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EXCHANGING
FRACTIONAL INTERESTS
AND/OR TENANCY IN
COMMON INTERESTS

BY

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**EXCHANGING FRACTIONAL INTERESTS AND/OR
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I. INTRODUCTION: The Internal Revenue Code 1/ provides in Code §1031 2/ for tax-deferred exchanges. As most commercial real estate practitioners know, this Code §1031 allows for the deferral of Federal income tax, if there is an exchange within that Code §1031 of what is generally referred to as "qualified, like-kind property." 3/

Without attempting to review the basics of tax-deferred exchanges, since there have been many texts written in that area, 4/ this short Note focuses on the issue of attempting to exchange, on a tax-deferred basis, under this Code §1031, tenancy in common properties and/or fractional interests in property. 5/

Under a tenancy in common position, where two (2) or more people own real property together, with undivided interests, and not in a partnership, the question has been whether such ownership can be exchanged under Code §1031.

Part of the problem with this issue is the limitation on tax-deferred exchanges provided under Code §1031(a). There cannot be an exchange of a partnership interest for a partnership interest under

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Code §1031. Historically, partnership interests could be exchanged under Code §1031. That is, they could have qualified for deferral. 6/

Given that the taxpayer had been successful in exchanging partnership interests in many instances, and the Government opposed the position, Congress addressed the issue by modifying the Code and providing specific language that excludes 7/ the exchanging of partnership interests, tax-deferred, under Code §1031. 8/

Having eliminated the ability to exchange partnership interests, the question continues to be whether one can exchange interests that are tenancy in common interests or fractional interests. That is, the question is whether parties owning properties “together,” that are not in a partnership, can exchange those interests, tax-deferred, under Code §1031.

II. HISTORICAL POSITION ON EXCHANGING FRACTIONAL OR TENANCY IN COMMON INTERESTS: There has been a great deal of authority over the last number of years which supports the position that, although partnership interests cannot be exchanged, tax-deferred, under Code §1031, as indicated earlier, 9/ such exchanges could take place if they are undivided tenancy in common interests.

One older Private Letter Ruling 10/ supported this position by allowing the exchange of undivided one-half (1/2) interest in property between individuals. The agricultural property in question was owned by two (2) individuals. That Ruling held that there could be an exchange of one (1) parcel for another parcel, even with undivided interests. (This assumes other requirements of the Code were met.)

That Ruling also cited an older Revenue Ruling 11/ which allowed undivided tenancy in common interests in three (3) separate parcels to be exchanged under Code §1031.

Supporting this same position, allowing tenancy in common exchanges to fall within Code §1031, see also another Private Letter Ruling, 12/ which allowed Taxpayers A, B, and C, each owning a one-third (1/3) undivided interest as tenants in common in three (3) separate parcels, Buildings D, E, and F, to exchange, allowing Taxpayer B to own the entire interest in Building D; Taxpayers A and C each owned a one-half (1/2) undivided interest as tenants in common in Buildings E and F. Assuming the other elements of Code §1031 were met, the Ruling supported such exchange under Code §1031. This Ruling also cited a number of other Revenue Rulings, for authority and approval of this position. 13/

In a more recent Private Letter Ruling, 14/ the Service supported the position that a tax-deferred exchange could come within Code §1031 where there were undivided interests exchanged for a 100% fee ownership interests. In this Private Letter Ruling, there were six (6) parties involved, owning undivided interests in 23 separate parcels. The parties attempted to, and were approved to, undertake a simultaneous exchange of their undivided interests in the 23 parcels for 100% interest in specific parcels (of the 23 parcels in the group). In other words, each of the Parties received a separate Deed for the property that they would own as a fee-title, 100% owner. (Consistent with this same position, an additional Private Letter Ruling was issued by the Service.) 15/

In summary, it is clear that there is strong authority over many years, allowing the exchange of undivided tenancy in common interests for other qualified property under Code §1031. The key point is that such exchange must in fact be tenancy in common interest, not interests that constitute partnerships.

III. THE DISTINCTION: PARTNERSHIP OR TENANCY IN COMMON/FRACTIONAL INTERESTS: The question is to distinguish between the situation where the exchange in question involves a partnership, or whether the exchange in question involves an undivided tenancy in common or fractional interest.

Code §761 16/ provides for a definition of "partnership," since this is the key contrast with "tenancy in common." (For most definitional purposes of applying these rules, whether as a tenancy in common or a partnership, local laws are referred to, for tax purposes.) The Federal Tax Code states that a partnership ". . . includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which business, financial operation or venture is carried on, and which is not, within the meaning of this title (subtitle), a corporation or a trust or estate."

Most state law provides that a partnership is an unincorporated entity of two (2) or more people to carry on a business for profit. In fact, decisions usually refer to this type of definition to see whether the entity in question is a partnership.

It is also recognized that most operations of property by tenants in common owning real estate for investment are certainly entering the same with a goal to gain profit. Such undertaking of an investment being made for profit is NOT the same as "carrying on" a regular operating business, which would generally involve the partnership, as noted.

Confusing the area even more so, between a partnership and undivided ownership positions, is the fact that under Code §761 17/ there are provisions for electing out of having the entity treated as a partnership for purposes of the general tax partnership rules under the Federal Code.

Under the election provisions, if it can be shown that the operation is for investment purposes only, and not for an active conduct of a business, along with showing that the joint production, or use of the property is present, but not for purposes of selling services or property produced or extracted from the operation, and that certain other requirements are met, then under the Regulations promulgated by the Secretary of the Treasury, the taxpayer's "entity," at the election of all of the members of the unincorporated organization, can elect out of the partnership provisions under the Code. 18/

Trying not to lose sight of the forest, the purpose of this examination is to determine when tax-deferred exchanges can take place when they involve real estate owned by multiple parties. The clear statement of the position is that such an exchange might be qualified where there are tenancy in common interests in ownership, but it will not be qualified under Code §1031 if there is a partnership involved that attempts to have the individual partners exchange their partnership interests.

A clear delineation or distinction must be made between partners attempting to exchange their partnership interests, which is not allowed to be undertaken under Code §1031, as contrasted with an exchange by a partnership of its property with another party. The latter position certainly is possible. For example, assuming the requirements under Code §1031 are otherwise met, a partnership can exchange real estate that it owns for other qualified real estate. 19/

On the issue of a fractional interest or a tenancy in common interest, the Service recently issued its long-awaited position statement that such exchanges can take place and meet the requirements under Code §1031, if all of the government's position for a safe harbor are met. The following Section of this Note examines this issue and this new Revenue Procedure.

IV. GOVERNMENT'S SUPPORT FOR TENANCY IN COMMON AND FRACTIONAL INTERESTS UNDER CODE §1031: Under a prior Revenue Procedure, 20/ the Service had ruled that it would not issue Advance Rulings or determination letters on the issue as to whether an undivided fractional interest in real estate was an interest in an entity, and, therefore, not within Code §1031 for tax-deferred exchange purposes.

The essence of the prior Revenue Procedures issued in the year 2000, and reaffirmed, was that the Service would not rule on whether such exchanges would be qualified under Code §1031. In fact, under Revenue Procedure 2000-46, the Ruling specifically stated: "The Service recently has become aware, in part through several requests for advance rulings, that taxpayers are taking the position that certain arrangements where taxpayers acquire undivided fractional interest in real property do not constitute separate entities for federal tax purposes, and, therefore, the fractional interest may be the subject of tax-free exchanges under Code §1031(a)(1). The Service intends to study further the facts and circumstances relevant to the determination of whether such arrangements are separate entities for Federal tax purposes." With that statement, the Service refused to rule on such positions.

In March, 2002, the Service issued Revenue Procedure 2002-22, which superseded the prior position. It allows for Rulings in this area. 21/ Under this important Revenue Proc. 2002-22, the Service recognized the concern with whether the exchange involved entity interests, such as an interest in a partnership, or whether it involved undivided interests being exchanged for other qualified property, such as an undivided interest in other real estate, or fee interests in other real estate.

The Service further cited the same position noted earlier as to whether there is an entity involved. 22/ The Government noted that a business entity, whether it is classified as a partnership or a corporation, cannot have its interest exchanged under Code §1031, as noted earlier.

The Government contrasted this entity position with a tenancy in common, noting that: "The central characteristic of a tenancy in common, one of the traditional concomitant estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property." 23/

In Revenue Proc. 2002-22, the Service cited a number of the Revenue Rulings and authorities mentioned earlier in this Note as to situations where a tenancy in common existed and came within Code §1031.

However, the Service also stated in this Revenue Proc. 2002-22 a circumstance where, in the case of Bergford v. Comm., 24/ it involved 78 investors that purchased what the Ruling stated were "co-ownership" interests in computer equipment. The Procedure then noted that because of the operation of this activity with the interest in the computer equipment, such co-ownership arrangement actually was a partnership for Federal tax purposes, notwithstanding what label might be put on the operation. The Procedure also cited other cases that were consistent with the Bergford position.

Revenue Procedure 2002-22 contrasted the Bergford case with the Regulations 25/ that noted that a 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."

Having made the distinction, as noted, the Revenue Proc. 2002-22 stated that this Revenue Procedure applies to only co-ownership positions of rental real property, excluding mineral interests, in an arrangement that would be classified under the state law in question as tenancy in common, as opposed to a partnership or other entity.

Revenue Procedure 2002-22 provided the steps or safe harbor positions that one must undertake to meet the guidelines of Revenue Proc. 2002-22, to submit Ruling requests on whether the entity in question is a qualified co-ownership interest under Code §1031, or whether it might be an entity disqualified under Code §1031 for purposes of exchanging interests in that entity.

The Service stated that it will not consider requests for a Ruling unless the detailed information described in the Procedure is met. It also hedged by saying that it may decline to issue a Ruling if the facts and circumstances are not “appropriate” for a Ruling.

To obtain a Ruling, at the very least, Revenue Proc. 2002-22 requires:

- a. Name, Taxpayer Identification Number, and percentage of fractional interest and property of each co-owner;
- b. Name, Taxpayer Identification Number, ownership of and any relationship among the parties involved;
- c. A description of the property;
- d. A representation that the co-owners hold title to the property as tenants in common under their local law;
- e. All promotional documents relative to the sale of the fractional interests, if any, must be included;
- f. All lending agreements, if any, related to property must be included;
- g. All agreements among the co-owners relating to the property must be included;
- h. Any lease agreements related to the property must be included;
- i. Any purchase or sale agreements related to the property must be included;
- j. Any Property Management Agreements or Brokerage Agreements that are applicable must be included; and
- k. Any other agreement relating to the property that was not already specified, but relates to the position, must be included, including any potential options on the property, among other items.

There are additional conditions under Section 6 of the Procedure that require additional compliance. For example, the property cannot be held, under local law, as an entity, but rather, it must be held individually, as a tenant in common.

There can be a maximum of 35 co-owners.

The operational entity or position cannot file a partnership or corporate return; it cannot conduct business under a common name; it cannot execute an agreement identifying the parties as partners,

shareholders or members of an entity, or otherwise hold itself out as one of these type of entities, or any other entity.

If there were prior ownership interests in the property in question through entities, prior to the co-ownership position forming, no Ruling will be allowed. (This stops parties from attempting to terminate the entity position, placing the property in a co-ownership position, and then applying for a Ruling.)

There can be certain types of "limited co-ownership agreements" for the property, but these are somewhat suspect as well.

There are restrictions on the transfer of the property, sharing of profits, sharing of debt, option limitations, limitations on management and brokerage agreements, limitations on leasing agreements, limitations on loan agreements, and limitations on payments to the sponsor, or the one who might organize the co-ownership position.

If the taxpayers can hurdle all of the requirements, as noted under Revenue Procedure 2002-22, the taxpayer can apply for, and hopefully obtain a favorable Ruling for the treatment of the property interest as co-ownership position, qualifying it for a possible exchange under Code §1031.

V. CONCLUSION: Revenue Procedure 2002-22 is a breakthrough, allowing Private Letter Rulings for undivided fractional interests or tenancy in common interests. However, with great hesitancy, apparently, in issuing this Revenue Procedure, the Service placed hurdles before the taxpayer that seeks a requested Ruling.

Many taxpayers may continue asserting the position that what they are exchanging is within Code §1031 as a fractional or tenancy in common interest, and not an exchange of an entity, notwithstanding their failure to apply for and receive a favorable Private Letter Ruling from the Government. Such position is more treacherous and exposed to greater risk than obtaining a Private Letter Ruling. The hurdles involved in such Ruling, however, as noted, make the task somewhat burdensome. 26/

The Service, given time, probably will reduce its more aggressive position and requirements under Revenue Procedure 2002-22. For now, the Service is proceeding more cautiously on its Rulings, despite the taxpayers' desire to "extend" the gamut of Code §1031.

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FOOTNOTES

1. 26 U.S.C.A. (I.R.C. 1986) Section 1031, hereinafter generally referred to as the "Code," or by "Code Section" "Code §."
2. See Code §1031.
3. See Code §1031(a). For a detailed discussion of the entire area of tax-deferred exchanges, see Levine, Mark Lee, Real Estate Transactions, Tax Planning, Chapter 29, The West Group, St. Paul, Minnesota (2004).
4. See Levine, Mark Lee, Exchanging Real Estate, 3 Volumes, PROFESSIONAL PUBLICATIONS AND EDUCATION, INC., Denver, Colorado (2002). See also this Work in part on Real Estate Cyberspace <http://www.recyber.com>
5. A "tenancy in common interest" is defined under our local law, as are fractional interests. The general position is that the tenancy in common involves two or more people owning undivided interests in real property. A "Fractional interest" definition follows somewhat this same format under most state laws. For more in this area, see Levine, Mark Lee, Real Estate Fundamentals, West Publishing Company (1984).
6. See the Levine text in Footnote 4, cited *supra*. Specifically, the Estate of Roland E. Meyer, 58 T.C. 311 (1972), *nonacq.*, 1975-1 C.B. 3, *aff'd per curiam* 503 F.2d 556 (9th Cir., 1974), allowed the tax-deferred exchange of partnership interests. However, the Government opposed such position and issued Revenue Ruling 78-135, 1978-1 C.B. 256, supporting its position of denying such tax-deferred treatment with the exchange of partnership interests.
7. See the article by Levine, Mark Lee, "Exchanging Interests In Partnerships Under Code §1031," Tax Notes (November 29, 1985). There were a number of other cases that supported the position involving tax-deferred exchanges of partnerships. For example, see Gulfstream Land Development Corp. v. Comm., 71 T.C. 587 (1979). See also Arthur E. Long, et. al. v. Comm., 77 T.C. ___ #71 (October 29, 1981). See also Peter Pappas v. Comm., 78 T.C. #77 (June, 1982).
However, Congress changed Code §1031 and provided a specific provision excluding the tax-deferred exchanges under Code §1031 of one partnership interest for another partnership interest, whether that be a general partnership interest or a limited partnership interest.
8. See Code §1031(a). This change was made under the Deficit Reduction Act of 1984.
9. See *supra*, Footnotes 7 and 8.
10. See Private Letter Ruling 8515016.
11. See Revenue Ruling 73-476, 1973-2 C.B. 300.
12. See Private Letter Ruling 8836006.
13. See *supra*, Footnote 11. See also Revenue Ruling 79-44, 1979-1 C.B. 265.
14. See Private Letter Ruling 9609016.
15. See Private Letter Ruling 9642029. See also Private Letter Ruling 9642032.
16. See specifically Code §761(a).

17. See Code §761(a).
18. See supra, Footnote 17.
19. Certainly one can also undertake an exchange of personalty, as opposed to real estate, under Code §1031, assuming the requirements are met. However, this Note focuses on real estate; therefore, this discussion involves real estate. Nevertheless, one should not assume that real estate is the only qualified property under Code §1031.
20. See Revenue Procedure 2000-46, 2002-2 C.B. 438. See also Revenue Procedure 2000-3, 2002-1, I.R.B. 117.
21. See Revenue Procedure 2002-22, 2002 WL 417295 (March 19, 2002).
22. See Code §761 and §7701 for the definitional issues in part of entities in question. See also Treasury Reg. §301.7701-1(a)(1).
23. See Revenue Proc. 2002-22. One concern that has been raised in the tax community dealing with tax-deferred exchanges is the question of consistency between Revenue Proc. 2002-22, the point discussed in this Note, and Revenue Procedure 2000-37, which allows for reverse exchanges.
The concern is the inconsistency between these two (2) Procedures. The question addressed is whether the taxpayer, who is undertaking a reverse exchange, consistent with Revenue Proc. 2000-37, would then be denied the Ruling position under Revenue Proc. 2002-22. In other words, although the taxpayer acted consistent with one Procedure, the taxpayer arguably was not consistent with the other Procedure.
24. See Bergford v. Comm., 12 F.3d 166 (9th Superior Cir., 1993).
25. See Treasury Reg. §1.761-1(a) and Treasury Reg. §301.7701-1.
26. One concern that has been already raised in the tax community dealing with tax-deferred exchanges is the question of consistency between Revenue Proc. 2002-22, the point discussed in this Note, and Revenue Procedure 2000-37, which allows for reverse exchanges.
The concern is the inconsistency between these two (2) Procedures. The question addressed is whether the taxpayer, who is undertaking a reverse exchange, consistent with Revenue Proc. 2000-37, would then be denied the Ruling position under Revenue Proc. 2002-22. In other words, although the taxpayer acted consistent with one Procedure, the taxpayer arguably was not consistent with the other Procedure.