Internal Revenue Service

Number: **201622008**
Release Date: 5/27/2016

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:B01
PLR-128500-15

Date:
February 23, 2016

LEGEND

Taxpayer =

Company =

Property =

State =

a% =

b% =

c% =

d% =

x =

Manager =

JV =

Dear :

This letter responds to a letter dated August 17, 2015, and subsequent correspondence, requesting on behalf of Taxpayer a ruling that undivided fractional interests in Property are not interests in a business entity under § 301.7701-2(a) of the Procedure and Administration Regulations for purposes of qualification of the undivided fractional interests as eligible relinquished property under § 1031(a) of the Internal Revenue Code.

FACTS

According to the information submitted, Taxpayer and Company are business entities. Taxpayer owns all the interests in Company. Company is classified as an entity that is disregarded for federal income tax purposes. Company currently holds 100% of the fee title to Property. Taxpayer, through Company, operates Property as a commercial office rental property. Taxpayer and Company are together referred to here as Taxpayer.

Taxpayer intends to triple net lease the Property under State law to an unrelated third party ("New Co-Owner"). Taxpayer represents that the New Co-Owner is likely to hold its lease interest in the Property through an entity that is disregarded for federal income tax purposes. (The New Co-Owner and its disregarded entity are together referred to here as the New Co-Owner.) Taxpayer represents that the triple net lease for the Property will be a bona fide lease for tax purposes and that the rent due under the lease will reflect the fair market value for the use of the Property. Further, Taxpayer represents that the rent under the triple net lease will not be determined, in whole or in part, based on the income or profits derived by any person from the Property.

Contemporaneous with the triple net lease, Taxpayer and an unrelated third party ("New Co-Owner") will enter into an Option Agreement under which Taxpayer will have an option to sell any or all of its interest in the Property to New Co-Owner at any time before the fifth anniversary of the effective date of the Option Agreement (the Put). If Taxpayer exercises the Put with respect to a part of its interest in the Property, it may exercise the Put again with respect to another part of its interest in the Property and continue to do so until all interests in the Property are transferred or the Put expires. Under the Option Agreement, New Co-Owner will also have an option to acquire the entire remaining interest then held by Taxpayer beginning on the seventh anniversary of the effective date of the Option Agreement, and ending x days later (the Call). The

purchase price for the exercise of the Put or the Call will be based on the fair market value of the Property at the time of the execution of the Option Agreement, increased at each anniversary date of the execution of the Option Agreement by b% of the then-current exercise price, as increased by any prior b% increases. Taxpayer represents that b% is a reasonable appreciation factor for the Property.

Within six months of executing the triple net lease and the Option Agreement, Taxpayer may exercise its right under the Put to sell a a% tenancy-in-common interest in the Property under State law to New Co-Owner. Taxpayer represents that neither co-owner will provide financing to the other co-owner to acquire a tenancy-in-common interest in the Property.

When Taxpayer sells the a% tenancy-in-common interest to New Co-Owner, Taxpayer and New Co-Owner will either (i) refinance the existing indebtedness encumbering the Property by borrowing from an unrelated lender and creating a blanket lien on the Property, or (ii) cause the debt agreement to be amended to provide that the lien is a blanket lien and that the cost will be shared proportionately. Each co-owner will share the indebtedness on the Property in proportion to that co-owner's interest in the Property.

The Property will be owned by the Taxpayer and New Co-Owner pursuant to a tenants-in-common agreement (the Co-Ownership Agreement) that will run with the land. Though the Co-Ownership Agreement will provide that there will not be more than five co-owners, Taxpayer intends at the present time to sell tenancy-in-common interests in the Property only to one co-owner, New Co-Owner. Taxpayer represents that Taxpayer and New Co-Owner will not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying the co-owners as members of a business entity, or otherwise hold themselves out as members of a business entity. The Co-Ownership Agreement will be consistent with these representations.

The Co-Ownership Agreement will provide that any sale, lease, or re-lease of all or a portion of 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. The Co-Ownership Agreement will provide that all actions not otherwise required to be taken by unanimous consent will require a vote of the majority of interests. Thus, all other actions on behalf of the co-ownership will require the vote of co-owners holding more than 50 percent of the undivided interests in the Property. The Co-Ownership Agreement will not contain a buy-sell agreement. There will be no waiver of partition rights among co-owners unless required by the lender. A co-owner will be free to partition its interest in the Property unless prohibited by the lender. A co-owner will also be able to create a lien upon its own interest without the agreement or approval of any person, subject to the terms of the Co-Ownership Agreement, provided it does not create a lien on any other co-owner's interest. The Co-Ownership

Agreement will provide that, in the event the Property is sold or refinanced, each co-owner will receive its percentage interest in the net proceeds from the sale or refinancing of the Property. Upon the sale of the Property, the co-owners must satisfy any blanket lien encumbering the Property in proportion to their respective interests in the Property.

The Co-Ownership Agreement will provide that the Taxpayer and the New Co-Owner will share in all revenues generated by the Property and have an obligation to pay all costs associated with the Property in proportion to their respective interests in the Property. Under the terms of the Co-Ownership Agreement, if either co-owner advances funds necessary to pay expenses associated with the Property, the other co-owner must repay such advance within 30 days of the date the expense, obligation, or liability was paid. The Co-Ownership Agreement will not contain a provision causing the owner of a co-owner that is a disregarded entity to be liable for an advance. Nevertheless, to secure such an advance repayment obligation, the Co-Ownership Agreement will provide that each co-owner grants each other co-owner a lien against such granting co-owner's interest in the Property and the rents and income therefrom and the leases thereof.

Taxpayer represents that the co-owners may, but are not required to, enter into a management agreement with either Manager or JV. The Co-Ownership Agreement provides that the term of any management agreement entered into by the co-owners will be for one year, and will be automatically renewed for one-year periods unless either the manager or any co-owner otherwise gives written notice to the other parties not less than twenty days prior to the then-current expiration date of the twelve-month term. Any such management agreement will 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. Any such management agreement will provide that the manager disburse the co-owner's share of net revenues from the Property within three months from the date of receipt of those revenues. But such disbursements are subject to holding back reserves for anticipated expenses of the Property. Each co-owner's share of such reserves will be proportionate to that co-owner's interest in the Property. Any such management agreement will also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property.

In addition, any such management agreement will 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. The determination of any fees paid by the co-ownership to the manager will not depend in whole or in part on the income or profits derived by any person from the Property and will not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker will be comparable to fees paid by unrelated parties to brokers for similar services. Any such management agreement will provide

for a management fee of c% times the gross revenue from the Property received by the co-owners for the year. Any such management agreement will provide for a d% improvement construction management fee times the costs of tenant improvements. Such fee will relate to construction of improvements to common areas of the Property. Taxpayer represents that the activities of the related manager in managing the property will not result in non-customary services with respect to the Property. Taxpayer also represents that activities of the co-owners' agents and any person related to the co-owners with respect to the property will be taken into account and attributed to the other co-owners, except to the extent that a particular co-owner holds his interest for less than six months.

Taxpayer represents that the New Co-Owner will acquire its interest in the Property through the use of its own capital or through funds from an unrelated lender. Taxpayer also represents that, when the Put or Call is exercised, the New Co-Owner will be required to pay the full purchase price of the interest in cash. Taxpayer represents that there will be no payments to a sponsor in connection with the proposed transaction.

LAW AND ANALYSIS

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 tax law and does not depend on whether the organization 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 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 which is not, within the meaning of the Code, 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 of the Procedure and Administration Regulations.

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. Section 6 of Rev. Proc. 2002-22 permits the Service to consider a request for a ruling under this revenue procedure where the facts and circumstances clearly establish that such a ruling is appropriate.

The Co-Ownership Agreement and Management Agreement will satisfy 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.

The Co-Ownership Agreement will provide 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 approval of both co-owners. The manager will be required to seek the approval of both co-owners for any matter outside day-to-day operational activities. The Management Agreement will provide that the term will be automatically renewed for one-year periods unless either the manager or any co-owner otherwise gives written notice to the other parties not less than twenty days prior to the then-current expiration date of the twelve-month term. Although not an affirmative consent, the requirement in the Management Agreement containing the right of any co-owner to terminate the agreement at any time with twenty days of notice satisfies the conditions in §§ 6.05 and 6.12 of Rev. Proc. 2002-22 regarding unanimous annual renewals of any management agreement.

Section 6.10 of Rev. Proc. 2002-22 provides that a co-owner may not acquire a put option to sell the co-owner's undivided interest to another co-owner. Yet, that is not what will happen in this case, and the put option in this case will not cause the fractional interests in the Property to constitute interests in a business entity. The Taxpayer's put option in this case is not an option to sell an existing undivided interest that was previously acquired by the Taxpayer. Rather, the put option is an option to sell property held by the Taxpayer prior to entering into the proposed transaction. The purpose of the put prohibition is not applicable to this case. Regarding the exercise price, though section 6.10 of Rev. Proc. 2002-22 requires that the exercise price be the fair market value at the time of exercise, the b% appreciation factor adequately approximates the fair market value of the Property.

Specifically 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. 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 a lessee is a co-owner, then all of the activities of the lessee (or any person related to the 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. Under these facts, the Taxpayer represents that the co-owners' activities with respect to the Property, conducted directly or through the manager, will be limited to customary activities.

CONCLUSION

Based on the facts submitted and representations made, we conclude that, if Taxpayer sells a tenancy-in-common interest in the Property to New Co-Owner pursuant to the terms described in this ruling, an undivided fractional interest in the Property will not constitute an interest in a business entity under § 301.7701-2(a) for purposes of qualification of the undivided fractional interests as eligible relinquished 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. For instance, we express or imply no opinion concerning whether the

refinancing of the debt on the Property would cause recognition of income under § 1031(a) for federal tax purposes.

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

In accordance with a power of attorney on file with this office, we are sending a copy of this letter to your authorized representatives.

Sincerely,

David R. Haglund
Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: