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Bradley T. Borden*

I. INTRODUCTION

The study of open tenancies-in-common leaves little doubt that tax law affects industry norms and individuals' decisions.¹ Open tenancies-in-common have developed primarily to provide Internal Revenue Code section 1031 like-kind exchange opportunities for sellers of real property.² Typically, any disposition of property generates a gain or loss that figures into the taxable income of the person dis-

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¹ See, e.g., Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397 (1987) (challenging the traditional stated justification for section 1031); Martin J. McMahon, Jr., *Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 WASH. & LEE L. REV. 459, 479 (1993) ("There is no good reason that investors should be able to move among various real estate investments without paying taxes on realized gains when the same privilege is not accorded to reinvestment of sales proceeds in a different investment."). See Bradley T. Borden & W. Richey Wyatt, *Syndicated Tenancy-in-Common Arrangements: How Tax-Motivated Real Estate Transactions Raise Serious Nontax Issues*, 18 PROB. & PROP. 18, 18 (2004) (describing real estate syndicators' efforts to create viable replacement property for investors seeking to complete section 1031 exchanges). Open tenancies-in-common may raise questions or confirm positions regarding the appropriateness of certain tax laws. For example, several commentators are already critical of section 1031. But see Bradley T. Borden, *The Like-Kind Exchange Equity Conundrum*, 60 FLA. L. REV. 643, 667-68, 695-96 (2008) (arguing that equity generally supports tax-free like-kind exchanges, but not exchanges of undivided interests for interests owned in severalty). This Article leaves discussion of those topics for a different venue. Instead, this Article focuses on the existence of open tenancies-in-common and considers the issues they raise in the current context.

² All section references are to the Internal Revenue Code, unless stated otherwise.

posing of the property.³ Property owners may avoid the immediate recognition of gain under section 1031 if they acquire like-kind property in exchange for the relinquished property.⁴ If two properties are like-kind, many property owners may be indifferent about which property they own, but they may hesitate to change ownership if they must pay tax on the change-of-ownership transaction.⁵ Thus, to accept a purchase offer, property owners often need assurance that they will be able to find suitable like-kind property for reinvestment. In times of rising prices, purchase offers tend to increase, and the availability of replacement property tends to decrease, causing a difficult situation for many owners wishing to remain invested in like-kind property.⁶ Furthermore, property owners at the end of their property management life cycles may wish to acquire property that has less demanding management obligations.⁷ Finally, investors may prefer investment-grade property with a credit tenant⁸ as replacement property, which they may not be able to acquire individually.

Real estate syndicators, who recognized property owners' needs for accessible investment-grade replacement property with minimal

³ Gross income includes gains from dealings in property. I.R.C. § 61(a)(3) (2000). The Internal Revenue Code defines gain or loss on the disposition of property and generally requires recognition of gain or loss. *Id.* § 1001(a), (c). Non-corporate taxpayers are entitled to a deduction for losses, to the extent of gains plus some additional amounts. *Id.* §§ 165(a), 1211(b).

⁴ See *Id.* § 1031(a)(1). Property owners also lose any losses realized on the disposition of property. See *id.* Generally, taxpayers prefer loss recognition because it provides a tax benefit by lowering taxable income. Because gains increase tax liability, taxpayers generally prefer to avoid gain recognition. Because open tenancies-in-common are used by property owners seeking gain deferral, this Article focuses on gain deferral with little additional mention of loss deferral.

⁵ Stated otherwise, the opportunity to defer gain recognition may make property available that owners would not ordinarily sell because of the tax implications. See Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX. L. REV. 1, 45 (1992) ("The similarity of the items exchanged suggests weaker nontax reasons for exchanging them, and thus a greater likelihood that tax such exchanges would merely deter them, rather than raise revenue.").

⁶ The difficulty arises because the owners sell property at high prices but are unable to identify and acquire replacement property within the statutory time periods. See I.R.C. § 1031(a)(3) (2000) (requiring that exchangers identify replacement property within forty-five days after the transfer of the relinquished property, and that they generally acquire replacement property within 180 days after the transfer of the relinquished property).

⁷ Property owners often confess the three "Ts" of ownership (tenants, trash, and toilets) make property management tiresome. See Kevin Thomason, *How to Keep the TIC's from Biting*, 42 S. FED. TAX INST. F-1, F-1 (2007).

⁸ A credit tenant is a tenant with a high credit rating, such as a large corporation or professional services firm.

management demands, created open tenancies-in-common.⁹ An open tenancy-in-common is an ownership arrangement of a large piece of real estate in which several unrelated, unaffiliated, and often unacquainted persons take undivided ownership interests.¹⁰ The members of an open tenancy-in-common hire third parties to manage the property, thus relieving themselves of management responsibilities. As long as the undivided interests are deemed real property for section 1031 exchange purposes, they should generally be like-kind to other real property and qualify as valid replacement property.¹¹ The combination of accessibility, section 1031 qualification, and minimal management responsibility for the co-owners made open tenancies-in-common popular a popular investment vehicle for certain property owners. Property owners from all over the country began investing exchange proceeds in open tenancies-in-common, and an industry grew up to package, market, manage, and facilitate the creation of open tenancies-in-common.¹²

Before the 2007 and 2008 market contraction, open tenancies-in-common witnessed explosive growth. From 2002 through 2006, the amount of equity invested in securitized open tenancy-in-common interests grew significantly.¹³ In absolute dollars, the

⁹ See Borden & Wyatt, *supra* note 1 (recognizing that some real estate syndicators have added tenancy-in-common interests to their traditional offerings of limited partnership interests); *2nd Quarter 2008 Numbers*, TIC|TALK Q. (Omni Research & Consulting, LLC, Salt Lake City, Utah), Fall 2008, at 5 (listing sixty-five sponsors of tenancy-in-common arrangements). Omni Research & Consulting, LLC, is an affiliate of Omni Brokerage, Inc. *Id.* at 2. "OMNI Brokerage is a nationwide securities brokerage firm specializing in investment real estate for the qualified and accredited investor. Distinctive in the marketplace for its focus on Tenant-In-Common (TIC) investments, OMNI has been providing investors with replacement property solutions for 1031 exchanges since 1995." 1031 Exchange and TIC Investments—Omni Brokerage, <http://www.omni1031.com> (last visited Mar. 17, 2009). Industry participants often refer to open tenancies-in-common as "syndicated tenancies-in-common." See, e.g., Darryl Steinhouse, *TICs as Real Estate: Another Nail in the Coffin*, TIC|TALK Q. (Omni Research & Consulting, LLC, Salt Lake City, Utah), Fall 2008, at 12.

¹⁰ See *infra* text accompanying notes 44–66.

¹¹ See Rev. Rul. 73-476, 1973-2 C.B. 300 (ruling that an exchange of an undivided interest real property for an interest in a single real property qualifies for section 1031 nonrecognition); BRADLEY T. BORDEN, TAX-FREE LIKE-KIND EXCHANGES ¶ 3.4[4] (2008).

¹² See Terrence Floyd Cuff, *Section 1031 Exchanges Involving Tenancies-in-Common*, 29 REAL EST. TAX'N 53, 54 (2002); Tenant-in-Common Association, <http://www.ticassoc.org/index.php> (last visited Mar. 17, 2009) (describing the open tenancy-in-common industry).

¹³ A securitized open tenancy-in-common is one marketed and sold as a security under federal and state securities laws. Apparently some syndicators also sold interests in open tenancies-in-common as real estate, but that practice appears to have

amount of equity invested in 2001 was approximately \$167 million, but it grew to \$3.7 billion in 2006.¹⁴ That represents a 2116 % growth in just five years. Those figures do not include the amount borrowed to acquire property. Assuming acquisition indebtedness is about fifty percent of the total value of the property, the industry is approximately twice as large as the amount of invested equity, meaning the market peaked at approximately \$7.5 billion in 2006.¹⁵ After peaking in 2006, the amount of equity invested in open tenancy-in-common interests predictably contracted as the real estate market contracted.¹⁶ Even with the recent contraction, the rapid early growth indicates that some form of open tenancies-in-common will likely survive the current market downturn.¹⁷ As a relatively new form of property ownership, open tenancies-in-common deserve critical legal, economic, and tax consideration. This Article presents the first such analysis.

Contrast open tenancies-in-common with close tenancies-in-common.¹⁸ The co-owners of close tenancies know each other and generally manage the property together or leave management to one of the co-owners.¹⁹ They work together to acquire the property or acquire it by inheritance. Property owned in a close tenancy-in-common will generally be smaller than property owned in an open

stopped. See Complaint at 4, *Spann Trust v. DBSI Inc.*, No. CV OC 0820435 (Idaho Dist. Ct. Oct. 27, 2008) [hereinafter *Spann Complaint*].

¹⁴ See Brady Flamm, *2006 Numbers*, TIC|TALK Q. (Omni Research & Consulting, LLC, Salt Lake City, Utah), Winter 2007, at 3. The size of the industry doubled for 2002 (\$357 million), 2003 (\$756 million), and 2004 (\$1.775 billion), and it grew sizably in 2005 (\$3.229 billion). *Id.* Numbers are not available for the sales of non-securitized interests. As discussed below, securities laws suggest that interests in open tenancies-in-common fall within the definition of security. See *infra* text accompanying notes 131–33. That characterization is another reason to focus on securitized open tenancies-in-common.

¹⁵ That estimate makes open tenancies-in-common a relatively small portion of the estimated \$210 billion of total property exchanged under section 1031 in 2003 (the latest year that such estimates were published by members of Deloitte Tax). See Dean A. Halfacre, *Measuring the 1031 Market*, TIC|TALK (Omni Brokerage, Inc., Salt Lake City, Utah), Winter 2005, at 6.

¹⁶ In 2007, less than \$3 billion of equity closed on open tenancies-in-common. *2nd Quarter 2008 Numbers*, TIC|TALK Q. (Omni Research & Consulting, LLC, Salt Lake City, Utah), Fall 2008, at 5. The market continued to contract during 2008. See *id.*

¹⁷ This assumes tax law continues incentivize investment in tenancy-in-common interests. See *infra* Part IV.A (discussing the viability of open tenancies-in-common in a non-tax-favored environment).

¹⁸ This Article uses the term open tenancies-in-common to parlay vernacular used in scholarly work to compare open business arrangements to close business arrangements.

¹⁹ See *infra* text accompanying notes 102–05.

tenancy-in-common. Traditionally, close tenancies-in-common had simple co-ownership agreements, if they had them at all. Open tenancies-in-common, by contrast, have sophisticated co-ownership agreements. Their formation also requires the coordinated efforts of many parties, including promoters, managers, securities broker-dealers, attorneys, and other advisors.²⁰ A significant body of corporate-law scholarship similarly considers the differences between open and close corporations and other business arrangements.²¹ This Article recognizes differences, both legal and economic, between open and close tenancies-in-common.

Tax law motivated the initial emergence of open tenancies-in-common and greatly influences their ownership structures today. The viability of open tenancies-in-common to serve as like-kind replacement property depends significantly on the tax classification of open tenancies-in-common. If tax law treats an open tenancy-in-common as a tax partnership, the interest will not be like-kind real property and will not qualify for nonrecognition.²² Tax classification therefore affects many of the structural components of open tenancies-in-common, as parties structure them to comply with tax law's tenancy-in-common classification. The tax classification of a co-ownership arrangement, such as an open tenancy-in-common, is not a state law question.²³ Instead, it is a matter of federal tax law and exists primarily in the common law definition of tax partnership.²⁴ An arrangement that is not a tax corporation is either a tax partnership

²⁰ See *infra* Part II.A.

²¹ Generally, the focus is on open and close corporations. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991) (focusing generally on open corporations, but focusing specifically on close corporations in Chapter 9); MICHAEL C. JENSEN, *A THEORY OF THE FIRM* § 4.2 (2000) (discussing the economic theory for separating ownership and management and the optimal size of a firm). More recent commentary also considers other business arrangements, such as limited liability companies. See, e.g., Douglas K. Moll, *Minority Oppression and The Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883 (2005).

²² See I.R.C. § 1031(a)(2)(D) (2000) (excluding partnership interests from the application of section 1031). Furthermore, a partnership interest is personal property, so it cannot be like-kind to real property. UNIF. P'SHIP ACT, § 502, 6 U.L.A. 156 (2001); see also Rev. Rul. 72-151, 1972-1 C.B. 225 (ruling that an exchange of real property for machinery did not satisfy the like-kind property requirement).

²³ See Treas. Reg. § 301.7701-1(a)(1) (as amended in 2006) ("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.").

²⁴ See Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 975-1001 (2006) (reviewing the common law tests used to determine whether an arrangement is a tax partnership).

or a tenancy-in-common, as determined by the definition of tax partnership.²⁵ The definition of tax partnership, however, is unclear.²⁶ Such lack of clarity appears to have stymied the growth of the open tenancy-in-common industry for a number of years.²⁷ A 2002 IRS publication provided guidance regarding the classification of co-owned rental real property and was the catalyst that spurred the growth of the industry.²⁸ The IRS's guidance dictates, to a significant degree, the structure of open tenancies-in-common. This Article reveals, however, that some of the tax-driven elements find little support in the common law tax definition of tenancies-in-common and place serious strains on the economic tendencies of co-owners and managers.

The coming together of promoters, managers, and numerous investors with disparate backgrounds, varying levels of knowledge about real estate investment and management, and potentially different objectives creates economic and legal issues that the structure of open tenancies-in-common must contemplate. For example, man-

²⁵ *Id.* at 936–38.

²⁶ See WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS* ¶ 3.01[1] (4th ed. 2007) (describing the definition of “tax partnership” as the most basic and perhaps most difficult question of partnership taxation).

²⁷ See *supra* note 9 (stating that Omni Brokerage was in the business of providing replacement property solutions since 1995, but the industry's significant growth did not occur until 2002). The unclear definition of tax partnership led taxpayers to seek private guidance from the IRS regarding the proper classification of open tenancies-in-common. See I.R.S. Priv. Ltr. Rul. 2000-19-014 (May 12, 2000). Shortly after providing that guidance, the IRS publicly stated that it would not provide guidance on the classification of co-ownership arrangements until it had studied the issue further. Rev. Proc. 2000-46, 2000-2 C.B. 438. The moratorium on rulings appears to be a consequence of the inflow of ruling requests and the IRS's awareness of emergence of the open tenancy-in-common industry. See Rev. Proc. 2000-46 § 2, 2000-2 C.B. 438; Bradley T. Borden, *Exchanges Involving Tenancy-in-Common Interests Can Be Tax-Free*, PRAC. TAX STRATEGIES, Jan. 2003, at 4–5 (reviewing briefly the development of the open tenancy-in-common industry).

²⁸ The guidance came in the form of a revenue procedure, which lists several conditions that a tenancy-in-common generally must satisfy to receive a favorable ruling from the IRS regarding the arrangement's tax classification. See Rev. Rul. 2002-22, 2002-1 C.B. 733. Although the revenue procedure is merely ruling guidelines, taxpayers rely upon it as though it provides a safe harbor for classification. If an arrangement meets substantially all of the conditions in the revenue procedure, tax advisors will generally provide an opinion letter supporting the non-partnership classification for tax purposes. See Bradley T. Borden & Todd D. Keator, *Tax Opinions in TIC Offerings and Reverse TIC Exchanges*, 23 REAL EST. J. 88, 89–96 (2007) (predicting that common deviations from the revenue procedure will not prevent tax advisors from providing a “should” level opinion, but significant deviations will likely result in a “more likely than not” opinion). Following the publication of Revenue Procedure 2002-22, the equity invested in open tenancies-in-common doubled annually for three years. See *supra* note 14.

agement is often separate from ownership in open tenancies-in-common, so the owners must consider how they might align the manager's interests with their own. Co-owners will wish to protect the property from claims of other owners' creditors, so arrangements must provide entity shielding.²⁹ Tenants in common traditionally have the power to dispose of undivided interests, partition the property, and take possession of the property.³⁰ Such powers, if unrestricted in open tenancies-in-common, could diminish the property's value and create unworkable structures. Ownership structures of open tenancies-in-common have evolved to provide such restrictions.³¹

The emergence of open tenancies-in-common raises several questions about their independent viability and value. Because they arose to fill a tax purpose, their existence may depend solely on the continued tax preference. The cumbersome open tenancy-in-common structure calls into question whether direct ownership is necessary to preserve tenancy-in-common classification under tax law. Finally, the resources devoted to open tenancies-in-common have created a new way to own and manage property. Many aspects of open tenancy-in-common structures may be transferable to close tenancies-in-common that heretofore could not justify the application of resources to invent such structures. This Article describes the industry that services open tenancies-in-common, examines the tax, legal, and economic aspects of open tenancies-in-common, and considers the issues involved with the application for close tenancies-in-common to open tenancies-in-common.³²

²⁹ See Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335, 1343–50 (2006) (describing the economics of entity shielding and its importance to business arrangements).

³⁰ See John V. Orth, *Tenancies in Common*, in 4 THOMPSON ON REAL PROPERTY § 32.02 (David A. Thomas ed., 2d ed. 1994) (recognizing the right to transfer and partition); Alfred A. Heon, Comment, *The Liability of a Cotenant to Other Cotenants for Rents, Profits and Use and Occupation*, 42 MARQ. L. REV. 363, 363 (1959) (“[E]ach cotenant of a tenancy-in-common had an equal and several right of entry and possession, and the possession of one was the possession of all.”).

³¹ See *infra* note 250 and accompanying text (discussing common restrictions placed on disposition and partition and the reasons for them).

³² Space limitations restrict the potential coverage of various issues raised by open tenancies-in-common. This Article focuses on tax law, property law, securities law, and economics. Further analysis could also consider the implications under bankruptcy law and corporate law.

II. THE INDUSTRY AND PRODUCTS

An industry has grown up to package, market, sell, and manage open tenancies-in-common. In fact, industry participants have created a trade organization—the Tenancy-in-Common Association (TICA).³³ Forming an open tenancy-in-common requires the coordination of many different functions, which industry participants have divided along lines of specialization. Sponsors package open tenancies-in-common.³⁴ They locate property, put it under contract or acquire it, arrange for financing, and ensure the property is ready for transfer on the transfer closing date.³⁵ The early success of open tenancies-in-common attracted many sponsors—as many as sixty-five sponsors were serving the securitized open tenancy-in-common market in 2008.³⁶

Because open tenancy-in-common interests are securities,³⁷ broker-dealers generally handle the marketing and selling of open tenancy-in-common interests.³⁸ A broker-dealer is licensed to trade securities for his own account or for customers.³⁹ Registered representatives often work as independent contractors for open tenancy-in-common broker-dealers and have direct interaction with in-

³³ See Tenant-In-Common Association, *supra* note 12 (describing TICA and providing information about the tenancy-in-common industry and promoting open tenancies-in-common).

³⁴ See Thomason, *supra* note 7, at F-2.

³⁵ See Borden & Wyatt, *supra* note 1, at 19. If promoters put the property under contract instead of acquiring it, they assign their rights in the contract to investors who then close on it. *Id.*

³⁶ See *19 of 65 Sponsors Surveyed Closed Deals in the 2nd Quarter*, TIC|TALK Q. (Omni Research & Consulting, LLC, Salt Lake City, Utah), Fall 2008, at 5. Undoubtedly, others marketed and sold tenancies-in-common as real estate during the same period. For example, DBSI purportedly sold tenancy-in-common interests as real estate during that period. See Spann Complaint, *supra* note 13, at 12.

³⁷ See *infra* note 131.

³⁸ See, e.g., 1031 Exchange and TIC Investments—Omni Brokerage, <http://www.omni1031.com> (last visited Mar. 17, 2009) (providing information about Omni Brokerage, which specializes in selling tenancy-in-common interests and claims to be the largest broker-dealer in the tenancy-in-common industry, based upon equity raised); *infra* note 131 (discussing the definition of a security and why open tenancy-in-common interests fall within that definition).

³⁹ See Securities Registration Act of 1934 § 3(a)(4)(A), 15 U.S.C. § 78c(a)(4) (2006) (defining broker as “any person engaged in the business of effecting transactions in securities for the account of others”); *Id.* § 78c(a)(5) (defining dealer as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise”); *Id.* § 78l(a) (requiring broker-dealers to register with the Securities and Exchange Commission).

vestors.⁴⁰ They work together to sell the interests.⁴¹ Registered representatives may work exclusively for a broker-dealer or may own an exchange facilitator business and sell tenancy-in-common interests as a side venture.⁴² Such a dual purpose puts the registered representative in direct contact with potential investors. Because most investors in open tenancies-in-common generally use section 1031 exchange proceeds to invest, broker-dealers and their representatives seek referrals from exchange facilitators.⁴³ The objective is to attract investors who have sold real estate as a part of an intended section 1031 exchange (or who are contemplating such a sale) but have not yet committed to acquire replacement property or who are still looking for suitable replacement property. Exchange facilitators often know these potential investors and are excellent referral sources.

A. *Creation of Open Tenancies-in-Common*

The creation of an open tenancy-in-common requires the coming together of several parties in a multi-step process. The investors and promoters often begin their processes independently of each other. They might meet only after they have each progressed along their respective process cycles. First, property owners sell real property as part of an intended section 1031 exchange, generally using a qualified intermediary to facilitate the exchange.⁴⁴ The property owners, who eventually end up acquiring interests together in a specific open tenancy-in-common, probably do not know each other at the time they sell their own properties. At the time of disposition, they may have some preferred property identified as replacement property and have no intent to acquire interest in an open tenancy-in-common, but those plans may be frustrated through the exchange process. Other property owners may sell property with the intent to exchange into an interest in an open tenancy-in-common.⁴⁵ Second,

⁴⁰ This information is based on the Author's professional interaction and informal discussions with broker-dealers and registered representatives.

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ See Thomason, *supra* note 7, at F-18. Most section 1031 exchanges are structured as multiple-party exchanges with a qualified intermediary receiving the proceeds from the sale of the relinquished property and facilitating the exchange. See BORDEN, *supra* note 11, ¶ 4.4[3] (discussing the technical requirements that property owners must satisfy to obtain section 1031 nonrecognition for a multiple-party exchange facilitated by a qualified intermediary and describing the process of a multiple-party exchange).

⁴⁵ Section 1031 allows property owners to transfer relinquished property and later acquire replacement property, if they identify the replacement property within

independent of the actions of the property owners, open tenancy-in-common sponsors locate and arrange to acquire the property for a new open tenancy-in-common.⁴⁶ Sponsors negotiate the purchase price of the property, secure blanket nonrecourse financing needed to acquire the property, and negotiate the terms of an appropriate lease, if the property has a single lessee or master lessee.⁴⁷ Thus, sponsors package the property and prepare it for acquisition by investors.

Third, sponsors prepare an offering memorandum.⁴⁸ The offering memorandum, including any addenda, will likely be hundreds of pages long and include copious information.⁴⁹ For example, the memorandum might include information such as risk factors relating to the property, tax matters, financing arrangements, and investments in the property.⁵⁰ The memorandum will also include information about the property and the market in which the property is located.⁵¹ The memorandum typically identifies the sponsors and the managers of the property, or the master tenant, describing the manner in which the co-owners will compensate them and their prior performance.⁵² Additionally, the memorandum should summarize the relevant agreements that co-owners will enter into, including rights of first offer or refusal and call-option agreements, the tenants-in-common agreement, and the property and asset management agreement.⁵³ The memorandum also includes copies of such agreements as exhibits, along with a tax opinion addressing the tax classification of the open tenancy-in-common and the section 1031 implica-

forty-five days after the relinquished property transfer. I.R.C. § 1031(a)(3)(A) (2000). Often property owners will sell relinquished property with no idea as to what they will acquire as like-kind replacement property and use the forty-five day identification period to find suitable replacement property. See Thomason, *supra* note 7 at F-1 (describing a typical situation that creates demand for a tenancy-in-common interest).

⁴⁶ See Cuff, *supra* note 12, at 54.

⁴⁷ See Thomason, *supra* note 7, at F-19.

⁴⁸ See *id.* at F-20.

⁴⁹ Information about offering memoranda comes from confidential materials on file with the Author. This Article refers to the confidential materials as "Confidential Private Placement Memorandum—P.M." because the memorandum provided for property-management structures, as "Confidential Private Placement Memorandum—M.L." for the memorandum issued for master-lease structures, or collectively as "Confidential Private Placement Memoranda" for both types of memoranda.

⁵⁰ See Confidential Private Placement Memoranda, *supra* note 49.

⁵¹ See *id.*

⁵² See *id.*

⁵³ See *id.*

tions of acquiring an interest in the property.⁵⁴ Because interests in open tenancies-in-common are likely securities, the offering should comply with the exceptions to the securities registration rules.⁵⁵ Most interests are offered under the Regulation D exception to the securities registration regime and the offering is often limited to accredited investors.⁵⁶

Fourth, the promoters present the tenancy-in-common offerings to the broker-dealers who solicit investments. Because the primary investors are property owners who have sold relinquished property as part of an intended section 1031 exchange, the broker-dealers look to qualified intermediaries for referrals to potential investors.⁵⁷ Qualified intermediaries have knowledge about the property owner's net worth because they hold exchange proceeds.⁵⁸ Thus, qualified intermediaries can perform initial screenings and introduce broker-dealers to those property owners with exchange proceeds that exceed the net worth element of the accredited investor definition.⁵⁹ Ultimately, interested investors execute the necessary documents and prepare for closing.

Finally, the transaction closes.⁶⁰ Qualified intermediaries transfer investors' exchange proceeds and the lender transfers loan proceeds to the seller of the property. Title of the property passes to the investors, who take the property as tenants-in-common.⁶¹ Advisors, such as accountants and lawyers, the sponsor, and the broker-dealers, receive their fees and commissions at the closing.⁶² The total fees and commissions can equal as much as nine percent of the total value of the property.⁶³

Although investment in an open tenancy-in-common is passive, the structure—prompted by lenders—generally requires each co-

⁵⁴ *See id.*

⁵⁵ *See infra* text accompanying notes 131–33.

⁵⁶ *See Borden & Keator, supra* note 28, at 96.

⁵⁷ This is based upon the Author's experience working in the section 1031 industry.

⁵⁸ *Id.*

⁵⁹ Qualified intermediaries are not regulated, so they may not be bound by rules of confidentiality—allowing them to share information with registered representatives. They should, however, be careful not to violate the anti-disclosure rules of Gramm-Leach-Bliley Act, which may apply. *See* Gramm-Leach-Bliley Act of 1999, 15 U.S.C. §§ 6801–09 (2006) (imposing privacy rules upon financial institutions, the definition of which may include qualified intermediaries).

⁶⁰ *See Thomason, supra* note 7, at F-22.

⁶¹ *See id.*

⁶² *See id.*

⁶³ *See Confidential Private Placement Memoranda—P.M., supra* note 49.

owner to form a special purpose entity to hold undivided interests in the property.⁶⁴ Thus, most co-owners form a single-member limited liability company, which tax law generally disregards,⁶⁵ to acquire and hold the undivided interest in the property. The co-owners take actions through those entities. After closing, the co-owners receive regular rent payments and service the blanket loan, but the managers or master lessees may handle the payment before making distributions to the co-owners.⁶⁶

B. *Open Tenancy-in-Common Structures*

Promoters generally use one of two structures for open tenancies-in-common: (1) the property-management structure or (2) the master-lease structure.⁶⁷ Under the property-management structure, the co-owners hire a third party—usually the promoter—to manage the property.⁶⁸ The property manager agrees to provide an annual budget and disburse revenue, net of operating expenses, to the co-owners. Operating expenses include loan payments and a reasonable reserve for improvements. The manager also furnishes financial reports and other notifications to the co-owners.⁶⁹ The management agreement should contain provisions addressing the term for which the manager will serve.⁷⁰ Because the promoters create, market, and manage the arrangements, they draft the governing documents to secure a long-term position as manager.⁷¹ The long-term structure of the management arrangement indicates that the co-owners understand that the acquisition of an interest in the property is subject to the promoter managing the property indefinitely.⁷² Thus, investors

⁶⁴ See *id.*

⁶⁵ See Treas. Reg. § 301.7701-1(a)(4) (as amended in 2006).

⁶⁶ See Thomason, *supra* note 7, at F-23.

⁶⁷ See *id.* at F-2.

⁶⁸ See *id.*; Confidential Private Placement Memorandum—P.M., *supra* note 49.

⁶⁹ See Confidential Private Placement Memorandum—P.M., *supra* note 49.

⁷⁰ See *id.*

⁷¹ See Confidential Private Placement Memoranda, *supra* note 49.

⁷² See Confidential Private Placement Memorandum—P.M., *supra* note 49. The management agreement may provide, for example, that the property manager will serve for twenty years, unless the manager or the co-owners terminate the agreement or sell the property before the end of twenty years. See *id.* Although the co-owners may have the right to terminate the management agreement, a termination by the co-owners may allow the lender to accelerate the loan and trigger the manager's option to acquire the interest from the terminating co-owners. See *id.* To comply with the IRS's guidance, the co-owners must renew the management agreement on an annual basis. See Rev. Proc. 2002-22, § 6.12, 2002-1 C.B. 733 (discussing the IRS's requirement that managers' contracts be renewed annually). Such a termination generally will, however, trigger the manager's option or the lender's right to accelerate

should consider part of the promoter's compensation to include the management fee. The benefits of the property-management structure are that it is simpler than the master-lease structure and the co-owners participate in rent growth.⁷³ The limitations of the property-management structure are that co-owners can engage only in limited activities, either directly or indirectly through an agent,⁷⁴ and the co-owners have no protection should rents or occupancies decline.⁷⁵

Under the master-lease structure, the co-owners lease the property to a master lessee.⁷⁶ The master lessee is usually the sponsor, or an affiliate of the sponsor, who subleases the property to tenants, hires and pays a property manager, and bears the expenses of operating the property.⁷⁷ The master lessee will also generally service any blanket liability secured by the property and pay the co-owners a fixed percentage of their cash investment (with possible rent bonuses based on the gross revenues of the property).⁷⁸ The master lessee reaps the excess of the payments it is obligated to make to cover expenses, service the liability, and pay the co-owners.⁷⁹ Thus, if the rents increase and the expenses stay the same, the master lessee's profit will increase, but a decrease in rents or an increase in expenses will reduce the master lessee's profit. This structure should shift the property's economic risk of loss to the master lessee. To the extent the master lessee does not have sufficient capital to meet its obligations (as is often the case), the risk of loss shifts to the co-owners when rental income decreases sufficiently.⁸⁰ As a consequence, any claims that the master-lease structure protects the co-owners from downturns in the rental market are often illusory.⁸¹ As with the prop-

the loan. Thus, as a practical matter, the co-owners do not have a viable opportunity to terminate the management agreement.

⁷³ See Thomason, *supra* note 7, at F-2.

⁷⁴ See Rev. Proc. 2002-22, § 6.11, 2002-1 C.B. 733 (providing that co-owners may perform only customary tenant services).

⁷⁵ See Thomason, *supra* note 7, at F-2 through F-3.

⁷⁶ See *id.* at F-3; Confidential Private Placement Memorandum—M.L., *supra* note 49.

⁷⁷ See Thomason, *supra* note 7, at F-3; Private Placement Memorandum—M.L., *supra* note 49.

⁷⁸ See Thomason, *supra* note 7, at F-3; Private Placement Memorandum—M.L., *supra* note 49.

⁷⁹ See Thomason, *supra* note 7, at F-3; Private Placement Memorandum—M.L., *supra* note 49.

⁸⁰ See Thomason, *supra* note 7, at F-3 (stating that most master lessees are thinly capitalized).

⁸¹ See *id.* The private placement memorandum for typical master-lease structures identifies the limited capital of the master tenant as a risk to co-owners. See Private Placement Memorandum—M.L., *supra* note 49. The memorandum notifies poten-

erty-management structure, the master-lease structure commits the owners to a long-term relationship with the promoter.⁸² The long-term relationship indicates that the promoters consider rents retained by the master lessee to be part of their economic interest in the arrangement.

The master-lease structure benefits co-owners by providing a flexible vehicle for operating the properties safely within the IRS's guidance.⁸³ The limitation of the master-lease structure is that it is more complex to organize,⁸⁴ so the co-owners sacrifice simplicity to obtain tax certainty. Thus, the main differences between the master-lease structure and the property-management structure are the level of tax certainty (the property-management structure provides greater certainty), the level of structural complexity (the master-lease structure is simpler), and the potential to share in rental increases (co-owners of a property-management structure benefit directly from increases).

C. Delaware Statutory Trusts

Although most open tenancies-in-common are structured to be state-law tenancies-in-common, the IRS allows promoters to package open tenancies-in-common in Delaware statutory trusts, subject to significant restrictions.⁸⁵ With such structures, the promoters form a Delaware statutory trust that acquires the property, and the investors use exchange proceeds to acquire interests in the statutory trust.⁸⁶

tial investors that the master tenant agrees to pay rent to co-owners without regard to the economic success of the property and warns the co-owners that their recourse against the master tenant is limited to the assets of the master tenant, which mainly include the master tenant's right to rent from the subtenants. *See id.* Such a notice may be reserved for the dense pages of the offering memorandum and may not be prominent in other marketing efforts, such as referrals to broker-dealers from qualified intermediaries, accountants, lawyers, or others who may recommend that a property owner consider a tenancy-in-common investment. *See, e.g.,* Video: How a TIC works and the Benefits to the Investor (Tenant-in-Common Association 2006), <http://www.ticassoc.org/sections/education.php> (last visited Mar. 17, 2009) (presenting the benefits of an investment in open tenancies-in-common without discussing the risks). Commentators do, however, recognize the risk. *See, e.g.,* Thomason, *supra* note 7, at F-3.

⁸² *See* Private Placement Memorandum—M.L., *supra* note 49.

⁸³ *See* Thomason, *supra* note 7, at F-3.

⁸⁴ *See id.*

⁸⁵ *See* Rev. Rul. 2004-86, 2004-2 C.B. 191; Richard M. Lipton et al., *Delaware Statutory Trusts and 1031: A Marriage Made in Heaven or Just a Pipe Dream?*, 101 J. TAX'N 140, 147-50 (2004) (discussing the limited use of Delaware statutory trusts under the ruling).

⁸⁶ *See* Lipton et al., *supra* note 85, at 145.

The IRS disregards the statutory trust as a separate entity, so the investors are treated as directly owning interests in the underlying property, which helps the interests satisfy the section 1031 like-kind property requirement.⁸⁷ The benefit of assigning a Delaware statutory trust is that the investors do not have to individually take undivided interests in the property.⁸⁸ Instead, the statutory trust takes title to the property in severalty, and the investors acquire interests in the statutory trust.⁸⁹ The use of a Delaware statutory trust thus helps simplify the structure and transfer of property.

Business law commentators predicted that statutory trusts would gain favor and create new uses as a choice of legal entity.⁹⁰ The use as an open tenancy-in-common structure is evidence of the prescience of those observations. Statutory trusts provide owners limited liability, create entity shielding, and grant almost unlimited contractual freedom.⁹¹ Those features make them attractive generally, but they are particularly useful for open tenancies-in-common. As discussed below, the IRS's guidance requires open tenancies-in-common to have certain features.⁹² The contractual flexibility of statutory trusts allows the members to satisfy those requirements.⁹³ The members of a statutory trust cause the statutory trust to lease the property to a master lessee.⁹⁴

Obtaining tenancy-in-common classification to satisfy the section 1031 like-kind property requirement motivated the formation of the general structures. The various structures provide investors with choices, but tax classification greatly influences the details of each type of structure. Even though tax law is the primary driver of open

⁸⁷ See Rev. Rul. 2004-86, 2004-2 C.B. 191.

⁸⁸ See Thomason, *supra* note 7, at F-14.

⁸⁹ Rev. Rul. 2004-86, 2004-2 C.B. 191.

⁹⁰ The business trust effectively represents the minimum required of law in creating a strong entity—asset partitioning and, in particular, strong entity shielding—and leaves the rest to be determined by contract. The business trust can thus be seen as the final step in the historical evolution of commercial entities. See Hansmann et al., *supra* note 29, at 1397.

⁹¹ See *id.*

⁹² See *infra* Part III.

⁹³ One obvious requirement the co-owners cannot satisfy is the direct-ownership. Delaware statutory trusts are separate legal entities that own the property. The IRS has, however, agreed to waive the direct-ownership requirement for properly structured Delaware statutory trusts. See Rev. Rul. 2004-86, 2004-2 C.B. 191. That sanction may represent a willingness by the IRS to consider disregarding other multiple-member legal entities, a position the Author advocates. See Borden, *supra* note 24, at 1008–11, 1026.

⁹⁴ See Rev. Rul. 2004-86, 2004-2 C.B. 191 (considering a Delaware statutory interest with a master-lease structure).

tenancy-in-common structures, promoters and investors must also consider other legal aspects and economic characteristics of such arrangements. Thus, economics, business law, and property law also affect the structure and features of open tenancies-in-common.

III. FEATURES OF OPEN TENANCIES-IN-COMMON

Ownership, management, and transferability of interests are three main features of open tenancies-in-common that tax law affects. The tax-driven features of each open tenancy-in-common reflect a general effort to comply with the IRS's guidance in order to avoid having the IRS treat the arrangement as a tax partnership.⁹⁵ These features, however, often veer from the common law tax definition of tenancy-in-common, leaving commentators confused by the IRS's guidance.⁹⁶ Although this guidance is merely a list of conditions for advanced private rulings regarding classification,⁹⁷ tax and legal advisors carefully consider it when structuring open tenancies-in-common.⁹⁸ Therefore, open tenancies-in-common rarely deviate significantly from the guidance, even though the guidance may not follow the common-law tax definition of tenancy-in-common.⁹⁹ Substantial compliance with the IRS's guidance creates legal structures that are complicated and raise economic issues.¹⁰⁰ The relative newness of open tenancies-in-common hopefully suggests that the passage of time will help simplify and improve the features discussed below. In

⁹⁵ See Borden & Keator, *supra* note 28, at 88–89.

⁹⁶ See, e.g., *supra* text accompanying notes 139–157.

⁹⁷ See Rev. Proc. 2002-22, § 3, 2002-1 C.B. 733.

⁹⁸ See Borden & Keator, *supra* note 28, at 88. Practitioners consider the guidance a safe harbor because they cannot fathom the IRS taking a position that an arrangement satisfying all of the conditions in the guidance is anything other than a tenancy-in-common. *Id.*

The Service's disavowal to the contrary notwithstanding, as a practical matter, the guidelines in Rev. Proc. 2002-22 will effectively become a safe harbor for structuring TIC interests that can be acquired as replacement property in like-kind exchanges. It can be anticipated that tax practitioners will be comfortable issuing a favorable opinion to taxpayers with respect to TIC interests that satisfy the requirements in the guidelines, whereas practitioners will be less comfortable issuing favorable opinions if the TIC interests are not described in these guidelines.

Richard M. Lipton, *New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges*, 96 J. TAX'N 303, 306 (2002).

⁹⁹ See Borden & Keator, *supra* note 28, at 88–96 (identifying situations in which tax advisors will provide a favorable legal opinion even if the arrangement deviates from the IRS's guidance).

¹⁰⁰ See, e.g., *infra* Part III.C (describing the unrestricted partition and disposition requirements and the mechanisms co-owners use to circumvent those requirements).

the meantime, formal structures intended to substantially comply with the IRS's guidance will govern open tenancies-in-common.

The formal structure of open tenancies-in-common stands in stark contrast to the ownership structure of many close tenancies-in-common.¹⁰¹ The creation and method of acquiring interests in close tenancies-in-common often explain the lack of formal ownership arrangements. Co-owners unintentionally create close tenancies-in-common by operation of law when a conveyance fails to satisfy all four unities required for joint tenancy and tenancy by the entirety.¹⁰² For example, a joint tenant's transfer of an interest in the property would break the unity of title and create a tenancy-in-common.¹⁰³ Such unintentional formation may leave co-owners unaware that they have created a tenancy-in-common and ignorant of the issues tenancy-in-common, co-ownership creates. Consequently, they would not enter into a formal co-ownership agreement. Inheritance or devise may also create a tenancy-in-common.¹⁰⁴ For example, a parent may die, leaving property owned in severalty to her children, who take the property as tenants-in-common. The heirs of such transfers may not anticipate the problems that arise among tenants-in-common or may lack the sophistication needed to consider such problems and, therefore, they may not create a formal co-ownership arrangement.

¹⁰¹ Some close tenancies-in-common have very formal ownership structures. See, e.g., BORDEN, *supra* note 11, at app. F (providing sample documents for close tenancies-in-common). Such formal structures generally attempt to comply with the IRS's guidance in Revenue Procedure 2002-22. See, e.g., *id.*; I.R.S. Priv. Ltr. Rul. 2008-26-005 (June 27, 2008) (applying Revenue Procedure 2002-22 but ruling that a two-person tenancy-in-common is not a tax partnership even though the co-owners entered into buy-sell agreements, had the right to approve pledges of interests, entered into indemnification agreements for non-pro rata share of loan guarantees, and leased a portion of the property to a co-owner's affiliate). Aspects of modern close tenancies-in-common derive from the features found in open tenancies-in-common. Such features are found in larger close tenancies-in-common formed by sophisticated investors.

¹⁰² See Orth, *supra* note 30, in THOMPSON ON REAL PROPERTY, *supra* note 30, at § 32.06. In some states, however, the focus is on the intent of parties at the time of formation and whether they use specific words in the conveyance documents. See *id.* The four unities are the unity of interest, title, time, and possession. See 2 WILLIAM BLACKSTONE, COMMENTARIES 180. Tenancies by the entirety also require the unity of person based on marriage. See John V. Orth, *Tenancies by the Entirety* [hereinafter Orth, *Tenancies by the Entirety*], in 4 THOMPSON ON REAL PROPERTY, *supra* note 30, § 33.06(b).

¹⁰³ See John V. Orth, *Joint Tenancies*, in 4 THOMPSON ON REAL PROPERTY, *supra* note 30, § 31.08(b).

¹⁰⁴ See Orth, *supra* note 30, § 32.06(b)(2) (providing that most states now presume that co-owned property, including property acquired by inheritance or devise, is held as a tenancy-in-common).

Co-owners may create a tenancy-in-common by express limitation,¹⁰⁵ but such intentional formation does not necessarily ensure a formal ownership structure. Many state statutes provide that conveyances of property to co-owners create tenancies-in-common, unless specifically stated otherwise.¹⁰⁶ Perhaps unaware of the significance of their co-ownership arrangements, friends or acquaintances who acquire property as tenants-in-common may not seek a formal ownership structure. Others acquire property as husband and wife with confidence and trust in each other's capabilities and loyalty. Changes in personal relationships or ownership of the property may alter the nature of the tenancy-in-common ownership arrangement.¹⁰⁷

Business law commentators have recognized and considered the lack of formality of close business arrangements. Forces that affect the lack of formality in close business arrangements also appear to affect the lack of formality of close tenancies-in-common. Like close tenancies-in-common, close business arrangements tend to be somewhat smaller and less complicated than open business arrangements and tenancies-in-common.¹⁰⁸ The size of close business arrangements, in terms of invested capital, often does not justify the cost of hiring legal counsel to help draft formal ownership documents.¹⁰⁹ The members of close business arrangements may not be sophisticated enough to recognize ex ante the need for planning and contracting.¹¹⁰ Finally, the members of close business arrangements generally are acquainted with each other, trust each other, and do not

¹⁰⁵ See *id.* § 32.06(b).

¹⁰⁶ See *id.* § 32.06(b)(2).

¹⁰⁷ For example, divorce would break the unity of person required for a tenancy by the entirety and could render the arrangement either a joint tenancy or tenancy-in-common, depending upon the applicable local law. See Orth, *Tenancies by the Entirety*, *supra* note 102, § 33.08(d). A spouse's transfer of an interest in a joint tenancy would break the unity of title and render the arrangement a tenancy-in-common. See Orth, *supra* note 103, § 31.08(b).

¹⁰⁸ See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 273 (1986) (Close business arrangements "tend to have relatively few managers, who tend to be the largest residual claimants."); Moll, *supra* note 21, at 888-89 (identifying a small number of owners, absence of market for ownership interests, owner participation in management, and owner relationships as characteristics typical of close business arrangements).

¹⁰⁹ See Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L.Q. 455, 477 (1995) ("Many small businesses . . . will elect not to assume the expense of negotiating, and hiring an attorney to draft, a carefully worded operating agreement.").

¹¹⁰ See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1805 (2001) (recognizing that failure to contract in close corporations often reflects "ignorance, lack of imagination, or poor legal advice").

foresee any potential dispute, or they prefer not to raise doubts about mutual trust by broaching the idea of entering into formal agreements.¹¹¹ As a result, they often do not create sophisticated ownership arrangements. Similar factors would explain the lack of formal agreements among many co-owners of close tenancies-in-common.¹¹²

In contrast, open business arrangements tend to be larger, with members from varying backgrounds who have no prior relationship or acquaintance with each other. Those factors suggest the need for greater structure in contractual arrangements, more available resources to consider and address issues raised by the structure, and fewer impediments to prevent the members from creating formal structures. The size of many open tenancies-in-common similarly supports and justifies hiring legal counsel to draft sophisticated ownership documents and consider state-law issues.¹¹³ The co-owners' lack of mutual acquaintance motivates the co-owners to enter into agreements that anticipate and address future events. The volume of open tenancy-in-common arrangements allows legal advisors to improve structures as they handle multiple open tenancies-in-common over an extended period of time.¹¹⁴ Advisors also become more familiar with open tenancies-in-common as they share their experiences and ideas with each other informally, formally at conferences, and

¹¹¹ See Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329, 1348 (2003) ("[S]hareholders may opt not to adopt shareholder contracts because they choose to rely on their mutual trustworthiness, and because proposing and bargaining over these contracts can undermine the often fragile trust that exists at the beginning of ventures.").

¹¹² The formation of a tenancy-in-common often may evidence the naivety of investors because sophisticated investors may prefer to acquire and own property in some form of legal entity.

¹¹³ The IRS guidelines explicitly allow co-owners to enter into agreements that run with the land. See Rev. Proc. 2002-22, § 6.04, 2002-1 C.B. 733. The co-ownership agreement takes the place of the partnership agreement used in traditional, syndicated structures.

¹¹⁴ A few decades ago, one commentator recognized the need for accessible information about tenancies-in-common:

The purpose of this article is, therefore, two-fold: first, to assist busy practicing lawyers in preparing cases involving the relative rights of cotenants where the amount involved does not make possible exhaustive research; and second, to make some small contribution to an organization and rationalization of the law on the subject and the development of a better body of law.

Dudley Weible, *Accountability of Cotenants*, 29 IOWA L. REV. 558, 558 (1944). Similar phenomena helped standardize documentation and other common features of business arrangements. See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 253-56 (1984) (discussing the role of the transactional attorney in adding value to transactions).

through published materials. Recognizing activity in the area, the IRS also takes an interest and influences its development through published guidance. As a consequence, the structures arguably become better, and the ideas and sophistication of the structures become more common and accessible to members of close tenancies-in-common and their advisors.¹¹⁵ Thus, the rise of open tenancies-in-common has helped expose issues prevalent with all tenancies-in-common, has formalized the features of open tenancies-in-common, and has provided opportunities for addressing those issues and analyzing the features.

A. *Ownership Features*

The ownership features of open tenancies-in-common serve dual purposes: they seek to comply with the IRS's guidance and they address the co-owners' lack of mutual acquaintance. The guidance includes several conditions that affect the ownership features of open tenancies-in-common.¹¹⁶ First, it provides that the co-owners must hold the property as tenants-in-common, as defined ostensibly by state law.¹¹⁷ Nonetheless, some of the features in the guidance differ significantly from features of traditional tenancies-in-common and may alter the legal attributes of the arrangement. The conditions limit co-owners' use and management of the property and consequently appear to destroy the unity of possession, a fundamental characteristic of tenancies-in-common.¹¹⁸ Unity of possession grants each co-owner the right to possess the whole property.¹¹⁹ Therefore, no co-owner has the right to exclude the other co-owners from possession or to solely possess any portion of the property, unless the other co-owners do not contest such possession.¹²⁰ Unity of possession also es-

¹¹⁵ As an example, sample documents for close tenancies-in-common are now publicly available. See BORDEN, *supra* note 11, at app. F.

¹¹⁶ The conditions in the guidance arguably ensure that an arrangement is not a tax partnership. Presumably the IRS would not challenge the classification of an arrangement that satisfies all of the conditions in the guidelines. They do not, however, necessarily comply with the federal definition of tax partnership. See Borden & Keator, *supra* note 28, at 88–89. To err on the side of safety, most open tenancies-in-common comply with most of the conditions in the guidance, but deviate only when they believe the law justifies such deviations. See *id.* at 89–96.

¹¹⁷ See Rev. Proc. 2002-22, §6.01, 2002-1 C.B. 733 (prohibiting ownership in a separate legal entity from holding title to the property as a whole).

¹¹⁸ See *infra* text accompanying notes 163–65 (discussing the restrictions on use and management and how the restrictions might affect the unity of possession).

¹¹⁹ See Orth, *supra* note 30, § 32.07(a).

¹²⁰ See Weible, *supra* note 114, at 558. Ousted co-owners may bring an ejectment action to recover possession, and failing to do so may lead to lost title by adverse possession. See Orth, *supra* note 30, § 32.07(d).

tablishes the parties' claims to income from the property. For example, an ousted co-owner may bring an action under common law for accounting to recover a share of the fair market rental value of the property.¹²¹ The IRS's guidance requires a different accounting method.¹²² Such requirements may destroy the unity of possession.

If the IRS's guidance frustrates the unity of possession, open tenancies-in-common may be something other than tenancies-in-common under state law. State law classification is important for tax purposes because the IRS's guidance appears to require the arrangement to be a tenancy-in-common under state law.¹²³ If the co-ownership arrangement disrupts the unity of possession, arguably the arrangement would fail to satisfy that condition of the guidance. Nonetheless, the IRS must anticipate that, to the extent its guidance creates internal inconsistency, the published guidance must accommodate the IRS's over-arching purpose, which is to provide guidelines for entity classification.¹²⁴ Thus, if following the guidance results in an entity that is not a tenancy-in-common under state law, the guidance should disregard state-law classification. Otherwise, the IRS could choose between the two alternatives to argue on audit for the position that favors it.¹²⁵ Thus, if the IRS's guidance creates something that is not a state-law tenancy-in-common, open tenancies-in-common appear to represent arrangements that tax law classifies independently of state-law classification.¹²⁶

Regardless of the tax-law classification, state law must address the classification and significance of open tenancies-in-common. Classification issues are generally derivative of other issues, such as liability of members or management rights, which are the immediate issues in state-law classification cases.¹²⁷ For example, if the arrangement is not

¹²¹ See Weible, *supra* note 114, at 558.

¹²² See Rev. Proc. 2002-22, § 6.08, 2002-1 C.B. 733 (requiring the co-owners to share revenue and expenses in proportion to their ownership interests in the property).

¹²³ See Rev. Proc. 2002-22, § 6.01, 2002-1 C.B. 733.

¹²⁴ See Rev. Proc. 2002-22, § 1, 2002-1 C.B. 733.

¹²⁵ The tax consequences of tax classifications often are not apparent on the date an arrangement comes into existence. See Borden, *supra* note 24, at 969-70. Depending upon the issue, the parties may prefer one classification above another. *Id.* at 957-70 (identifying the tax consequences of tax partnership classification). The guidelines should provide some certainty to avoid such potentialities.

¹²⁶ Tax law often disregards state law in determining whether an arrangement is a tax partnership or tax corporation. See, e.g., Treas. Reg. § 301.7701-3(a) (as amended in 2006) (providing that arrangements that are not corporations under state law—e.g., partnerships and limited liability companies—may elect to be tax corporations).

¹²⁷ See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 2.02(a) (2007).

a state-law tenancy-in-common, it could be a state-law partnership.¹²⁸ That could expose the co-owners to joint and several liability for the other co-owners' actions performed on behalf of the arrangement and could also impose duties of loyalty and care on the co-owners.¹²⁹ Provisions in standard open tenancy-in-common ownership documents address some of those issues, but state-law classification may raise unforeseen issues and consequences. Time will tell whether state law respects the arrangement and the parties' agreements and treats them as tenancies-in-common or disregards the tax classification and treats the arrangements as state-law partnerships.

The IRS's guidance generally allows no more than thirty-five persons to join an open tenancy-in-common.¹³⁰ That limitation does not reflect property law, nor does it find support in tax-entity classification; the IRS appears to have extracted that limitation from securities law. An interest in an open tenancy-in-common appears to be a security under the Securities Act of 1933.¹³¹ Therefore, sellers generally must register interests in open tenancies-in-common to sell them.¹³² Exemptions, in particular the private offering exemption, permit the sale of unregistered securities, if the offering is limited to

¹²⁸ See *id.* § 2.06(b).

¹²⁹ See UNIF. P'SHIP ACT, §§ 306 and 404, 6 U.L.A. 117 and 143 (2001) (describing partner liability and standards of conduct).

¹³⁰ See Rev. Proc. 2002-22, § 6.02, 2002-1 C.B. 733. The guidelines treat a husband and wife as a single person for the thirty-five-owner limitation and treat all persons who acquire interests in the property by inheritance as a single person. See *id.* Therefore, the number of co-owners of an open tenancy-in-common could exceed thirty-five actual persons without violating the thirty-five person rule.

¹³¹ Section 2(a)(1) of the Securities Act of 1933 defines securities to include "any . . . investment contract." Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006). The Supreme Court held that the term "investment contract" includes interests in real property if investors acquired interests in the property as part of "a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves." *SEC v. Howey Co.*, 328 U.S. 293, 298 (1946) (holding that land sales contracts, warranty deeds, and service contracts related to narrow strips of property in citrus groves were investment contracts where investors, with no knowledge of managing such groves, relied upon a management company for profit). Open tenancies-in-common grant investors interests in property, include an ownership agreement and management agreement, and allow the co-owners to rely upon managers to earn a profit. Therefore, interests in open tenancies-in-common appear to come within the securities law definition of investment contract. A recent lawsuit seeks \$2 billion damages from promoters of open tenancies-in-common who did not register the interests as securities or seek to come within one of the registration exceptions. Complaint at 22, *Spann Trust v. DBSI Inc.*, No. CV OC 0820435 (Idaho Dist. Ct. Oct. 27, 2008). That case could further clarify whether interests in open tenancies-in-common are securities.

¹³² See Securities Act of 1933, § 5(a), 15 U.S.C. § 77e(a)(1).

no more than thirty-five purchasers.¹³³ Those exemptions appear to be the source of the thirty-five-owner limitation. The thirty-five-owner limitation does not reflect a tax principle, but it may evince sound economic concepts in the absence of other mechanisms that would protect investors from unscrupulous promoters.

As the number of co-owners increases, the actual control of any co-owner would tend to decrease, assuming that co-owners have proportionate ownership in the arrangement.¹³⁴ Diminution of control would make the arrangement look more like a large publicly traded company.¹³⁵ As control diminishes, investors become further removed from the management of the property. As a consequence, they become less familiar with the management of the property and have less access to information. To ensure that investors in open business arrangements have access to information, securities laws require disclosure of information and registration of securities in arrangements that will have more than thirty-five investors.¹³⁶

Distance from management in large companies justifies the thirty-five-person limit for exemption from the securities registration rules, but the IRS's guidance has other mechanisms for ensuring access to information. For example, because the guidance requires unanimous consent of the co-owners for certain actions, including hiring and retaining managers,¹³⁷ the unanimous-consent requirement grants each owner, regardless of ownership interest, the power to veto major actions. Managers' need for annual approval of each co-owner also helps ensure that the co-owners will acquire regular information about the managers' performance. Thus, diminution of

¹³³ See Securities Act of 1933, § 4, 15 U.S.C. § 77d ; 17 C.F.R. §§ 230.505(b)(2)(ii) (as amended in 1992), 230.506(b)(2)(i) (as amended in 1989).

¹³⁴ If a single co-owner had a super majority, diluting the ownership of the minority by spreading it among an increasing number of co-owners generally would not affect the control of the majority co-owner. Perhaps if the pre-dilution minority co-owners generally favored the acts of the majority co-owner, dilution could, if nothing else, create an annoyance for the majority co-owner.

¹³⁵ See *Williamson v. Tucker*, 645 F.2d 404, 423 (5th Cir. 1981) (recognizing that partners' control diminishes as more partners join the partnership).

¹³⁶ See *supra* text accompanying notes 131–33 (discussing the registration requirement and exemptions to it); see also CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, *CORPORATE FINANCE AND THE SECURITIES LAWS* § 7.06 (4th ed. 2008) (discussing the history of the private placement exemption and the rationale for the thirty-five-person limit).

¹³⁷ See Rev. Proc. 2002-22, § 6.05, 2002-1 C.B. 733. Promoters, however, use options and other mechanisms to minimize the effect of such rules. See *infra* text accompanying notes 268–69.

control and lack of investor information do not appear to be the rationale for the IRS's thirty-five-person limitation.¹³⁸

The IRS's thirty-five-person limitation appears to be arbitrary from a tax perspective, but it may reflect a concern that more owners will convert the arrangement to a tax partnership or tax corporation. Unfortunately, that concern finds little support in tax theory. Partnership tax law and tax partnership classification are intended to facilitate tax accounting and reporting.¹³⁹ The integration of property and services and the method for determining residual risk causes complexities in tax accounting and reporting.¹⁴⁰ The number of owners does not affect tax accounting and reporting. For example, the accounting and reporting issues do not change if a piece of property managed by a third party is owned by ninety instead of thirty-five persons. In either situation, if the manager provides only customary tenant services for fair market value, the co-owners should generally share revenue and expenses in proportion to their ownership interests, and the parties can trace income from resources they own.¹⁴¹ Therefore, the thirty-five person limitation remains an inexplicable aspect of open tenancies-in-common.

The IRS's guidance also prohibits co-owners from doing things that would evince an intent to form an arrangement that is a legal entity separate from its members.¹⁴² The definition of partnership appears to provide that parties who hold themselves out as partners or members of another form of business entity, such as a limited liability company, should be estopped from taking a tax position that the

¹³⁸ If the unanimous-consent rule vests owners with too much control, the interests may not be securities under the 1933 Securities Act. See *Williamson*, 645 F.2d at 421–23. Furthermore, if the owners must rely upon specialized skills or knowledge or a manager, they may not have control that is sufficient to overcome the investment contract test. See *id.* at 423–24 (“[A] partnership can be an investment contract only when the partners are so dependent on a particular manager that they cannot replace him or otherwise exercise ultimate control.”).

¹³⁹ See H.R. REP. NO. 72-708, at 53 (1932) (providing that the Congress enacted a statutory definition of tax partnership to “make it easier for the members to determine the distributive shares in the [partnership] gains and losses which are to be included in their returns”); Borden, *supra* note 24, at 941–57.

¹⁴⁰ See Bradley T. Borden, *Residual-Risk Model for Classifying Business Arrangements*, 37 FLA. ST. U. L. REV. (forthcoming 2010), available at ssrn.com/paper=1365933.

¹⁴¹ See *infra* text accompanying notes 145–49.

¹⁴² See Rev. Proc. 2002-22, § 6.03, 2002-1 C.B. 733 (prohibiting the co-ownership arrangement from (1) filing a partnership or corporate tax return; (2) conducting business under a common name; (3) executing an agreement that identifies the co-owners as partners, shareholders, or members of a separate business entity; and (4) holding themselves out as some form of business entity). The prohibited activities are those that evidence a subjective intent to form a partnership. See BROMBERG & RIBSTEIN, *supra* note 127, § 2.05(b).

arrangement is anything other than what the intent manifests.¹⁴³ Thus, the restriction is consistent with the current definition of tax partnership, which adopts both an estoppel and an intent test.¹⁴⁴ That does not, however, mean that tax theory supports the IRS's guidance on this issue.

The economic theory of tax partnership would reject the thirty-five person limit and the intent restriction, however, if the owners do not have an ownership interest in any services that generate income.¹⁴⁵ Under the economic theory of tax partnerships, a tax partnership should exist only if the parties are unable to trace income from co-owned resources.¹⁴⁶ Tenancies-in-common, as a general rule, grant the owners of the respective interests in the property rights to income from the property in proportion to their ownership interests.¹⁴⁷ Thus, the co-owners are able to trace income from the property based on their respective ownership interests in the property. Such simple arrangements do not need the complex rules that apply to tax partnerships and tax corporations, nor should they be allowed access to them.¹⁴⁸ Intent is not relevant if the parties do not share ownership and control of both property and services. The number of owners an arrangement has does not change that conclusion. The thirty-five person limit remains inexplicable. Even though economic theory does not support the intent test, the IRS's adoption of the intent test is consistent with the current definition of tax partnership and the state-law definition of tenancy-in-common.¹⁴⁹ An adherence to those rules explains the IRS's adoption of the intent test.

¹⁴³ See *Maletis v. United States*, 200 F.2d 97, 97-98 (9th Cir. 1952) (using estoppel to hold that an arrangement is a tax partnership).

¹⁴⁴ See Borden, *supra* note 24, at 980-82 (concluding that the courts have derived an intent test from the substantive-law definition of partnership); *id.* at 1000-01 (describing the estoppel test). But see *Lewis v. Comm'r*, 23 T.C. 538, 550 (1954); *Lulu Lung Powell v. Comm'r*, 26 T.C.M. (CCH) 161 (1967) (holding that an arrangement that filed a partnership tax return was not a tax partnership).

¹⁴⁵ See Borden, *supra* note 140.

¹⁴⁶ See Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. (forthcoming May 2009), available at <http://ssrn.com/abstract=1121351>.

¹⁴⁷ Enforcing such rights may be difficult because of the application of the various remedies, which include actions for waste, contribution, account, and ejectment. See Orth, *supra* note 30, § 32.07. See generally Weible, *supra* note 114.

¹⁴⁸ See Borden, *supra* note 24, at 951-56.

¹⁴⁹ The IRS generally will not consider whether a co-ownership arrangement is a tax partnership if immediately before its creation the co-owners held the property through a partnership or corporation. See Rev. Proc. 2002-22, § 6.03, 2002-1 C.B. 733. This provision reflects the IRS's long-standing position that a distribution of property to members of a business arrangement immediately prior to an exchange should disqualify the exchange from section 1031 treatment. See Rev. Rul. 77-337, 1977-2 C.B. 305. However, the IRS has been unsuccessful in presenting that position

The IRS's guidance requires co-owners to share indebtedness secured by a blanket lien on the property in proportion to their undivided interests in the property.¹⁵⁰ To the extent a blanket lien is a nonrecourse loan, the nature of the indebtedness will ensure that the co-owners share the indebtedness proportionately.¹⁵¹ Possibilities of disproportionate sharing of debt arise when the indebtedness is recourse. In such situations, if the co-owners are jointly and severally liable for the indebtedness, they may agree among themselves to use indemnification provisions or other agreements to disproportionately allocate the indebtedness. The co-owners may change a liability that would otherwise be nonrecourse into a recourse liability if one or more co-owners guarantees all or a portion of the liability. Such arrangements would violate the IRS's guidance, but disproportionate sharing of blanket-lien indebtedness does not appear to be inconsistent with the common law tax definition of a tenancy-in-common.¹⁵² Furthermore, proportionate sharing of blanket-lien indebtedness may make investing in such arrangements unattractive for some property owners.¹⁵³

The IRS's unfavorable view of disproportionate sharing of blanket-lien indebtedness may derive from a common practice among

to courts. *See, e.g.,* Bolker v. Comm'r, 760 F.2d 1039, 1045 (9th Cir. 1985) (granting section 1031 nonrecognition to an exchange of property occurring immediately after a corporation distributed it to the exchanger); Mason v. Comm'r, 55 T.C.M. (CCH) 1134 (1988) (holding that an exchange of undivided interests received from a partnership could qualify for section 1031 nonrecognition). Thus, the IRS's position finds little support in case law.

¹⁵⁰ See Rev. Proc. 2002-22, § 6.09, 2002-1 C.B. 733. The IRS defines "blanket lien" as "any mortgage or trust deed that is recorded against the [p]roperty as a whole." *Id.* § 4.

¹⁵¹ The holder of nonrecourse indebtedness has recourse only against the property securing it. BLACK'S LAW DICTIONARY 1083 (8th ed. 2004). Any blanket nonrecourse loan would be secured by the property as a whole, and if the lender proceeded against the property to collect the loan, it would affect each co-owner in proportion to the interests in the property they hold.

¹⁵² See Borden & Keator, *supra* note 28, at 93. The prohibition of disproportionate sharing of blanket-lien indebtedness also appears to violate equity. *See id.* (providing an example of inequity the prohibition creates).

¹⁵³ Investors often have different levels of comfort regarding leverage. Some may be more comfortable with larger levels of indebtedness, whereas others may need a specific level of indebtedness to preserve nonrecognition for their exchange. Section 1031(d) provides that liability discharged as part of an exchange is taxable boot. I.R.C. § 1031(d) (2006). If, however, the exchanger requires replacement property subject to the same amount of liability that was discharged, the discharged liability will not be taxable as boot. *See* Treas. Reg. §1.1031(d)-2, ex. 2 (1956). Thus, if an exchanger's proportionate share of the blanket-lien indebtedness is insufficient to cover the discharged liability, the exchanger must find a way to compensate for the difference.

partners: specially allocating partnership liability, which allows partners to disproportionately share partnership liability.¹⁵⁴ Disproportionate sharing of liability is not unique to partnerships, however. Common law allows tenants in common to disproportionately share blanket-lien indebtedness by entering into indemnification agreements or by guaranteeing blanket-lien indebtedness. Disproportionately sharing blanket-lien indebtedness should not be deemed to be an activity that would create a tax partnership.¹⁵⁵ The prohibition against blanket-lien indebtedness also encourages co-owners individually borrowing against their own interests. By borrowing individually against their respective interests, co-owners can obtain a debt structure that would mirror an arrangement with disproportionate sharing of blanket-lien indebtedness.¹⁵⁶ The IRS prohibition thus appears to do nothing other than cause unneeded complexities. Consequently, lawyers do not hesitate to counsel investors that the disproportionate sharing of blanket-lien indebtedness should not frustrate the tenancy-in-common classification.¹⁵⁷

Without a doubt, the IRS's guidance significantly influences the ownership features of open tenancies-in-common. However, several of the ownership features lack support in tax law and economic theory. The features could place members of open tenancies-in-common at a competitive disadvantage in the market. The IRS should consider revising its guidance to comply more closely with tax and economic theory. In particular, it should remove both the thirty-five person limit and the prohibition against disproportionate sharing of blanket-lien indebtedness. It should also consider whether the in-

¹⁵⁴ See I.R.C. § 752 (treating changes in a partner's share of partnership liability as partner contributions or distributions to the partner); Treas. Reg. § 1.752-2(b)(3) (as amended in 2006) (listing items to consider in determining a partner's obligation for partnership liabilities.).

¹⁵⁵ Tax practitioners recognize that the IRS's guidance on this issue deviates from the definition of tax partnership. Consequently, they will write tax opinion letters stating that co-ownership arrangements with disproportionate sharing of blanket-lien indebtedness are more likely than not tenancies-in-common for tax purposes. See Borden & Keator, *supra* note 28, at 93. Many persons who invest in open tenancies-in-common use section 1031 exchange proceeds to acquire their interests. Section 1031 requires parties to offset liability on relinquished property with liability on replacement property. See Treas. Reg. § 1.1031(d)-2, ex. (2) (1956). Generally, the parties acquiring interests in open tenancies-in-common will need different liability-to-investment ratios on their acquired tenancy-in-common interests to accurately offset the liability they had on replacement property. See Borden & Keator, *supra* note 28, at 93.

¹⁵⁶ See Borden & Keator, *supra* note 28, at 93 (providing examples of arrangements that subject co-owners to similar liability with respect to their interests in property, even though one arrangement has blanket-lien indebtedness).

¹⁵⁷ See *id.*

tent test is necessary and whether the co-owners should be allowed to own the property through legal entities in addition to statutory trusts. Finally, it should focus on rules that ensure the separate ownership of the property and services. The guidance should prohibit property owners from providing services and prohibit service providers from owning an interest in the property. Those modifications would help the guidance comply with existing tax law and theory and ease the economic difficulties the guidance causes.

B. Management Features

Investors often buy interests in open tenancies-in-common to relieve themselves of management responsibilities.¹⁵⁸ They delegate the management responsibilities to professional property managers. Therefore, the arrangement must provide for the management of the property, orderly distribution of the property's income, and sharing of expenses. The IRS's guidance specifically addresses many management aspects of open tenancies-in-common. Co-owners and managers structure their arrangements with the IRS's guidance in mind, but also must incorporate other legal and economic concepts into their agreements.

A significant part of the IRS's guidance is the unanimous consent requirement. This guidance requires the co-owners to approve unanimously: (1) the hiring of managers; (2) any disposition of the property; (3) leases of any portion of the property; and (4) any action related to a blanket lien.¹⁵⁹ The IRS's unanimous-consent requirement for disposing of the property and borrowing against the property as a whole reflects the concept of concurrent ownership, namely that each co-owner has an undivided interest in the property that is freely alienable.¹⁶⁰ Consequently, a single co-owner cannot unilaterally sell the entire property or offer the entire property as collateral for a loan. Instead, single co-owners can act according to their respective interests and may unilaterally sell those interests or offer

¹⁵⁸ See *supra* text accompanying note 7.

¹⁵⁹ Rev. Proc. 2002-22, § 6.05, 2002-1 C.B. 733. The IRS's guidance allows co-owners to agree to be bound by the majority vote of the undivided interests or any other action. *Id.* The IRS's guidance prohibits co-owners from granting another person a global power of attorney to act on behalf of the co-owner, but co-owners may grant a specific power of attorney to allow someone else to carry out actions that the co-owners have approved. *Id.*

¹⁶⁰ See Orth, *supra* note 30, § 32.02 ("Each tenant in common possesses an interest in the concurrent estate that is alienable, devisable, and inheritable.").

them as collateral for personal loans.¹⁶¹ A creditor who forecloses on an undivided interest in property takes the rights the debtor-co-owner had, and a purchaser of such an interest subrogates the rights the seller-co-owner had.¹⁶² By negative inference, others cannot sell or encumber another co-owner's interest without the co-owner's consent. Therefore, the IRS's unanimous-consent requirement appears to focus on preserving a fundamental feature of traditional tenancies-in-common.

The unanimous-consent requirement nullifies aspects of unity of possession. Under common law, all tenants in common have the right to possess the property.¹⁶³ The right to possess the property vests the co-owners with power to lease unilaterally their rights to any person, which would vest the lessee with the right to possess the property, but not to prohibit other co-owners from taking possession.¹⁶⁴ The majority of states requires the co-owners to share rents and profits received from non-co-owners with the other co-owners.¹⁶⁵ These common law rules demonstrate that a single co-owner may lease the property to a third party by leasing an undivided interest in the property. The IRS's requirement that co-owners must unanimously approve leases of any portion of the property appears to override the common law right to lease an undivided interest in the property and vest the lessee with the right of possession. Thus, the unanimous consent requirement distinguishes open tenancies-in-common from unstructured close tenancies-in-common.

The IRS's unanimous-consent requirement for hiring a manager also appears to be inconsistent with the common-law definition of tenancy-in-common. A co-owner's unilateral right to hire managers is implicit in the co-owners' actions for contribution or accounting under common law. The common law actions for accounting and contribution help establish that co-owners may unilaterally hire managers in tenancies-in-common governed by common law. Common law allows any co-owner to improve the property, but a co-owner who improves the property has an action for contribution against the other co-owners only if the other co-owners agreed to be liable for a share

¹⁶¹ See *id.* § 32.07(e) (recognizing that each co-owner has an interest in the property to which a creditor may attach a security interest).

¹⁶² See *id.* (providing that a creditor who acquires a debtor co-owner's interest has no rights greater than the debtor co-owner had).

¹⁶³ See *id.* § 32.07(d); Weible, *supra* note 114, at 558.

¹⁶⁴ See Orth, *supra* note 30, § 32.07(d).

¹⁶⁵ See Weible, *supra* note 114, at 559–62 (discussing the laws that govern rent-sharing in situations where a co-owner is in sole possession and a third party is in possession of the property).

of the improvement costs.¹⁶⁶ The co-owner who improves property can recover the costs in an accounting for rents and profits collected from non-co-owners only to the extent the improvements increase the rents.¹⁶⁷ If the property can be conveniently divided, the improver will take the improved portion in an in-kind partition action; otherwise, the improver will be awarded any increase in value from the improvements in a partition by sale and distribution.¹⁶⁸ A co-owner who repairs the property has no right of contribution for the repairs unless the nonrepairing co-owners agreed to be liable for the costs of repairs or the repairs are necessary to preserve the estate.¹⁶⁹

The rules relating to actions for contribution and accounting indicate that a co-owner may improve or repair property or hire others to perform the repairs or improvements. Co-owners would not have to resort to actions for contribution or accounting if they had agreed to improvements or repairs.¹⁷⁰ The remedies are therefore available only when a co-owner acts unilaterally. The IRS's unanimous-approval requirement thus modifies the rights generally possessed by tenants in common to manage the property and hire man-

¹⁶⁶ See Orth, *supra* note 30, § 32.07(b) (“[A] cotenant cannot be compelled to contribute to the expenses of improvement, lest the costs reduce, or even destroy, the unrealized value of the undivided share.”).

As a general proposition in the absence of an express or implied agreement to pay for improvements, a cotenant may not charge the property of his cotenant with contribution for the cost of improvements. Otherwise stated, the rule is that there is no recovery at law for improvements and whatever relief a cotenant may secure must be in equity.

Weible, *supra* note 114, at 577 (citations omitted).

¹⁶⁷ Orth, *supra* note 30, § 32.07(b) (“[I]ncreased income attributable to the improvement should be allocated to the improver.”). Because any doubts about the increased income will be decided against the improver, prudence suggests a co-owner should obtain an agreement from other co-owners before making the improvements. See *id.*

¹⁶⁸ See *id.* The right to partition provides any dissatisfied co-owner a remedy if the action of contribution does not provide the desired outcome, so the rules do not attempt to make an improver whole. See *id.*

¹⁶⁹ See *id.* The rationale for enforcing contribution for the cost of necessary repairs is that an action for waste is available to enforce the duty to make such repairs, and necessary repairs to do not improve a co-owner out of an estate. See *id.* Public policy may not, however, discourage permissive waste, so courts could deny both the action for waste and the action for contribution; thus, leaving dissatisfied co-owners with the action of partition to deal with perceived or actual harms. See *id.* The repairing partner may recover the costs through adjustments made in a partition or in an accounting action. See *id.* (referring to costs of improvements, but similar rules should apply to costs of repairs because actions for accounting should recognize outlays made by the repairer).

¹⁷⁰ See *supra* text accompanying note 166.

agers unilaterally. This is another example of how open tenancies-in-common differ from unstructured close tenancies-in-common. It also illustrates the IRS's disregard for state-law tenancies-in-common. Although common law does not appear to prohibit unanimous consent for hiring property managers, it does not require such consent.

The IRS's basis for requiring unanimous consent for certain actions is unclear. This deviation from common law indicates the IRS is not merely concerned in ensuring that open tenancies-in-common retain common law features of tenancies-in-common. The unanimous-consent requirements may derive from the centralized management characteristic of obsolete classification rules.¹⁷¹ Before the Treasury promulgated the check-the-box regulations in 1997, tax law classified tax partnerships and tax corporations using entity characteristics.¹⁷² One of those characteristics was centralized management, which delegates owners' decision-making authority to managers, who may not be owners.¹⁷³ The characteristics traditionally distinguished tax partnerships and tax trusts from tax corporations; they did not distinguish tax partnerships from tax tenancies-in-common.¹⁷⁴

Entity classification rules abandoned a centralized management requirement when the Treasury promulgated a formalistic elective classification regime.¹⁷⁵ The IRS appears to have revived the centralized-management characteristic in its tenancy-in-common guidance, which distinguishes tax partnerships from tenancies-in-common. The irony is that centralized management does not appear to be a characteristic used to distinguish tenancies-in-common from tax partnerships.¹⁷⁶ Thus, in revivifying the centralized-arrangement characteristic, the IRS applies it to a new classification issue. Its application appears tenuous, however, because it disallows arrange-

¹⁷¹ Earlier income tax regulations listed several characteristics that the Treasury considered common to entities and that distinguished entities from arrangements that are aggregates of their owners. See, e.g., Treas. Reg. § 301.7701-2(a)(1) (1960) (listing the following as characteristics of entities: (1) associates; (2) an objective to carry on business and divide the gains therefrom; (3) continuity of life; (4) centralization of management; (5) liability for corporate debts limited to corporate property; and (6) free transferability of interests).

¹⁷² See Treas. Reg. §§ 301.7701-1, -2(a)(2), -2(a)(3) (1960).

¹⁷³ See *id.* § 301.7701-2(c).

¹⁷⁴ See *id.* §§ 301.7701-1, -2(a)(2), -2(a)(3).

¹⁷⁵ See *id.* § 301.7701-3(a) (as amended in 2006) (providing that any business entity that is not a tax corporation is a tax partnership, unless it elects to be a tax corporation). A tax corporation is defined generally as any arrangement incorporated under state law. Treas. Reg. § 301.7701-2(b) (as amended in 2008).

¹⁷⁶ See Borden, *supra* note 24, at 975–1001 (listing the tests used to distinguish tax partnerships from tenancies-in-common and other disregarded arrangements).

ments to do that which the common law allows in tenancies-in-common, which would not generally affect their tax classification.

The IRS has relaxed its unanimous-consent requirement somewhat, apparently in reaction to market demands. Many open tenancy-in-common co-owners may have no interest in the management of the property and would prefer to defer to others for decisions about hiring managers, leasing the property, or financing the property's maintenance and improvement. Requiring unanimous consent for all actions thus frustrates the objectives of investors who wish to have a passive investment. It also causes administrative difficulties because those who lack the interest may not take the time to vote or may simply disregard notice of pending notes. Realizing that many investors, even in open tenancies-in-common, prefer little or no involvement, the IRS has ruled privately that co-owners may provide silent consent after receiving written notice of certain actions.¹⁷⁷ As modified by the private ruling, the IRS's guidance moves a step closer to allowing centralized management and adhering to traditional aspects of tenancies-in-common. Centralized management is a common feature of open business arrangements,¹⁷⁸ and the IRS's move in that direction reflects an understanding of market realities. As long as the managers are paid a fair market rate for their services, the manner in which they are hired or retained should not affect the classification of an arrangement.¹⁷⁹ The IRS could move further to allow centralized management.

¹⁷⁷ I.R.S. Priv. Ltr. Rul. 2003-27-003 (ruling that a co-owner satisfies the consent requirement by not replying to a proposed action within a certain time period). Open tenancies-in-common use provisions such as the following in co-ownership agreements to facilitate the consent requirement and allow for passive investment:

Whenever in this Agreement the consent or approval of the Tenants in Common is required or otherwise requested with respect to any decision, each Tenant in Common shall have a period of time (the "Approval Period") ending on the date that is seven days after the date the request for such consent or approval is given in which to give written notice of its approval or disapproval of such decision. Each Tenant in Common agrees to use its best efforts to timely respond to any request for consent or approval. If a Tenant in Common does not give written notice of its disapproval of such decision with the Approval Period, such inaction shall constitute approval of such decision by the Tenant in Common.

Borden & Keator, *supra* note 28, at 90.

¹⁷⁸ See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 308-09 (1983) (presenting an economic theory for separation of ownership—referred to by Fama and Jensen as residual claims—and management, referred to as decision control, in larger business arrangements).

¹⁷⁹ See *supra* text accompanying notes 145-49 (discussing the theory of partnership tax and significance of integrating services and property in classification).

The IRS's guidance also limits the type of activities that a co-owner may perform with respect to the property. Under the guidance, a co-owner may perform only customary rental services.¹⁸⁰ This allowance deviates from the definition of a tax partnership, which provides that if a partner contributes services to a co-ownership arrangement, the arrangement will be a tax partnership.¹⁸¹ Partnership tax law exists to facilitate tax administration and simplify tax accounting and reporting.¹⁸² Arrangements become complicated and need partnership tax account and reporting rules when parties contribute property and services to a common business venture.¹⁸³ In such arrangements, the parties take an interest in all contributed resources and cannot accurately identify the source of income they receive from the arrangement.¹⁸⁴ The income may be from contributed property or contributed services, resources in which all members have an interest. The inability to trace income requires tax accounting rules that deviate from the assignment-of-income doctrine.¹⁸⁵ Thus, instead of looking to the source of income, the law looks to allocation provisions to determine the members' shares of income from arrangements that integrate resources.¹⁸⁶ Partnership and cor-

¹⁸⁰ Rev. Proc. 2002-22, § 6.11 2002-1 C.B. 733 ("The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental property customary activities." (citing Rev. Rul. 75-374, 1975-2 C.B. 261)). The IRS's guidance generally imputes to the co-owners activities performed by parties related to the co-owners and the co-owners' agents. See *id.* (disregarding activities of a co-owner who holds an interest in the property for less than six months).

¹⁸¹ The definition of tax partnership distinguishes between the type of service an arrangement provides and the source of the service. See Borden, *supra* note 24, at 992-98. An arrangement is not a partnership if a manager receiving fair management fees provides only customary tenant services with respect to the property. See Rev. Rul. 75-374, 1975-2 C.B. at 261. If a co-owner provides the same services, the arrangement is probably a tax partnership. See *Cusik v. Comm'r*, 76 T.C.M. (CCH) 241, 243 (1998).

¹⁸² See *supra* note 139 and accompanying text.

¹⁸³ See Borden, *supra* note 146.

¹⁸⁴ See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organizations*, 62 AM. ECON. REV. 777, 779 (1972) (suggesting that parties integrate resources to increase output and to help monitor behavior); Borden, *supra* note 140 (discussing the accounting difficulty integration creates); Benjamin Klein, Robert G. Crawford & Armen Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297, 308-24 (1978) (providing examples of resource integration).

¹⁸⁵ See Borden, *supra* note 24, at 951-56 (describing the inability to apply the assignment-of-income doctrine to arrangements that integrate property and services or services of multiple parties); Darryll K. Jones, *Toward Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1070-71 (2006) (recognizing the relationship between the assignment-of-income doctrine and the partnership allocation rules).

¹⁸⁶ See Borden, *supra* note 140.

porate tax rules address difficulties raised by integrating property and services.¹⁸⁷ In the case of tenancies-in-common, the classification question should be whether the arrangement needs the partnership tax accounting and reporting rules.

By allowing co-owners to provide customary tenant services, the IRS's guidance ignores partnership tax theory and the definition of tax partnership. If a co-owner provides customary tenant services, the co-owners can no longer trace income from its sources and must use allocation rules to determine the co-owners' shares of the arrangement's income.¹⁸⁸ By allowing such activities, the IRS's guidance appears to misinterpret existing laws that permit co-owners to pay third-party managers market value to provide customary tenant services.¹⁸⁹ That allowance does not frustrate the parties' ability to trace income from its source.¹⁹⁰ If parties to an arrangement are able to accurately trace income from the contributed resource to the contributor, the arrangement does not need the partnership tax rules.¹⁹¹ Instead, the arrangement should allocate income to parties based upon the resources they own. As owners of the property, the co-owners can have income only from the property, and the service provider can have income only from services.¹⁹² Allowing the co-owners to provide customary tenant services would frustrate the ability to trace income from its source.

The ability to trace income from property to the owners of property justifies disregarding tenancies-in-common for tax purposes. Each co-owner has an interest in property and, as a general rule, is entitled to a proportionate share of income from the property.¹⁹³ Be-

¹⁸⁷ See *id.* (discussing the current tax classification rules and how they should distinguish between different business arrangements, even though they may fall short under the current regime).

¹⁸⁸ See *id.*

¹⁸⁹ See Rev. Rul. 75-374, 1975-2 C.B. 261 (ruling that a co-ownership arrangement was not a tax partnership even though the co-owners paid a manager fair market value to provide customary tenant services).

¹⁹⁰ Service providers can trace income from their services and property owners can trace income from the property they own, so they do not need allocation rules. See Borden, *supra* note 140.

¹⁹¹ See Borden, *supra* note 140.

¹⁹² See Borden, *supra* note 140 (using an example of an apartment owner and manager to describe the ability to allocate income from its source in the case of arrangements where parties retain the unitary residual risk of the respective resources).

¹⁹³ See *infra* text accompanying notes 221-29 (describing the rights a tenant-in-common generally has in property). The general rule is that each co-owner is entitled to a proportionate share of the property's income, even though parties may have the right to offset for expenses incurred in maintaining the property and may not be made whole until they dispose of the property.

cause the parties can trace income directly from their interests in the property, they do not need the partnership tax accounting and reporting rules, and those rules should be off limits to such arrangements.¹⁹⁴ Thus, the guidance should prohibit the co-owners from providing any service with respect to the property, but allow them to hire a third party to provide customary tenant services for fair market compensation. It disregards tax law by allowing co-owners to provide customary tenant services.

Co-owners of open tenancies-in-common generally hire a third party to manage the property.¹⁹⁵ The IRS's guidance permits any person other than lessees to manage the property.¹⁹⁶ The IRS, however, limits the manner in which the co-owners may compensate the manager; specifically, the IRS's guidance prohibits the manager from sharing in the profits or income of the property.¹⁹⁷ This rule apparently derives from the joint-profit test of the definition of tax partnership.¹⁹⁸ Apparently, the IRS is concerned that if a manager performs the services for a percentage of the profits or income of the arrangement, the manager could be deemed to be a partner.¹⁹⁹ Several courts have, however, found that a tax partnership does not exist, even though a service provider shares profits with property owners.²⁰⁰ Thus, profit sharing alone does not establish that an arrangement is a

¹⁹⁴ See Bradley T. Borden, *Policy and Theoretical Dimensions of Qualified Tax Partnerships*, 56 U. KAN. L. REV. 317, 367–68 (2008) (reasoning that access to the partnership tax accounting and reporting rules should not be elective).

¹⁹⁵ See *supra* text accompanying note 7 (recognizing that co-owners of open tenancies-in-common seek to relieve themselves of the three Ts of property ownership).

¹⁹⁶ See Rev. Proc. 2002-22, § 6.12, 2002-1 C.B. 733. The IRS's guidance provides that co-owners may hire a co-owner or any party related to the co-owner to manage the property, but to be consistent with the other condition, the IRS must anticipate that any services a co-owner (or party related to the co-owner) provides will be limited to allowed customary tenant services. *Id.* The IRS's guidance also permits the manager to maintain a common bank account but requires the manager to disburse funds within three months after receiving them. See *id.*

¹⁹⁷ See *id.* (requiring further that the fee paid to a manager not exceed the fair market value for the manager's services).

¹⁹⁸ See Borden, *supra* note 24, at 984–91 (describing the joint-profit test as a test that excludes from the definition of tax partnership arrangements that lack a joint profit motive).

¹⁹⁹ See Rev. Proc. 2002-22, § 2, 2002-1 C.B. 733 (citing *Bergford v. Comm'r*, 12 F.3d 166 (9th Cir. 1993) and the manager's share of profits as authority for tax partnership treatment of arrangements with profit-sharing).

²⁰⁰ See, e.g., *Luna v. Comm'r*, 42 T.C. 1067, 1078–79 (1964) (holding that a profit-sharing arrangement between an insurance agent and the insurance company was not a tax partnership); *Copeland v. Ratterree*, No. 5215, 1957 U.S. Dist. LEXIS 4556, at *13 (N.D.N.Y. July 23, 1957) (holding that control, not profit-sharing, is important in determining whether an arrangement is a tax partnership).

tax partnership. If the compensation paid to the manager reflects fair market value, its dependence on profits should not matter in determining what the manager owns.²⁰¹ The IRS thus adds a restriction that is not found in the common law definition of tax partnership. Perhaps the IRS erred on the side of caution in prohibiting profit sharing with managers, but its rule has significant economic ramifications.

Often, ownership and management are combined in close business arrangements but are separated in open business arrangements.²⁰² Parties separate ownership and control to obtain the benefits of specialized capital allocation and specialized management.²⁰³ Owners will often share profits with managers or grant them an ownership interest to reduce agency costs and to help ensure that their divergent interests align.²⁰⁴ The IRS's guidance allows co-owners to grant ownership interests to a manager who provides only customary tenant services, but forbids profit sharing.²⁰⁵ Thus, the guidance violates the tax definition of tenancy-in-common and prohibits the use of profit sharing to align the interests of owners and managers. If managers do not have an ownership interest, the anticipated consequence of the profit-sharing restriction is that managers will

²⁰¹ See Stanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical Integration*, 94 J. POL. ECON. 691, 694-95 (1986).

²⁰² See EASTERBROOK & FISCHEL, *supra* note 21, at 228-29 (providing that a common feature of close corporations is that principal investors often manage the corporation). Describing the differences between control features in a large public corporation and a closely held corporation, Professor Moll states:

In the traditional public corporation, the shareholder is normally a detached investor who neither contributes labor to the corporation nor takes part in management responsibilities. In contrast, within a close corporation, a more intimate and intense relationship exists between capital and labor. Close corporation shareholders usually expect employment and a meaningful role in management, as well as a return on the money paid for [their] shares.

Moll, *supra* note 21, at 888 (citations and quotations omitted).

²⁰³ See Fama & Jensen, *supra* note 178, at 312 ("[S]ince decision skills are not a necessary consequence of wealth or willingness to bear risk, the specialization of decision management and residual risk bearing allowed by unrestricted common stock enhances the adaptability of a complex organization to changes in the economic environment.").

²⁰⁴ See EASTERBROOK & FISCHEL, *supra* note 21, at 232-33 ("Compensation agreements link changes in managers' wealth to performance of the firm, which reduces though it cannot eliminate the divergence of interest implied by the separation of management and risk bearing."); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 323 (1976) (recognizing that firms use compensation to help reduce agency costs).

²⁰⁵ Rev. Proc. 2002-22, §§ 6.11, 6.12, 2002-1 C.B. 733 (allowing co-owners to provide customary tenant services, but prohibiting profit sharing with managers).

act in their own self-interest to the detriment of the owners. Indeed, a recent lawsuit brought against the promoters of several open tenancies-in-common suggests that managers may have followed that predictable course.²⁰⁶

If the co-owners cannot use traditional mechanisms such as shared ownership or profit sharing, government regulation should help align parties' interests. Fortuitously, securities regulation helps fill the gap the IRS's guidance creates.²⁰⁷ Stringent penalties under the securities laws help motivate promoters to disclose their performance with respect to other properties they manage and to disclose all information about the property in the offering.²⁰⁸ Such disclosure provides information that will likely influence investor behavior. For example, prior mismanagement will destroy a promoter's reputation and make capital more expensive in future offerings.²⁰⁹ Disclosing prior performance would therefore appear to dissuade investment. Thus, the securities laws help compensate for an apparent deficiency in the IRS guidance. With no indication from the IRS that this was its intent, the gap filling appears to be a coincidence.

²⁰⁶ See generally Complaint, Spann Trust v. DBSI Inc., No. CV OC 0820435 (Idaho Dist. Ct. Oct. 27, 2008) (alleging that the promoters of nonsecuritized open tenancies-in-common committed several counts of fraud regarding various aspects of the offering and property).

²⁰⁷ The application of securities laws appears fortuitous because, apparently, no evidence exists to suggest that the IRS contemplated the applicability of the securities laws.

²⁰⁸ For example, federal securities laws allow a person to rescind a purchase, if the seller used untrue statements of material facts or omits material facts in an offering.

Any person who offers or sells a security [through communication], which includes an untrue statement of a material fact or omits to state a material fact . . . , shall be liable . . . to the person purchasing such security from him, who may sue . . . to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Securities Act of 1933 § 12(a), 15 U.S.C. § 771(a) (2000).

²⁰⁹ Judge Easterbrook and Professor Fischel recognize the efficiency of capital markets, which should apply similarly to other markets, such as the open tenancy-in-common market.

Few markets are as efficient as capital markets. Poor performance leads the markets to respond in ways that bring the costs home to the managers. First, investors (both informed and uninformed) will pay less for shares. The more investors believe that their dollars will be used by those in control of firms in ways inconsistent with maximizing the value of the firm, the less they will pay for shares. To minimize this rational fear, those in control have incentives to adopt governance mechanisms that limit their discretion to benefit at the investors' expense.

EASTERBROOK & FISCHEL, *supra* note 21, at 96.

The IRS's guidance also prohibits a lessee from paying rent as a percent of income or profits derived by any person from the property.²¹⁰ This prohibition apparently derives from the joint-profit test of tax partnership classification.²¹¹ However, the joint-profit test does not definitively answer whether an arrangement is a tax partnership,²¹² so the IRS's absolute prohibition is not consistent with the definition of tax partnership. The prohibition also limits the types of arrangements that co-owners may use to reduce lessee opportunistic behavior. The inability to share tenant income may place members of open tenancies-in-common at a disadvantage in the market.

Property owners and tenants commonly use revenue-sharing arrangements to automatically adjust rent payments to reflect changes in the market and to share the risks of owning and using the property.²¹³ For example, if the tenant's business improves, the rental agreement may provide that the co-owner will receive more rent. The lease also could provide for reduced rental payments if business slows down. The reason for such provisions in leases is that a tenant's income is often both a function of the tenant's efforts and the property. Without such mechanisms, members of tenancies-in-common may be unable to attract some tenants in periods of escalating rents and may witness greater rental delinquencies in periods of declining rents. Although the IRS's guidance does not prohibit co-owners to determine rent as a percentage of revenue, determining whether an

²¹⁰ Rev. Proc. 2002-22, § 6.13, 2002-1 C.B. 733. Leasing arrangements must be bona fide leases for federal tax purposes and must reflect the fair market value for the use of the property. *Id.* The amount of rent may depend upon a fixed percentage of receipts or sales, but it may not depend upon "net income from the [p]roperty, cash flow, increases in equity, or similar arrangements." *Id.*

²¹¹ See Borden, *supra* note 24, at 984-91 (describing the use of the joint-profit test); *supra* text accompanying notes 197-201 (discussing the joint-profit test and the IRS prohibition of profit-sharing with managers).

²¹² See *Luna v. Comm'r*, 42 T.C. 1067, 1078-79 (1964); *Copeland v. Ratterree*, No. 5215, 1957 U.S. Dist. LEXIS 4556, at *1 (N.D.N.Y. 1957).

²¹³ See *Harlan E. Moore Charitable Trust v. United States*, 9 F.3d 623, 625 (7th Cir. 1993) ("Leases that no one would doubt were bona fide involve some, and sometimes considerable, sharing of business risks between landlord and tenant to their mutual benefit.").

[Percentage rent] is common, economists conjecture, in part because it shares with partnerships the agreeable feature of risk sharing, . . . (this as we said is a common function of leases and does not transform them into partnerships), in part because it reduces the cash-flow demands of the tenant (so it is a form of lending by landlord to tenant).

Id. at 626; WILLIAM B. BRUEGGEMAN & JEFFREY D. FISHER, *REAL ESTATE FINANCE AND INVESTMENTS* 258-61 (13th ed. 2008) (describing various methods, including percentage rent, that parties use to determine rents).

arrangement is a revenue-sharing arrangement and not a profit-sharing arrangement may be difficult.²¹⁴

The master-lease structure provides an opportunity for co-owners to allow others to share in increased rental income, without sharing profits or income.²¹⁵ Under such a structure, the promoter forms an affiliated entity (a master tenant) to lease the property from the co-owners.²¹⁶ If the rents increase, the master tenant may pay a rental bonus to the co-owners.²¹⁷ If the rent decreases below the costs of managing the property the master tenant will become insolvent and stop making rental payments to the co-owners.²¹⁸ Such structures allow the tenants to share in the upside of rental increases and to bear the risk of market downturns. Furthermore, the IRS guidelines do not appear to restrict the master tenant's sharing of profits with subtenants. Thus, although a master-lease structure may not be a pure profit-sharing arrangement with the co-owners, it does allow them to share in the arrangement's financial performance with others. Such arrangements may be more consistent with the tax definition of tenancy-in-common than the IRS's guidance.

The IRS's guidance provides that co-owners must share revenue and expenses of the property in proportion to their undivided interests in the property.²¹⁹ That requirement represents another deviation from common law. Common law provides fairly sophisticated rules that determine co-owners' shares of the profits and expenses of the property.²²⁰ Common law allows co-owners to enforce their rights to profits or expenses through an action for waste, contribution, or accounting.²²¹ The rules have a degree of vagueness because co-owners may settle differences through the equitable remedy of partition and courts hesitate to assume a supervisory role in ongoing co-ownership relationships.²²² The rules do not, however, provide that the co-owners must share revenues and expenses from the property

²¹⁴ See *Harlan E. Moore Charitable Trust*, 9 F.3d 623 (deciding that a crop-sharing arrangement was not a profit-sharing arrangement, even though the landlord paid some of the costs of farming the property).

²¹⁵ See *supra* text accompanying notes 76–85 (explaining the master-lease structure).

²¹⁶ Private Placement Memorandum—M.L., *supra* note 49.

²¹⁷ *Id.*

²¹⁸ *Id.*

²¹⁹ Rev. Proc. 2002-22, § 6.08, 2002-1 C.B. 733.

²²⁰ See generally Weible, *supra* note 114. (describing tenants' rights to revenue and responsibility for expenses of the property).

²²¹ Orth, *supra* note 30, § 32.07.

²²² *Id.*

in proportion to their undivided interests in the property. A co-owner's right to income from the property or obligation to pay expenses of the property often depends upon whether the co-owner is in possession of the property.

Under common law, nonpossessing co-owners generally are not entitled to rent from co-owners who take possession of the property because all co-owners have a right to possession.²²³ Instead of claiming a right to rent, a nonpossessing co-owner may take possession of the property.²²⁴ A nonpossessing co-owner may, however, offset fair rental value if a possessing co-owner makes expenditures with respect to the property and seeks to recover a share of the expense through an action of contribution.²²⁵ An ousted co-owner who brings an action for accounting may be entitled to the fair rental value for the ousted co-owner's interest in the property.²²⁶ In the absence of an action for contribution or ejectment, however, the possessing co-owner may enjoy the actual economic benefit of possessing the property. Because a nonpossessing co-owner may not receive a benefit from the property while the possessing co-owner enjoys possession, the common law does not appear to require proportionate sharing of revenue.

A co-owner who makes a payment necessary for the preservation of title, such as property taxes or mortgage payments, may recover a portion of the payment from other co-owners in an action for contribution only if the jurisdiction makes the co-owners personally liable for such payments.²²⁷ If the jurisdiction provides that payments are only a charge against the property, the co-owner who makes payments may be able to recover a portion of the expenditures as a defensive offset in an action for accounting for rents collected from the property or in a partition action.²²⁸ Finally, if the co-owner who makes payments is in sole possession of the property, the nonpossessing co-owner may offset the value of sole possession against claims for contribution.²²⁹ The common law therefore does not require proportionate sharing of expenses, and if offset is the only recourse against a

²²³ Weible, *supra* note 114, at 559.

²²⁴ Orth, *supra* note 30, § 32.07(c).

²²⁵ See Weible, *supra* note 30, at 566-75.

²²⁶ See *id.* at 558.

²²⁷ Orth, *supra* note 30, § 32.07(b).

²²⁸ *Id.* (recognizing that the expense-paying co-owner may "attain the same economic result by equitable liens so that in case of partition (in kind or by sale and division of the proceeds) or in an action of accounting the tax-paying cotenant will be compensated"); Weible, *supra* note 114, at 567.

²²⁹ Orth, *supra* note 30, § 32.07(b)-(c).

non-possessory co-owner, a significant amount of time could elapse between the payment and recovery.

The greater sophistication of open tenancies-in-common suggests that co-owners would include revenue- and expense-sharing provisions in the agreement instead of relying upon common-law remedies.²³⁰ Because the IRS's guidance generally prohibits co-owners from managing or leasing the property, they each should have similar ownership interests in the property. As a result, it would be a very unusual situation (e.g., where a co-owner provides customary tenant service) in which the co-owners consider anything other than proportionate sharing of the revenue and expenses of the property. Therefore, even though co-owners of close tenancies-in-common may not agree to share revenue and expenses proportionately, co-owners of open tenancies would likely always agree to do so, even without the requirement in the IRS's guidance.²³¹ Consequently, the guidance's deviation from the common law may be immaterial.²³²

The IRS's guidance generally prohibits co-owners from advancing funds to each other to cover expense contributions.²³³ This prohibition also deviates from the common law rule, which may deny an action for contribution by a co-owner who is in possession of the property.²³⁴ The denial of contribution creates a de facto loan granting the injured co-owner an equitable lien; on disposition or in an action for accounting, the party seeking contribution may recover the

²³⁰ Indeed, the co-ownership documents for both the managed property and the master-lease structures include revenue and expense sharing provisions.

²³¹ A dissatisfied owner of an interest in an open tenancy-in-common should be able to enforce the agreement and require a distribution of revenue. In fact, the IRS guidelines require the manager of an open tenancy-in-common to distribute revenue (net of expenses) from the property to the co-owners within three months after receiving the revenue. Rev. Proc. 2002-22, § 6.12, 2002-1 C.B. 733. That requirement should help nullify the actions for contribution and accounting.

²³² It would, however, result in allocations that do not reflect economic reality if a co-owner provides customary tenant services. A co-owner who provides customary tenant services should be allocated a share of revenue (or decreased share of expenses) to reflect compensation for the services. Proportionate sharing of revenue and expenses would not account for the services, unless the co-owners pay the service provider fair market value. Tax law should account for allocations that do not reflect economic reality. See Bradley T. Borden, *Partnership Tax Allocations and the Internalization of Tax-Item Transactions*, 59 S.C. L. REV. 297, 333-44 (2008). This issue reveals another reason why tax law should treat an arrangement as a tax partnership if an owner contributes services to the arrangement.

²³³ Rev. Proc. 2002-22, § 6.08, 2002-1 C.B. 733. The guidelines allow a co-owner to borrow funds needed to meet expenses associated with the co-ownership interest from another co-owner, the sponsor, or the manager only if the borrower accepts individual liability for the loan and it does not exceed thirty-one days. *Id.*

²³⁴ Orth, *supra* note 30, § 32.07(b).

requested payments if appropriate.²³⁵ Thus, the IRS prohibition appears to deviate from the common law of tenancies-in-common, which allows equitable liens.

The IRS's guidance also limits the parties from whom co-owners may borrow against the property and their respective interests therein. Specifically, with respect to any debt encumbering the property or any debt incurred to acquire an interest in the property, the lender cannot be a person related to a co-owner, the sponsor, the manager, or a lessee of the property.²³⁶ This restriction should relate to the definition of tax partnership, but, as with many provisions in the guidance, such relationships appear tenuous. If a loan is negotiated at arm's length and at fair market rates, it should not affect the classification of the arrangement, regardless of the relationship between the lender and the co-owner or the role the lender plays in the arrangement. As with the rules regarding lease arrangements, this rule places members of open tenancies-in-common at a competitive disadvantage. Members of other arrangements may borrow from related parties without adversely affecting the arrangement's classification. The limits the IRS's guidance placed on co-owners may increase their costs of capital by limiting sources of financing.

The IRS's prohibition against inter-co-owner lending finds little support in economic theory. A lender who takes a security interest in the property of a borrower also takes an interest in the property but does not become an owner of the property. The lender may require the borrower to seek lender approval before transferring, leasing, improving, or further encumbering the property. Thus, by granting a security interest, the borrower transfers some rights with respect to the property and may subject the property to some lender restrictions. Nonetheless, the borrower retains all rights not contracted away to the lender.²³⁷ Therefore, at the termination of the security interest, the borrower would have full control of the property and should be the owner of the property.²³⁸ The source of the loan should not affect that analysis, and the IRS overreaches by prohibiting inter-co-owner loans.

The management features that derive from the IRS's guidance leave much to be desired. First, the guidance restricts the co-owners' tendency to use profit sharing to influence manager behavior. Second, it places open tenancies-in-common at a competitive disadvan-

²³⁵ *Id.*

²³⁶ Rev. Proc. 2002-22, §6.14, 2002-1 C.B. 733.

²³⁷ See Grossman & Hart, *supra* note 201, at 695.

²³⁸ *Id.* at 694.

tage by restricting the manner in which they may charge rent. Finally, it limits the source of financing for open tenancies-in-common. The damage appears to be gratuitous because the tax definition of tenancy-in-common neither prohibits profit sharing with managers or tenants, nor does it restrict sources of financing. The IRS should, therefore, revisit the guidance and make adjustments as necessary to conform with partnership tax law and theory.

C. Marketability Features

The common law has traditionally accepted vague accounting and distribution rules for tenancies-in-common because dissatisfied co-owners could sell their interests or bring partition actions to terminate the relationship and receive an equitable portion of sale proceeds.²³⁹ The IRS's guidance imposes strict accounting and distribution rules, but it expressly requires co-owners to retain the right to dispose of their interests and partition the property.²⁴⁰ It then allows certain agreements that could help deter or prevent dispositions and partition actions. For example, other co-owners or the promoter may acquire an option to obtain an interest from a co-owner who contemplates selling an interest or partitioning the property.²⁴¹ Such arrangements could nullify the stated right to dispose of an interest or partition the property. The IRS's guidance thus appears to recognize that strict accounting and reporting rules somewhat diminish the need for free transferability and an absolute right to partition the property. As long as co-owners have an ostensible right to partition the property, however, the co-owners will be concerned about who joins the arrangement. They will, therefore, use tools at their disposal to restrict the transfer of interests. Restricted transferability distinguishes open tenancies-in-common from open business arrangements.

Several conditions in the IRS's guidance affect the marketability of interests in open tenancies-in-common. At first blush, the marketability features appear most concerned with preserving the alienability of co-ownership interests and the co-owners' rights to property—features the IRS apparently believes are paramount to a tenancy-in-

²³⁹ Orth, *supra* note 30, § 32.07.

²⁴⁰ Rev. Proc. 2002-22, §6.08, 2002-1 C.B. 733 (requiring proportionate sharing of revenue and expenses and the distribution of net revenues within three months after the date of the receipt of the revenues); *Id.* § 6.06 (requiring co-owners to retain the right to transfer, partition, and encumber their respective interests).

²⁴¹ Co-owners may grant rights of first offer and first refusal, *id.* § 6.06, or call options in their interests, *id.* § 6.10.

common classification. The marketability features thus limit the type of restrictions co-owners can place on each other's ability to dispose of property or partition it.²⁴² Transferability is a prominent feature of traditional tenancies-in-common.²⁴³ It stands in stark contrast to the restrictions members of close business arrangements commonly place on ownership interests.²⁴⁴ The purpose of transfer restrictions in close business arrangements is to keep ownership within a small control group—control being one of two primary concerns in close corporations.²⁴⁵ Members of close tenancies-in-common may have similar desires if they are fully informed when acquiring their interests. Restricting transferability of interests and the right to partition would eliminate a traditional remedy available to co-owners and require other remedies to fill the void. Tax theory does not, however, suggest that limitations on transferability and void-filling remedies should dictate an arrangements' classification.

Co-owners of close tenancies-in-common would appear to be motivated by conditions similar to those that motivate members of close business arrangements to restrict transfers of interests. Co-owners would generally prefer to choose the persons with whom they will co-own the property. Transferability of interests prevents members of close tenancies-in-common from choosing their co-owners. Nonetheless, the common law appears to prevent tenants in common from imposing such restrictions. Even if co-owners choose the persons with whom they originally form a tenancy-in-common, the inability to restrict transferability prohibits them from choosing future co-owners. Co-owners cannot control who will own other interests in the property, but they may sell their own interests if they become dissatisfied with other owners. If selling the interest is not feasible, a co-owner can bring an action of partition to either receive a portion of the property in severalty or a portion of the proceeds from the sale of the property.²⁴⁶ Thus, close tenancies-in-common invert the transferability feature commonly found in close business arrangements and

²⁴² *Id.* § 6.06 ("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."). The IRS's guidance does not however prohibit restrictions on the right to transfer, partition, or encumber interests in the property—if a lender requires such restrictions and the restrictions are consistent with customary commercial lending practices. *Id.*

²⁴³ See Orth, *supra* note 30, § 32.02.

²⁴⁴ See EASTERBROOK & FISCHER, *supra* note 21, at 889–92.

²⁴⁵ See Moll, *supra* note 21, at 889–92. Liquidity is the other primary concern. *Id.*

²⁴⁶ Orth, *supra* note 30, § 32.07.

subject themselves to the possibility of owning the property with undesirable co-owners.

As business arrangements grow and ownership and management begin to diverge, transfer restrictions lose their appeal. Owners of open business arrangements generally prefer free transferability of interests because it encourages investment in the arrangement and performs a monitoring function. Freely transferable interests are attractive to investors because the transferability provides a form of liquidity.²⁴⁷ Free transferability performs a monitoring function because managers' desire for inexpensive capital motivates them to act in the best interest of shareholders to attract cheap capital. The free transferability of ownership creates a market for the interests, and the market value of the interests reflects the performance of management and helps align management's interests with the owners' interests.²⁴⁸ Thus, free transferability of interests often distinguishes open and close business arrangements and fulfills an important role for open business arrangements.

Free transferability of interests in open tenancies-in-common is a very unattractive feature because the members also have a right to partition the property. Property held in open tenancies-in-common generally will not be suitable for partition in kind. For example, commercial or residential rental property (such as an office building or an apartment complex) generally does not lend itself to physical partition; partition by sale and distribution of proceeds may result in a sale below the price the property could attract through a routine market sale. Consequently, the co-owners of open tenancies-in-common will insist upon restricting the right to partition the property or will restrict the right that other co-owners have to dispose of the property in order to control who becomes a co-owner. Restricting the right to dispose of the property will have limited effect in an open tenancy-in-common. The co-owners in an open tenancy-in-common are not familiar with each other, and they do not know each other's tendencies. They may join an arrangement with others who are inclined to partition the property. Thus, the right to partition is problematic in open tenancies-in-common and dampens the effect of transfer restrictions.

As stated above, the right to partition is an important remedy in close tenancies-in-common because other remedies are often vague and courts prefer not to interfere.²⁴⁹ The right to partition is less im-

²⁴⁷ See Hansmann et al., *supra* note 29, at 1376–77.

²⁴⁸ See *supra* note 209.

²⁴⁹ See *supra* text accompanying note 222.

portant in open tenancies-in-common that are structured pursuant to the IRS's guidance, because co-co-owners have a right, by agreement, to a proportionate share of the property's revenue and should receive that share regularly. They can bring a breach of contract action to enforce the agreement. Consequently, they do not need to use partition to enforce their rights to revenue. That being the case, the IRS's guidance should be able to dispense with the right-to-partition requirement. If the co-co-owners did not have a right to partition, restrictions on transferability would be less important. If the IRS eliminated the right-to-partition requirement co-owners may relax their transfer restrictions. Until the IRS removes the right-to-partition requirement, co-co-owners will look for ways to restrict transferability of interests.

The IRS's guidance allows co-co-owners of open tenancies-in-common to grant call options in their interests and to grant other co-owners the right of first offer or first refusal before selling an interest.²⁵⁰ These permitted arrangements grant co-owners some control over who will become co-co-owners after formation of the open tenancy-in-common. The co-owners' control cannot, however, exceed the resources they have available to acquire the interests of a departing co-co-owner. Consequently, the ability to restrict transferability through rights to acquiring interests may be limited. The inability to effectively restrict transfer, and the owners' right to partition, may ultimately affect the attractiveness of interests in open tenancies-in-common.

The IRS does not explain its reasoning for requiring free transferability and the right to partition. Presumably, the IRS had in mind the alienability and partition features of common-law tenancies-in-common. Perhaps it reasoned that an arrangement could not be a tenancy-in-common for tax purposes, unless the interests in the arrangement were transferable and the co-co-owners had the right to

²⁵⁰ See Rev. Proc. 2002-22, § 6.06, 2002-1 C.B. 733 (allowing rights of first offer and first refusal,); *id.* at § 6.10 (allowing co-owners to grant call options in their interests). The right of first offer grants the holder of the right the first opportunity to offer to purchase an interest, in the event the owner of the interest decides to sell the interest. *Id.* § 6.06. The owner of an interest grants a right of first refusal to another person by agreeing to offer the interest to such other person before exercising the right to transfer the interest. The IRS's guidance appears to distinguish between rights of first offer and rights of first refusal, limiting the use of the right of latter to situations in which a co-owner contemplates partition. See *id.* Some commentators question whether there is any practical distinction between a right of first offer and right of first refusal. See Borden & Wyatt, *supra* note 1, at 20-21. Thus, the distinction the IRS appears to draw may be meaningless in practice.

partition.²⁵¹ Transferability of interests does not, however, make an arrangement a tenancy-in-common. As stated above, a common feature of open business arrangements is transferability of interests.²⁵² In fact, free transferability is a relic of the entity-characteristic classification regime.²⁵³ Ironically, under the old classification regime, free transferability was an arrangement constituting a tax corporation. Transferability of interests no longer distinguishes tax partnerships from tax corporations.²⁵⁴ Close business arrangements with transfer restrictions can be either tax corporations or tax partnerships. Similarly, open business arrangements with publicly-traded interests can be either tax partnerships or tax corporations.²⁵⁵ Just as the other entity characteristics should not govern the tax classification of open tenancies-in-common,²⁵⁶ neither should transferability.

Tax policy does not suggest that an arrangement with restricted transferability of interests should be a business arrangement. If the members of an arrangement can determine their shares of income from the arrangement without computing income at the arrangement level, they do not need one of the tax regimes that govern business arrangements.²⁵⁷ Thus, tax policy does not explain the IRS's transferability requirement. The use of mechanisms in the co-ownership and management agreements that minimize the threat of sale or partition indicates that open tenancy-in-common co-owners prefer transfer and partition restrictions. The use of such restrictions is likely a reaction to the right-to-partition requirement.

Because tax theory does not require co-owners to have the rights to partition for an arrangement to be a tenancy-in-common, the IRS could remove the right-to-partition requirement from its guidance. Doing so would solve the issue related to free transferability. If co-owners did not have to concern themselves with others partitioning the property, they would be less concerned about who joined the arrangement as a co-owner. Consequently, they would naturally relax restrictions on alienability. That would provide an additional check on management performance. Co-owners would not demand the

²⁵¹ See Orth, *supra* note 30, § 32.02.

²⁵² See *supra* text accompanying notes 247–28.

²⁵³ See Treas. Reg. § 301.7701-2(a)(1)(vi) (1960).

²⁵⁴ See *id.* §§ 301.7701-1 to 301.7701-3 (as amended in 2006).

²⁵⁵ I.R.C. § 7704(a) (2000). Tax law will, however, treat some publicly traded partnerships and limited liability companies as tax corporations, but that determination does not depend upon the transferability of the arrangement's interests. See *id.*

²⁵⁶ See *supra* text accompanying notes 171–77 (discussing the inappropriate use of entity characteristics for classifying tenancies-in-common).

²⁵⁷ See Borden, *supra* note 140.

right to partition because they have other remedies under the co-ownership arrangement. Thus, the IRS should remove the right-to-partition requirement from its guidance.

Even with the right to partition, another impediment would stand in the way of free transferability of interests. As discussed above, the IRS's guidance requires unanimous consent for some actions.²⁵⁸ All other actions require approval by co-owners owning a majority of interests in the property.²⁵⁹ The unanimous-consent requirement, in particular, presents potential for a minority holdup. The co-owner with the smallest ownership interest can hold up the hiring of a manager, the entrance of a new tenant, and financing arrangements.²⁶⁰ Such potential makes open tenancy-in-common interests less attractive. To prevent such possibilities, co-owners or managers will acquire call options in all interests. If a minority co-owner threatens to hold up a decision requiring unanimous approval, the other co-owners or manager may prevent the hold up by exercising the call option. Such options restrict transferability of interests.

The unanimous-consent requirement and the right-to-partition requirement create incentives for co-owners to restrict the transferability of interests in open tenancies-in-common. Those incentives run contrary to the IRS's free-transferability requirement because co-owners will use call options and other permissible mechanisms to prevent partition of the property and minority holdup. Because tax theory does not require tenancies-in-common to grant partition rights or require unanimous consent, the IRS should consider eliminating those requirements to help eliminate the transfer restrictions that co-owners implement.

IV. FUTURE OF OPEN TENANCIES-IN-COMMON

The recent market downturn has diminished the demand for open tenancies-in-common.²⁶¹ The rhetoric growth and recent diminished demand for open tenancies-in-common raise several questions about their relevance. First, are open tenancies-in-common vi-

²⁵⁸ See *supra* text accompanying notes 159.

²⁵⁹ Rev. Proc. 2002-22, §6.05, 2002-1 C.B. 733.

²⁶⁰ See *id.*

²⁶¹ See *TIC Industry Quarterly Statistics*, TIC|TALK Q. (Omni Research & Consulting, LLC, Salt Lake City, Utah) Fall 2008 at 4. (revealing that total equity invested in securitized open tenancies-in-common in through the first two quarters of 2008 was no more than \$800 million, a small fraction of the \$3.7 billion peak in 2006—assuming sustained performance through the end of 2008, the total 2008 investment in securitized open tenancies-in-common would be less than fifty percent of the 2006 amount).

able absent the section 1031 tax preference? Second, assuming tax law continues to favor interests in open tenancies-in-common, should tax law preserve the cumbersome, and often uneconomic, structures of open tenancies-in-common? Finally, are aspects and innovations of open tenancies-in-common transferable to close tenancies-in-common?

A. *Viability in Absence of Section 1031 Benefits*

As discussed above, open tenancies-in-common are the brain child of entrepreneurial real estate syndicators who seized an opportunity to provide accessible section 1031 replacement property to a particular market segment.²⁶² Generally, open tenancy-in-common investors are property owners looking to relieve themselves of property management responsibilities, preserve the value of their property through section 1031 gain deferral, and maintain or improve the return they have been realizing on their investments. Because investors generally can find similar non-tax characteristics in other real estate investment vehicles, section 1031 appears to influence the choice to invest in open tenancies-in-common. Some investors consider the front-end tax consequences of the investment in an open tenancy-in-common. Those investors want to invest section 1031 proceeds in real estate to avoid tax on the disposition of their relinquished property. Other open tenancy-in-common investors may be attracted by the back-end tax consequences. The tax classification of open tenancies-in-common enables the investors to dispose of an open tenancy-in-common interest tax free, if they reinvest the sales proceeds in like-kind real property. Consequently, some open tenancy-in-common investors bring non-exchange money to open tenancies-in-common, but they consider the back-end tax consequences when making the investment. Thus, section 1031 motivates both front-end and back-end open tenancy-in-common investors.

Because open tenancies-in-common focus primarily on the tax benefits of section 1031, one thesis is that they would not exist but for section 1031. To test that thesis, consider what an investor would do if section 1031 did not benefit open tenancies-in-common. Assume Olivia owns real property that she manages. Olivia decides to divest the property to relieve herself of property-management responsibilities. Assuming section 1031 does not grant preference to open tenancy-in-common interests, Olivia will recognize taxable gain on the disposition, regardless of where she invests the proceeds from the sale

²⁶² See *supra* text accompanying notes 9–12.

of her property. She wants to reinvest in real estate, but she does not want to have any management responsibilities. She has decided that the best way to obtain her objectives is to invest in some form of open real estate ownership arrangement. Her investment choices include an open tenancy-in-common, an interest in a limited partnership holding real estate, or stock in a real estate investment trust (REIT).²⁶³ Various factors will affect Olivia's reinvestment decision. For example, Olivia will likely consider the liquidity of the interest she acquires, the extent to which co-owners control or influence the manager, her exposure to liability, the simplicity of the arrangement, and the tax treatment of the various alternatives.

The three alternatives offer varying degrees of liquidity. An interest in a publicly-traded REIT would provide significant liquidity. Although interests in open tenancies-in-common are ostensibly transferable, they may have no secondary market, and transfer restrictions may make dispositions of open tenancy-in-common interests difficult. The threat of a rogue co-owner threatening to partition the property would also negatively affect the marketability of an interest. The interest in the limited partnership may be publicly traded, and, therefore, it may be very marketable.²⁶⁴ If interests in the limited partnership are publicly traded, however, her investment would be liquid. Thus, if Olivia prefers a liquid investment, her choice will be between the interest in a publicly-traded REIT and a publicly-traded limited partnership. An interest in an open tenancy-in-common would be less liquid because a secondary market for such interests has not developed, and it would be subject to some transfer restrictions.²⁶⁵

Although Olivia will be one of numerous members of the arrangement in which she invests, she will likely be concerned about the extent to which co-owners may control or influence management. In typical open business arrangements that separate ownership from management, owners often use profit sharing and equity compensation to help align managers' interests with the owners.²⁶⁶ Thus, even though individual members may not carry significant influence, as a

²⁶³ A REIT is a tax-favored real estate ownership structure that can avoid entity level tax by distributing or reinvesting its income. See I.R.C. § 857(b) (2000). Members of REITs pay tax on income they receive from the REIT. See *id.* Therefore, REITs are not subject to the double-tax regime that applies to tax corporations.

²⁶⁴ See Larry E. Ribstein, *The Rise of the Uncorporation* 22-24 (Univ. Ill. Law & Econ. Pub. Research Working Paper No. LE07-026, 2007), available at <http://papers.ssrn.com/paper=1003790> (describing economic and legal attributes of publicly traded partnerships and REITs).

²⁶⁵ See *supra* text accompanying notes 250.

²⁶⁶ See *supra* note 204.

body, the owners may establish policies that help influence manager behavior. Co-owners of open tenancies-in-common cannot use profit sharing to influence manager behavior.²⁶⁷ Instead, co-owners vote annually to retain managers, but often a negative vote is subject to buyout provisions that could cost the dissenter an interest in the arrangement.²⁶⁸ The managers of open tenancies-in-common retain significant control over their rights to manage the property.²⁶⁹ Furthermore, the lack of a public market for interests in open tenancies-in-common may exert less pressure on managers to act in the best interests of the co-owners. Even though the promoters/managers must disclose their prior performance in offering memoranda, that information may travel slower than information relating to a publicly traded company. Thus, co-owners in open tenancies-in-common appear to have less influence over managers than do owners of other types of open real estate ownership arrangements. That would tend to lead Olivia to an investment form other than an open tenancy-in-common.

Olivia will likely wish to protect herself from liability arising from the management and ownership of the property. Each of the three alternatives can provide her liability protection. Owners of limited partnership interests and interests in REITs are protected by statutory limited liability.²⁷⁰ Co-owners of open tenancy-in-common interests can form wholly owned limited liability companies to hold their individual interests.²⁷¹ Because Olivia can obtain limited liability with any of the alternatives, liability protection likely would not influence her decision.

The arrangement's simplicity will be important to Olivia, because it will affect her understanding of the arrangement and the cost to structure and manage it. Open tenancies-in-common are contractual arrangements governed by common law. They require extensive documentation and do not have a long track record. Many questions

²⁶⁷ See Rev. Proc. 2002-22, § 6.12, 2002-1 C.B. 733.

²⁶⁸ See Confidential Private Placement Memoranda—P.M., *supra* note 49. Even though the dissenter may receive fair value for the interest, if the investor is unable to reinvest in like-kind property pursuant to section 1031, the tax liability of the transaction would diminish the benefit of the buyout.

²⁶⁹ See *supra* note 72.

²⁷⁰ See UNIF. LTD. P'SHIP ACT § 303, 6A U.L.A. 418 (2008) (providing that limited partners are not liable for partnership liabilities); MODEL BUS. CORP. ACT § 6.22 (2007) (providing that shareholders are not liable for acts or debts of the corporation).

²⁷¹ Such ownership does not frustrate the direct ownership requirement in the IRS's guidance. See Rev. Proc. 2002-22, § 6.01, 2002-1 C.B. 733 (allowing co-ownership through a disregarded entity).

still exist regarding legal aspects of open tenancies-in-common.²⁷² Limited partnerships and corporations are the product of state statutory law. State law may grant contractual freedom to members of such arrangements, but the law generally provides default rules for those areas not addressed in contracts.²⁷³ That statutory structure adds certainty to the formation, ownership, and management of such arrangements. Consequently, such arrangements are generally simpler than open tenancies-in-common. Furthermore, the prevalence and history of other arrangements make them more familiar to investors and advisors. Thus, Olivia will prefer the simplicity of the other arrangements over the open tenancy-in-common.

Finally, Olivia will consider the taxation of the various arrangements. If Olivia acquires an interest in a limited partnership, she will generally be taxed on her allocable share of partnership tax items in accordance with the partnership agreement.²⁷⁴ Partners may also benefit from allocations of partnership liabilities.²⁷⁵ Consequently, tax partnerships are attractive forms of business arrangements. REITs provide less tax latitude for allocating tax items, but they allow the owners to obtain a single level of taxation in any business form.²⁷⁶ Thus, if Olivia prefers an interest in a publicly traded company, she may prefer stock in a REIT. If Olivia acquires an interest in an open tenancy-in-common, she will be taxed on income from her interest in the property. The tax treatment of the various alternatives does not provide a definitive choice for Olivia. Each alternative has unique tax treatment, but no one single tax treatment is clearly better than the others in all situations. Olivia will have to choose from the various alternatives based upon her individual preferences.

This analysis does not conclusively identify the investment vehicle Olivia would choose in the absence of section 1031 nonrecognition. Simplicity, liquidity, and owner control favor the limited partnership and REIT investments. Tax aspects of the various arrangements do not factor in as a general matter. Consequently, simplicity, liquidity, and owner control indicate that Olivia would

²⁷² See *supra* text accompanying notes 123–211 (questioning whether state law will accept the classification of open tenancies-in-common).

²⁷³ See EASTERBROOK & FISCHER, *supra* note 21, at 237.

²⁷⁴ I.R.C. § 704(a) (2000). The IRS will respect allocations expressed in the partnership agreement if they have substantial economic effect. See § 704(b).

²⁷⁵ See *id.* § 752 (providing that changes in partners' shares of partnership liabilities are constructive contributions or distributions); Treas. Reg. § 1.752-2(b)(3) (as amended in 2006) (providing that partners may determine by contract which partner will bear the obligation of a partnership liability).

²⁷⁶ See *supra* note 263.

likely choose the limited partnership or REIT over the open tenancy-in-common, in the absence of the section 1031 benefit. This analysis indicates that without section 1031 benefits investors probably would not acquire interests in open tenancies-in-common. Thus, open tenancies-in-common do not appear to be viable without the section 1031 benefits. Nonetheless, there is no indication that section 1031 will disappear or cease to favor interests in open tenancies-in-common. Therefore, they will probably remain a viable part of the real estate market, and they deserve greater attention to help deal with their significant shortcomings.

B. Disregarded Multiple-Member Arrangements

The complexity of open tenancies-in-common is one disadvantage they present. The complexity stems in part from the IRS generally prohibiting the co-owners from owning the property indirectly through a commonly owned separate legal entity.²⁷⁷ By ruling that a multiple-member Delaware statutory trust, if properly formed and structured, may be disregarded for federal tax purposes,²⁷⁸ the IRS has already allowed a multiple-member legal entity to be an open tenancy-in-common. That ruling suggests that perhaps different legal entities (such as limited liability companies or limited partnerships)²⁷⁹ should also be disregarded, if properly formed and structured. The tax issue is whether an arrangement with a separate legal entity holding the property should be treated as a separate entity for tax purposes. If treated as a separate entity, the arrangement would be a tax partnership, and the interests could not qualify for section 1031 non-recognition.²⁸⁰ The definition of tax partnership should govern that

²⁷⁷ Other sources of complexity are the unanimous-consent and right-to-partition requirements discussed *supra* at text accompanying notes 159–79, 242–61.

²⁷⁸ See Rev. Rul. 2004-86, 2004-2 C.B. 191; *supra* Part II.C. (discussing the use of Delaware statutory trusts to own open tenancy-in-common property).

²⁷⁹ Some states allow the formation of limited partnerships with the general partner taking no economic interest in the arrangement. See, e.g., TEX. BUS. ORGS. ANN. § 153.101(c) (Vernon 2006). Such a structure would permit a nonowner to manage the property.

²⁸⁰ See I.R.C. § 1031(a)(2)(D) (2000) (excluding partnership interests from assets eligible for section 1031 nonrecognition); Treas. Reg. § 301.7701-1 (as amended in 2006) (providing a general definition of separate entity); Treas. Reg. § 301.7701-2 (as amended in 2007) (defining business entity and providing that an arrangement incorporated under state law shall be a tax corporation); Treas. Reg. § 301.7701-3 (as amended in 2006) (providing that all multiple-member business entities that are not tax corporations are tax partnerships by default or tax corporations by election).

classification, and partnership tax theory should influence the definition.²⁸¹

As stated above, partnership tax theory suggests that an arrangement should be a tax partnership only if it needs the partnership tax accounting and reporting rules.²⁸² That need arises only if members have a residual claim in both the property and services of the arrangement.²⁸³ The freedom to contract in limited liability companies and all forms of partnership allows the members to create arrangements that separate the residual claims of property from residual claims of services. For example, the parties may agree that the service provider, i.e., the manager, will receive a membership interest in a limited liability company but restrict the manager's control of the property.²⁸⁴ The limited liability company's operating agreement may limit the manager's vote on matters such as decisions to dispose of the property, encumber it, or alter lease terms in the case of a property with major tenants. The other owners may retain the right to remove the manager by majority vote and terminate the employment arrangement by distributing any unpaid share of profits.

As states continue to relax the default rules of noncorporate entities (by extending the availability of statutory trusts, for example), individuals will have greater freedom to structure ownership arrangements with legal entities. The IRS should recognize that freedom and allow co-owners to indirectly own property in open tenancies-in-common through mutually owned legal entities. Through those separate entities, the co-owners could contract with a property manager, enter into leases, and borrow against the property. The use of a separate legal entity would likely deprive co-owners of the right to partition the property. As stated above, however, the right to partition does not appear to be essential to tenancy-in-common classification and should be eliminated from the IRS's guidance.²⁸⁵ Once freed from that burden, the interests would be more freely transferable, and a separate legal entity would facilitate such transferability, eliminating some of the major complexities of open tenancies-in-common.

²⁸¹ See Borden, *supra* note 24, at 931–32.

²⁸² See *supra* text accompanying notes 139–44.

²⁸³ See Borden, *supra* note 140.

²⁸⁴ The Author suggests in another venue that private equity managers may indeed be employed by investors even though they become members of limited partnerships. See Bradley T. Borden, *Profits-Only Partnership Interests*, 74 BROOK. L. REV. (forthcoming 2009), available at <http://papers.ssrn.com/abstract=1262493>.

²⁸⁵ See *supra* text accompanying notes 251–56.

C. *Transferable New Knowledge*

Bringing together several unassociated persons to form an open tenancy-in-common merges disparate interests and creates a significant pool of resources. The pool of resources is sufficient to attract legal advisors, tax advisors, and the IRS to carefully consider the issues in depth and create new ownership structures. Concepts that result from that work are now available to lawyers advising members of close tenancies-in-common. Aspects of open tenancy-in-common structures will be attractive to members of close tenancies-in-common.²⁸⁶ For example, the revenue- and expense-sharing provisions in open tenancy-in-common arrangements would help eliminate some of the uncertainty regarding co-owners' rights to income and obligations for expenses under common law. The rights of first offer and first refusal and option agreements in open tenancy-in-common documents would help co-owners of close tenancies-in-common restrict the transferability and partition rights of their co-owners.²⁸⁷

The management and lease structures used by open tenancies-in-common may also benefit co-owners of close tenancies-in-common. Instead of an independent third party managing the property, however, a co-owner of a close tenancy-in-common will likely manage the property either directly or through a closely-held management company.²⁸⁸ The co-ownership and management agreements will have to limit the scope of services that a co-owner can provide to ensure compliance with the IRS's guidance.²⁸⁹ Nonetheless, the open tenancy-in-common structure can provide guidance to the advisor creating the close-tenancy-in-common structure. If limited management creates problems, then the parties may decide to use a master-lease structure. Again, models of open tenancies-in-common will inform the creation of such structures for close tenancies-in-common.

Because open tenancies-in-common generally comply with the IRS's guidance, the IRS should not challenge the classification of close tenancies-in-common that adopt features of open tenancies-in-

²⁸⁶ Documents drafted for close tenancies-in-common incorporate features of open tenancies-in-common, providing evidence that close tenancies-in-common will adopt features of open tenancies-in-common. See, e.g., BORDEN, *supra* note 11, app. F.

²⁸⁷ See *id.* at F-6 through F-7 (providing examples of buy-sell agreements that may appear in documents used by co-owners of close tenancies-in-common).

²⁸⁸ See *id.* at app. F (providing sample documents that contemplate an affiliate of one of the co-owners managing the property but providing no more than customary tenant services).

²⁸⁹ See Rev. Proc. 2002-22, § 6.11, 2002-1 C.B. 733 (limiting the services that a co-owner can provide to customary tenant services).

common.²⁹⁰ In fact, the IRS has ruled privately that its guidance also applies to close tenancies-in-common.²⁹¹ The effort that lawyers and others have devoted to structure open tenancies-in-common will serve advisors of close tenancies-in-common who also wish to structure ownership arrangements to comply with the IRS's guidance. Thus, many aspects of open tenancies-in-common may find application in close tenancies-in-common. Adopting already-created concepts gives members of smaller arrangements access to tools formerly unavailable due to resource restrictions.

V. CONCLUSION

Even if open tenancies-in-common would not exist without the demand created by the tax law, tax law currently supports open tenancies-in-common and greater attention should focus on them. More attention from academics and commentators outside the tax realm will help this new form of investment vehicle evolve in a manner that will provide greater protection for investors and more direction for promoters, broker-dealers, and other market participants. Open tenancies-in-common differ from close tenancies-in-common primarily in their ownership composition. The different ownership composition affects the economic nature of the two types of tenancies-in-common. Consequently, the parties to the various types of arrangements often seek different legal attributes in the differing arrangements.

A significant body of economic research and analysis considers close and open business arrangements such as corporations, partnerships, and limited liability companies. That analysis helps explain why business participants form arrangements that separate ownership and management, and use various legal mechanisms to establish the relationship among co-owners and between owners and managers. Tax commentators have also focused extensive efforts on explaining the perceived need (or lack thereof) of different tax regimes for close and open business arrangements. Little attention, however, has focused on the various aspects of open and close tenancies-in-common. The comparisons of close and open business arrangements help inform the analysis of closed and open tenancies-in-common. This Article demonstrates that such commentary and analysis helps expose weaknesses in the IRS's guidance and provides grounds for recom-

²⁹⁰ See *supra* text accompanying note 98 (discussing the legal significance of the IRS's guidance).

²⁹¹ See I.R.S. Priv. Ltr. Rul. 2008-26-005 (June 27, 2008).

mending change. Further analysis should help refine the structures further and lead to better guidance from the IRS.

**APPENDIX A: COMPARATIVE SUMMARY OF CLOSE AND OPEN
TENANCIES-IN-COMMON AND BUSINESS ARRANGEMENTS**

Close Tenancy-in-Common	Open Tenancy-in-Common	Close Business Arrangement	Open Business Arrangement
Direct ownership of interest in property.	Direct ownership of interest in property.	Indirect ownership of property.	Indirect ownership of property.
No limit on number of co-owners.	Thirty-five-co-owner limit.	No limit on number of members.	No limit on number of members.
Intent of parties relevant to classification.	Intent to form business arrangement prohibited.	Intent of parties relevant to classification.	Intent of parties relevant to classification.
No business form.	Business entity prohibited.	Partnership, limited liability company, corporation, or other legal form.	Partnership, limited liability company, corporation, or other legal form.
Co-ownership agreement traditionally informal, if extant.	Formal co-ownership agreement.	Less formal governing documents.	Formal governing documents.
Right to sell interest or partition.	Right of first refusal / offer before exercising right to partition, call options	Buy-sell agreements typical.	Typically publicly traded.
Unity of possession grants each co-owner right to manage property, hire a manager, or lease interests. Co-owners cannot sell or encumber other co-owners' interests.	Unanimous approval to hire manager, sell, or lease property, and to create or modify blanket lien. Co-owners can only provide customary tenant services.	Ownership and management typically combined, but all management authority is delegable.	Ownership and management typically separate.

Close Tenancy-in-Common	Open Tenancy-in-Common	Close Business Arrangement	Open Business Arrangement
Action of account, action for contribution, and action of waste determine co-owners rights to income and obligations for expenses.	Co-owners must share revenues and expenses in proportion to ownership interests.	If governing documents are silent, state law will generally allocate income and loss equally.	Governing documents should determine how and when profits are distributed.
Co-owners may enter into agreements that determine their respective shares of blanket-lien indebtedness.	Co-owners must share blanket-lien mortgage in proportion to ownership interests.	Owners are jointly and severally liable for business liabilities, unless organized as a limited partnership, limited liability company, or corporation.	Members not liable for business liabilities.
No restrictions on methods used to determine manager compensation.	Sharing profits with managers is prohibited.	No restrictions on methods used to determine manager compensation.	No restrictions on methods used to determine manager compensation.

