

1031 EXCHANGES: THE IRS SHEDS MORE LIGHT ON TENANCY IN COMMON AGREEMENTS

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Introduction

Everyone working in real estate today has heard of “like-kind” or “1031 Exchanges.” Section 1031 of the Internal Revenue Code allows taxpayers to sell property (“relinquished property”) and buy similar “like kind” “replacement property” and defer the capital gains taxes on the proceeds from the relinquished property. Several years of low interest rates and low stock market returns have fueled a seller’s real estate market. This boom has led to explosive growth in the 1031 exchange industry as sellers have sought to shelter their sales proceeds from taxation. As the number of investors seeking suitable replacement property has increased, real estate professionals have scrambled to meet the demand.

TICs and the Partnership Problem

The syndicated tenancy-in-common (or TIC) resulted from the effort to increase the supply of replacement property. TICs allow investors to purchase undivided fractional interests in real estate with several other investors. However, Section 1031 does not allow someone to exchange property for a partnership interest. If several 1031 investors acquired real estate, hired a manager, leased space and split the profits and losses like a traditional real estate investment project, the IRS might consider that arrangement a partnership.

The IRS Addresses TICs: Good News/Bad News

In 2002, the IRS issued guidelines on how to structure a TIC to avoid classification as a partnership. Unfortunately, many of these guidelines were inconsistent with the practical reality of running a retail rental project. For example, the guidelines required that:

- Co-tenants must unanimously approve the sale, lease, or release of any part of the property, any negotiation or re-negotiation of a loan secured by a blanket lien on the property or the hiring of a property manager (which must be done annually).
- All other actions regarding the property must be approved by owners of at least 50% of the interest in the property.
- Each co-tenant must retain a right of partition unless prohibited by customary commercial lending practices.
- Co-tenants (and their manager) may only provide “customary” types of services to the property (i.e. trash removal, heating

and cooling, maintenance of common areas).

These guidelines seemed to eliminate the flexibility and delegation of responsibility to a professional property manager that many passive investors sought. The guidelines seemed to make it difficult to have multiple tenants because of the need for unanimous approval of all leases. The requirement of unanimous approval of a sale or refinancing of the project also made exit-strategy planning difficult and uncertain. Many in the real estate industry ignored some or all of the guidelines as unduly oppressive or not reflecting the law. As a result, few practitioners solicited the IRS for “private letter rulings” approving their TIC structures under Section 1031.

The IRS Addresses TICs Again: Good News

However, earlier this year, the IRS did issue a private letter ruling (the “PLR”) approving a TIC structure that complies with the guidelines and provides a workable framework for multiple-tenant projects with some flexibility for sales, management and refinancing. Although private letter rulings may not be used or cited as precedent, tax professionals rely on them in providing insight into how the IRS would likely rule on similar requests. With that in mind, the PLR approved the following structure:

- One entity (the “Sponsor”) will purchase the property and lease portions thereof to several tenants pursuant to triple net leases that do not include percentage rent provisions.
- Following the acquisition, the Sponsor will sell undivided fractional interests in the property to no more than 35 co-tenants in exchange for cash and/or an assumption of an existing blanket debt on the property and will retain an interest for itself.
- The Co-tenants will execute a co-tenancy agreement which will require unanimous consent to any amendments, consents to assignment, subleases, re-leases or modifications of any lease or guarantees of any lease; the sale of the property; the appointment or re-appointment of a manager; or the incurrence of any indebtedness secured by the property and all other actions would require majority approval.
- Co-tenants will allocate income and expenses in proportion to their ownership of the property.
- Co-tenants may sell, finance or otherwise create a lien on their interest as long as it does not encumber another co-tenant’s interest.
- Subject to customary loan restrictions, a co-tenant may seek partition of its interest, but only after offering its interest to the other co-tenants at fair market value.

- Each co-tenant will grant an option to the other co-tenants to purchase its interest in the event (1) there is an offer to sell all or a part of the property or to incur debt secured by the property or to modify any lease and the co-tenant votes not to proceed when more than 50% of the co-tenants approve the action or (2) a co-tenant provides notice of its intent to terminate the management agreement with respect to its interest.
- Each co-tenant will execute a management agreement with a manager related to the Sponsor and the manager will manage all administrative, operational and management matters of the property.
- The management agreement will have a 12-month, annually renewable term. Co-tenants will be notified of each renewal and have a certain period of time to object to any provision of the management agreement. Co-tenants objecting to the manager must provide timely notice thereof and nominate a substitute manager. If any co-tenant objects to the substitute manager, the non-objecting co-tenants may exercise their option to acquire the objecting co-tenant’s interest at fair market value. If the other co-tenants do not exercise their option, the objecting co-tenant may engage the substitute manager with respect to his interest only.
- The manager may lease space without the consent of the co-tenants provided that such lease meets certain guidelines unanimously approved by the co-tenants annually. Such guidelines will relate to credit worthiness, type of tenants, rental ranges and length of rental term.
- Each co-tenant will pay its pro-rata share of the management fee which will be a fair market value fixed fee payable irrespective of whether rents are actually collected.

Conclusion

While the PLR should give comfort to sponsors of completed projects, it does not address whether a TIC could develop a project. Real estate professionals should continue to evaluate all of the IRS guidance available on TICs and Section 1031 and consult with experienced tax advisors prior to beginning any 1031 exchange. Because of Section 1031’s procedural deadlines and substantive requirements, many investors feel confused and rushed into a decision. However, professional guidance prior to the sale of the relinquished property can substantially ease this process.

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