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New Private Letter Ruling Continuing IRS Approval of "TIC" Interests as Replacement Property in Section 1031 Exchanges; New Guidance on Permissible Leasing Activities

On April 1, 2005, the IRS released PLR 200513010 (the "2005 PLR"), only the second private letter ruling providing guidance regarding how a tenancy-in-common ("TIC") interest might serve as qualifying replacement property in a Section 1031 like-kind exchange of real estate. While the 2005 PLR does not break a great deal of new ground, it highlights two important points: (1) the IRS continues to approve TIC arrangements generally meeting the guidelines of Rev. Proc. 2002-22 (discussed in more detail below); and (2) the IRS has expanded the boundaries of Rev. Proc. 2002-22 with respect to leasing activity at a site. As such, this latest guidance is very good news for the TIC industry.

The IRS views a properly structured TIC interest meeting the guidelines of Rev. Proc 2002-22 as qualifying "replacement property" in a Section 1031 exchange of real property. Section 1031 benefits aside, TIC interests are also attractive to many real estate investors as such investments typically involve high quality real estate, provide steady cash flow and require little or no management responsibilities. Owners of real estate are repositioning their assets to meet buyer demand.

SECTION 1031 – IN GENERAL

Properly structured, a Section 1031 exchange allows for the deferral of taxable gain on the disposition of an asset. In general, Section 1031 exchanges of realty take two forms: simultaneous exchanges and deferred exchanges. The mechanics of a simultaneous Section 1031 exchange are relatively straightforward and easy to understand; in these real estate transactions, a property owner simply exchanges his owned property (the "relinquished" property) with the owner of, and in exchange for, a second property (the "replacement" property). Deferred exchanges, which are more common than simultaneous exchanges, are a bit more complicated. A deferred Section 1031 exchange involving the sale of real estate requires, among other things, that (i) the sales proceeds go to a "qualified intermediary" rather than the seller; (ii) from the date of

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the sale, the seller must identify a "replacement property" within 45 days; and (iii) the closing for the replacement property must generally occur within 180 days from the date of the sale. If these requirements are not met, the benefits of Section 1031 will typically not be available to defer the gain on the original sale.

TIC INTERESTS

Three years ago the IRS issued Rev. Proc. 2002-22, resulting in formal "guidelines" under which TIC arrangements could qualify for "replacement" property status in a Section 1031 exchange of real estate. Investors, looking to better navigate the difficult and cumbersome timing requirements of a deferred exchange, have turned to TIC investments as a viable option to solve their potential tax concerns upon a sale of real estate. The TIC industry has experienced exponential growth over a short period - approximately \$200 million total deal volume was recorded in 2002 and there is expected to be \$4 billion in total deal volume in 2005. Under a TIC arrangement, a TIC interest holder will own an undivided fractional interest in an entire parcel of real estate, and likewise share proportionally in the net income from such property. TIC interests are packaged such that the asset is positioned with third-party management and financing in place.

While the specifics of this revenue procedure are too complicated to describe in great detail, some highlights include the following:

- There can generally be no more than 35 TIC interest holders, although a husband and wife are treated as a single person for this purpose.
- Each TIC interest holder must hold title to the property directly or through a disregarded entity, and any debt on the property must be shared by the TIC interest holders proportionately.
- The TIC arrangement cannot be held out as a partnership or other business entity.
- The TIC interest holders are allowed to enter into a limited TIC agreement that may run with the land. Such agreement might, for example, provide that a TIC interest holder must offer the TIC interest for sale to the other TIC interest holders, the TIC arrangement sponsor, or even the lessee at then fair market value *before* exercising any right to partition.
- The TIC interest holders must retain the right to approve the hiring of any manager, the sale or other disposition of the real estate, any leases, or the terms of a blanket lien. Any sale, lease, or re-lease of all or a portion of the realty, any negotiation or renegotiation of debt secured by a blanket lien on the real estate, the hiring of any manager, or the negotiation, extension or renewal of any management contract must be by unanimous approval of the co-owners. All other actions on behalf of the TIC arrangement can be accomplished by the affirmative vote of more than 50 percent of the TIC interests.
- Each TIC interest holder must generally retain the right to transfer, partition, and encumber the TIC interest without the approval of any person. However, customary lender-imposed restrictions on the right to transfer, partition, or encumber the TIC interests are permissible. The other TIC interest holders, the sponsor, or the lessee can possess the first chance to offer to purchase the TIC interest.
- If the real estate is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the TIC interest holders.
- Each TIC interest holder must proportionately share in all revenues and expenses from the realty. Neither the other TIC interest holders, the sponsor, or the property manager may make an advance to a TIC interest holder to meet property expenses unless the advance is both recourse to the TIC interest holder and is for a 31 day or less period.
- Such debt may not come from a lender who is a related person to any TIC interest holder, the sponsor, the manager, or any lessee.
- A TIC interest holder may grant a call option on the TIC interest as long as such option has an exercise price of then fair market value.
- The TIC interest holders' activities with respect to the real estate must be limited to activities customarily performed in connection with the maintenance and repair of rental real property. Importantly, all activities at the property by the TIC interest holders, their agents (i.e., the property manager), and any person related to the TIC interest holders will be taken into account.
- The TIC interest holders may enter into a management agreement, which must be renewable no less frequently than annually, with an agent, who may also be the sponsor or a TIC

interest holder (or any related person), but who may not be a lessee. The manager may prepare statements for the TIC interest holders showing their shares of revenue and costs from the real property. In addition, the manager may obtain or modify insurance on the real property. Fees paid to the manager must not depend in whole or in part on the income or profits derived by any person from the realty and may not exceed the fair market value of the services rendered.

- All leases must be bona fide leases at fair market value. Importantly, 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 real property, except an amount based on a fixed percentage or percentages of receipts or sales rendered).
- The amount of any payment to the sponsor in connection with the purchase of the TIC interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired TIC 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 real estate.

The requirements listed above are widely viewed as a form of safe harbor, and thus TIC deals which do not strictly comply with all of these criteria are routinely marketed.

PLR 200513010

The 2005 PLR described a TIC arrangement that included (i) each TIC holder's right to partition the entire property; (ii) each TIC holder's grant of a purchase option to other TIC investors exercisable upon certain events; (iii) each TIC holder's right to substitute manager; and (iv) the ability for the property manager to act on its own initiative - pursuant to certain pre-approved guidelines - in leasing space at the property (the specific amount of space was unspecified in the 2005 PLR).

With respect to the TIC arrangement described in the 2005 PLR, such TIC holders had the right, subject to lender restrictions, to exercise a right of partition with respect to their TIC interests. Before exercise of such right, however, each TIC holder agreed to offer its TIC interest for sale to the other TIC interest holders at then fair market value.

The ruling also describes how each TIC holder grants to the other TIC holders a "springing" option to acquire, at then fair market value, the TIC

interest if such TIC holder objects to (1) the proposed sale of the property, (2) the incurrence of debt secured by the property, (3) the modification to any lease at the property, or (4) if such holder provides a notice of termination with respect to the property management agreement, in each case provided more than 50% of the other TIC holders have voted to proceed with such proposed action (or in the case of the property manager, if more than 50% of the other TIC holders have agreed to renew such management contract).

Most significantly, the 2005 PLR provides how unanimous consent may be given for the lease or re-lease of all or any portion of the building. Strictly interpreted, the management company may enter into leases without unanimous consent of the TIC holders so long as the management company follows pre-approved leasing guidelines. The leasing guidelines, which must be approved annually by the TIC holders, factor into consideration the credit quality of tenants, the amount of rent, and the length of the lease term. This step is a movement away from an exact reading of Rev. Proc. 2002-22.

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PLR 200513010 is important because it expands on the guidance originally provided in Rev. Proc. 2002-22, and also shows continuing IRS approval of TIC structures as prepackaged replacement property in Section 1031 exchanges.

If you have any questions regarding TIC interests, either as replacement property in a Section 1031 exchange or as a potential disposition strategy for your real estate, please contact John G. Balboni at (617) 338-2438 or another member of Sullivan & Worcester's TIC Practice Group.

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