**Internal Revenue Service**

Number: **200513010**
Release Date: 4/1/2005
Index Number: 7701.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:3
PLR-134191-04

Date:
December 06, 2004

Legend

Company =

Management Company =

Property =

Dear :

This letter responds to a letter dated June 15, 2004, and subsequent correspondence, requesting a ruling on behalf of Company that an undivided fractional interest in rental real property is not an interest in a business entity under § 301.7701-2(a) of the Procedure and Administration Regulations for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031(a) of the Internal Revenue Code.

## FACTS

According to the facts submitted and representations made, Company intends to acquire a fee interest in Property. Prior to the acquisition by Company, portions of Property will have been leased to . None of the tenants are related to Company. Under each lease, the tenant will be responsible for its pro-rata share of real estate taxes and operating expenses. In addition, each tenant will be responsible for the maintenance, repair and replacement of heating and air conditioning fixtures, equipment and systems, all lighting and plumbing fixtures, all interior walls, partitions, doors and windows, all exterior entrances, windows, doors and docks and the

replacement of all broken glass. In addition, each tenant will keep and maintain Property and areas adjoining Property in a clean and orderly condition, free of accumulation of dirt, rubbish, snow and ice. The term of each lease will vary, but will generally be from years. Company represents that the rent due under each lease will reflect the fair market value for the use of Property and will not depend, in whole or in part, on the income or profits derived by any person from Property. Company represents that all future leases entered into with respect to Property will be consistent with the leases in existence when Property is acquired.

Following acquisition, Company will create and sell undivided fractional interests in Property at fair market value to no more than 35 persons (Co-owners). Company will retain a % undivided fractional interest in Property. Each Co-owner will acquire its interest in Property by paying cash and/or assuming a pro-rata share of a blanket debt on, and all obligations relating to, Property.

Each Co-owner will be required to enter into a co-tenancy ownership agreement (co-tenancy agreement). The co-tenancy agreement will provide that the unanimous consent of all Co-owners shall be required to enter into any amendments, consents to assignment, subleases, re-leases, or modifications of any lease of Property or guarantees of lease, the sale of the Property, the appointment or reappointment of a property manager for Property under the management agreement, or the incurrence of any indebtedness secured by Property. For all other actions, the approval by holders of more than 50 percent of the undivided fractional interests will be required.

In addition, the co-tenancy agreement will provide for the allocation of income, expenses (including debt service payments for any debt which is a blanket lien on Property), and any net proceeds from a sale or refinancing of Property, among the Co-owners in proportion to their respective ownership interests in Property.

Under the co-tenancy agreement, a Co-owner may, at any time, sell, finance, or otherwise create a lien upon the Co-owner's own interest, provided it does not create a lien on anyone else's interest. In addition, any Co-owner may freely sell, assign, or transfer all or a part of its interest in Property. Each Co-owner will also have the right, subject to any restrictions contained in any documents related to any loan on Property, to exercise a right of partition with respect to its interest in Property, and to file a complaint or institute any proceeding at law or in equity to have Property partitioned. However, before exercising any right to partition, each Co-Owner will agree to offer its interest for sale to the other Co-Owners at fair market value, as determined by an independent appraisal.

The co-tenancy agreement will further provide that each Co-owner will grant an option to the other Co-owners to acquire its interest at fair market value in the event: (i) there is a proposal to sell part or all of Property, or to incur indebtedness to be secured by Property, or to modify any lease (or guarantee of a lease) of Property and the Co-

owner votes not to proceed in circumstances where holders of more than 50% of the Co-Ownership interests vote to proceed with the proposed action; or (ii) a Co-owner provides a notice of termination of the management agreement. If the proposed action is to sell part or all of Property to an unrelated third party who has made a bona fide offer, the fair market value shall be determined by reference to the price proposed for the entire property multiplied by the Co-owner's percentage interest in Property. Otherwise, the fair market value shall be determined by an independent appraisal of the total fair market value of the entire Property multiplied by the Co-owner's percentage interest in Property.

Following the purchase of an interest, each Co-owner will enter into a management agreement with Management Company. Management Company is related to Company through a common parent. Under the management agreement, Management Company will agree to manage all administrative, operational and management matters of Property, including but not limited to the management of all lease agreements. The management agreement will provide that each Co-owner who enters into the agreement retains the Management Company to act as the manager and oversee all administrative, operational and management matters of Property, which include monitoring the submission of rents and any other payments due under the lease, monitoring the payment of any taxes and special assessments with respect to Property, ensuring that they are paid in a timely fashion and commencing collection activities if a lessee is delinquent, requesting annual financial statements and other reports to the extent required from any lessee under the terms of the lease, overseeing the inspection of Property, monitoring lessee's compliance with terms of the lease, establishing accounts to hold funds collected pursuant to each lease and disbursing those funds to the Co-owners, providing customary property management services necessary to preserve, protect and enhance the value of Property, re-leasing Property, and providing for timely payment of principal, interest and other amounts due to any lender which has a blanket lien on Property. All activities with respect to Property will be customary services as defined in Rev. Rul. 75-374, 1975-2 C.B. 261.

Under the management agreement, Management Company will maintain full, accurate and complete records of the Co-owners' income and operating expenses at its principal office and each Co-owner will have access to the records. Management Company will distribute to each Co-owner: (i) within 30 days after the end of each calendar quarter, financial statements prepared by the Management Company; (ii) within 90 days after the end of each calendar year, financial statements prepared by an independent accounting firm; and (iii) annual tax information relating to Property.

The management agreement will also provide that each Co-owner agrees to be obligated for a proportionate share of all costs associated with Property, to the extent that the revenues from Property are insufficient to cover the costs. In addition, if Property operates at a loss or if capital improvements, repairs or replacements are required, for which capital reserves do not exist, the Co-owners shall, upon request, make necessary payments in proportion to their individual ownership interests in

Property. Distributions of each Co-owner's share of net revenue will be made at least quarterly.

The term of the management agreement will be 12 months (12-month term), renewable annually under the following procedures. At least days, but no more than days, prior to the end of each 12-month term (renewal period), the Management Company will provide Co-owners with a notice of renewal of the management agreement. Such notice will provide each Co-owner the opportunity to object to specific provisions of the agreement as well as to terminate the agreement as set forth in the notice of renewal. The notice of renewal will be sent to each Co-owner at the address provided by the Co-owner for this purpose using certified mail, return receipt requested (postage prepaid), or by using a nationally recognized courier service that guarantees overnight delivery, either alternative being an "approved notice method". The notice of renewal will set forth the following procedures and will include the names and addresses of each Co-owner.

Any Co-owner (objecting Co-owner) may cause the management agreement not to be renewed by providing a notice of termination to the Manager and to the other Co-owners by the approved notice method at least days prior to the end of the renewal period, provided the objecting Co-owner sets forth a substitute manager and the material terms under which the substitute manager will be engaged. The engagement of the substitute manager shall be subject to the approval of each of the other Co-owners.

Each Co-owner shall have days after the date of the notice of termination to provide written notice by the approved notice method to the Objecting Co-owner and the other Co-owners that the substitute manager is unacceptable and the reasons therefore.

If any Co-owner provides notice that the substitute manager is unacceptable, the following procedures apply.

1. The other non-objecting Co-owners may exercise the option to acquire the ownership interest(s) of the objecting Co-owner at fair market value.
2. If the other non-objecting Co-owners do not exercise their option to acquire the ownership interest of the objecting Co-owner, the objecting Co-owner, within days of being notified that the alternative management arrangements are not acceptable, on its own behalf and at its own expense, may retain the substitute management company. As a result, the objecting Co-owner will cease to be a party to the original management agreement and will no longer be responsible to Management Company for any fees or associated expenses. However, the objecting Co-owner will remain subject to the terms of the co-tenancy agreement. In this event the objecting Co-owner must provide written notice to Management Company and the other non-objecting Co-owners. In such case, the managers must consult on all actions; however, except in cases in which unanimous

approval of all Co-owners is required, the manager representing the controlling Co-owners shall be able to act without the approval of the co-manager.

3. The Co-owners who did not provide a notice of termination will be treated as consenting to a renewal of the Management Agreement.

In addition, a Co-owner may object to specific provisions in the Management Agreement by providing a notice of objection to the Management Company and to the other Co-owners within days of the receipt of the notice of renewal. The Management Company and the Co-owner(s) may negotiate to modify specific terms of the Management Agreement. If no agreement is reached, a Co-owner may provide a notice of termination as described above on or before the day before the end of the renewal period. Subsequently, the procedures described above will apply.

The management agreement will further provide that, notwithstanding the requirement that Management Company otherwise obtain unanimous consent for the lease or re-lease of all or any portion of Property, Management Company may, without obtaining consent of the Co-owners, lease (or re-lease) up to % of the total leaseable space, in the aggregate. Any leases entered into by the Management Company pursuant to this provision must meet certain unanimously approved lease guidelines provided by the Co-owners annually. Such lease guidelines will include parameters relating to credit worthiness, type of tenants, rental ranges and length of rental term. Once unanimously agreed to, the lease guidelines cannot be altered or amended except upon the unanimous consent of all the Co-owners.

Under the management agreement, each Co-owner will be obligated to pay the Co-owner's pro rata share of a fee set at fair market value for the services provided. The fee will be payable irrespective of whether rents are actually collected. Management Company will be authorized to offset the costs of operating Property against any revenues derived from Property before distributing each Co-owner's proportionate share of net income. In addition, Management Company may advance funds on behalf of any Co-owner. The advance will be recourse as to each Co-owner and each Co-owner will be obligated to repay the advance within days. In the event that the Co-owner is a disregarded entity that provides limited liability to the owner of the entity, the advance shall be recourse to the owner of the disregarded entity.

## LAW & ANALYSIS

Section 301.7701-1(a)(1) provides that whether an entity 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, for example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.

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 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.

In Rev. Rul. 75-374, 1975-2 C.B. 261, the Service concluded 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 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 concluded 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.

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 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 (9th 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 169-170.

In Rev. Proc. 2002-22, 2002-1 C.B. 733, the Service provided certain conditions under which it would consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity for federal tax purposes. The conditions relate to tenancy-in-common ownership of the property, number of co-owners, no treatment of the co-ownership as an entity, co-ownership agreements, voting by co-owners, restrictions on alienation, sharing of proceeds and liabilities upon sale of the property, proportionate sharing of profits and losses, proportionate sharing of debt, options, no business activities by the co-owners, management and brokerage agreements, leasing agreements, loan agreements, and payments to sponsors. In addition, the revenue procedure sets forth a list of documents, supplementary materials, and general information required for a ruling.

Company's co-ownership arrangement satisfies all of the conditions set forth in Rev. Proc. 2002-22. Specifically regarding voting, § 6.05 of Rev. Proc. 2002-22 provides, in part, that 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. Relating to hiring a manager, § 6.12 of Rev. Proc. 2002-22 provides, in part, that 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.

Company's co-tenancy agreement provides that any sale, lease, or re-lease of a portion or all the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, and the hiring of a manager, requires the unanimous approval of the Co-owners. All other actions on behalf of the co-ownership require the vote of those

holding more than 50 percent of the undivided interests in the Property. The management agreement requires the Management Company to send a notice of renewal to each Co-owner annually at which time each Co-owner could exercise its right to terminate the management agreement. The renewal procedures allow each Co-owner to exercise the right of an owner of real property to control the use of the Property. As a result, the provisions relating to changing managers and altering the management agreement satisfy the requirements of §§ 6.05 and 6.12 of Rev. Proc. 2002-22.

In addition, Company's management agreement provides that Management Company may lease or re-lease up to % in the aggregate of the total leaseable space of Property based on specific lease guidelines unanimously approved by the Co-owners. The lease guidelines will relate to the credit worthiness and type of tenant, rental ranges, and length of lease term. The guidelines can be amended only by unanimous agreement of the Co-owners. This arrangement to provide some limited flexibility in managing the leasing of Property while maintaining the owners' rights to direct and limit that flexibility satisfies the requirements of § 6.05 of Rev. Proc. 2002-22

Regarding business activities, § 6.11 of Rev. Proc. 2002-22 provides that 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.

Accordingly, the activities of Company and any person related to Company with respect to the Property must be taken into account in determining whether the Co-owners' activities are customary activities under § 6.11 of Rev. Proc. 2002-22. After acquiring and leasing the Property, Company will create and sell undivided fractional interests in the Property at fair market value. Company will continue to own a % undivided interest in Property and is related to Management Company through a common parent. The Property will be leased under a net lease to unrelated tenants. In addition, Company represents that the only activities of the Co-owners, including Company, (or any person related to the Co-owners) with respect to the Property will be customary activities within the meaning of § 6.11 of Rev. Proc. 2002-22.

## CONCLUSION

Based on the facts submitted and representations made, we conclude that an undivided fractional interest in Property will not constitute an interest in a business entity under § 301.7701-2(a) for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031(a).

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion concerning whether an undivided fractional interest in the Property otherwise qualifies as eligible replacement property under § 1031(a) for federal tax purposes.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representative.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely Yours,

Jeanne Sullivan
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes

cc: