Internal Revenue Service

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March 17, 2008

LEGEND

A =

B =

C =

D =

E =

F =

G =

Company 1 =

Company 2 =

Company 3 =

Company 4 =

Company 5 =

Company 6 =

LP =

Property 1 =

Property 2 =

Property 3 =

Year 1 =

Year 2 =

X =

Y =

a% =

b% =

c% =

Dear :

This letter responds to a letter dated February 27, 2007, and subsequent correspondence, requesting on behalf of A and B a ruling that undivided fractional interests in Property 1, Property 2, and Property 3 (together, the Properties) are not interests in business entities under § 301.7701-2(a) of the Procedure and Administration

Regulations for purposes of qualification of the undivided fractional interests as eligible replacement property under § 1031(a) of the Internal Revenue Code.

FACTS

According to the information submitted, Company 1, Company 2, and Company 3 are business entities that, together with Company 4, have held title to Property 1 as tenants in common and operated Property 1 in accordance with a tenants-in-common agreement since Year 2. Company 5 and B are unrelated business entities that have held title to Property 2 as tenants in common and operated Property 2 in accordance with a tenants-in-common agreement since Year 1. Company 6 and LP are unrelated business entities that have held title to Property 3 as tenants in common and operated Property 3 in accordance with a tenants-in-common agreement since Year 1. (Together, Company 1, Company 2, Company 3, Company 4, Company 5, Company 6, and LP, together with B, are referred to as the Co-owners. Individually, Property 1, Property 2, and Property 3, are referred to as the Property, and together, they are referred to as the Properties.)

Each of the Properties is governed by a tenants-in-common agreement (the Co-ownership Agreement) under which terms an affiliate (or, affiliates jointly, in the case of Property 1) of A owns an undivided 50 percent interest in the Properties and an affiliate of B owns an undivided 50 percent interest in the Properties. Company 1, Company 2, Company 3, Company 5, and Company 6, (together, the A Co-owners) are affiliates of A, and Company 4, and LP, (together, with B, the B Co-owners) are affiliates of B.

Each Co-ownership Agreement between the respective A Co-owner and B Co-owner, and the other agreements between them, are virtually identical for each of the Properties. These agreements provide that the A Co-owner and the B Co-owner each have a right to 50 percent of all income and an obligation to pay 50 percent of all expenses. Under the terms of the agreements, each of the Co-owners retains the right to approve the hiring of any manager, the sale or other disposition of the Property, the leasing of all or a portion of the Property, the creation or modification of any blanket lien, the hiring of a property manager, the resolution of any claims, lawsuits, or demands of any type or nature whatsoever potentially affecting the Property, and the encumbering or pledging as collateral an interest in the Property. If either Co-owner advances funds necessary to pay expenses associated with the Property, the other Co-owner must repay such advance within 31 days of the date the expense, obligation or liability was paid.

Each Co-owner has the right to sell an interest in the Property but, if the sale would result in a change in control of the Property, a specified buy-sell procedure must be followed. A change in control is deemed to occur if any person or entity, other than C or C's descendants (as to the A Co-owner) or D or D's descendants (as to the B Co-owner) becomes the owner of securities or of membership interests in a Co-owner representing 50 percent or more of the combined voting power of the Co-owners' then outstanding ownership interests. The buy-sell procedure is as follows. The Co-owner desiring to transfer or sell (the initiating Co-owner) must give the other Co-owner (the responding Co-owner) a pre-offer notice that includes an initial due diligence disclosure (including, but not limited to, the most recent physical inspection report of the physical condition of the Property prepared by a professional building inspector not affiliated with the initiating Co-owner; the most recently prepared environmental report on the Property; a current rent roll; and a current profit and loss statement for its interest in the Property) and shall provide written notice of the initiating Co-owner's intent to sell its interest in the Property (a pre-offer notice). For a period of 30 days (the pre-offer period) the parties are to negotiate in good faith the terms of the sale or transfer and to obtain certain other inspections of the physical condition of the Property. If the Co-owners do not reach agreement during the pre-offer period, the initiating Co-owner may serve a formal offering notice on the responding Co-owner at a stated dollar amount. The purchase price shall be the stated dollar amount less that portion, corresponding to the seller's percentage interest in the Property, of the principal balance and accrued interest outstanding on the closing date of any loan secured by the Property which is assumed by the purchaser. The responding Co-owner has 90 days to elect to sell its interest or to purchase the offering Co-owner's interest in the Property for the purchase price in the offering notice. If the responding Co-owner does not exercise either option within the option period, then the responding Co-owner is conclusively deemed to have elected to sell his interest in the Property in accordance with the terms of the offering notice. Closing will occur 150 days after the date of the offering notice. Because A and B own a number of properties together, the first time a pre-offer notice is submitted, the 30-day period for negotiating is extended to 150 days. In addition, the A Co-owners and the B Co-owners have agreed to limit to two the number of properties that can be subject to a pre-offer notice within any 180-day period. Moreover, certain events are stipulated to extend the time periods by a specified period.

The Co-owners retain the right to partition the Property but agree to invoke the buy-sell procedures (described above) prior to exercising that right. Moreover, the Co-owners agree that the Property may be partitioned through arbitration. Each Property is subject to a non-recourse loan extended by an unrelated lender, certain provisions of which are guaranteed by A and B and, in the case of Property 3, E (jointly and severally with B). If any Co-owner or affiliate pays more than the Co-owner's 50 percent share of the amount due under the loan agreement, pursuant to a guaranty or otherwise, that Co-owner has a right to be indemnified by the other Co-owner for the amount in excess of a 50 percent share of the expense.

A and B entered into agreements with F, an affiliate of A, to manage each Property for a market-rate fee equal to a% of certain gross receipts from the respective Property. The agreements with F must be renewed annually by consent of the respective A Co-owners and B Co-owners and F.

A and B, together with G, an affiliate of A, are also parties to verbal agreements, pursuant to which the A Co-owners and B Co-owners authorize G to negotiate and modify leases with tenants, subject to the approval of the respective A Co-owners and B Co-owners. The agreements with G are terminable by either co-owner at any time. The market-rate lease commissions paid by tenants are passed through in total to an independent broker who works closely with G but is not an employee of or related to G.

It is represented that the A Co-owners and B Co-owners have made repairs and capital maintenance to the Properties, but there have been no major expansions over the last X years (or, since Year 2 with regard to Property 1).

It is further represented that, with Y isolated exceptions, there have been no sales of any fractional interest in the Properties.

Each Property is leased to several lessees, one of whom is E, an affiliate of B. E leases between b% and c% of each Property and conducts a business that is unrelated to the management and leasing of the Property. All other lessees are unrelated to the A Co-owners and the B Co-owners. The rent payable under each lease is not dependent on the profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). The lessees are required to repair, maintain, and insure their premises and pay all utilities and taxes related to the premises. F collects rents, offsets expenses and distributes the proceeds pro rata to the respective A Co-owner and B Co-owner, while G negotiates and modifies leases (subject to approval by the A Co-owner and B Co-owner). The A Co-owner and B Co-owner, through F, perform only those activities customarily performed in connection with the maintenance and repair of rental real property. See Rev. Rul. 75-374, 1975-2 C.B. 261.

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 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. Rul. 75-374, 1975-2 C.B. 261, the Service 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 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. In addition, in Rev. Rul. 79-77, 1979-1 C.B. 448, the Service concluded that the transfer of a commercial office building subject to a net lease to a trust having three individuals as beneficiaries was a trust for federal tax purposes and not a business entity.

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.

The Co-ownership Agreements 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 Agreements provide that any sale, lease, or re-lease of a portion or all the Property, any creation or modification of a blanket lien, and the hiring of a manager, requires the approval of the respective A Co-owners and B Co-owners. F is required to seek the approval of both co-owners for any matter outside day-to-day operational activities.

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 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. Under these facts, the activities of the A Co-owners and B Co-owners with respect to the Properties, conducted directly and through F and G, are limited to customary activities.

Section 6.04 of Rev. Proc. 2002-22 provides that the co-owners may agree that a co-owner must offer the co-ownership interest for sale to the other co-owner(s), the sponsor or lessee at fair market value (determined as of the time the partition right is exercised). Section 6.06 provides that, while each co-owner must have the right to transfer, partition, and encumber the co-owner's interest in the property without the agreement or approval of any person, 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.

In this situation, in which the A Co-owners and B Co-owners each own a 50% interest in each Property, the restrictions on such Co-owners' right to engage in activities that could diminish significantly the value of the other 50 percent interest in the Property (such as pledging the interest in the Property as collateral or otherwise encumbering the interest) without the approval of the other Co-owner is consistent with the requirement that each respective A Co-owner and B Co-owner has the right to approve an arrangement that will create a lien on the Property. Moreover, the buy-sell procedure under these facts, in which the co-owners are unrelated and are dealing at arms' length, is consistent with establishing a right to acquire 50 percent of the Property at fair market value.

CONCLUSION

Based on the facts submitted and representations made, we conclude that an undivided fractional interest in the Properties 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 a Property otherwise qualifies as eligible replacement property 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,

/s/

Leslie H. Finlow
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: