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1031 Tax Primer – Real Estate or Partnership Interests?

General

In order to qualify for like-kind exchange treatment under Section 1031 of the Code, among other things, the co-ownership interests in a property must constitute undivided interests in real estate, and not interests in a partnership or securities for federal income tax purposes. 1031 Sponsors attempt to structure the agreement among investors (typically a Tenant in Common Agreement or Co-Ownership Agreement) such that, for federal income tax purposes, a co-ownership interest will be treated as an interest in real estate, and not as an interest in a partnership or a security.

Typically, however, no advance ruling is obtained from the Internal Revenue Service ("IRS") that, for federal income tax purposes, the co-ownership interests will be treated as undivided interests in real estate, and not as partnership interests or securities. Absent an advance ruling, the IRS may take the position that co-ownership interests are partnership interests or securities. If co-ownership interests are treated as partnership interests or securities, the co-ownership interests would not qualify as like-kind real estate for purposes of Section 1031. The determination as to whether co-ownership interests will be treated as real estate and not as partnership interests or securities is dependent upon all applicable facts and circumstances, including the terms of the arrangement among the co-owners.

In addition, to satisfy lender concerns, investors typically are required to invest through a single member limited liability company (a "SMLLC"). In some cases, the SMLLC is formed for the investor and in others the investor forms the SMLLC. Regulations issued by the IRS provide that an SMLLC is a "disregarded entity," so most practitioners take the position that the assets of the SMLLC are deemed to be held directly by the investor (and an acquisition of the interests in an SMLLC is treated like an acquisition of the underlying assets). If the SMLLC interests were treated as securities, the investment would not qualify as like-kind real estate. The IRS could take the position that the purchase of SMLLC interests does not constitute a direct acquisition of like-kind property as required by Section 1031(a)(1), and that the purchase of SMLLC interests is excluded from Section 1031 pursuant to Section 1031(a)(2) which states that Section 1031 shall not apply to any exchange of, among other things, stocks, bonds or notes; other securities or evidences of indebtedness or interest; interests in a partnership; or choses in action.

Partnership Classification

There is no clear guidance as to whether a tenant in common relationship will be classified as a direct investment in real estate or a partnership for federal income tax purposes. Rather, the determination for a particular transaction must be made based on the particular facts and circumstances of each case. Section 761 of the Code provides that for federal income tax purposes, the term "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. Further, applicable Treasury Regulations provide that the term "partnership" is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships.

While a primary factor in determining whether a partnership exists is the intention of the parties, the courts and the IRS have generally taken into account a number of additional factors including: (i) joint sharing of profits and losses, (ii) joint sharing of control over the business, (iii) joint contribution of capital or services; (iv) the nature of the agreement among the parties, (v) maintenance of separate books and records and (vi) representation of the business to others as a partnership.

In the typical transaction, the two primary potential partnerships that could exist for tax purposes are (i) among the investors and (ii) between the investors and the sponsor entities. As to whether a partnership exists between investors and the sponsor, factors to be examined include (i) control by the sponsor and (ii) sharing of profits by the sponsor. For example, where a management agreement cannot be terminated easily, it can be argued that the sponsor exercises control like that of a sponsor. Further, the fees received could under certain circumstances be seen as a sharing of profits. Thus, the relationship amongst all of these parties needs to be carefully examined to determine whether the indicia of a partnership arrangement are indicative of a higher degree of tax risk than is desired.

Rev. Proc. 2002-22

When the applicability of tax laws to the facts of a particular situation is uncertain, taxpayers may request the IRS to rule as to the tax consequences of a particular transaction. A favorable ruling indicates the agreement of the IRS to the taxpayer's position. However, private rulings cannot be relied on by other taxpayers as precedent (although they may constitute "substantial authority" for the positions taken on the taxpayer's income tax return). The IRS may also publish revenue procedures from time to time to explain the conditions under which it will issue a private letter ruling to a taxpayer in a particular area of tax law. A revenue procedure generally does not constitute substantive law, but rather reflects administrative policies of the IRS. With respect to the issuance of undivided fractional ownership interests in real property, the IRS has published guidelines (Revenue Procedure 2002-22) which, if satisfied, will cause the IRS to consider issuing a private letter ruling that the co-ownership of property does not give rise to a partnership for federal income tax purposes. While Rev. Proc. 2002-22 establishes guidelines for taxpayers desiring to obtain a private letter ruling that an undivided interest in real estate is not an interest in a partnership, it re-affirms the IRS position that, if an undivided fractional interest in real property is classified as an interest in a separate entity,

the interest will not be deemed to be an interest in real estate and, therefore, not a transaction eligible for tax-deferred exchange treatment under Section 1031.

Rev. Proc. 2002-22 sets forth 15 guidelines which, if satisfied, would allow the IRS to rule in a taxpayer's favor on this issue. In the structuring of transactions, sponsors frequently make the decision that complete compliance with all of these guidelines is impractical or otherwise not in the best interests of all parties. Therefore, advance rulings are seldom obtained for various reasons including: (i) the lengthy time (at least 6-9 months) it typically takes to obtain a private letter ruling; (ii) even if all 15 conditions of Revenue Procedure 2002-22 were to be satisfied, the IRS could still decline to rule "whenever appropriate in the interest of sound tax administration"; and (iii) the fact that most sponsors (with the advice of their tax lawyers) believe that structuring a transaction in complete conformity with all of the conditions in the Rev. Proc. guidelines is not required by substantive law to avoid a business entity classification for tax purposes and would not be in the best interests of the parties from a business point of view.

With that said, most transactions attempt to comply with as many of the guidelines as possible and an analysis of the deviations therefrom, and any additional tax risks, requires a careful analysis of the particular transaction. For example, one guideline requires that a property management agreement must be renewable no less frequently than annually. While this guideline appears to require an affirmative renewal, the industry generally has taken the position that automatic renewal with a right to terminate annually is sufficient. However, the failure to provide for an affirmative unanimous approval annually could be deemed to be a failure to satisfy this guideline. Further, the fact that the property manager typically remains in place until a new property manager is selected, coupled with the lender's right to approve any new property manager, may be deemed to be a procedure which is not in strict compliance with this guideline.

Another example that is property related, rather than structural, is that a Rev. Proc. 2002-22 condition requires that (i) the activities of the co-owners must be limited to those customarily performed in connection with the maintenance and repair of real estate, (ii) in determining the co-owners' activities, all activities of the co-owners and any persons or entities related to the co-owners will be taken into account, and (iii) the activities of a co-owner or a related person with respect to the property will not be taken into account if the co-owner owns an undivided interest in the property for less than six months. If services required to be provided to a tenant under a lease are services not "customarily performed" in connection with the maintenance and repair of the property, such as extraordinary cleaning services this condition may also be deemed not to be satisfied.

Tax Opinions

Most transactions include a tax opinion rendered by the sponsor's legal counsel as to the treatment of the interests purchased as direct interests in real estate for like-kind exchange purposes. These tax opinions typically conclude at some level of certainty that the interests either "more likely than not" or "should" be treated as interests in real estate in the event of litigation or other adversarial proceedings. A "more likely than not" opinion says that there is more than a 50% chance the desired tax consequences will prevail in the event of litigation. A "should" opinion typically denotes around a 70% likelihood of success. Regardless of what type of opinion is provided, there is no assurance as to the ultimate tax treatment resulting from the transaction under Section 1031, or otherwise.

It is noteworthy that allowing an investor to rely on the tax opinion may assist the investor in avoiding penalties if the proposed tax treatment is disallowed. The Code provides for a penalty equal to 20% of any "substantial underpayment" of tax, or of any portion of any understatement of tax which is attributable to negligence. The amount of any such understatement may be reduced if the taxpayer has "substantial authority" for the taxpayer's treatment of any item giving rise to the understatement. An investor usually can establish that the investor reasonably believed that the tax treatment of a transaction was correct if the investor relies upon an opinion at a "more likely than not" or higher (i.e., a "should") level of comfort, but there can be no assurance that an investor will be able to satisfy this standard.

Costs

It is also noteworthy that the law is not entirely clear on the issue of what costs associated with the property purchase, such as costs attributable to financing and syndication, qualify for deferral of gain recognition under Section 1031. Further, the portion of the purchase price used to fund reserves probably does not qualify for deferral of gain recognition under Section 1031 on the basis that such portion of the purchase price has not been invested in like-kind property. In addition, investors may also be required to recognize depreciation recapture income upon the disposition of their relinquished properties, notwithstanding that such purchasers have otherwise complied with the requirements of Section 1031. Finally, qualification for nonrecognition of gain under Section 1031 requires strict compliance by each investor with all other requirements of Section 1031, in addition to those summarized above. Compliance with these other requirements will depend on the particular facts and circumstances applicable to each individual investor.

Conclusion

There are many tax issues involved in a tenant in common investment including the classification of the investment as real estate. Only a careful and detailed analysis of a particular transaction can allow an investor to apply the facts and circumstances to assess risk. This assessment should include both an examination of structure issues and property issues. Further, there are numerous other issues that may arise. For example, in connection with a master lease transaction, the nature of the master lease should be examined to determine whether or not it would be deemed a "true lease" for tax purposes. Only after all relevant tax risks have been identified and assessed, should an investor make his or her investment decision.