permitted. Section 6.14 restricts who may be a lender. Rights of first offer and agreements to offer to co-owners before exercising the right of partition may be given.
- 7. Sharing Proceeds and Liabilities upon Sale of Property.** If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.
- 8. Proportionate Sharing of Profits and Losses.** Each co-owner must share in revenues and costs in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager 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, where the co-owner is a

**Sacramento**

916.448.4332

**Fresno**

559.230.8321

**San Jose Corporate**

800.833.4343

**Walnut Creek**

925.927.2102

**San Francisco**

800.552.1031

First American Exchange is a Qualified Intermediary and precluded from giving tax or legal advice.

You must consult with your tax or legal advisor about your specific circumstances.

First American Exchange is a wholly owned entity of First American Title Company

[www.firstexchange.com](http://www.firstexchange.com)



# First American Exchange

A QUALIFIED 1031 EXCHANGE INTERMEDIARY

disregarded entity, the owner of the co-owner) and is not for a period exceeding 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.** A co-owner may issue an option to purchase the co-owner's interest (call option), provided the exercise price reflects the fair market value at time of exercise. A co-owner may not acquire an option to sell the co-owner's interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to them.

**11. No Business Activities.** Generally, the co-owners' (including their agents and related persons) activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities).

**12. Management and Brokerage Agreements.** The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may authorize the manager:

- to maintain a common bank account,
- to prepare statements for the co-owners showing their shares of revenue and costs from the Property,
- to obtain or modify insurance on the Property, and
- to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. Management fees must not depend on income or profits derived from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a

broker must be comparable to fees paid by unrelated parties to brokers for similar services.

**13. Leasing Agreements.** All leasing arrangements must be bona fide leases for federal tax purposes. Rents must reflect the fair market value for the use of the Property and must not depend on the income or profits derived from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales).

**14. Loan Agreements.** The lender with respect to any debt that encumbers the Property or any debt incurred to acquire an undivided interest may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.

**15. Payments to Sponsor.** Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived from the Property.

## SUMMARY

It is difficult to measure the impact this revenue ruling will have. Will sponsors of tenancy-in-common interests be able to obtain advance rulings before all the interests have been sold in light of the requirement that the names of all co-owners be submitted? Will auditors ignore the limited scope of the Revenue Procedure and try to impose the conditions for obtaining a ruling as conditions for a valid tenancy-in-common. Will the IRS issue a safe harbor in the future after they have issued a number of advance rulings. Like many of the cutting edge issues that face us, we won't know the answer to these questions until the future. In the meantime, we at least know what we have to do to get an advance ruling from the IRS.

If you would like a complete copy of Revenue Procedure 2002-22, in paper or electronic format, please contact our office.

**Sacramento**  
916.448.4332

**Fresno**  
559.230.8321

**San Jose Corporate**  
800.833.4343

**Walnut Creek**  
925.927.2102

**San Francisco**  
800.552.1031

First American Exchange is a Qualified Intermediary and precluded from giving tax or legal advice.

You must consult with your tax or legal advisor about your specific circumstances.

First American Exchange is a wholly owned entity of First American Title Company

[www.firstexchange.com](http://www.firstexchange.com)