TENANT IN COMMON INTERESTS IN SECTION 1031 EXCHANGES

JOINT FALL MEETING OF THE
AMERICAN BAR ASSOCIATION
SECTIONS OF REAL PROPERTY, PROBATE AND TRUST AND TAXATION
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I. THE HISTORY

A. The difficulty of finding suitable replacement property within the limited 45-day identification period has spawned companies that acquire large parcels of land and commercial properties and then sell small tenant in common interests to taxpayers as replacement properties in exchanges.

B. This practice came to the attention of the Service and because so many taxpayers were seeking private letter rulings as to whether such interests would qualify as replacement property or constituted partnership interests, and the Service first announced that it would not issue any rulings while it studied the matter. Rev. Proc. 2000-46

C. The Service subsequently announced Rev. Proc. 2002-22 specifying the conditions under which it will consider a request for a ruling that an undivided fractional interest in real property (other than a mineral property as defined in Code Sec. 614) is not an interest in a business entity within the meaning of §301.7701-2(a) of the Procedure and Administration Regulations

II. REVENUE PROCEDURE 2002-22 (EXHIBIT A)

A. Describes when the Service will give a letter ruling on acquisition of a tenant in common interest.

B. Includes a lengthy, detailed analysis of the factors which would lead to the conclusion that a tenant in common interest is in fact a partnership interest and not an interest in real estate and specifies the conditions under which the Service will consider a ruling request that an undivided fractional interest in real property is not an interest in a business entity, within the meaning of Reg. §301.7701-2(a)

C. Describes the regulations which define whether an organization is an entity separate from its owners for federal tax purposes

1. the determination is not based upon whether it is an entity under state law;

2. determined by whether the participants carry on a trade, business, financial operation or venture and divide the profits from their joint activities.

D. Co-ownership of property that is maintained, kept in repair and rented or leased does not per se constitute a separate entity for federal tax purposes.

E. A business entity for tax purposes contrasted with a tenancy in common. Tenancy in common is characterized by

1. each participant owning individually a physically undivided part of the entire parcel of property;

2. being entitled to share with the other owners in possession of the property; and

3. having the right to a proportionate share of rents or profits from the property, to transfer the interest and to demand a partition of the property.

III. INFORMATION TO BE SUBMITTED.

A. The name, taxpayer identification number, and percentage fractional interest in property of each co-owner;

B. The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of property, including the sponsor, lessee, manager and lender;

C. A full description of the property;

D. A representation that each of the co-owners holds title to the property (including each of multiple parcels of property treated as a single property under this revenue procedure) as a tenant in common under local law;

E. All promotional documents relating to the sale of fractional interests in the property;

F. All lending agreements relating to the property;

G. All agreements among the co-owners relating to the property;

H. Any lease agreement relating to the property;

I. Any purchase and sale agreement relating to the property;

J. Any property management or brokerage agreement relating to the property; and

K. Any other agreement relating to the property, including agreements relating to any debt secured by the property (such as guarantees or indemnity agreements) and any call and put options relating to the property.

IV. CONDITIONS FOR RULINGS

A. Tenancy in Common Ownership. Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law

B. Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons.

C. No Treatment of Co-Ownership as an Entity. The co-ownership cannot

1. file a partnership or corporate tax return,

2. conduct business under a common name,

3. execute an agreement identifying any or all of 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.

4. The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership.

D. Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may

1. run with the land

2. providing for such things as offering the co-ownership interest for sale to the other co-owners, the sponsor or the lessee at fair market value before exercising any right to partition, or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the property.

E. Voting. The co-owners must retain the right to approve

1. the hiring of any manager,

2. the sale or other disposition of the property,

3. any leases of a portion or all of the property,

4. the creation or modification of a blanket lien,

5. the sale, lease or re-lease of a portion or all of the property,

6. negotiation or renegotiation of indebtedness secured by a blanket lien,

7. the negotiation of any management contract must be by unanimous approval of the co-owners.

F. Restrictions on Alienation. Each co-owner must have the rights to

1. transfer, partition, and encumber his or her undivided interest in the property without the agreement or approval of any person,

(a) restrictions on the right to transfer, partition, or encumber interests in the property imposed by a lender, rights of first refusal, and an obligation of

co-owners to first offer it to other co-owners before seeking partition are not prohibited.

2. Sharing Proceeds and Liabilities upon Sale of Property. If the property is sold, debt secured by a blanket lien must be paid and the remaining sales proceeds distributed to the co-owners.

3. Proportionate Sharing of Profits and Losses. Each co-owner must share in

   (a) all revenues generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property;

   (b) advances to a co-owner to meet expenses associated with the property must be with recourse with repayment required in not less than 31 days.

4. Proportionate Sharing of Debt. The co-owners must be liable for indebtedness secured by a blanket lien in proportion to their undivided interests.

5. Options.

   (a) An option to purchase a co-owner's undivided interest must be at fair market value at the time the option is exercised.

   (b) A co-owner may not acquire an option to sell the co-owner's undivided interest to the sponsor, the lessee, another co-owner or the lender, or any person related to the sponsor, the lessee, another co-owner or the lender.

6. No Business Activities. The co-owners' activities with respect to the property must be limited to maintenance and repair of rental real property (customary activities).

7. Management and Brokerage Agreements. The co-owners may and the manager must

   (a) 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.

   (b) authorize the manager a common bank account for the collection and deposit of rents and to pay property expenses, obtain and modify insurance, negotiate leases or indebtedness, subject to approval of the co-owners.

   (c) disburse shares of net revenues within 3 months from the date of receipt of the revenues.

(d) fees paid to the manager must not depend in whole or in part on the income or profits derived from the property and may not exceed the fair market value of the manager's services.

8. Leasing Agreements.

(a) All leasing arrangements must be bona fide leases for federal tax purposes at fair market value.

(b) 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 (other than an amount based on a fixed percentage or percentages of receipts or sales).

9. Loan Agreements. The lender holding a blanket lien may not be a related person to any co-owner, the sponsor, the manager or any lessee of the property.

10. Payments to Sponsor. The 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 be at 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 by any person from the property.

G. Revenue Procedure 2004-86 (Exhibit B)

1. Taxpayer exchanged real property for an interest in a Delaware statutory trust

2. A Delaware statutory trust is an unincorporated association recognized as an entity separate from its owners under Delaware law

3. The Delaware statutory trust described in the ruling is deemed an investment trust, under § 301.7701-4(c), that will be classified as a trust for federal tax purposes

4. A taxpayer may exchange real property for an interest in the Delaware statutory trust described in the ruling without recognition of gain or loss under §1031, if the other requirements of §1031 are satisfied.

EXHIBIT A

Revenue Procedures

Rev. Proc. 2002-22, 2002-1 CB 733, 03/19/2002, IRC Sec(s). 1031

Domestic “no rule” areas—exchange of property held for productive use or investment.

Headnote:

IRS has removed from its list of domestic “no-rule” or “limited rule” areas question of whether undivided fractional interest in real property (other than Code Sec. 614; mineral property) is an interest in a separate tax entity ineligible for tax-free exchange under Code Sec. 1031(a)(1); . Topic was added to list in 2000, with rulings and letters not to be issued pending further guidance. *Rev Proc 2000-46,* 2000-2 CB 438, is superseded. *Rev Proc 2002-3,*2002-1 CB 117, is modified.

Reference(s): ¶ 10,315.03(40); ¶ 76,557.48(10); Code Sec. 1031;

Full Text:

Section 1. Purpose

This revenue procedure specifies the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity, within the meaning of § 301.7701-2(a) of the Procedure and Administration Regulations.

This revenue procedure supersedes Rev. Proc. 2000-46, 2002-2 C.B. 438, which provides that the Service will not issue advance rulings or determination letters on the questions of whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under § 1031(a)(1) of the Internal Revenue Code and whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes under § 7701. This revenue procedure also modifies Rev. Proc. 2002-3, 2002-1 I.R.B. 117, by removing these issues from the list of subjects on which the Service will not rule. Requests for advance rulings described in Rev. Proc. 2000-46 that are not covered by this revenue procedure, such as rulings concerning mineral property, will be considered under procedures set forth in Rev. Proc. 2002-1, 2002-1 I.R.B. 1 (or its successor).

Section 2. Background

Section 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the

entity is recognized as an entity under local law. Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 761(a) provides that 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 that is not a corporation or a trust or estate.

Section 1.761-1(a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under §§ 301.7701-1, 301.7701-2, and 301.7701-3.

The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common. 7 Richard R. Powell, Powell on Real Property §§ 50.01-50.07 (Michael Allan Wolf ed., 2000).

Rev. Rul. 75-374, 1975-2 C.B. 261, concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the revenue ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. See also Rev. Rul. 79-77, 1979-1 C.B. 448, which did not find a business entity where three individuals transferred ownership of a commercial building subject to a net lease to a trust with the three individuals as beneficiaries.

Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among the co-owners, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership. For example, in Bergford v. Commissioner, 12 F.3d 166 (9 Cir. 1993), seventy-eight

investors purchased "co-ownership" interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Bergford, 12 F.3d at 169-170. Accord Bussing v. Commissioner, 88 T.C. 449 (1987), aff'd on reh'g, 89 T.C. 1050 (1987); Alhouse v. Commissioner, T.C. Memo. 1991-652.

Under § 1.761-1(a) and §§ 301.7701-1 through 301.7701-3, a federal tax partnership does not include mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased. However, as the above authorities demonstrate, a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships. Bergford, 12 F.3d at 169. Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. Bussing, 88 T.C. at 460. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. Bergford, 12 F.3d at 169.

Section 3. Scope

This revenue procedure applies to co-ownership of rental real property (other than mineral interests) (the Property) in an arrangement classified under local law as a tenancy-in-common.

This revenue procedure provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes.

Section 4. Guidelines For Submitting Ruling Requests

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the information described in section 5 of this revenue procedure is included in the ruling

request and the conditions described in section 6 of this revenue procedure are satisfied. Even if sections 5 and 6 of this revenue procedure are satisfied, however, the Service may decline to issue a ruling under this revenue procedure whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

Where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single "Property." In such a case, the Service will generally not consider a ruling request under this revenue procedure unless: (1) each co-owner's percentage interest in each parcel is identical to that co-owner's percentage interest in every other parcel, (2) each co-owner's percentage interests in the parcels cannot be separated and traded independently, and (3) the parcels of property are properly viewed as a single business unit. The Service will generally treat contiguous parcels as comprising a single business unit. Even if the parcels are not contiguous, however, the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. For example, an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous.

For purposes of this revenue procedure, the following definitions apply. The term "co-owner" means any person that owns an interest in the Property as a tenant in common. The term "sponsor" means any person who divides a single interest in the Property into multiple co-ownership interests for the purpose of offering those interests for sale. The term "related person" means a person bearing a relationship described in § 267(b) or 707(b)(1), except that in applying § 267(b) or 707(b)(1), the co-ownership will be treated as a partnership and each co-owner will be treated as a partner. The term "disregarded entity" means an entity that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include qualified REIT subsidiaries (within the meaning of § 856(i)(2)), qualified subchapter S subsidiaries (within the meaning of § 1361(b)(3)(B)), and business entities that have only one owner and do not elect to be classified as corporations. The term "blanket lien" means any mortgage or trust deed that is recorded against the Property as a whole.

Section 5. Information To Be Submitted

.01 Section 8 of Rev. Proc. 2002-1 outlines general requirements concerning the information to be submitted as part of a ruling request, including advance rulings under this revenue procedure. For example, any ruling request must contain a complete statement of all facts relating to the co-ownership, including those relating to promoting, financing, and managing the Property. Among the information to be included are the items of information specified in this revenue procedure; therefore, the ruling request must provide all items of information and conditions specified below and in section 6 of this revenue procedure, or at least account for all of the items. For example, if a co-ownership arrangement has no brokerage agreement permitted in section 6.12 of this revenue procedure, the ruling request should so state. Furthermore, merely submitting documents and supplementary materials required by section 5.02 of this revenue procedure does not satisfy all of the information requirements contained in section 5.02 of this revenue procedure or in section 8 of Rev. Proc. 2002-1; all material facts in the documents submitted must be explained

in the ruling request and may not be merely incorporated by reference. All submitted documents and supplementary materials must contain applicable exhibits, attachments, and amendments. The ruling request must identify and explain any information or documents required in section 5 of this revenue procedure that are not included and any conditions in section 6 of this revenue procedure that are or are not satisfied.

.02 Required General Information and Copies of Documents and Supplementary Materials. Generally the following information and copies of documents and materials must be submitted with the ruling request:

(1) The name, taxpayer identification number, and percentage fractional interest in Property of each co-owner;
(2) The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of Property, including the sponsor, lessee, manager, and lender;
(3) A full description of the Property;
(4) A representation that each of the co-owners holds title to the Property (including each of multiple parcels of property treated as a single Property under this revenue procedure) as a tenant in common under local law;
(5) All promotional documents relating to the sale of fractional interests in the Property;
(6) All lending agreements relating to the Property;
(7) All agreements among the co-owners relating to the Property;
(8) Any lease agreement relating to the Property;
(9) Any purchase and sale agreement relating to the Property;
(10) Any property management or brokerage agreement relating to the Property; and
(11) Any other agreement relating to the Property not specified in this section, including agreements relating to any debt secured by the Property (such as guarantees or indemnity agreements) and any call and put options relating to the Property.

Section 6. Conditions For Obtaining Rulings

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the conditions described below are satisfied. Nevertheless, where the conditions described below are not satisfied, the Service may consider a request for a ruling under this revenue procedure where the facts and circumstances clearly establish that such a ruling is appropriate.

.01 Tenancy in Common Ownership. Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

.02 Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons. For this purpose, "person" is defined as in § 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

.03 No 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 any or all of 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 partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.

.04 Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

.05 Voting. The co-owners must retain the right to approve the hiring of any manager, 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. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

.06 Restrictions on Alienation. In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the Property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See section 6.14 of this revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the Property. In addition, a 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 as of the time the partition right is exercised) before exercising any right to partition.

.07 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.

.08 Proportionate Sharing of Profits and Losses. Each co-owner must share in all revenues generated by the Property and all costs associated with the Property 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 disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

.09 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 undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the 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 (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

.11 No Business Activities. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

.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 management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, 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 also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager 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. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole 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.

.13 Leasing Agreements. All leasing arrangements must be bona fide leases for federal tax purposes. 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 (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.

.14 Loan Agreements. 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 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 by any person from the Property.

Section 6. Effect On Other Documents

Rev. Proc. 2000-46 is superseded. Rev. Proc. 2002-3 is modified by removing sections 5.03 and 5.06.

Section 7. Drafting Information

The principal authors of this revenue procedure are Jeanne Sullivan and Deane Burke of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Sullivan or Mr. Burke at (202) 622-3070 (not a toll-free call).

EXHIBIT B

Revenue Rulings

Rev. Rul. 2004-86, 2004-33 IRB, 07/20/2004, IRC Sec(s).

Headnote:

Reference(s):

Full Text:

ISSUE(S)

(1) In the situation described below, how is a Delaware statutory trust, described in Del. Code Ann. title 12, §§ 3801 - 3824, classified for federal tax purposes?

(2) In the situation described below, may a taxpayer exchange real property for an interest in a Delaware statutory trust without recognition of gain or loss under § 1031 of the Internal Revenue Code?

Facts

On January 1, 2005, A, an individual, borrows money from BK, a bank, and signs a 10-year note bearing adequate stated interest, within the meaning of § 483. On January 1, 2005, A uses the proceeds of the loan to purchase Blackacre, rental real property. The note is secured by Blackacre and is nonrecourse to A.

Immediately following A's purchase of Blackacre, A enters into a net lease with Z for a term of 10 years. Under the terms of the lease, Z is to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, Z is to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. Z may sublease Blackacre. Z's rent is a fixed amount that may be adjusted by a formula described in the lease agreement that is based upon a fixed rate or an objective index, such as an escalator clause based upon the Consumer Price Index, but adjustments to the rate or index are not within the control of any of the parties to the lease. Z's rent is not contingent on Z's ability to lease the property or on Z's gross sales or net profits derived from the property.

Also on January 1, 2005, A forms DST, a Delaware statutory trust described in the Delaware Statutory Trust Act, Del. Code Ann. title 12, §§ 3801 - 3824, to hold property for investment. A contributes Blackacre to DST. Upon contribution, DST assumes A's rights and obligations under the note with BK and the lease with Z. In accordance with the terms of the note, neither DST nor any of its beneficial owners are personally liable to BK on the note, which continues to be secured by Blackacre.

The trust agreement provides that interests in DST are freely transferable. However, DST interests are not publicly traded on an established securities market. DST will terminate on the earlier of 10 years from the date of its creation or the disposition of Blackacre, but will not terminate on the bankruptcy, death, or incapacity of any owner or on the transfer of any right, title, or interest of the owners. The trust agreement further provides that interests in DST will be of a single class, representing undivided beneficial interests in the assets of DST.

Under the trust agreement, the trustee is authorized to establish a reasonable reserve for expenses associated with holding Blackacre that may be payable out of trust funds. The trustee is required to distribute all available cash less reserves quarterly to each beneficial owner in proportion to their respective interests in DST. The trustee is required to invest cash received from Blackacre between each quarterly distribution and all cash held in reserve in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. In addition to the right to a quarterly distribution of cash, each beneficial owner has the right to an in-kind distribution of its proportionate share of trust property.

The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to DST. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with Z or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law. The trust agreement further provides that the trustee may engage in ministerial activities to the extent required to maintain and operate DST under local law.

On January 3, 2005, B and C exchange Whiteacre and Greenacre, respectively, for all of A's interests in DST through a qualified intermediary, within the meaning of § 1.1031(k)-1(g). A does not engage in a § 1031 exchange. Whiteacre and Greenacre were held for investment and are of like kind to Blackacre, within the meaning of § 1031.

Neither DST nor its trustee enters into a written agreement with A, B, or C, creating an agency relationship. In dealings with third parties, neither DST nor its trustee is represented as an agent of A, B, or C.

BK is not related to A, B, C, DST's trustee or Z within the meaning of § 267(b) or § 707(b). Z is not related to B, C, or DST's trustee within the meaning of § 267(b) or § 707(b).

Law

Delaware law provides that a Delaware statutory trust is an unincorporated association recognized as an entity separate from its owners. A Delaware statutory trust is created by executing a governing instrument and filing an executed certificate of trust. Creditors of the

beneficial owners of a Delaware statutory trust may not assert claims directly against the property in the trust. A Delaware statutory trust may sue or be sued, and property held in a Delaware statutory trust is subject to attachment or execution as if the trust were a corporation. Beneficial owners of a Delaware statutory trust are entitled to the same limitation on personal liability because of actions of the Delaware statutory trust that is extended to stockholders of Delaware corporations. A Delaware statutory trust may merge or consolidate with or into one or more statutory entities or other business entities.

Section 671 provides that, where the grantor or another person is treated as the owner of any portion of a trust (commonly referred to as a "grantor trust"), there shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that the items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that, for purposes of subchapter J, a grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.

Under § 1.671-2(e)(3), the term "grantor" includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in § 301.7701-4(c).

Under § 677(a), the grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed, or held or accumulated for future distribution, to the grantor or the grantor's spouse.

A person that is treated as the owner of an undivided fractional interest of a trust under subpart E of part I, subchapter J of the Code (§§ 671 and following), is considered to own the trust assets attributable to that undivided fractional interest of the trust for federal income tax purposes. See Rev. Rul. 88-103, 1988-2 C.B. 304; Rev. Rul. 85-45, 1985-1 C.B. 183; and Rev. Rul. 85-13, 1985-1 C.B. 184. See also § 1.1001-2(c), Example 5.

Section 761(a) provides that 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 that is not a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of the unincorporated organization, exclude such organization from the application of all or part of subchapter K, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income and the organization is availed of (1) for investment purposes only and not for the active conduct of a business, (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities.

Section 1.761-2(a)(2) provides the requirements that must be satisfied for participants in the joint purchase, retention, sale, or exchange of investment property to elect to be excluded from the application of the provisions of subchapter K. One of these requirements is that the participants own the property as coowners.

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(2) provides that § 1031(a) does not apply to any exchange of stocks, bonds or notes, other securities or evidences of indebtedness or interest, interests in a partnership, or certificates of trust or beneficial interests. It further provides that an interest in a partnership that has in effect a valid election under § 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of the partnership and not as an interest in a partnership.

Under § 301.7701-1(a)(1) of the Procedure and Administration Regulations, whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Generally, when participants in a venture form a state law entity and avail themselves of the benefits of that entity for a valid business purpose, such as investment or profit, and not for tax avoidance, the entity will be recognized for federal tax purposes. See Moline Properties, Inc. v. Comm'r, 319 U.S. 436 (1943); Zmuda v. Comm'r, 731 F.2d 1417 (9th Cir. 1984); Boca Investerings P'ship v. United States, 314 F.3d 625 (D.C. Cir. 2003); Saba P'ship v. Comm'r, 273 F.3d 1135 (D.C. Cir. 2001); ASA Investerings P'ship v. Comm'r, 201 F.3d 505 (D.C. Cir. 2000); Markosian v. Comm'r, 73 T.C. 1235 (1980).

Section 301.7701-2(a) defines the term "business entity" as any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more owners is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded.

Section 301.7701-3(a) provides that an eligible entity can elect its classification for federal tax purposes. Under § 301.7701-3(b)(1), unless the entity elects otherwise, a domestic eligible entity is a partnership if it has two or more owners or is disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-4(a) provides that the term "trust" refers to an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting and conserving it for the beneficiaries. Usually the beneficiaries of a trust do no more than accept the benefits thereof and are not voluntary planners or creators of the trust

arrangement. However, the beneficiaries of a trust may be the persons who create it, and it will be recognized as a trust if it was created for the purpose of protecting and conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them.

Section 301.7701-4(b) provides that there are other arrangements known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but that are not classified as trusts for federal tax purposes because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business that normally would have been carried on through business organizations that are classified as corporations or partnerships.

Section 301.7701-4(c)(1) provides that an "investment" trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. See Comm'r v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power to vary the investment of the certificate holders.

A power to vary the investment of the certificate holders exists where there is a managerial power, under the trust instrument, that enables a trust to take advantage of variations in the market to improve the investment of the investors. See Comm'r v. North American Bond Trust, 122 F.2d at 546.

Rev. Rul. 75-192, 1975-1 C.B. 384, discusses the situation where a provision in the trust agreement requires the trustee to invest cash on hand between the quarterly distribution dates. The trustee is required to invest the money in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. Rev. Rul. 75-192 concludes that, because the restrictions on the types of permitted investments limit the trustee to a fixed return similar to that earned on a bank account and eliminate any opportunity to profit from market fluctuations, the power to invest in the specified kinds of short-term investments is not a power to vary the trust's investment.

Rev. Rul. 78-371, 1978-2 C.B. 344, concludes that a trust established by the heirs of a number of contiguous parcels of real estate is an association taxable as a corporation for federal tax purposes where the trustees have the power to purchase and sell contiguous or adjacent real estate, accept or retain contributions of contiguous or adjacent real estate, raze or erect any building or structure, make any improvements to the land originally contributed, borrow money, and mortgage or lease the property. Compare Rev. Rul. 79-77, 1979-1 C.B. 448 (concluding that a trust formed by three parties to hold a single parcel of real estate is classified as a trust for federal income tax purposes when the trustee has limited powers that do not evidence an intent to carry on a profit making business).

Rev. Rul. 92-105, 1992-2 C. B. 204, addresses the transfer of a taxpayer's interest in an Illinois land trust under § 1031. Under the facts of the ruling, a single taxpayer created an Illinois land trust and named a domestic corporation as trustee. Under the deed of trust, the taxpayer transferred legal and equitable title to real property to the trust, subject to the provisions of an accompanying land trust agreement. The land trust agreement provided that the taxpayer retained exclusive control of the management, operation, renting, and selling of the real property, together with an exclusive right to the earnings and proceeds from the real property. Under the agreement, the taxpayer was required to file all tax returns, pay all taxes, and satisfy any other liabilities with respect to the real property. Rev. Rul 92-105 concludes that, because the trustee's only responsibility was to hold and transfer title at the direction of the taxpayer, a trust, as defined in § 301.7701-4(a), was not established. Moreover, there were no other arrangements between the taxpayer and the trustee (or between the taxpayer and any other person) that would cause the overall arrangement to be classified as a partnership (or any other type of entity). Instead, the trustee was a mere agent for the holding and transfer of title to real property, and the taxpayer retained direct ownership of the real property for federal income tax purposes.

Analysis

Under Delaware law, DST is an entity that is recognized as separate from its owners. Creditors of the beneficial owners of DST may not assert claims directly against Blackacre. DST may sue or be sued, and the property of DST is subject to attachment and execution as if it were a corporation. The beneficial owners of DST are entitled to the same limitation on personal liability because of actions of DST that is extended to stockholders of Delaware corporations. DST may merge or consolidate with or into one or more statutory entities or other business entities. DST is formed for investment purposes. Thus, DST is an entity for federal tax purposes.

Whether DST or its trustee is an agent of DST's beneficial owners depends upon the arrangement between the parties. The beneficiaries of DST do not enter into an agency agreement with DST or its trustee. Further, neither DST nor its trustee acts as an agent for A, B, or C in dealings with third parties. Thus, neither DST nor its trustee is the agent of DST's beneficial owners. Cf. Comm'r v. Bollinger, 485 U.S. 340 (1988).

This situation is distinguishable from Rev. Rul. 92-105. First, in Rev. Rul. 92-105, the beneficiary retained the direct obligation to pay liabilities and taxes relating to the property. DST, in contrast, assumed A's obligations on the lease with Z and on the loan with BK, and Delaware law provides the beneficial owners of DST with the same limitation on personal liability extended to shareholders of Delaware corporations. Second, unlike A, the beneficiary in Rev. Rul. 92-105 retained the right to manage and control the trust property.

Issue 1. Classification of Delaware Statutory Trust

Because DST is an entity separate from its owner, DST is either a trust or a business entity for federal tax purposes. To determine whether DST is a trust or a business entity for federal tax purposes, it is necessary, under § 301.7701-4(c)(1), to determine whether there is a power under the trust agreement to vary the investment of the certificate holders.

Prior to, but on the same date as, the transfer of Blackacre to DST, A entered into a 10-year nonrecourse loan secured by Blackacre. A also entered into the 10-year net lease agreement with Z. A's rights and obligations under the loan and lease were assumed by DST. Because the duration of DST is 10 years (unless Blackacre is disposed of prior to that time), the financing and leasing arrangements related to Blackacre that were made prior to the inception of DST are fixed for the entire life of DST. Further, the trustee may only invest in short-term obligations that mature prior to the next distribution date and is required to hold these obligations until maturity. Because the trust agreement requires that any cash from Blackacre, and any cash earned on short-term obligations held by DST between distribution dates, be distributed quarterly, and because the disposition of Blackacre results in the termination of DST, no reinvestment of such monies is possible.

The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to DST. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with Z or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law.

This situation is distinguishable from Rev. Rul. 78-371, because DST's trustee has none of the powers described in Rev. Rul. 78-371, which evidence an intent to carry on a profit making business. Because all of the interests in DST are of a single class representing undivided beneficial interests in the assets of DST and DST's trustee has no power to vary the investment of the certificate holders to benefit from variations in the market, DST is an investment trust that will be classified as a trust under § 301.7701-4(c)(1).

Issue 2. Exchange of Real Property for Interests under § 1031

B and C are treated as grantors of the trust under § 1.671-2(e)(3) when they acquire their interests in the trust from A. Because they have the right to distributions of all trust income attributable to their undivided fractional interests in the trust, B and C are each treated, by reason of § 677, as the owner of an aliquot portion of the trust and all income, deductions, and credits attributable to that portion are includible by B and C under § 671 in computing their taxable income. Because the owner of an undivided fractional interest of a trust is considered to own the trust assets attributable to that interest for federal income tax purposes, B and C are each considered to own an undivided fractional interest in Blackacre for federal income tax purposes. See Rev. Rul. 85-13.

Accordingly, the exchange of real property by B and C for an interest in DST through a qualified intermediary is the exchange of real property for an interest in Blackacre, and not the exchange of real property for a certificate of trust or beneficial interest under § 1031(a)(2)(E). Because Whiteacre and Greenacre are of like kind to Blackacre, and provided the other requirements of § 1031 are satisfied, the exchange of real property for an interest in DST by B and C will qualify for nonrecognition of gain or loss under § 1031. Moreover, because DST is a grantor trust, the

outcome to the parties will remain the same, even if A transfers interests in Blackacre directly to B and C, and B and C immediately form DST by contributing their interests in Blackacre.

Under the facts of this case, if DST's trustee has additional powers under the trust agreement such as the power to do one or more of the following: (i) dispose of Blackacre and acquire new property; (ii) renegotiate the lease with Z or enter into leases with tenants other than Z; (iii) renegotiate or refinance the obligation used to purchase Blackacre; (iv) invest cash received to profit from market fluctuations; or (v) make more than minor non-structural modifications to Blackacre not required by law, DST will be a business entity which, if it has two or more owners, will be classified as a partnership for federal tax purposes, unless it is treated as a corporation under § 7704 or elects to be classified as a corporation under § 301.7701-3. In addition, because the assets of DST will not be owned by the beneficiaries as coowners under state law, DST will not be able to elect to be excluded from the application of subchapter K. See § 1.761-2(a)(2)(i).

Holdings

(1) The Delaware statutory trust described above is an investment trust, under § 301.7701-4(c), that will be classified as a trust for federal tax purposes.
(2) A taxpayer may exchange real property for an interest in the Delaware statutory trust described above without recognition of gain or loss under § 1031, if the other requirements of § 1031 are satisfied.

Effect On Other Revenue Rulings

Rev. Rul. 78-371 and Rev. Rul. 92-105 are distinguished.

Drafting Information

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