



TO: Client

FROM: Skip Kessler

RE: Safe-Harbor Co-Tenancy Provisions Under Rev. Proc. 2002-22

As you requested, I am providing you with a summary of the safe-harbor requirements under Revenue Procedure 2002-22 relating to co-tenancy arrangements in connection with rental real property. Before providing the summary, I wanted to provide some background on this Revenue Procedure.

Background Matters.

1. The Revenue Procedure states that it is issued to provide guidance on the IRS's requirements for issuing a favorable ruling that an arrangement purporting to be a co-ownership of rental real estate is not a business entity. In fact, practitioners in the area also regard these requirements as the IRS's audit position. Therefore, any material deviations could cause a co-ownership arrangement to be treated as a business entity, namely a partnership, and could jeopardize the exchange that preceded the co-ownership arrangement.

2. The Revenue Procedure states that the following are the hallmarks of a co-tenancy arrangement.

- a. Each co-tenant is entitled to share possession of the entire parcel with the other co-tenants.
- b. Each co-tenant is entitled to a proportionate share of the rents or profits from the property.



- c. Each co-tenant has the right to transfer his interest.
- d. Each co-tenant has the right to partition.
- e. No co-tenant's rights may be exercised to the detriment of the other co-tenants.

To the extent that a co-tenancy agreement differs from the following requirements, it may be possible to argue substantial compliance on the basis of the foregoing 5 factors.

3. This Revenue Procedure was requested by persons who market tenancy-in-common interests as replacement property in connection with exchanges. You will see that some of the conditions are only relevant to such persons.

Conditions For Co-Tenancy Status.

1. Tenancy In Common Ownership. Each co-tenant has to hold title (either directly or through a disregarded entity) as a tenant-in-common under local law. Title to the property, as a whole, cannot be held by a legal entity under local law. Obviously, this is a relatively easy condition to satisfy. It probably makes no difference that co-tenancy ownership is through a chain of disregarded entities.

2. Number of Co-Owners. The number of co-owners must be limited to no more than 35. Husband and wife co-owners are considered 1 co-owner. All persons who inherit a single co-tenancy interest are considered as 1 co-owner. Once again, this is a relatively each condition to satisfy.

3. No Treatment of Co-Ownership As An Entity. The co-ownership and co-tenants cannot do any of the following:

- a. File a partnership or corporate tax return. This should not be a problem.
- b. Conduct business under a common name. This would mean that for purposes of opening a bank account, the co-tenants could not adopt a fictitious business name. However, as discussed in Section 12 below, there is a solution to the bank account problem.
- c. Execute an agreement identifying themselves, or otherwise hold themselves out, as partners, shareholders or members of a business entity or as a partnership or other business entity. So long as the co-owners are cautioned by us, this should not be a problem.



d. The co-owners cannot have acquired their interests from a partnership or corporation of which they were partners or co-owners. Once again, this should not be a problem.

4. Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that runs with the land and contains provisions consistent with the other conditions. Obviously, this is advisable.

5. Voting.

a. The co-owners must retain the right to vote on the following matters.

- 1) Hiring of any manager.
- 2) The sale or other disposition of the property.
- 3) **Any** leases of all or any portion of the property.
- 4) The creation or modification of any blanket lien on the property.

b. The following items must be approved by **all** of the co-owners:

- 1) Hiring of any manager.
- 2) The sale of the property.
- 3) The lease or re-lease of all or any portion of the property.
- 4) The negotiation or renegotiation of any blanket lien on the property.

c. Any other matters may be approved by a majority of the co-owners.

d. Once an action is approved in accordance with this condition, the manager or another person may be appointed attorney-in-fact to sign a specific document in connection with such approval. However, a global power of attorney is not permitted.

Given the reality of this co-ownership arrangement, these conditions do not appear to be burdensome. The same applies to the conditions contained in Section 5 through 10.



5. Restrictions on Alienation.

a. Each co-owner must have the right to sell and encumber his interest without the consent of any other person.

b. There are 2 exceptions to this rule.

1) Restrictions on the right to transfer or encumber imposed by a lender and that are consistent with customary commercial lending practices.

2) The other co-owners, the "sponsor," and the manager may have a right of first offer to purchase the transferring co-owner's interest prior to his making the transfer.

7. Sharing Proceeds and Liabilities Upon Sale of Property. Upon a sale of the property, any debt secured by a blanket lien must be satisfied first and the remaining sales proceeds must be distributed to the co-tenants.

8. Proportionate Sharing of Profits and Losses.

a. Revenues and profits of the property must be shared by the co-owners in proportion to their undivided percentage interests.

b. Advances by any co-owner, sponsor or manager must be on a recourse basis and repaid within 31 days.

9. Proportionate Sharing of Debt. The co-owners must share in any debt secured by a blanket lien on the property in accordance with their undivided percentage interests.

10. Options.

a. Call Options. A co-tenant can grant a call option so long as the call price is at fair market value at the time of exercise. Fair market value is the fair market value of the entire property multiplied by the grantor's undivided interest.

b. Put Options. A co-owner cannot have the right to put his interest to the sponsor, the lessee, another co-owner or the lender or to any person related to a member of such group. Interestingly, there is no prohibition on a put to the manager.



11. No Business Activities.

a. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair or rental real property. The Revenue Procedure cites to Rev. Rul. 75-374, 1975-2- C.B. 261 which provides that customary services in an apartment context include providing heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning of public areas. We should confirm the level of service that the co-ownership is providing.

b. This condition must be satisfied by the co-owners, their agents and related persons, unless the co-owner owns the co-tenancy interest for less than 6 months.

12. Management and Brokerage Agreements.

a. Management agreements and brokerage agreements are permitted so long as they are renewable annually.

b. The manager or broker cannot be the lessee.

c. The management agreement may permit a common bank account into which rents are deposited and from which expenses are paid prior to disbursing the remaining balance to the co-tenants. This solves the problem of needing a fictitious business name to open a bank account; all banking is done through the manager.

d. The manager must disburse the net revenues within 3 months of the date of receipt.

e. The manager may be authorized to prepare statements showing each co-tenant's share of revenue and expenses.

f. The manager may be permitted to do the following:

1) Obtain or modify insurance on the property.

2) Negotiate modifications to leases and blanket indebtedness, subject to the approval of all co-tenants.



g. Fees to the manager.

1) Fees may not exceed the fair market value of the manager's services.

2) Fees may not depend in whole or in part on any income or profits derived by any person from the property.

h. Fees paid to brokers must be comparable to fees paid to by unrelated parties to brokers for similar services.

Given the various restrictions contained in the other conditions, the property should be managed by a manager under a management agreement consistent with this Section 13 and the rest of the conditions.

13. Leasing Arrangements.

a. Leases must be bona fide leases for federal income tax purposes.

b. Rents must reflect the fair market value for the use of the property.

c. Rents must not depend on the income or profits derived by any person from the property leased. However, rent based on a fixed percentage or percentages of receipts or sales is permissible.

I would not expect this condition to present a problem.

14. Loan Agreements. Any lender making a blanket loan encumbering the property may not be a related person to any co-tenant, the sponsor, the manager or any lessee of the property.

15. Payments to Sponsors. This condition is not relevant. In any case, any payment must reflect the fair market value of the sponsor's services and may not depend in whole or in part on the income or profit derived by any person from the property.