

SAVING THE FAMILY FARM:
A REPORT OF THE PROPERTY PRESERVATION TASK FORCE

Program Time and Date

Friday, September 16, 2005
8:00 AM to 9:45 PM
Hyatt Regency & Park Hyatt
San Francisco, California

Panelists

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Program Mission

This program will present the work of the Property Preservation Task Force, a joint effort of the American Bar Association and the National Bar Association, to codify land trust law and provide effective means for landowners who own land as tenants in common to protect their investment and livelihood from forced partition sales and other means of turning farmland into development land. The program will focus on potential land trust legislation that can address some of these issues, including possible uniform laws on partition rights in these situations.

A. Introduction

“Tenancy-in-common” real estate ownership often exists as a result of a lack of estate or business planning. If such real estate is held outside of a tenancy-in-common agreement or a business entity such as a Limited Liability Company, it is vulnerable to forfeiture in the event of partition. Land speculators may acquire a fractional tenancy-in-common interest at or below fair market value, force a partition sale rather than a physical division of the property, and pay the remaining co-tenant significantly less than their ratable fair market value for the real property.¹

After studying the problem for over two years, the ABA’s Real Property, Probate and Trust Law Section, acting through the Property Preservation Task Force (“PPTF”), has determined that the loss of partition land loss is indeed widespread. See Preliminary Report of the Property Preservation Task Force, attached to these materials as Exhibit A. Although the problem occurs in any area where there has been a lack of entity formation and estate planning, with accompanying increases in land values making such real estate vulnerable to real estate speculation, the problem is most widespread among African-American rural communities in the Southeast.²

The PPTF has accordingly submitted the problem for study by the National Council of Commissioners on Uniform State Laws (“NCCUSL”). See copy of submission letter dated June 16, 2005 attached as Exhibit A-1.

The focus of this outline is the avoidance of tenancy-in-common real estate loss through the use of tenancy-in-common agreements and limited liability companies. The outline describes state law attributes of tenancy-in-common ownership, tenancy-in-common agreements, limited liability agreements, and related tax drafting considerations.

B. Overview of Partition Law

Partition means the division of land held in co-tenancy into the co-tenants’ respective fractional shares. If the land cannot be fairly divided, then the entire estate may be sold and the proceeds appropriately divided. Every co-tenant has the right to compel partition, but that right may be modified or eliminated by the co-tenants’ agreements or acts.³ Forty-six states have enacted statutes governing the partition of co-tenancy real property.⁴

Co-tenants can agree to private partition by (a) written agreement of all the co-tenants, (b) by an exchange of deeds that dissolves the co-tenancy, (c) by ratification of a co-tenant’s earlier conveyance of part of the land to an outsider or (d) by taking exclusive possession after an oral agreement to partition.⁵ Barring such agreements or circumstances, however, the right to partition

¹ See December 2001 Associated Press article entitled “Torn From The Land,” authored by Todd Lewan and Delores Barclay This articles may be accessed through the following website: www.ag.fvsu.edu/news/torn.

² See African-American Rural Land Retention, paid for by the Federation of Seven Cooperatives/Land Assistance Fund submitted at the 2004 Joint Fall CLE meeting in Boston by Ulysses Clayborn. See also, Mitchell, Thomas, “From Reconstruction to Deconstruction: Undermining Black Land Ownership, Political Independence and Community Through Partition Sales of Tenancies-in-Common,” 95 NWU Law Review 505, 2001.

³ POWELL ON REAL PROPERTY § 50.07[1] (Matthew Bender & Co. Inc. Rel.91-6/00).

⁴ *Id.* at § 50.07 [4][a]

⁵ *Id.* at § 50.07[2].

is virtually unconditional.⁶ Partition is not barred by the minority of a party, the existence of encumbrances on a co-tenants' share or the homestead rights held by one co-tenant.⁷ Nor is partition prevented by an outstanding lease of the co-tenancy property or a lien or encumbrance on the property.⁸

Partition in kind (by physical division) is the preferred method of partition unless the co-tenants agree to a partition sale or that a physical division is impracticable.⁹ If partitioning in kind produces minor inequalities in owners' shares, the court may award monetary payments or "owelty" to offset the differences.¹⁰ If a sale of the property and division of the proceeds is more equitable, and a fair division is not possible, all jurisdictions permit partition by sale and division of the proceeds.¹¹

Every partition action includes a final accounting for both charges and credits upon each co-tenant's interest.¹² Charges include received rents and profits beyond the co-tenants fractional share, fair rental value of the entire tenancy-in-common if the co-tenant has excluded the others, and waste committed by the co-tenant.¹³ Credits include expenditures in excess of the co-tenants fractional share for necessary repairs, improvements that enhance the value of the property, taxes, payments of principal and interest on mortgages and other liens, insurance for the common benefit, and amounts expended in protecting and preserving title.¹⁴

C. Legal Causes of the Problem

The legal causes of the problem in general, arise from the inherent, unstable nature of tenancy-in-common ownership. The problem is aggravated by the fractionalization of co-tenancy ownership through successive generations of intestacy transfers of real estate ownership.¹⁵ Furthermore, the lack of consistent and predictable partition rules in the various state jurisdictions makes the defense of a hostile partition action a difficult prospect for the non-partitioning co-tenant.

The Property Preservation Task Force has requested the National Conference of Commissioners on Uniform State Laws to review and consider a uniform partition act.¹⁶ Southeastern jurisdictions have developed unique legislative solutions which may serve as a source for NCCUSL and other states' solutions to the problem. One such solution is proposed Article II of the General Statutes of North Carolina, GS 46-22, attached as Exhibit B. Although the statute has not yet been passed by the North Carolina legislature, it articulates a feature of remedial partition statutes enacted elsewhere, in particular, Alabama Statute 35-6-100 through 104 attached as Exhibit C.

⁶ *Id.* at § 50.07[3][a].

⁷ *Id.*

⁸ *Id.* at § 50.07[3][b].

⁹ *Id.* at § 50.07[4][a].

¹⁰ *Id.* at § 50.07[4][c].

¹¹ *Id.* at § 50.07[4][c] n.61-63.

¹² *Id.* at § 50.07[4][c] n.61-63.

¹³ *Id.* at § 50.07[4][c] n.61-63.

¹⁴ *Id.* at § 50.07[6] n.76.

¹⁵ The Federation of Southern Cooperatives/Assistance Fund, "African-American Rural Land Retention", submitted at 2004 Joint Fall CLE meeting, pps. 3-16.

¹⁶ See copy of submission letter dated June 16, 2005.

The statute provides that upon the filing of a petition for partition of real estate held in tenancy-in-common, “the Court shall provide for the purchase of the interest of the petitioning joint tenants to the non-petitioning joint tenants.” In the event the parties cannot reach agreement regarding the price, the value of the interest to be sold shall be appraised by court appointed appraisers. After the filing of the appraiser’s report, the responding tenants-in-common, seeking to purchase the petitioning tenants-in-common have 45 days to pay in the Court price set as the value of the interest to be purchased. Should the responding or non-petitioning joint tenants fail to pay the purchase price, the Court then reverts to traditional partition methods, namely physical partition or public sale. The proposal amplifies an enacted Alabama statute, § 35-6-100 through 104.

The enacted Alabama statute and the proposed North Carolina statute raise the following issues with respect to the existing law governing tenancy-in-common partitions:

1. Because the non-partitioning co-tenants have a right to purchase the partitioning co-tenant’s interest, must the non-partitioning co-tenants purchase all or only part of the interest held by the partitioning co-tenants?
2. Must the non-partitioning co-tenants purchase the partitioning co-tenant’s shares on a ratable basis or can one non-partitioning co-tenant purchase all of the partitioning co-tenant’s interest without participation by the remaining non-partitioning co-tenants?
3. How is the appraiser to appraise the interest of the partitioning co-tenant? Is it to be done with “cost of partition” discounts only or must there be other discounts applied?
4. Should uniform partition statutes affording non-partitioning co-tenants the right to purchase exempt from the reach of the statute co-tenancy properties having management or tenancy-in-common agreements in place?
5. Should statutes affording non-partitioning co-tenants the right to purchase a partitioning co-tenant’s share exempt from the reach of the statute urban versus agricultural land?
6. What is the effect of a bona fide purchaser for value without notice of a partitioning or non-partitioning co-tenant?
7. Should state statutes include a fair market value post partition sale hearing to protect the non-partitioning co-tenant, in lieu or in addition to a purchase option as described above?
8. Should a doctrine of constructive ouster be included a uniform partition act to allow an “on the farm” co-tenant the right to purchase remaining co-tenant’s interest without having to prove “ouster”?
9. Should the “on the farm” co-tenant be afforded the opportunity to recoup improvements paid by him or her on the property during his or her tenancy?
10. What is the impact on partition law reform statutes on commercial “TIC” properties used in IRC 1031 transactions and can such properties be easily exempted from any reform statutes?

D. Use of Tenancy-In-Common Agreements

Due to the uncertainty and variance of State partition laws, a common practice among co-tenancy real estate owners is to use tenancy-in-common agreements. This practice has been sanctioned by IRS Rev. Proc. 2002-22, which establishes for federal tax purposes the basis upon which the IRS will not characterize a tenancy-in-common agreement as a partnership, primarily to preserve tax deferral treatment under IRS § 1031.

An example of a tenancy-in-common agreement is attached as Exhibit D. The following are common features of a tenancy-in-common agreement:

1. The agreement specifies a specific term of the agreement.
2. The agreement specifies that an entity, usually a limited liability entity such as a limited liability company, may manage the property to handle the leasing operation and maintenance of the property.
3. The agreement provides that if additional operating capital be needed from the owners to operate, improve or otherwise manage the property, the manager may notify the owners of the requirement of such additional funds. The failure of any owner to make such additional contributions within ten days after the notice, may constitute a default under the agreement. Any non-defaulting owner has the right, not the obligation, to pay the defaulting owners pro-rata share of the requested contribution.
4. In the event a non-defaulting owner elects to pay the defaulting owners share, the non-defaulting owner shall be entitled to a percentage of the defaulting owners interest.
5. In the event of sale, the owner shall have the right to sell or exchange its interest in the property but must first offer to sell such property to other owners. The selling owner shall first offer to the other owners the property for a period of 30 days. In the event the non-selling owners reject the offer, then the selling owner shall be free to sell its interest in the property. In the event the non-selling owners accept the offer to purchase the property, then the non-selling owners shall have 60 days within which to purchase the property.
6. All owners shall have the right to partition the property provided that they first offer to sell their interest to the other owners with an MAI appraisal. In the event the non-selling owners decide to name their own appraiser, they may do so and those two appraisers may identify a third appraiser to appraise the property.
7. The sale price, under the attached agreement, carries with it a 25% discount from the appraised owner's percentage ownership. In the event that the non-partitioning owner rejects the offer, the partitioning owner is free to initiate a partition action in the appropriate court.
8. The agreement contains an express waiver or statement that the parties do not intend to become partners under the agreement.

E. IRS Rev. Proc. 2002-22

In response to the burgeoning tenancy-in-common industry (referred to as "TIC property"), the Internal Revenue issued a Rev. Proc. 2002-22, which identifies the basis upon which the Service will issue rulings as to whether a co-tenancy relationship is not a partnership. The ruling specifically applies to co-ownership of rental real property, other than mineral interests, in an

arrangement classified under local law as a tenancy-in-common. It is therefore critical to confirm that the rules applicable to the local jurisdiction do not create a partnership by default.¹⁷

Generally, under RUPA § 204(c) property is presumed to be partnership property if it is purchased with partnership assets, even if not acquired in the name of the partnership or one or more of the partners with an indication in interest transferring title to the property of the person's capacity as a partnership or the existence of a partnership. Furthermore, should the parties file a partnership return, this would be fatal to any claim that the property is in fact tenancy-in-common property.

Rev. Proc. 2002-22 is attached as Exhibit E. It contains the following conditions for a ruling to determine that property is not held as a partnership:

1. The number of co-owners must be limited to no more than 35 persons. All persons who acquire interest from a co-owner by inheritance are treated as a single person.
2. Co-ownership may not file a partnership or corporate tax return, or execute a business entity agreement.
3. Co-owners may enter into a limited co-ownership agreement that runs with the land which provides that a co-owner must offer the co-owner interest for sale to the other co-owners or the sponsor before exercising any right to partition, or that certain actions on behalf of the co-ownership require the co-owners holding more than 50% of the undivided interest in the property.
4. The co-owners must retain the right to approve the hiring of any manager, sale or other disposition of the property, in leases of a portion or all of the property, or the creation or modification of a blanket lien. Any sale, lease or release of a portion or all of the property in a negotiation or re-negotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract must be by unanimous approval of the co-owners. For all other actions on behalf of the co-owners, the co-owners may agree to be bound by the vote of those holding more than 50% of the undivided interest in the property. Individual limited powers of attorney in favor of the co-owners are not permitted but a co-owner may not provide a manager or other person with a global power of attorney.
5. Each co-owner must have the right to transfer, partition and encumber the co-owner's undivided interest in the property without the agreement or approval of any person. The co-owners, the sponsor or the lessee may have a right of "first offer," i.e. the right to have the first opportunity to offer to purchase the co-owner interest (with respect to any co-owner's exercise of the right to transfer the co-owner interest in the property. In addition, the co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor or the lessee at fair market value, determined either at the time the partition right is exercised, before exercising any right to partition.
6. If the property is sold, any debt secured by blanket lien must be satisfied and the remaining sales proceeds must be distributed pro rata to the co-owners.
7. Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owners undivided interest in the property. Neither the co-owners nor the sponsor nor the manager may advance funds to a co-owner to meet

¹⁷ For a discussion of the involuntary application of the Revised Uniform Partnership Act to Tenancy-in-Common Properties, see "Mandatory Sales of Joint Ownership Property Under the Revised Uniform Partnership Act" by Dietrich, David J. in ABA's Real Property, Probate and Trust Law Section publication Probate & Property, September/October 2004 Vo. 18 No. 5, pps. 8-12.

expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner for a period not exceeding 31 days.

8. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interest.

9. A co-owner may issue an option to purchase the co-owner's undivided interest (a call option), provided that the exercise price for the call option reflects the fair market value of the property determined at the time the option is exercised. For this purpose, fair market value of an undivided interest in the property is equal to the co-owner's percentage interest in the property multiplied by the fair market value of the property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (a put option) to the sponsor, the lessee, another co-owner, or the lender or any person related to the sponsor, lessee, other co-owner, or lender.

10. The co-owners activity must be limited to those customarily performed in connection with the maintenance and care of rental property.

11. The co-owners may enter into a management or brokerage agreement which must be renewable no less frequently than annually with an agent who may be the sponsor or co-owner but who may not be a lessee. The manager must disburse to the co-owners their shares within three months of the date of receive of those revenues. The management agreement may authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the property. It may also authorize the manager to obtain and modify insurance on the property and to negotiate modifications of the terms of any lease or indebtedness encumbering the property subject to the approval of the co-owners. The determination of any fees paid by the co-ownership to the manager must not depend in full or in part on the income or profits derived by any person 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.

12. Leasing agreements must be bone fide leases for federal tax purposes and rents paid by a lessee must reflect the fair market value for the use of the property. The determination of the amount of the rent must not depend in whole or in part on the income or profits derived by any person from the property leased. The amount of rent paid by lessee may not be based on a percentage of net income from the property cash flow, increases in equity or similar arrangements.

13. The lender, with respect to any debt that encumbers the property or with respect to any debt incurred to acquire an undivided interest in the property, may not be a related person to any co-owner, the sponsor, the manager, or the lessee of the property.

14. 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 for services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property.

F. Management Issues With Respect To Non-Commercial Tenancy-in-Common or Business Entity Property

Land Loss may occur where co-owners own recreational property and underestimate the complexity of co-ownership. The problem is aggravated by rapidly appreciating land values in areas of recreational property. Regardless of the business organization used, or the tax compliance features of a tenancy-in-common agreement with IRS Rev. Proc. 2002-22, basic operational issues

must be addressed in any co-ownership arrangement.¹⁸ Management issues relating to recreational property, whether such arrangements are placed in a limited liability company operating agreement, tenancy-in-common agreement or otherwise, should address the following issues:

- i. A schedule for use of the cabin.
- ii. Determined whether outsiders should be allowed to use the cabin, on what basis (*e.g.*, will outsiders only be allowed to use the cabin when accompanied by a family member/owner), and whether they will be charged rent.
- iii. Establish rules applicable during the time that the cabin is in use.
- iv. Determine how maintenance and repairs are to be handled.
- v. Establish annual membership dues or rent (normally equal in amount per member).
- vi. Levy special assessments (generally proportionate to percentage ownership interests) if annual membership dues are insufficient.
- vii. Establish usage fees (to reflect actual use of the property by members). The use of membership dues, special assessments, and usage fees allows the managers to spread the financial burden among members in a manner that reflects differing amounts of use and differing percentage ownership interests. This promotes fairness between those who frequently use the property and those who are unable to enjoy it regularly.
- viii. If there are to be a manager or managers, who should serve in that role? Should a successor manager be identified? If multiple families own the property, should there always be a manager from each family?
- ix. Determine whether outsiders can become owners.
- x. Determine whether family members should be allowed to withdraw. If they are allowed to withdraw, what value will they receive? (A withdrawal may place a definite financial burden on the remaining members.)
- xi. Determine how to handle the periodic replacement of improvements such as a dock or a deck.
- xii. Determine how ownership rights may be transferred and how to deal with the financial crisis of an owner (bankruptcy, judgment, tax lien, marital dissolution) resulting in a lien against the property.
- xiii. Establish a procedure to resolve future disputes.

¹⁸ See “Keeping The Cabin in the Family: A Guide To Joint Ownership And Use,” Wendy Goff, presented at the 2004 ABA Spring Section Meeting; and “How To Pass It On, The Ownership and Use of Summer Homes,” Ken Huggins and Judith Huggins Balfe.