

26 CFR 601.201: Rulings and determination letters. (Also Part I, §§ 267, 511, 512, 707, 761, 856, 1031, 1361; 1.761-1, 1.761-2; 301.7701-1, 301.7701-2, 301.7701-3, 301.7701-4.)

Rev. Proc. 2002-22

SECTION 1. PURPOSE

This revenue procedure specifies the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity, within the meaning of § 301.7701-2(a) of the Procedure and Administration Regulations.

This revenue procedure supersedes Rev. Proc. 2000-46 (2000-2 C.B. 438), which provides that the Service will not issue advance rulings or determination letters on the questions of whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under

§ 1031(a)(1) of the Internal Revenue Code and whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes under § 7701. This revenue procedure also modifies Rev. Proc. 2002-3 (2002-1 I.R.B. 117) by removing these issues from the list of subjects on which the Service will not rule. Requests for advance rulings described in Rev. Proc. 2000-46 that are not covered by this revenue procedure, such as rulings concerning mineral property, will be considered under procedures set forth in Rev. Proc. 2002-1 (2002-1 I.R.B. 1) (or its successor).

SECTION 2. BACKGROUND

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 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 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 Internal Revenue 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.

The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common. 7 Richard R. Powell, Powell on Real Property §§ 50.01-50.07 (Michael Allan Wolf ed., 2000).

Rev. Rul. 75-374 (1975-2 C.B. 261) concludes 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 revenue 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 concludes 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. See also Rev. Rul. 79-77 (1979-1 C.B. 448), which did not find a business entity where three individuals transferred ownership of a commercial building subject to a net lease to a trust with the three individuals as beneficiaries.

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 the 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 at 169-170. *Accord Bussing v. Commissioner*, 88 T.C. 449 (1987), *aff’d on reh’g*, 89 T.C. 1050 (1987); *Alhousé v. Commissioner*, T.C. Memo. 1991-652.

Under § 1.761-1(a) and §§ 301.7701-1 through 301.7701-3, a federal tax 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. However, as the above authorities demonstrate, a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships. *Bergford*, 12 F.3d at 169. Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. *Bussing*, 88 T.C. at 460. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. *Bergford*, 12 F.3d at 169.

SECTION 3. SCOPE

This revenue procedure applies to co-ownership of rental real property (other than mineral interests) (the Property) in an arrangement classified under local law as a tenancy-in-common.

This revenue procedure provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes.

SECTION 4. GUIDELINES FOR SUBMITTING RULING REQUESTS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the information described in section 5 of this revenue procedure is included in the ruling request and the conditions described in section 6 of this revenue procedure are satisfied. Even if sections 5 and 6 of this revenue procedure are satisfied, however, the Service may decline to issue a ruling under this revenue procedure whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

Where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single "Property." In such a case, the Service will generally not consider a ruling request under this revenue procedure unless: (1) each co-owner's percentage interest in each parcel is identical to that co-owner's percentage interest in every other parcel, (2) each co-owner's percentage interests in the parcels cannot be separated and traded independently, and (3) the parcels of property are properly viewed as a single business unit. The Service will generally treat contiguous parcels as comprising a single business unit. Even if the parcels are not contiguous, however, the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. For example, an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous.

For purposes of this revenue procedure, the following definitions apply. The term "co-owner" means any person that owns an interest in the Property as a tenant in common. The term "sponsor" means any person who divides a single interest in the Property into multiple co-ownership interests for the purpose of offering those interests for sale. The term

"related person" means a person bearing a relationship described in § 267(b) or 707(b)(1), except that in applying § 267(b) or 707(b)(1), the co-ownership will be treated as a partnership and each co-owner will be treated as a partner. The term "disregarded entity" means an entity that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include qualified REIT subsidiaries (within the meaning of § 856(i)(2)), qualified subchapter S subsidiaries (within the meaning of § 1361(b)(3)(B)), and business entities that have only one owner and do not elect to be classified as corporations. The term "blanket lien" means any mortgage or trust deed that is recorded against the Property as a whole.

SECTION 5. INFORMATION TO BE SUBMITTED

.01 Section 8 of Rev. Proc. 2002-1 outlines general requirements concerning the information to be submitted as part of a ruling request, including advance rulings under this revenue procedure. For example, any ruling request must contain a complete statement of all facts relating to the co-ownership, including those relating to promoting, financing, and managing the Property. Among the information to be included are the items of information specified in this revenue procedure; therefore, the ruling request must provide all items of information and conditions specified below and in section 6 of this revenue procedure, or at least account for all of the items. For example, if a co-ownership arrangement has no brokerage agreement permitted in section 6.12 of this revenue procedure, the ruling request should so state. Furthermore, merely submitting documents and supplementary materials required by section 5.02 of this revenue procedure does not satisfy all of the information requirements contained in section 5.02 of this revenue procedure or in section 8 of Rev. Proc. 2002-1; all material facts in the documents submitted must be explained in the ruling request and may not be merely incorporated by reference. All submitted documents and supplementary materials must contain applicable exhibits, attachments, and amendments. The ruling request must identify and explain any information or documents required in sec-

tion 5 of this revenue procedure that are not included and any conditions in section 6 of this revenue procedure that are or are not satisfied.

.02 *Required General Information and Copies of Documents and Supplementary Materials.* Generally the following information and copies of documents and materials must be submitted with the ruling request:

(1) The name, taxpayer identification number, and percentage fractional interest in Property of each co-owner;

(2) The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of Property, including the sponsor, lessee, manager, and lender;

(3) A full description of the Property;

(4) A representation that each of the co-owners holds title to the Property (including each of multiple parcels of property treated as a single Property under this revenue procedure) as a tenant in common under local law;

(5) All promotional documents relating to the sale of fractional interests in the Property;

(6) All lending agreements relating to the Property;

(7) All agreements among the co-owners relating to the Property;

(8) Any lease agreement relating to the Property;

(9) Any purchase and sale agreement relating to the Property;

(10) Any property management or brokerage agreement relating to the Property; and

(11) Any other agreement relating to the Property not specified in this section, including agreements relating to any debt secured by the Property (such as guarantees or indemnity agreements) and any call and put options relating to the Property.

SECTION 6. CONDITIONS FOR OBTAINING RULINGS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the conditions described below are satisfied. Nevertheless, where the conditions described below are not satisfied, the Service may consider a request for a ruling under this revenue procedure where the facts and

circumstances clearly establish that such a ruling is appropriate.

.01 *Tenancy in Common Ownership.* Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

.02 *Number of Co-Owners.* The number of co-owners must be limited to no more than 35 persons. For this purpose, “person” is defined as in § 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

.03 *No Treatment of Co-Ownership as an Entity.* The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.

.04 *Co-Ownership Agreement.* The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

.05 *Voting.* 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 modifi-

cation 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. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

.06 *Restrictions on Alienation.* In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner’s undivided interest in the Property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See section 6.14 of this revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner’s exercise of the right to transfer the co-ownership interest in the Property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

.07 *Sharing Proceeds and Liabilities upon Sale of Property.* If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

.08 *Proportionate Sharing of Profits and Losses.* Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner’s undivided interest in the Property. Neither the other

co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

.09 *Proportionate Sharing of Debt.* The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

.10 *Options.* A co-owner may issue an option to purchase the co-owner’s undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner’s percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner’s undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

.11 *No Business Activities.* 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.

.12 *Management and Brokerage Agreements.* 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 management agreement may 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. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may 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. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

.13 *Leasing Agreements.* All leasing arrangements must be *bona fide* leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. 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 Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.

.14 *Loan Agreements.* The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest

in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.

.15 *Payments to Sponsor.* Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership 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 Property.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000-46 is superseded. Rev. Proc. 2002-3 is modified by removing sections 5.03 and 5.06.

SECTION 7. DRAFTING INFORMATION

The principal authors of this revenue procedure are Jeanne Sullivan and Deane Burke of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Sullivan or Mr. Burke at (202) 622-3070 (not a toll-free call).