2023

TICnerships

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TICNERSHIPS

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ABSTRACT

Tenancy-in-common (TIC) ownership has been around for centuries, but the commercial use of TIC ownership of real property has accelerated over the last couple of decades. The impetus for TIC ownership of real property is twofold: (1) a desire property owners have to obtain the tax benefits of section 1031 of the Internal Revenue Code and (2) the desire property owners have to own property with other property owners and other professional managers and developers. Because section 1031 only applies to exchanges of real property, interests in partnerships and LLCs—the most common type of real property ownership—do not qualify for section 1031 nonrecognition. Thus, property owners enter into TIC arrangements, so transfers of their ownership interests will qualify for favorable section 1031 treatment. Such arrangements sound ideal, but there is a downside—for TIC arrangements to qualify as real property, for section 1031 purposes, the arrangement cannot include partnership attributes. Partnership attributes make co-ownership arrangements economically viable, so co-owners face the prospect of losing section 1031 treatment or foregoing co-ownership attributes that make the co-ownership arrangement palatable.

A TICnership comes into existence when the co-owners of real property papered as a TIC arrangement enter into agreements that cause the arrangement to take on partnership attributes and become a partnership for tax purposes. Because section 1031 drives most TIC arrangements and because the co-owners would typically otherwise prefer to own property through a more economically palatable partnership or limited liability company, the number of TIC arrangements appears to be on the rise, and the number of TICnerships, as a percentage of total TIC arrangements, is also undoubtedly on the rise. This Article presents TICnerships as an increasing phenomenon in the real estate market. It describes how TICnerships come into existence, the law governing the classification of co-ownership arrangements as TICs or TICnerships for federal income tax purposes, and how federal income tax treats TICs and TICnerships differently. Most importantly, the Article shows how TICnerships can undermine the very tax treatment they are designed to provide and shows how property owners and their advisors can order affairs to preserve the desired section 1031 treatment and obtain the sought-after economic benefits of owning real property in a partnership or limited liability company.

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I. INTRODUCTION

TICnership (as defined below) is not a sought-after co-ownership classification,[1] but, unfortunately, TICnerships come into existence all too frequently and often unbeknownst to the TIC co-owners who unwittingly enter into them. TICnerships come into existence when TIC co-owners of real property paper the ownership of the property as a tenancy-in-common (TIC) arrangement but add attributes to the arrangement that provide desirable management, profit-sharing, and other features that are common with ownership through partnerships and limited liability companies (LLCs). Federal income tax law classifies property ownership arrangements based upon federal income tax classification rules, not state-law classification,[2] so TIC ownership arrangements that have too many partnership features should be classified as partnerships for federal income tax purposes.

A primary reason to form a TIC is to enable property owners to complete exchanges under section 1031 of the Internal Revenue Code.[3] Section 1031 provides that a property owner does not recognize gain on the transfer of real property (the real-property requirement) in exchange (the exchange requirement) for like-kind real property (the like-kind requirement) if the transferred property was held for productive use in a trade or business or for investment and the replacement property is acquired to be held for productive use in a trade or business or for investment (the qualified-use requirement).[4] Members of entities taxed as partnerships often desire to separate from each other when they sell the property of the partnership. To allow the partners to go their separate ways as part of the sale of property, the partners often cause the partnership to distribute undivided interests in the partnership's property prior to the sale of the property (this creates a disposition-side TIC[5]). The distributee partner can then sell the undivided interest as part of a transaction intended to qualify for section 1031 treatment. For the transfer of the undivided interest to qualify for section 1031 nonrecognition, the undivided

1. The Author coined the term "TICnership" to efficiently communicate the idea of TIC arrangement that had sufficient partnership attributes to be classified as a partnership for federal income tax purposes. *See* Bradley T. Borden, *A Dialogue Debunking the Section 1031 Holding Period Myth*, TAX NOTES FED. Apr. 3, 2023, at 43, 52.

2. Treas. Reg. § 301.7701-1(a)(1) ("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.")

3. All section references are to the Internal Revenue Code of 1986, as amended, unless stated otherwise. Unless the context dictates otherwise, this Article uses the term "investor" in a general sense to include any person who owns real property, including those who own property for productive use in a trade or business or for investment.

4. I.R.C. § 1031(a)(1). Two other articles published as companion articles to this Article consider the exchange requirement and the qualified-use requirement, respectively. *See* Bradley T. Borden, *The Exchange Requirement*, 18 BROOK. J. CORP. FIN. & COM. L. 407 (2024) [hereinafter Borden, *Exchange Requirement*]; Bradley T. Borden, *The Qualified-Use Requirement*, 19 BROOK. J. CORP. FIN. & COM. L. 497 (2024) [hereinafter Borden, *Qualified-Use Requirement*].

5. *See infra* Part III.C.1.

interest must be an interest in real property and cannot be a partnership interest.[6] Thus, the co-ownership arrangement of the property between the time it was distributed and the time the exchanger transfers it must remain as a TIC. On the other side of section 1031 exchanges, an exchanger may wish to acquire an interest in property owned (or to be owned) by multiple other property owners and therefore wish to acquire a TIC interest in the property (an acquisition-side TIC[7]). For the acquisition to qualify as part of a valid section 1031 exchange, the arrangement must be a TIC interest. These disposition-side TICs and acquisition-side TICs are very common and undoubtedly comprise a significant percentage of all TIC arrangements that are being formed.

Because section 1031, and not economics or other non-tax factors, drive the formation of many TIC arrangements, the likelihood of a tax-motivated structure being classified as a TICnership is greater than such classification for a structure that TIC co-owners form for non-tax reasons. For instance, if TIC co-owners decide to form a TIC arrangement because they want to have all the central characteristics of a TIC,[8] that arrangement will likely be a TIC. On the other hand, TIC co-owners may prefer an economic arrangement that is more like a typical limited partnership with some active members and some passive members and profit incentive for the manager, but some TIC co-owners may need their interests to qualify for section 1031 treatment. The TIC co-owners may attempt to shoehorn their desired arrangement into a TIC structure. Doing so increases the likelihood that the arrangement will be a TICnership. This latter scenario describes many TIC arrangements, so many TIC arrangements likely are TICnerships.

Despite the tax motivation, a significant number of TICnerships come into existence in situations that do not call for or require TIC ownership or do not call for long-term TIC ownership. For instance, parties may receive advice that replacement property must be held for some period to satisfy the exchange and qualified-use requirement of section 1031,[9] which advice is not

6. I.R.C. § 1031(a)(1); Treas. Reg. § 1.1031(a)-3(a)(5)(i)(C).

7. *See infra* Part III.C.2.

8. *See infra* Part IV.C.

9. *See, e.g.*, Brian S. Masterson, *Held for Productive Use in a Trade or Business or for Investment*, 2 TUCKER ON TAX PLAN. REAL EST. TRANS. § 18:5 (2023) ("It is recommended that property be held for productive use in a trade or business or for investment purposes at least two taxable years before a like-kind exchange is attempted."); Bradford Updike, *Exploring the Frontier of Non-Traditional Real Estate Investments*, 40 CREIGHTON L. REV. 271, 303 (2007); *1031 Exchange Safe Harbor Rules: What You Need to Know*, REALIZED (Dec. 15, 2021), https://www.realized1031.com/blog/1031-exchange-safe-harbor-rules-what-you-need-to-know ("You must have held the asset for a minimum of two years. This is called the 'qualifying use' period."); David R. Chan, *Drop and Swap: Can You Relax if the Police Aren't Looking for You?*, TAX DEV. J. 1, 5 (2009) ("Of course getting a taxpayer to wait one or two years to complete the transaction may be impossible from a practical point of view, so if the taxpayer can be convinced to wait until the next taxable year to complete the transaction, many tax advisors would be pleased.").

supported by the law.[10] If the plan is to hold property in a TIC arrangement long-term, the TIC co-owners may adopt elements (such as management and profit-sharing provisions) that will cause the arrangement to be a TICnership. After formation, by holding property in a TIC arrangement longer than needed, the TIC co-owners may increase the risk that the arrangement will be a TICnership. In particular, TIC ownership structures are often formed in connection with exchanges that occur in proximity to business transactions (i.e., contributions to or distributions from an entity). If the structures are transitory, the likelihood of TIC co-owners engaging in prohibited business activity is minimized, and a longer holding period increases the likelihood of the TIC co-owners engaging in prohibited business activity.[11] These two simple illustrations show how the number of TICnerships may be on the rise, and, to the extent property owners enter into tax-motivated TIC arrangements, TICnerships as a percentage of total TIC arrangements is also likely on the rise.

Because the term "TICnership" was coined recently,[12] its definition and the definitions of related concepts are most likely unfamiliar to many readers. Part II therefore presents definitions that are important in discussing TICnerships. Part III describes the rise of TICnerships and how, as tax-motivated arrangements, many TIC arrangements are more likely to be deemed TICnerships. Part IV reviews the law governing the classification of TICs and TICnerships. The analysis reveals that a TIC is a co-ownership arrangement that has the central characteristics of a TIC and lacks features that would make it a partnership for tax purposes (a tax partnership[13]). After discussing TIC characteristics, the focus turns to what causes a co-ownership arrangement to become a tax partnership. The discussion identifies features that property owners generally would prefer to have in a co-ownership arrangement and how such features typify tax partnerships and can cause a TIC arrangement to become a TICnership. That Part uses several examples of arrangements that appear in practice all too often.

Part V explains the different ways in which tax law treats the operations and transactions of TICs and TICnerships. Both the transactional and operational differences can be significant. Because TICs often come into existence to facilitate section 1031 exchanges, that Part closely examines how tax law treats transactions between and among TIC co-owners and

10. *See* Borden, *Exchange Requirement*, *supra* note 4, at 438–40; Borden, *Qualified-Use Requirement*, *supra* note 4, at 573–82.

11. In a well-structured TIC arrangement with disciplined TIC co-owners, the likelihood that a TIC co-owner will engage in a prohibited business activity should be low, but engaging in such activity is impossible if the TIC arrangement is transitory and the arrangement ceases to be a TIC shortly after formation. *See infra* Part VII.A.1 (discussing this concept).

12. Borden, *supra* note 1.

13. This Article uses the term "tax partnership" to refer to any arrangement that is taxed as a partnership for federal income tax purposes. *See infra* Part IV.A.1. Such arrangements can include TICnerships, state-law partnerships, and LLCs. Treas. Reg. §§ 301-7701-1, -2, -3, -4.

between partnerships and partners and between and among partners. Property owners and advisors should be aware of the tax consequences of these transactions and operations to avoid pitfalls. Part VI examines several different types of transactions that result from transfers of interests in TIC arrangements that are TICnerships. That discussion shows how TICnership classification can disrupt the intended section 1031 tax treatment of a transaction that the property owners thought included a TIC interest. That Part also illustrates that the disruptiveness of TIC classification may depend upon whether the property interest is disposed of or acquired as part of an intended section 1031 exchange. For instance, the acquisition of a TICnership interest could be deemed to be an acquisition of an interest in property followed by the immediate contribution of that interest to a tax partnership, but the disposition of a TICnership interest may not have similar protection. Part VII provides best-practices strategies for managing risks that are inherent in TIC structures and presents several structures that property owners and their advisors should consider to mitigate the risks of TICnership classification. Well-structured arrangements also allow property owners and their advisors to manage the transaction to allow for the effective completion of exchanges with interests that should be classified as interests in real property before or after the transaction. Such planning not only mitigates tax risk but also allows the owners to use their ownership structure of preference, which may include an LLC. Part VIII concludes.

II. TICTIONARY

This Article adopts terminology that is not in common usage or that is being introduced herein. The new terminology is simple to grasp and provides a basis for discussing matters conveniently. The terminology also helps elucidate the concept of TICnerships as a distinct tax phenomenon. With that distinction and the related terminology, property owners and their tax advisors can isolate tax and non-tax risks and plan to mitigate or knowingly accept them. At the risk of being too cute by half, the Article calls this section a TICtionary. Despite the cuteness of this term, the topic of TICnerships is serious, and the frequent occurrence of TICnerships in practice warrants an in-depth study of the TICnership phenomenon. This is the relevant terminology used throughout the Article.

> **<u>Central Characteristics of a TIC</u>:** *TICs have the following central characteristics: (1) each co-owner is deemed to own individually a physically undivided part of the entire parcel of property; (2) each co-owner is entitled to share with the other tenants the possession of the whole parcel; (3) each co-owner has rights to a proportionate share of rents or profits from the property; (4) each co-owner has the rights to transfer their interest; (5) each co-owner has the right to demand a partition of the property; and (6) the co-owners' rights*

generally are subject to the constraint that no rights may be exercised to the detriment of the other tenants in common.[14]

Quick TIC: *A TIC arrangement that lasts a short period of time. The life of a quick TIC usually (1) begins when one or more TIC co-owners acquire a TIC interest in property as part of a section 1031 exchange and ends at the time the TIC co-owners contribute their TIC interests to a tax partnership or (2) begins when a co-owner receives a TIC interest from a tax partnership and ends when the co-owner sells the interest as part of an intended section 1031 exchange. The period is very short in situations where the acquisition as part of an exchange is followed immediately by a contribution of the replacement property to a partnership or a distribution that is followed immediately by a transfer as part of an exchange.*[15]

Tax Partnership: *An entity treated as a partnership for federal income tax purposes. Limited liability companies and partnerships are typical tax partnerships.*[16]

TIC: *A tenancy-in-common ownership arrangement that is one of the traditional concurrent estates in land. Such an arrangement results from multiple parties owning undivided interests in real property, and it is not treated as a partnership for federal tax purposes. The central characteristics of a TIC are present with such an arrangement.*

TIC Agreement: *An agreement among TIC co-owners of undivided interests in a property that may run with the land. The TIC agreement includes provisions related to the management of property, sharing of revenues and expenses, disposition of the property, and other matters relevant to owning and operating the property. The concept of a TIC agreement is broad enough to include any agreements among or between co-owners. Thus, the TIC agreement would*

14. Rev. Proc. 2002-22, 2002-1 C.B. 733 (citing 7 RICHARD R. POWELL, POWELL ON REAL PROPERTY §§ 50.01–50.07 (Michael Allan Wolf ed. 2000)). *See also In re* Nashville Senior Living, LLC, 407 B.R. 222, 227 (B.A.P. 6th Cir. 2009) ("Tenancy in common is a form of concurrent ownership that allows more than one owner to hold an interest in the same property. They own separate undivided shares of the whole estate. This means that, subject only to the concurrent rights of the co-owners, each tenant in common has an equal right to possess and use the whole property.")

15. *See, e.g.*, Magneson v. Comm'r, 753 F.2d 1490 (9th Cir. 1985) (granting section 1031 nonrecognition to an exchange that included the acquisition of an undivided interest in replacement property followed immediately by the contribution of the property to a partnership); Mason v. Comm'r, 55 T.C.M. (CCH) 1134 (1988) (granting section 1031 nonrecognition to an exchange that immediately followed the distribution of undivided interests in real property from multiple partnerships).

16. Multiple-member LLCs and partnerships that do not elect otherwise are tax partnerships. Treas. Reg. §§ 301.7701-1, -2, -3.

include any document referred to as a TIC agreement and any side letters to such an agreement entered into between any co-owners.

TIC Arrangement: *An arrangement structured by the TIC co-owners of property that grants TIC co-owners legal title to undivided interests in the property. A TIC arrangement can be classified as either a TIC or a TICnership for federal income tax purposes, depending on the characteristics of the arrangement.*

TIC Co-Owner: *An owner of an interest in a TIC arrangement.*

TIC Interest: *An interest held by a co-owner of a TIC.*

TICner: *A member of a TICnership.*

TICnership: *Real estate co-ownership arrangement evidenced by multiple TIC co-owners each holding legal title to undivided interests in the property but that possesses partnership attributes and thus comes within the federal definition of tax partnership. TICnerships should be treated as partnerships for federal income tax purposes and may come within the state-law definition of partnership.*

TICnership Interest: *An interest in a TICnership, typically evidenced by legal title to an undivided interest in real property and one or more agreements associated with ownership of the undivided interest in real property.*

III. THE RISE OF TICNERSHIPS

Property has been owned by tenants-in-common for centuries,[17] so the TIC ownership structure is nothing new. Nonetheless, the popularity of TICs as tax-favored structures is a fairly recent phenomenon, with use increasing significantly beginning around the turn of the millennium when TIC syndicators began marketing and selling TIC interests as section 1031 replacement property.[18] That increase in popularity has been met with an increased understanding of TICs and increasingly sophisticated (and sometimes just needlessly complicated) TIC structures used in section 1031

17. *See, e.g.*, 1 THOMPSON ON REAL PROPERTY § 4.06 (Thomas ed. 2024) ("[D]uring the fourteenth century, a concurrent conveyance to separate persons began to be recognized as a tenancy in common, and royal courts of that era were able to distinguish between tenancies in common and joint tenancies. The tenancy in common had no right of survivorship and, until 1540, could be created only by *inter vivos* conveyance. After 1540, the Statute of Wills permitted a tenancy in common to be devised.").

18. *See, e.g.*, Bradley T. Borden, *Open Tenancies-In-Common*, 39 SETON HALL L. REV. 387, 388–90 (2009) (describing the origin around 1995 and ascension of the syndicated TIC industry up through its peak around 2006).

exchanges.[19] The syndicated TIC market peaked in 2006, but non-syndicated or close TICs have become popular and are prevalent as property owners seek to sell interests in real estate ventures as part of a section 1031 exchange and seek to acquire interests in real estate ventures as replacement property.[20] The sophistication of property owners and their advisors who form close TIC arrangements can vary significantly. Unfortunately, based upon the Author's observation, the increase in the number of TIC ownership arrangements has also resulted in sloppy structures, many of which could come within the definition of TICnership and be classified as partnerships under state law.[21] Those that are properly structured to withstand classification scrutiny often include characteristics that TIC co-owners may not desire. Thus, poorly structured TIC arrangements can include provisions that jeopardize the arrangement's status as a TIC, and a TIC arrangement structured to withstand classification scrutiny may include characteristics that are undesirable to the co-owners. Figure 1 lists several unfortunate aspects of TIC arrangements (all of which are discussed in greater detail below).

Figure 1:
Unfortunate Aspects of TIC Arrangements

Well-Structured TIC

- TIC co-owners become parties to an undesirable co-ownership arrangement (TIC)
    - Proportionate sharing of revenue and expenses
    - Mandatory unanimity for some actions
    - TIC co-owner rights to sell interests or partition property
    - Manager subject to TIC co-owner reappointment
    - Limited buy-sell provisions

Poorly Structured TIC

- Potential classification as a default partnership (state law)
    - Joint and several liability for each default partner
    - Each default partner has management rights

Poorly Structured TIC

- Potential classification as a tax partnership (tax law)
    - Potential loss of desired tax outcome
    - Requirement to file partnership tax return

19. *See, e.g.*, Bradley T. Borden, *Fixed-Price Put Options Undermine Section 1031 Treatment of Tenant-in-Common Interests*, TAX NOTES FED., June 27, 2022, at 1989 [hereinafter *Fixed-Price Put Options*]; Bradley T. Borden & Todd D. Keator, *Tax Opinions in TIC Offerings and Reverse TIC Exchanges*, TAX MGT. REAL EST. J., Mar. 7, 2007, at 88; Bradley T. Borden, *Exchanges Involving Tenancy-In-Common Interests Can Be Tax Free*, 70 PRAC. TAX. STRATEGIES 4 (2003); Terence Floyd Cuff, *Section 1031 Exchanges Involving Tenancies-in-Common*, 29 REAL EST. TAX'N 53 (2002); Richard M. Lipton, *New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges*, 96 J. TAX'N 303 (2002).

20. *See infra* Part VI.B.

21. *See infra* Part III.B.

For decades, courts have recognized that an arrangement labeled as a TIC by the TIC co-owners can be a TICnership (i.e., partnerships for federal income tax purposes).[22] Over the last several years, based upon the Author's

22. *See, e.g.*, Cusick v. Comm'r, 76 T.C.M. (CCH) 241 (1998) (holding that a co-ownership arrangement was a tax partnership): Gabriel v. Comm'r, 66 T.C.M. (CCH) 1283 (1993) (holding that co-ownership arrangement was a not a tax partnership); Bergford v. Comm'r, 12 F.3d 166 (9th Cir. 1993) (holding that a co-ownership arrangement was a tax partnership); Alhouse v. Comm'r, 62 T.C.M. (CCH) 1978 (1991) (holding that a co-ownership arrangement was a tax partnership); Marinos v. Comm'r, 58 T.C.M. (CCH) 97 (1989) (holding that a co-ownership arrangement was a tax partnership); Cokes v. Comm'r, 91 T.C. 222 (1988) (holding that a co-ownership arrangement was a tax partnership); Bussing v. Comm'r, 89 T.C. 1050 (1987) (holding that a co-ownership arrangement was a tax partnership); Bussing v. Comm'r, 88 T.C. 449 (1987) (holding that a co-ownership arrangement was a tax partnership); Press v. Comm'r, 52 T.C.M. (CCH) 285 (1986) (holding that a co-ownership arrangement was a tax partnership); Underwrites Ins. Agency of Am. v. Comm'r, 40 T.C.M. (CCH) 5 (1980) (holding that a co-ownership arrangement was a tax partnership); Madison Gas and Electric Co. v. Comm'r, 633 F.2d 512 (7th Cir. 1980) (holding that a co-ownership arrangement was a tax partnership); Estate of Levine v. Comm'r, 72 T.C. 780 (1979) (holding that a co-ownership arrangement was a tax partnership); McManus v. Comm'r, 583 F.2d 443 (9th Cir. 1978) (holding that a co-ownership arrangement was a tax partnership); McShain v. Comm'r, 68 T.C. 154 (1977) (holding that a co-ownership arrangement was not a tax partnership); Demirjian v. Comm'r, 457 F.2d 1 (3d Cir. 1972) (holding that a co-ownership arrangement was a tax partnership); Podell v. Comm'r, 55 T.C. 429 (1970) (holding that a co-ownership arrangement was a tax partnership); Rothenberg v. Comm'r, 48 T.C. 369 (1967) (holding that a co-ownership arrangement was a tax partnership); Lulu Lung Powell v. Comm'r, 26 T.C.M. (CCH) 16 (1967) (holding that a co-ownership arrangement was not a tax partnership); Luckey v. Comm'r, 334 F.2d 719 (9th Cir. 1964) (holding that a co-ownership arrangement was a tax partnership); United States v. U.S. Nat'l Bank of Portland, 239 F.2d 475 (9th Cir. 1956) (holding that a co-ownership arrangement was a tax partnership); Greenspon v. Comm'r, 229 F.2d 947 (8th Cir. 1956) (holding that a co-ownership arrangement was not a tax partnership); Hahn v. Comm'r, 22 T.C. 212 (1954) (holding that a co-ownership arrangement was not a tax partnership); Coffin v. United States, 120 F. Supp. 9 (S.D. Ala. 1954) (holding that co-ownership arrangement was not a tax partnership); Gilford v. Comm'r, 201 F.2d 735 (2d Cir. 1953) (holding that a co-ownership arrangement was not a tax partnership); Bentex Oil Corp. v. Comm'r, 20 T.C. 565 (1953) (holding that a co-ownership arrangement was a tax partnership); Estate of Langer v. Comm'r, 16 T.C. 41 (1951) (holding that a co-ownership arrangement was a tax partnership); Smith v. Comm'r, 8 T.C. 1319 (1947 (holding that co-ownership arrangement was not a tax partnership); Estate of Appleby v. Comm'r, 41 B.T.A. 18 (1940) (holding that a co-ownership arrangement was not a tax partnership); Tompkins v. Comm'r, 97 F.2d 396 (4th Cir. 1938) (holding that a co-ownership arrangement was a tax partnership); Winmill v. Comm'r, 93 F.2d 494 (2d Cir. 1937) (holding that a co-ownership arrangement was a tax partnership); Rerynolds v. McMurray, 60 F.2d 843 (10th Cir. 1932) (holding that a co-ownership arrangement was a tax partnership); Rev. Rul. 2004-86, 2004-33 I.R.B. 191 (ruling that when participants in a venture form a state law entity and avail themselves of the benefit of the entity, the entity will be treated as a tax partnership for federal income tax purposes); Rev. Rul. 75-374, 1975-2 C.B. 261 (ruling that a co-ownership arrangement was not a tax-partnership); Rev. Rul. 68-334, 1968-1 C.B. 569 (ruling that a co-ownership arrangement was a qualified partnership); Rev. Proc. 2002-22, 2002-1 C.B. 733 (providing ruling conditions for obtaining an advance ruling that a co-ownership arrangement is not a tax partnership); I.T. 2785, XIII-1 C.B. 96 (1934) (ruling that a co-ownership arrangement was a qualified partnership); I.T. 3930, 1948-2 C.B. 126 (1948) (ruling that co-ownership arrangement was a qualified partnership); I.T. 2749, XIII-1 C.B. 99 (1934) (ruling that co-ownership arrangement was a tax partnership); I.T. 2081, 111-3 C.B. 176 (1924) (ruling that co-ownership arrangement was a tax partnership); I.T. 1604, 11-1 C.B. 1 (1923) (ruling that a co-ownership arrangement was a tax partnership); I.R.S. Priv. Ltr. Rul. 83-150-03 (June 17, 1982) (ruling privately that a co-ownership arrangement was a tax partnership). *See also*, Bradley T. Borden, *Taxing Shared Economies of Scale*, 61 BAYLOR L. REV. 721 (2009) (discussing qualified tax partnerships and the theoretical aspects of treating co-generation

observations and fundamental reasoning, the number of TICnerships is on the rise. As the discussion below elaborates, one would predict that the number of TICnerships being formed correlates positively to the total number of titled TICs.[23] In fact, because tax avoidance drives the formation of many TIC arrangements,[24] as the number of TIC arrangements increases, the percentage of those arrangements that are TICnerships is most likely increasing and likely at a rapid rate.[25] Tax-avoidance motives, complex ownership structures, advisors' rudimentary knowledge of the definition of tax partnership, and the failure of many TIC co-owners to seek lawyer assistance when structuring TIC arrangements contribute to the rise of TICnerships.

A. GENERAL UNATTRACTIVENESS OF TICS

But for the potential tax benefits to be obtained under section 1031, the central characteristics of a TIC often make TICs unattractive forms of owning property.[26] For instance, TIC ownership gives each TIC co-owner the right to possession of the whole property.[27] First, the right of possession is a common feature of property ownership,[28] but owners who lease property assign the right of possession to tenants.[29] Consequently, a lease on the property may restrict the co-owners' right to use the property, but the TIC co-owners would expect to have a voice in decisions regarding renting the property. TIC ownership also gives each TIC co-owner a right to a

arrangements as tax partnerships); Bradley T. Borden, *Policy and Theoretical Dimensions of Qualified Tax Partnerships*, 56 KANSAS L. REV. 317 (2008) (explaining qualified partnerships); Bradley T. Borden, *Catalogue of Legal Authority Addressing the Federal Definition of Tax Partnership*, 746 TAX PLAN. FOR DOMESTIC & FOREIGN P'SHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLS. 477 (Louis S. Freeman & Clifford M. Warren eds., 2007) (listing 225 cases that have considered whether an arrangement is a tax partnership or have been cited as such).

23. *See infra* Part III.B.

24. This Article does not use tax avoidance pejoratively. "Between two equally direct ways of achieving the same result, [property owners are] free to choose the method which entail[s] the most tax advantages to them." Magneson v. Comm'r, 753 F.2d 1490, 1497 (9th Cir. 1985). The use of a TIC in *Magneson* allowed the exchangers to qualify for section 1031 nonrecognition. *Id.* at 1492, 1494–95. Although they could have structured the transaction differently, the structure they used allowed them to avoid paying tax on the disposition of their property.

25. *See infra* Part III.B.

26. *See also* 86 C.J.S., *Tenancy in Common*, § 1 at 361 (1954) ("A 'tenancy in common' is a tenancy by two or more persons, in equal or unequal undivided shares, where each person has an equal right to possess the whole property, but with no right of survivorship. A tenancy in common is generally defined as the holding of property by several persons by several and distinct titles, with unity of possession only. Stated another way, a tenancy in common is a form of ownership in which each cotenant owns a separate fractional share of undivided property. Each cotenant's title is held independently of the other cotenants. Tenancy in common is characterized by possession or the right to possession of the common property. A tenancy in common is referred to in the civil law system of Louisiana as holding in indivision.").

27. *See supra* text accompanying note 14.

28. *See* Henry T. Terry, *Legal Duties and Rights*, 12 YALE L. J. 185, 199 (1903).

29. *See, e.g.*, Johnson v. Northpointe Apts, 744 So. 2d 899, 902 (Ala. 1999) (recognizing that tenant has a right of possession of the leased property during the term of the lease).

proportionate share of the revenues of the property.[30] This characteristic of a TIC prohibits TIC co-owners from paying a TIC co-owner or other person with a share of the profits of the property. Thus, managers cannot draw a promote from a TIC.[31] Finally, each TIC co-owner has the right to transfer their interest and has the right to demand a partition of the property.[32] This right restricts the rights other TIC co-owners have to determine who will own property with them, which is unattractive to most property owners, particularly considering that each TIC co-owner has rights in management. The central characteristics of a TIC therefore generally make TICs unattractive forms of property ownership. Those unattractive features (outside the section 1031 context) generally lead TIC co-owners to use some other form of ownership, such as limited partnership or LLC that allow them to grant management authority to one party, divide profits disproportionately, and restrict transfers of interests. In the Author's experience, only in rare situations do non-tax factors drive the formation of a TIC arrangement.

The combination of the general unattractiveness of the central characteristics of a TIC and the property owners' desire to engage in section 1031 exchanges prompts property owners and their advisors to form TIC arrangements and then add features that make them more attractive from a non-tax perspective. Those same features push the arrangements toward TICnership classification. Thus, section 1031 acts as an accelerant for the creation of TICnerships.

B. SECTION 1031 AS TICNERSHIP ACCELERANT

A desire to have interests in property-ownership structures qualify as section 1031 relinquished or replacement property undoubtedly drives up the number of TICnerships as a percentage of TIC arrangements. Only real property qualifies as section 1031 relinquished or replacement property.[33] Interests in partnerships and other types of entities are specifically excluded from section 1031 nonrecognition,[34] but a TIC interest in real property can qualify as section 1031 relinquished and replacement property.[35] Many

30. *See supra* text accompanying note 14.

31. A promote grants the sponsor (or manager) a share of profits from the operation and disposition of property that exceeds the sponsor's (or manager's) ownership interest in the property. *See* Brett Freudenberg & Bradley T. Borden, *Contribution and Distribution Flexibility and Tax Pass-Through Entities*, 23 FLA. TAX REV. 349, 379 (2019).

32. *See supra* text accompanying note 14.

33. I.R.C. § 1031(a)(1).

34. Treas. Reg. § 1.1031(a)-3(5(i)(C). Prior to the Tax Cuts and Jobs Act of 2017, section 1031(a)(2) provided that partnership interests and interests in other types of entities did not qualify for section 1031 nonrecognition. Act § 77(a) of the Deficit Reduction Act of 1984, Pub. L. No 98-369 (1984); The Tax Cuts and Jobs Act of 207 amended section 1031(a)(2) to exclude property held primarily for sale. Pub. L. No. 115-97, 131 Stat. 2123, § 13303(b)(1)(A) (2017).

35. Magneson v. Comm'r, 753 F.2d 1490, 1492 (9th Cir. 1985) (granting section 1031 nonrecognition to the exchange of a fee interest in real property for an undivided interest in real

property owners who are contemplating selling or acquiring interests in real property find themselves in a predicament. They want the interests in the property to not be interests in partnerships, so the interests can qualify for section 1031 nonrecognition, but they do not want the interests to have all of the central characteristics of a TIC.

Property owners who find themselves in this predicament have multiple alternatives, including the following: (1) stay with traditional joint venture structures and forego section 1031 nonrecognition; (2) structure ownership to ensure the arrangement is a TIC and forego attributes that are available in a traditional joint venture; (3) enter into a complex, carefully structured co-ownership arrangement that comes within the definition of TIC and provides some of the attributes available in a traditional joint venture; (4) enter into a sketchy, complicated ownership structure that may not come within the definition of TIC and that could create undesirable ownership aspects; or (5) enter into a TIC, hold the TIC interest momentarily, and then exchange it or contribute it to an entity (the so-called "quick TIC"). Each alternative has advantages and disadvantages, as expressed in Figure 2.

Figure 2:
Alternatives with Respect to Transferring and Acquiring Interests in Real Property

Alternative	Advantages	Disadvantages
1. Traditional JV arrangement with no section 1031 treatment	• Legal standing of entity and among members is generally known • Complex ownership agreements can be incorporated into the governing document	• Ownership interest does not qualify as section 1031 relinquished or replacement property
2. Simple TIC arrangement	• Ownership interest can qualify as section 1031 relinquished or replacement property • Ownership structure is simple and understandable	• Ownership arrangement does not include typical entity features, such as complex finance provisions, division of ownership and control, or buy-sell restrictions

property); Rev. Rul. 73-476, 1973-2 C.B. 300 (granting section 1031 nonrecognition to an exchange of undivided interests in real property).

Figure 2: Alternatives with Respect to Transferring and Acquiring Interests in Real Property		
Alternative	**Advantages**	**Disadvantages**
3. Complex, carefully structured TIC arrangement	• Ownership interest might qualify as section 1031 relinquished or replacement property • Structure might provide some attributes available in traditional joint ventures	• Arrangement is complex • Structuring arrangement is costly • Unsophisticated TIC co-owners may not understand the arrangement
4. Sketchy, complicated structure	• Perhaps lower cost than carefully structured arrangement • TIC co-owners do not know that arrangement is a TICnership, so they might treat their ownership interest as real property	• Creates legal uncertainty for the co-owners • Creates tax uncertainty as arrangement might be classified as a TICnership • No one really understands the structure • Arrangement uses complex language in documents and multiple agreements and side letters to obfuscate actual arrangement (assuming there is an identifiable actual arrangement)
5. Quick TIC	• Support for section 1031 nonrecognition • Avoid prolonged ownership in an arrangement with central characteristics of a TIC	• If property interest is replacement property, the property owner converts the interest into an interest in an entity, which cannot be exchanged later. For the property owner to exchange its interest later, the interest would have to be converted back to real property.

Alternative 1 is desirable from a non-tax perspective but generally does not provide opportunities to exchange ownership interests as part of a section 1031 exchange.[36] Alternative 2 is desirable from a tax perspective but does not provide desired non-tax attributes. Property owners, who would not otherwise enter into an arrangement with the central characteristics of a TIC,

36. The exception to this general rule is an acquisition of an interest in a wholly-owned LLC or other entity, which appears to qualify as valid replacement property under Rev. Rul. 99-5. *See infra* Part VI.B.1 (discussing the application of Rev. Rul. 99-5).

may consider such arrangements to obtain section 1031 tax benefits. Alternative 2 requires property owners to choose between section 1031 treatment and the benefits of owning property in a typical joint-venture form. Alternative 3 and Alternative 4 come into existence because some advisors appear to believe that such ownership structures can furnish desired section 1031 tax benefits without the central characteristics of a TIC. An Alternative 3 arrangement might qualify as a TIC but be needlessly cumbersome. An Alternative 4 would be needlessly complex and run the risk of being a TICnership.

Consider how advisors might come to recommend Alternative 3 or Alternative 4. The central characteristics of a TIC are undesirable for most property owners, but one or more TIC co-owner might desire an interest in the arrangement to qualify for section 1031 nonrecognition. For instance, the TIC co-owners of a real estate venture may wish to provide the manager with a promote or other profit incentives, which deviate from sharing revenues and expenses in proportion to ownership interests. They also may prefer to hire a manager who will manage the property that will make decisions with respect to the property and serve for an indefinite term and wish to restrict the transfer of interests to be able to choose their co-owners. Any one of these types of arrangements removes a central characteristic of a TIC from the arrangement, undermining the arrangement's TIC status. Knowing that property owners want TIC status but want those features, some advisors devise structures that attempt to provide TIC status but also jeopardize the central characteristics of a TIC, causing the arrangement to veer toward TICnership status.

Features related to revenue-sharing illustrate how some arrangements jeopardize TIC status. Knowing that disproportionate sharing of revenues could jeopardize TIC status, an advisor might suggest that a TIC co-owner admit the sponsor as a member of the TIC co-owner entity.[37] If done correctly, this could be an Alternative 3 structure. Other advisors might suggest using complex language in the TIC agreement that provides the equivalent of a promote but is written to be difficult to understand with the hopes that if IRS agents ever read it, they would not attempt to decipher the complex language and assume (perhaps based upon a section heading to that effect) that it requires proportionate sharing of revenue and expenses.[38] Alternatively, an advisor may suggest that the TIC agreement clearly provide

37. *See infra* Part VII.B.6 (discussing this structure). As used in this Article, the term "sponsor" can include any person who, for a fee or share of profits, procures, manages, or arranges the sale of property. Thus, such term can include managers when used generally. When context requires, the Article uses the term manager to refer specifically to someone whose function is to manage the property.

38. *See infra* Part VII.B.3(a) (discussing such an arrangement).

for proportionate sharing of revenue and expenses but draft a side letter that provides the manager with the equivalent of a promote.[39]

Either of these latter two strategies is an Alternative 4 strategy. Because neither strategy provides for proportionate sharing of revenue and expenses, the TIC arrangement would lack a central characteristic of a TIC and should be classified as a TICnership.[40] The motivation to obtain section 1031 nonrecognition drove the parties to form a TIC arrangement; the unattractiveness of the central characteristics of a TIC drove them to add features that jeopardized TIC status. The goal of obtaining section 1031 treatment, not a general preference for the TIC structure, motivated formation of the TIC arrangement. Once the decision was made to adopt a TIC structure, the TIC co-owners attempted to shoehorn an economic arrangement that is not suited for TIC ownership into a TIC arrangement. But for the desire to obtain section 1031 nonrecognition, the arrangement would not have been structured as a TIC. Forming the arrangement for section 1031 purposes and then adding features that the TIC co-owners would have used in a non-TIC arrangement increases the likelihood that the arrangement would be a TICnership. Because the TIC co-owners would not have adopted a TIC arrangement but for a desire to obtain section 1031 benefits and because they were not willing to forfeit partnership features in their arrangement, the arrangement is more likely to be classified as a TICnership than a TIC arrangement that is motivated by the co-owners' preference for the central characteristics of a TIC.

It stands to reason that tax-motivated factors, such as a preference to qualify for section 1031 nonrecognition, increase the likelihood that a TIC arrangement will be classified as a TICnership. If parties are drawn to a TIC arrangement because they want their ownership structure to possess the central characteristics of a TIC, structuring the arrangement as a TIC should be very doable, and the arrangement would be unlikely to cross the TICnership line. On the other hand, if the parties prefer to own property in an arrangement that expressly excludes the central characteristics of a TIC, they will not want the arrangement to adopt TIC characteristics and will be more likely to push the envelope on every undesirable characteristic, increasing the likelihood that the arrangement is not a TIC. Several examples illustrate how section 1031 increases the likelihood that parties will enter into TIC arrangements and how tax motivations increase the likelihood that the arrangement will be a TICnership.

1. *Acquisition & Ownership of Raw Land*

Some arrangements are suited for TIC ownership, and parties may choose a TIC structure for such arrangements. To illustrate, assume two

39. *See id.* (discussing the use of a side letter in a grotesque TIC arrangement).
40. *See infra* Part IV (discussing the classification rules).

friends want to buy raw land, share management, have the right to exit ownership unilaterally, and share the expenses of owning the property in proportion to their ownership interests. A TIC arrangement appears to be suited for this arrangement, and if the friends take title to the property as tenants-in-common and do not enter into agreements that alter the arrangement's central characteristics as a TIC, their arrangement would appear to be a TIC. In fact, they might be prohibited from treating the arrangement as a tax partnership.[41] If they each form a disregarded entity to own their respective interests in the land, they could shield themselves from individual liability that may be associated with owning the land. With such an arrangement, TIC ownership may be the most preferred form of ownership because it does not require forming a separate entity or filing a separate tax return and gives the members the flexibility of being able to dispose of real property interests without restructuring.

2. *Acquisition & Development of Raw Land*

Consider a developer and investor who wish to combine resources to acquire, develop, and manage property. The investor has sold relinquished property and would like to use exchange proceeds to acquire an interest in the property as part of a section 1031 exchange. The developer wants a promote, both parties want the developer to manage the development and the property indefinitely following development, the investor wants a very passive investment, they want to be able to determine by agreement each party's share of liabilities secured by the property, and they want to include strict restrictions on the right to sell ownership interests in the arrangement. Furthermore, the parties may prefer that the ownership arrangement be treated as a partnership because partnership taxation allows for special allocations of tax items and for allocations of partnership liabilities.[42] The parties' preferred structure would give the arrangement attributes that eliminate the central characteristics of a TIC. If the parties simply add provisions to the TIC agreement that will incorporate their desired features, the arrangement will most likely become a TICnership. To avoid that, they may attempt some Alternative 3 structuring such as by adding the developer as a managing member of the investor entity.[43] They would struggle to find a way to give the developer unilateral control of the management of the

41. *See, e.g.*, Gilford v. Comm'r, 201 F.2d 735 (2d Cir. 1953); Coffin v. United States, 120 F. Supp. 9 (S.D. Ala. 1954); McShain v. Comm'r, 68 T.C. 154 (1977); Hahn v. Comm'r, 22 T.C. 212 (1954); Smith v. Comm'r, 8 T.C. 1319 (1947); Estate of Applegate v. Comm'r, 41 B.T.A. 18 (1940), *aff'd on other grounds*, 123 F.2d 700 (2d Cir. 1941).

42. I.R.C. §§ 704, 752; *infra* Part V.B.1.

43. This type of structuring is only available in the circumstances related to the investor's support of the structure. For instance, the investor would need to be an entity separate from its owners if the investor had sold relinquished property and was using exchange proceeds to acquire its interest in the property. *See infra* Part VII.B.6.

property and to restrict transfer of ownership interests without compromising the central characteristics of a TIC. Any Alternative 4 efforts to obfuscate such arrangements with side letters or complex language or multiple documents could jeopardize the economics of the arrangement (if the effort to obfuscate actually results in ambiguity, the parties might end up agreeing to something they did not intend). Any arrangement that removes central characteristics of a TIC also increases the likelihood that the arrangement is a TICnership. The likelihood that this second arrangement will be a TICnership is much higher than the likelihood that the ownership of the land by the friends will be a TICnership.

This latter arrangement shows the tension between desiring an interest in a property to qualify as valid section 1031 property and desiring an arrangement to not have central characteristics of a TIC. The desire for section 1031 treatment leads to the TIC structure, and efforts to minimize the central characteristics of a TIC increases the likelihood that the arrangement will be a TICnership. But for the investor's desire to have the acquired interest qualify as valid section 1031 replacement property, the parties would not have structured the ownership in a TIC arrangement. The unattractiveness of the central characteristics of a TIC prompted the parties to add features to the arrangement that would jeopardize its TIC status.

Many property owners that seek TIC classification do it for the sole purpose of qualifying the property as section 1031 relinquished or replacement property. But for section 1031, property owners and other TIC co-owners would have no interest in holding the property in a TIC arrangement. The desirability of the central characteristics of a TIC does not appear to be a driving force in the proliferation of TIC arrangements. Instead, the driving force appears to be a desire to obtain favorable treatment under section 1031. Property owners may be unaware of the central characteristics of a TIC and may enter into arrangements that they would not otherwise enter into, and if the arrangement is a TICnership, they enter into an arrangement that may not provide the tax benefits they sought under section 1031. It is important for property owners and advisors to be aware of where TICnerships lurk.

C. WHERE TICNERSHIPS LURK

Property owners that enter into TIC arrangements for section 1031 purposes focus on the classification of the arrangements at two points in time: (1) when the property interest is acquired and (2) when the property interest is transferred. At the acquisition and disposition phase of a section 1031 exchange, the property acquired and disposed of must be real property.[44] Thus, TIC arrangements often come into existence in proximity to the disposition of real property and upon acquisition of real property. Anytime a

44. I.R.C. § 1031(a)(1).

TIC is formed for purposes of facilitating a section 1031 exchange, it runs the risk of being a TICnership, so TICnerships lurk with respect to any TIC arrangement that is formed to facilitate the disposition or acquisition of property as part of a section 1031 exchange. Recent thinking in this area is that the longer an arrangement remains in TIC form, the more likely the arrangement will be a TICnership.[45]

1. *Disposition-Side TICs*

TICs often come into existence on the sale side of an intended section 1031 exchange. Under a typical transaction of this nature, members of a partnership decide to divide the partnership using a so-called drop-and-swap transaction.[46] Pursuant to such a transaction, the partnership deeds undivided interests in real property to one or more members of the partnership. The distributee members then deed the undivided interest as the disposition-side of an intended section 1031 exchange. If structured correctly, the arrangements following the deeding of the undivided interest from the partnership to the members could be a TIC. If the arrangement is structured incorrectly, the structure could be a TICnership.

2. *Acquisition-Side TICs*

TICs may come into existence on the buy-side of section 1031 exchanges. For example, an exchanger may wish to invest exchange proceeds in a multiple-member ownership structure. A properly structured TIC would provide the exchanger the opportunity to acquire a TIC interest as valid section 1031 replacement property. Such an acquisition-side TIC requires the other TIC co-owners to accommodate the exchanger by structuring the ownership of the property as a TIC. Both the exchanger and the other TIC co-owners may prefer not to include the central characteristics of a TIC, but if the arrangement is not structured properly, it could be a TICnership.

3. *The TICnership Trap*

As a theoretical matter, TIC interests can be relinquished property or replacement property in a section 1031 exchange. As a practical matter, the undesirable aspects of TICs, exchangers' focus on cost-cutting, and advisor neglect can result in an intended TIC becoming a TICnership. When the central characteristics of a TIC conflict with the co-owners' structural preferences, the likelihood that the co-ownership arrangement will be a TICnership appears to increase. Indeed, from the Author's experience, TICnerships are often born from the ill-fated efforts to provide an interest in a multiple-owner vehicle that qualifies for section 1031 nonrecognition but

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45. *See infra* Parts III.D, VII.A.1(c).

46. *See, e.g.*, Bradley T. Borden, *Code Section 1031 Drop-and-Swaps Thirty Years after* Bolker, J. PASSTHROUGH ENT., Sept.–Oct. 2015, at 21.

excludes the unattractive central characteristics of a TIC. Despite best intentions of those who form TIC arrangements, efforts to cleanse them of the central characteristics of a TIC have the negative effect of creating a TICnership. Thus, TICnerships lurk anywhere a TIC arrangement is created to facilitate the acquisition or disposition of property as part of a transaction intended to qualify for section 1031 nonrecognition.

D. Longer-Lasting TICs are at Greater Risk of TICnership Classification

The risk that a TIC arrangement will be classified as a TICnership undoubtedly correlates with the length of time parties intend for the TIC arrangement to be in existence and how long it will be in existence.[47] First, if parties intend for property to remain in a TIC arrangement for an indefinite period of time, they are more likely to add features to the TIC arrangement upon its formation that eliminate one or more of the central characteristics of a TIC. The longer the parties plan to hold property in a TIC arrangement, the more contingencies they will want to cover in their agreement. For instance, if a developer and investor become TIC co-owners of property, they will be less concerned about profit sharing if they only hold the property in a TIC arrangement until construction begins. If they plan to hold the property in a TIC arrangement through the construction phase, they will most likely want to add features to the TIC arrangement that grant the developer authority to make decisions on behalf of the arrangement and grant the developer a disproportionate share of the profits.

Second, the longer parties remain in a TIC arrangement, the more likely they are to add features to the arrangement that eliminate the central characteristics of a TIC. For instance, if the co-owned property is rental property, the market may demand that the TIC co-owners begin adding services that go beyond those required to rent the property and turn the arrangement into a business or venture.[48] If other property owners buy interests in the property, the TIC co-owners may wish to add buy-sale restrictions that eliminate the central characteristics of free transferability and the right to partition. Thus, TICnerships lurk in TIC arrangements that are formed to continue longer than required to establish the existence of a TIC, which, as shown below, is generally only an instant.[49]

IV. CLASSIFICATION OF TICS & TICNERSHIPS

The law governing whether a TIC arrangement is a TIC or TICnership is largely found in cases and IRS rulings, and the question of whether an arrangement is a tax partnership or TIC can be one of the most difficult

47. *See infra* Part VII.A.1.
48. *See infra* Part IV.B.1(k) (discussing the level of permitted activity).
49. *See infra* Part VII.A.1.

questions in tax law.[50] A co-ownership arrangement can be a TIC only if it is not a tax partnership. Thus, any TIC arrangement that comes within the definition of tax partnership is a TICnership and not a TIC. Conversely, any TIC arrangement that does not come within the definition of tax partnership is a TIC.

For property owners attempting to do a section 1031 exchange with an interest in co-owned property, the classification of the arrangement as a TIC is essential to the property owner completing the section 1031 exchange. In other situations, the relative tax benefits of a TIC over a TICnership may not be obvious. The discussion below illustrates how the tax treatment of the two types of arrangements can vary and how the differences can affect whether tax partnership classification or TIC classification will be more beneficial to TIC co-owners at a particular point in time or with respect to particular issues.[51] This Part reviews the law governing the classification of TIC arrangements as TICs or TICnerships by first considering the federal definition of tax partnership and then considering guidance that relates to TIC classification. The discussion in this Part focuses on the classification of a TIC arrangement as a TIC or TICnership. The next Part focuses on the tax treatment of TICs and TICnerships. That discussion demonstrates that TIC co-owners typically cannot have their proverbial TIC cake and eat it too—if they claim TIC classification for a TIC arrangement with partnership features, they must account for transactions that may generate unexpected and perhaps unpleasant tax consequences.

A. PARTNERSHIP CLASSIFICATION

Partnership classification rules exist in tax law and under state law. The two classification systems are similar, and they each are significantly relevant to the co-owners. Tax classification determines the nature of the interest held by the members of an arrangement, and state-law classification can affect the members' legal rights and obligations.

1. *Tax-Law Classification*

A tax partnership is an arrangement between two or more persons that "carry on a trade, business, financial operation, or venture and divide the profits therefrom," which is not a corporation.[52] Based upon this definition, the question of whether a co-ownership arrangement is a TIC or tax partnership depends upon whether it carries on a business or venture and divides the profits therefrom. Case law and IRS rulings consider that question

50. *See* Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV 925 (2006) [hereinafter, Borden, *Federal Definition*].
51. *See infra* Part V.
52. I.R.C. § 761(a); Treas. Reg. §§ 301,7701-1(a)(2), -2, -3.

in numerous contexts,[53] providing guidelines but no clear distinction between TICs and tax partnerships that are close to the line dividing the two classifications.[54]

The level of business activity of TIC co-owners can cause a co-ownership arrangement to be a tax partnership. A joint undertaking merely to share expenses is not, however, a tax partnership.[55] A mere co-ownership arrangement is not a tax partnership if it "is maintained, kept in repair, and rented or leased."[56] A co-ownership of an apartment building is a tax partnership if "the co-owners of . . . [the] building lease space and in addition provide services to the occupants either directly or through an agent."[57] The IRS has also provided this guidance regarding the effect the level of business activity has on the classification of a co-owned apartment project: "The furnishing of customary services in connection with the maintenance and repair of the apartment project will not render a coownership a partnership. However, the furnishing of additional services will render a coownership a partnership if the additional services are furnished directly by the coowners or through their agent."[58] The level of business activity of TIC co-owners is therefore critical in determining whether a TIC arrangement is a TIC or a TICnership. If the TIC co-owners of a TIC arrangement engage in too much business activity, the arrangement will be a TICnership.

Some other general concepts derive from the case law and rulings regarding the definition of tax partnership. First, courts often attempt to determine if the TIC co-owners intended for an arrangement to be a tax partnership.[59] Because intent is subjective, courts may downplay its relevance

53. Bradley T. Borden, *Catalogue of Legal Authority Addressing the Federal Definition of Tax Partnership*, 746 TAX PLAN. FOR DOMESTIC & FOREIGN P'SHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLS. 1, 1 (2007).

54. *See* Borden, *Federal Definition*, *supra* note 50.

55. Treas. Reg. § 301.7701-1(a)(2).

56. *Id.* ("For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.").

57. *Id.*

58. Rev. Rul. 75-374, 1975-2 C.B. 261.

59. *See, e.g.*, Comm'r v. Culbertson, 337 U.S. 733, 748 (1949) (instructing the Tax Court to reconsider which of the family members had "a bona fide intent [to] be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital of which they were the true owners"); ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 516 (D.C. Cir. 2000) (finding that no tax partnership existed when "none of the supposed partners had the intent to form a real partnership"); Comm'r v. Olds, 60 F.2d 252, 254–55 (6th Cir. 1932) (holding that parties' intent to form a tax partnership is sufficient to overcome the IRS's challenge that family arrangement was a sham); Alhouse v. Comm'r, 62 T.C.M. (CCH) 1678 (1991) (stating that whether a co-ownership arrangement is a tax partnership "is a question of fact, that turns on the parties' intent"); Estate of Levine v. Comm'r, 72 T.C. 780, 785 (1979) (stating that the crucial question is whether parties "intended to create, as evidenced by their actions, a partnership."); Allison v. Comm'r, 35 T.C.M. (CCH) 1069 (1976) (stating that the tax partnership question is "essentially factual with emphasis placed on the intention of the parties").

and consider facts that indicate the parties intended the arrangement to be a tax partnership.[60] A common list of factors include the following:

> [1] The agreement of the parties and their conduct in executing its terms; [2] the contributions, if any, which each party has made to the venture; [3] the parties' control over income and capital and the right of each to make withdrawals; [4] whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; [5] whether business was conducted in the joint names of the parties; [6] whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; [7] whether separate books of account were maintained for the venture; and [8] whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.[61]

Some of these factors are simple to spot in a co-ownership arrangement, and their effect is obvious. For instance, the filing of a partnership tax return for a co-ownership arrangement is easy to spot and generally indicates the arrangement is a tax partnership.[62] Maintaining separate books and accounts for a co-ownership arrangement indicates the arrangement is a tax partnership.[63] A separate balance sheet and profit-loss statement for the arrangement would appear to be separate books and accounts that indicate the arrangement is a tax partnership.

Traditional entity characteristics include continuity of life of an arrangement and centralized management.[64] Centralized management is

60. *See, e.g.*, Evans v. Comm'r, 447 F.2d 547, 550–51 (7th Cir. 1971) (concluding that "[i]f the corporation's ownership is real then the subjective intent of the parties is not a determinative test," and *Commissioner v. Culbertson* is no longer the test since it was decided before the enactment of section 704(e)(1)).

61. *See* Luna v. Comm'r, 42 T.C. 1067, 1077–78 (1964).

62. *See, e.g.*, McManus v. Comm'r, 583 F.2d 443, 447 (9th Cir. 1978) (estopping co-ownership arrangement that purchased and subdivided property, treated the arrangement as a partnership for accounting purposes, opened a bank account, and filed a partnership tax return from treating the arrangement as something other than a tax partnership); Demirgian v. Comm'r, 457 F.2d 1, 4–5 (3d Cir. 1972) (estopping the TIC co-owners from claiming arrangement they held out as a partnership and which filed a tax return was not a tax partnership); Rothenberg v. Comm'r, 48 T.C. 369, 373 (1967) (estopping the TIC co-owners from claiming the arrangement was not a tax partnership). *But see* Powell v. Comm'r, 26 T.C.M. (CCH) 161 (1967) (finding that the sibling TIC co-owners did not intend to form a partnership even though they filed a partnership tax return for the co-ownership arrangement).

63. *See McManus*, 583 F.2d at 447.

64. *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); A. Ladru Jensen, *Is a Partnership Under the* 33 *Uniform Partnership Act an Aggregate or an Entity?*, 16 VAND. L. REV. 377, 381 (1963) (listing the following as factors as essentials of a separate entity: (1) its own name; (2) a continuous life separate from that of its owners; (3) the right to contract; (4) the power to acquire, manage, and

manifested by a manager who can make decisions and carry out actions independent of owner approval. In such arrangements, the owners typically have passive roles. Thus, if TIC co-owners of a TIC arrangement cede management authority to another person, the arrangement has an essential entity characteristic and is more likely to be classified as a TICnership.

2. *State-Law Classification*

The IRS and courts are not bound by the state-law definitions of TIC and partnership,[65] but the state-law definition can inform the analysis of an arrangement.[66] The definition of partnership from the Restated Uniform Partnership Act has been adopted by many states:[67] "an association of two or more persons to carry on as co-owners a business for profit . . . ."[68] Many co-ownership arrangements that add business activity or profit-sharing would come within this definition. The significance of coming within the state-law definition of partnership is that the *de facto* partners become jointly and severally liable for the liabilities of the *de facto* partnership,[69] and the arrangement can create fiduciary duties.[70] The imposition of fiduciary duties should be of particular interest to TICnership sponsors who represent to section 1031 property owners that their arrangements will be treated as TICs. In fact, the situations in which classification may be relevant are difficult to predict. One can imagine, however, that if classifying a TIC arrangement as a state-law partnership could give property owners a fiduciary-duty claim against the sponsor in the case of questionable sponsor behavior and poor performance of the property, the property owners might assert that the arrangement is a state-law partnership.

Despite a significant body of case law that considers whether a co-ownership arrangement is a TIC or TICnership, the law in this area is not well established. Many property owners who are undertaking a section 1031 exchange seek certainty regarding the classification of a TIC arrangement in which they will invest. Because there is no clear definition of TIC and tax partnership, advisors struggled to know where the line between TIC and partnership should be drawn and often could not provide a high level of

dispose of both personal and real property; (5) sole liability for torts; and (6) the right to sue and be sued).

65. Treas. Reg. § 301.7701-1(a).

66. Borden, *Federal Definition*, *supra* note 50.

67. The Uniform Law Commission reports that 45 states have adopted the RUPA. *See Partnership Act*, UNIF. L. COMM'N, https://www.uniformlaws.org/committees/community-home?CommunityKey=52456941-7883-47a5-91b6-d2f086d0bb44#:~:text=The%20Uniform%20Partnership%20Act%20of,an%20aggregate%20of%20individual%20partners (last visited Feb. 2, 2024).

68. Uniform Partnership Act of 1997 § 102(11) (2015).

69. *Id.* § 306(a).

70. *Id.* §§ 404(b) (imposing the duty of loyalty on partners), (c) (imposing the duty of care on partners). On the other hand, "[t]here is no privity or fiducial relationship between cotenants." Taylor v. Brindly, 164 F.2d 235, 240 (10th Cir. 1947).

certainty regarding the classification of TIC arrangements. The IRS has provided guidance in Rev. Proc. 2002-22 that advisors may rely upon to gain a fairly high degree of certainty that an arrangement will be a TIC,[71] so many TIC arrangements are structured to comply with that guidance.

B. REV. PROC. 2002-22 & TIC CLASSIFICATION

In the early 2000's, a market arose for syndicated TICs as section 1031 replacement property for exchangers who sold property they had managed for years and sought a passive source of income.[72] TIC syndicators sought guidance from the IRS regarding the classification of their syndicated TICs. In response, the IRS issued Rev. Proc. 2002-22, providing guidelines for taxpayers seeking advanced rulings that an arrangement would be treated as a TIC for federal income tax purposes.[73] The cost of private letter rulings exceeds the capacity of many exchangers,[74] and obtaining a private letter ruling requires advisor time to request the ruling and time for the IRS to issue the ruling, which time will normally extend beyond the time afforded to exchangers to complete exchanges.[75] Consequently, the IRS has only issued a handful of private rulings under Rev. Proc. 2002-22.[76] Furthermore, IRS

71. Rev. Proc. 2002-22, 2002-1 C.B. 733.

72. Borden, *supra* note 18, at 387–93 (recounting the growth of the syndicated TIC industry); Kevin Thomason & Todd Keator, *IRS Offers Lenience for Beleaguered Tenancy-in-Common Investors*, 38 REAL EST. TAX'N 4 (2010); Bradley T. Borden, *New Safe Harbor Promotes Reverse Exchanges*, PRAC. TAX STRAT. Feb. 2001, at 68, 11 J. OF CONST. ACTG. AND TAX'N 3, 1 (2001).

73. Rev. Proc. 2002-22, 2002-1 C.B. 733, § 3 ("This revenue procedure provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes.").

74. The IRS charges a $38,000 fee for most private letter rulings. Rev. Proc. 2024-1, Appendix A(A)(3)(c)(ii), 2024-1 I.R.B. 1. Added to that IRS fee would be the fees for attorneys to draft the letter ruling request and have pre-ruling conferences with the IRS. The attorney fees could easily exceed the IRS's fee. A TIC investment could be attractive to the owner of a small property who desires to be relieved of property management responsibilities and draw passive income. To obtain a private letter ruling under today's fee structure, the property owner may have to pay more than $100,000 in IRS and advisor fees. The gain to be recognized on the property would have to be great enough to generate a tax greater than the fees to justify the costs of obtaining a private letter ruling. Many transactions, when the adjusted basis of the property and the amount realized are taken into account to compute gain, would not justify the cost. Even for larger transactions with seven-figure taxes at issue, a six-figure transaction cost could exceed 10 percent of the potential tax savings. That is a significant cost.

75. The IRS commits to respond to requests for letter rulings within 180 days after the date it receives the request. Internal Revenue Service, INTERNAL REVENUE MANUAL, ¶ 32.3.2.3 (July 9, 2014), https://www.irs.gov/irm/part32/irm_32-003-002. The IRS also provides a twelve-week fast-track program for requests that satisfy certain criteria. Rev. Proc. 2022-10, §§ 3.02, 4, 2022-6 I.R.B. 473. In addition to the time required for the IRS to issue its ruling, the property owner must incur the time and cost to prepare the ruling request. Often, such time will exceed the forty-five-day identification period and 180-day-exchange period provided for in section 1031(a)(3).

76. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2016-22-008 (Feb. 23, 2016) (ruling privately that the seller's option to put interests in property to a buyer at a fixed amount, subject to escalators, did not cause the arrangement to become a TICnership); I.R.S. Priv. Ltr. Rul. 2008-29-012 (Mar. 17, 2008) (allowing co-ownership arrangement to include certain buy-sell provisions); I.R.S. Priv. Ltr. Rul.

private letter rulings only apply to the taxpayer to whom they are issued,[77] and of the few private letter rulings issued with respect to Rev. Proc. 2002-22, some appear to have been obtained by TIC syndicators,[78] so those few rulings have almost no precedential value.[79] Instead, the issued private letter rulings can be authority for avoiding penalties.[80]

Despite the limited requests for rulings and the few resulting rulings under Rev. Proc. 2002-22, the revenue procedure became important to anyone seeking to form a TIC arrangement that needed to be classified as a TIC. The conditions in Rev. Proc. 2002-22 are more stringent than the common-law definition of TIC,[81] so the prevailing thought is that compliance with the guidelines in Rev. Proc. 2002-22 should almost certainly result in an arrangement being classified as TIC for federal income tax purposes.[82] Thus, Rev. Proc. 2002-22 has become a starting point for structuring TIC arrangements. Prudence dictates that, when possible, TIC arrangements should be structured to comply with Rev. Proc. 2002-22. Such structuring is made easier when the temporal need for the TIC arrangement is limited.

1. *Rev. Proc. 2002-22-Compliant TICs*

Revenue Procedure 2002-22 presents conditions for requesting an advance ruling that interests in an arrangement are TIC interests.[83] The revenue procedure thus provides no substantive law or rules that would bind the IRS or the courts, and the IRS is not to use the guidelines for audit purposes.[84] Furthermore, a TIC arrangement's failure to comply with all of the conditions in Rev. Proc. 2002-22 does not necessarily indicate that the

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2008-26-005 (Mar. 17, 2008) (allowing co-ownership arrangement to include certain buy-sell provisions); I.R.S. Priv. Ltr. Rul. 2006-25-009 (Mar. 17, 2008) (allowing co-ownership arrangement to include certain buy-sell provisions and right to indemnification of advance payments that exceed a co-owner's interest); I.R.S. Priv. Ltr. Rul. 2003-27-003 (Mar. 7, 2003) (allowing approval to be inferred from no response to notice of action).

77. I.R.C. § 6110(k)(3) ("Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent."), *cited in* I.R.S. Priv. Ltr. Rul. 2003-27-003 (July 2, 2003) ("This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent" along with most other private letter rulings).

78. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2003-27-003 (July 3, 2003) (issuing private ruling to a company that would acquire property and sell undivided interests).

79. *See supra* note 77.

80. Treas. Reg. § 1.6662-4(d)(3)(iii) (providing that private letter rulings may be relied upon to determine if a reporting position has substantial authority); Bradley T. Borden, *Tax-Law Analysis*, 19 BROOK. J. CORP. FIN. & COM. L. 385 (2024); Borden & Keator, *supra* note 19, at 88–89 (discussing the manner in which practitioners look to Rev. Proc. 2002-22 when drafting opinion letters regarding the classification of TIC arrangements).

81. Borden, *Federal Definition*, *supra* note 50 (identifying ten tests that derive from case law and rulings for determining whether an arrangement is tax partnership).

82. Borden & Keator, *supra* note 19, at 88–92.

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

84. *Id.*

arrangement will not be a TIC.[85] Thus, some arrangements that do not comply with all the Rev. Proc. 2002-22 conditions could be a TIC for federal income tax purposes, but any deviations from the conditions in Rev. Proc. 2002-22 should be supported by case law or other IRS guidance.[86] Not all conditions are created equal, and tax advisors in the know realize that failing certain conditions would be fatal to the TIC classification while failing other conditions might not adversely affect TIC classification.[87]

The following discussion identifies Rev. Proc. 2002-22 conditions. Although the conditions are not requirements that TIC co-owners must establish to obtain TIC classification, the conservative nature of the conditions provide the comfort discussed above.[88] Thus, advisors often inform property owners that if a TIC arrangement complies with the conditions in Rev. Proc. 2002-22, the arrangement should be classified as a TIC. Arrangements that comply with the conditions in Rev. Proc. 2002-22 are often referred to as compliant TICs and are distinguished from arrangements that do not comply with all of the conditions.

(a) Condition 1: Tenancy in Common Ownership

The first condition is that each TIC co-owner must hold title to the property either directly or through a disregarded entity as a tenant in common under the local law of where the property is located.[89] Under this condition, title to the property cannot be held by an entity recognized under local law.[90] This condition may be inconsistent with general principles of tax law, which recognizes that legal title is just one indicium of ownership.[91] At times, transferring legal title from one entity may be infeasible due to various

85. In fact, the IRS acknowledges that it may issue rulings that an arrangement is a TIC even though it does not satisfy all the conditions. *Id.* at § 6. *See also* Borden & Keator, *supra* note 19, at 89.

86. Borden & Keator, *supra* note 19, at 89–92.

87. *Id.* at 92–96.

88. *See supra* text accompanying notes 81–87.

89. Rev. Proc. 2002-22, § 6.01.

90. *Id.*

91. Comm'r v. Union Pacific R.R. Co., 86 F.2d 637, 639 (2d Cir. 1936) ("A closed transaction for tax purposes results from a contract of sale which is absolute and unconditional on the part of the seller to deliver to the buyer a deed upon payment of the consideration and by which the purchaser secures immediate possession and exercises all the rights of ownership."); Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221, 1236 (1981) ("[T]he Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of the property where the transferor continues to retain significant control over the property transferred."), 1237 (listing whether legal title passes as one of eight factors to consider, including "(2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property" (citations omitted)).

restrictions, including lender restrictions. In such situations, the parties may be able to transfer tax ownership to tenants in common using a nominee arrangement pursuant to which all the benefits and burdens of ownership are transferred to tenants in common even though legal title is held by a separate entity as nominee.[92]

(b) Condition 2: Number of Co-Owners

The second condition limits the number of TIC co-owners to no more than thirty-five.[93] The rationale for this condition is uncertain, but the IRS appears concerned that if the number of TIC co-owners becomes too large, the arrangement will begin to be more like a separate entity than a TIC arrangement. With the exception of syndicated TIC arrangements, which may have dozens of TIC co-owners, most TIC arrangements that are formed to accommodate the section 1031 exchange of one or more TIC co-owners have a few co-owners. This condition is not an issue for most TIC arrangements seeking to obtain TIC classification.

(c) Condition 3: No Treatment of Co-Ownership as an Entity

This condition prohibits TIC arrangements from filing a separate partnership or corporate tax return, conducting business under a common name, entering into an agreement identifying any or all of the TIC co-owners as partners or members of a business entity, or otherwise holding themselves out as partnerships.[94] This condition appears to be drawn directly from the common law definition of tax partnership.[95] A TIC arrangement that does any of the activities prohibited by this condition is at significant risk of being classified as a TICnership because these are activities that the TIC co-owners control and that demonstrate their intent as communicated to other parties.

(d) Condition 4: Co-Ownership Agreement

The fourth condition permits TIC co-owners to enter agreements that run with the land and permits such agreements to provide that TIC co-owners must offer to sell their property interests to other TIC co-owners before exercising a right to partition and to provide that some actions require the vote of more than 50 percent of the undivided interests in the property.[96] Tax and other areas of the law take into account any and all agreements, including side letters and other documents, and arrangements between and among TIC

92. *See, e.g.*, Keith v. Comm'r, 115 T.C. 605 (2000) (holding that a transfer occurred upon execution of contracts for deed that were not accompanied by transfer of legal title).

93. Rev. Proc. 2002-22, § 6.02.

94. *Id.* § 6.03; *see also* Taylor v. Brindley, 164 F.2d 235, 240 (10th Cir. 1947) ("The relationship may be involuntary, and does not contemplate a joint venture or joint profit.").

95. *See supra* text accompanying note 68.

96. Rev. Proc. 2002-22, § 6.04.

co-owners to determine whether a TIC arrangement includes the central characteristics of a TIC.[97] Tax law can consider a primary TIC agreement, side letters, management agreements, unwritten agreements, actual practice among the TIC co-owners and between the TIC co-owners and others, and any other facts that reveal the true nature and substance of a co-ownership arrangement.[98]

Property owners may ask about using side letters or other side agreements as a possible means of concealing the true nature of an arrangement. In drafting such agreements, they should assume that the IRS will become aware of them. Thus, property owners should not consider using letters or other agreements to conceal arrangements. Such agreements are effective for confidentially granting some rights or interests to specific members but not all members. To the extent such arrangements do not violate the law or fiduciary or other duties owed to other members of a TIC arrangement, they could have a worthy legal purpose. Such agreements must, however, be taken into account when determining the terms of a TIC arrangement for the purposes of classifying the arrangement.

(e) Condition 5: Voting

The fifth condition requires the TIC co-owners to retain the right to approve the hiring and contract of a manager, the sale or other disposition of the property, entering into or modifying leases of a portion or all of the property, and negotiating the terms of a blanket lien on the property.[99] This condition recognizes that a feature of entities is that they can separate ownership from management. This condition keeps the management within the control of the TIC co-owners.

97. *See, e.g.*, United States v. Silver, 948 F.3d 538, 571 (2d Cir. 2020) (considering the terms of a side letter in deciding whether the *quid pro quo* existed between the parties to the side letter); Putanec v. Comm'r, 112 T.C.M. (CCH) 620 (2016) (considering a promise to renew a loan that was included in a side letter); Santa Monica Pictures, LLC v. Comm'r, 89 T.C.M. (CCH) 1157 (2005) (treating a side letter agreement as part of the arrangement between the parties); ESG Capital Partners II, LP v. Passport Special Opportunity Master Fund, LP, C.A. No. 11053–VCL, 2015 WL 9060982, at *12–*15 (Del. Ch. Dec. 16, 2015) (considering whether a side letter was a valid amendment to a limited partnership agreement); Elisabeth de Fontenay & Yaron Nili, *Side Letter Governance*, 100 WASH. U. L. REV. 907 (2023) (recognizing the standard use of side letters in private equity industry to provide differential treatment to various investors).

98. *See* Gregory v. Helving, 293 U.S. 465 (1935) (taking into account the whole undertaking to determine the substance of the transaction). Courts abandon the substance-over-form doctrine when considering whether a transaction satisfies the section 1031 exchange requirement. *See* Borden, *Exchange Requirement*, *supra* note 4, at 421–36. That exception would not apply to the determination of whether the multiple agreements between and among TIC co-owners of a TIC arrangement create a TIC or a TICnership.

99. Rev. Proc. 2002-22, § 6.05.

(f) Condition 6: Restrictions on Alienation

A central characteristic of a TIC is that the TIC co-owners separately own their undivided interests in the property and that they can partition the property.[100] Cognizant of this central characteristic, the IRS created a condition that generally requires TIC co-owners to have the right to transfer, partition, or encumber their respective undivided interests.[101] The IRS recognizes that arrangements do not unduly restrict the right to transfer or partition by granting TIC co-owners the right of first offer with respect to the right to transfer and offering undivided interests to other TIC co-owners before exercising the right to partition.[102] It also recognizes that some property owned in TIC arrangements will be subject to transfer restrictions imposed by lenders and allows such restrictions if they are consistent with customary commercial lending practices.[103]

Restrictions on transferring interests in closely-held companies are important to most investors because they want to be able to choose with whom they will be in partnership. This condition that limits such restrictions renders TIC arrangements that comply with Rev. Proc. 2002-22 unattractive to many investors.

(g) Condition 7: Sharing Proceeds & Liabilities upon Sale of Property

Continuity is an entity attribute, meaning entities tend to continue even if they sell property, discontinue a line of business, or ownership changes. The seventh condition appears to address the continuity attribute by requiring that, upon sale of property owned in a TIC arrangement, any debt secured by a blanket lien on the property be satisfied and proceeds be distributed to the TIC co-owners.[104] TIC arrangements that satisfy this condition cease to exist when they sell their property, ensuring that the arrangement does not continue beyond the sale of the property.

To satisfy this condition, a TIC arrangement could not provide that sale proceeds would be used to pay outstanding expenses related to the property, unsecured loans made to any of the TIC co-owners, or to pay outstanding fees to third parties. If a TIC agreement were to provide for the payment of such amounts, it would add entity characteristics to the arrangement—the arrangement, not the individual TIC co-owners, would pay those items at closing. An alternative to such disbursements is to have the TIC co-owners each prepare their own closing statements and arrange to pay their respective

100. *See supra* Part II (defining central characteristics of a TIC).
101. Rev. Proc. 2002-22, § 6.06.
102. *Id.*
103. *Id.*
104. *Id.* § 6.07; *see also In re* Hedrick, 441 B.R. 601, 608 (Bankr. S.D. Ill. 2010) ("Therefore, upon a sale of property held in tenancy in common, each cotenant is entitled to a distribution of the proceeds in accordance with his or her respective interest in the property.").

shares of expenses, unsecured loans, and unpaid fees at closing instead of having the TIC arrangement pay those amounts. The IRS does not explain why it did not provide that sale proceeds could be used to pay other items at closing, so its reasoning is unknown, but the provision is consistent with a non-entity view of TIC arrangements.

(h) Condition 8: Proportionate Sharing of Profits & Losses

Owners of undivided interests in real property own a fractional interest of the entire property,[105] so they are entitled to a proportionate share of the revenues from the property and are responsible for a proportionate share of the expenses of the property[106]. The IRS incorporates this central characteristic of a TIC into the eighth condition, requiring that each TIC co-owner must share in all revenues from and all costs associated with the property in proportion to their undivided interests in the property.[107] Because each TIC co-owner in a TIC owns an undivided interest in the property, deviations from this requirement to share revenue and expenses in accordance with ownership interests in the property will undermine TIC classification. This is one of the most important central characteristics of a TIC, so property owners who are serious about having a TIC arrangement be classified as a TIC must ensure that the arrangement requires a proportionate sharing of revenue and expenses.[108]

(i) Condition 9: Proportionate Sharing of Debt

Consistent with the notion that TIC co-owners own undivided interests in property, condition 9 requires that the TIC co-owners share proportionately (based on their ownership interests) in any indebtedness secured by a blanket lien on the property.[109] Any deviations from this condition would defy the central characteristic of a TIC that each TIC co-owner has an undivided interest in the property. A liability secured by a blanket lien that is not borne proportionately by the TIC co-owners indicates the TIC co-owners have done something to alter their proportionate ownership of undivided interests in the property.[110]

105. *See, e.g.*, D'Ercole v. D'Ercole, 407 F. Supp. 1377, 1380 (D. Mass. 1976) ("Each tenant owns an undivided fraction, being entitled to an interest in every inch of the property.").

106. *See, e.g.*, *In re Hedrick*, 441 B.R. at 607–08 ("As a result, each cotenant is entitled to no more than his or her fractional share of the whole.").

107. Rev. Proc. 2002-22, § 6.08.

108. Notice the heading for this condition uses the term "profit." The use of that term appears to be misplaced. Profit is the difference between revenue and expenses. To compute profit, a person must have revenue and expenses. Because a TIC arrangement classified as a TIC is not a distinct entity, it cannot have its own revenue and expenses, so it cannot have or compute profits. The heading probably should have used the term "revenue" instead of "profit."

109. Rev. Proc. 2002-22, § 6.09.

110. *See infra* Part VI.A.4.

(j) Condition 10: Options

Options to acquire or sell property have the potential of shifting revenue and expense sharing. For instance, a fixed-price call option would allow one TIC co-owner (the purchasing TIC co-owner) to acquire an undivided interest in the property from another TIC co-owner (the selling TIC co-owner) at a below-market price and then sell it at a fair-market price. The difference between the below-market exercise price of the option and the fair-market price at which the purchasing TIC co-owner sells the undivided interest is profit that goes to the purchasing TIC co-owner instead of going to the selling TIC co-owner. Thus, the fixed-price call option creates a deviation from the proportionate-share-of-revenue central characteristic of a TIC. Deviation from this fundamental central characteristic of a TIC would most likely cause a TIC arrangement to lose TIC status. Similar outcomes result from fixed-price put options.[111]

The IRS appears to have recognized that options can cause TIC arrangements to abandon proportionate sharing of revenue and expenses, so the tenth condition allows TIC co-owners to grant call options that are exercisable at market value to other TIC co-owners.[112] That condition specifically prohibits TIC co-owners from granting put options to other TIC co-owners, and by only sanctioning call options exercisable at market value, it implicitly prohibits TIC co-owners from granting fixed-price call options to other TIC co-owners.[113]

(k) Condition 11: No Business Activity

As discussed above, the general definition of tax partnership refers to the joint carrying on of a business or other venture.[114] For a TIC arrangement to be classified as a TIC, the activities of the TIC co-owners and their agents must be limited. Condition 11 of Rev. Proc. 2002-22 cites Rev. Rul. 75-374 and provides that their activities must be limited to those "customarily performed in connection with the maintenance and repair of rental property."[115] This condition also draws from the rules governing the definition of rent in the tax-exempt context.[116] The limitation on business activities helps ensure that the TIC co-owners are only receiving revenue and paying expenses related to owning real property. If the TIC co-owners

111. *See* Borden, *Fixed-Price Put Options*, *supra* note 19.

112. Rev. Proc. 2002-22, § 6.10 (defining fair market value of an undivided interest as equal to the TIC co-owner's percentage interest in the property multiplied by the value of the property as a whole).

113. *Id.*

114. *See supra* text accompanying notes 52–58.

115. Rev. Proc. 2002-22, § 6.11.

116. *Id.* ("Activities will be treated as customary for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying for rent under § 512(b)(3)(A) and the regulations thereunder.").

receive revenue or profits from other activities they engage in with respect to the property, then the arrangement would be something more than a TIC because TIC co-owners of a TIC only hold undivided interests in the property.

The restriction on business activities would jeopardize TIC classification for many TIC arrangements. For instance, the TIC co-owners of a hotel held in a TIC arrangement most likely could not manage the hotel. Instead, the TIC co-owners would most likely lease the hotel to an operating company, and the operating company would manage the hotel and retain the profits from managing the hotel.[117] Because activities of the agents of TIC co-owners are taken into account when determining the level of activities of the TIC co-owners, any structure must ensure that the operating company is not acting as the agent of the TIC co-owners.

(l) Condition 12: Management & Brokerage Agreements

A fundamental characteristic of an entity is that some members are passive while others actively manage the business. Such an entity characteristic is contrary to the central characteristic of a TIC that each TIC co-owner holds an undivided interest in the property with possessory rights. By ceding authority to a long-term manager, TIC co-owners diminish their possessory rights.[118] Thus, any TIC arrangement that cedes management authority to a manager long-term begins to look more like an entity.

The twelfth condition of Rev. Proc. 2002-22 imposes restrictions on the authority TIC co-owners can grant managers, the term for which managers can be appointed, and the manner in which managers can be compensated.[119] For instance, this condition requires that management agreements be renewable no less frequently than annually, prohibits manager compensation from depending on the income or profits derived from the property, and requires that such fees not exceed the fair market value for such services.[120] Any agreement with a manager, whether in a TIC agreement or a separate management agreement, that does not adhere to these restrictions would violate the condition.

The twelfth condition allows the TIC co-owners to commission the manager to maintain a common bank account for the collection of rent and payment of expenses associated with the property, but the manager must disburse net revenues to the TIC co-owners within three months from the date of receipt.[121] Along those lines, this condition also allows the manager to prepare statements for the TIC co-owners showing their shares of revenue and costs from the property (notice the condition does allow preparing

117. *See infra* Part VII.B.5 (discussing this type of Propco-Opco arrangement).
118. *See supra* text accompanying notes 27–29 (discussing rights of possession generally).
119. Rev. Proc. 2002-22, § 6.12.
120. *Id.*
121. *Id.*

financial statements, such as balance sheets and income statements for the TIC arrangement).[122] Thus, this condition allows TIC co-owners to hire a manager for a limited term to fulfill functions that are needed for the rental of property but that reflect the central characteristics of a TIC.

(m) Condition 13: Leasing Agreements

The thirteenth condition of Rev. Proc. 2002-22 requires that all leases be *bona fide* leases, which requires that the rents reflect the fair market value for the use of the property and not depend upon the income or profits derived by any person from the leased property.[123] Courts consider whether the terms of a lease might create a tax partnership,[124] so the requirement for *bona fide* market-value leases that are independent of tenant income helps ensure that TIC arrangements are not in partnership with tenants.

(n) Condition 14: Loan Agreements

The fourteenth condition prohibits lenders from being related to any TIC co-owner or lessee.[125] Arrangements structured as financings can be scrutinized to determine whether they are tax partnerships.[126] The relationship of the lender to the borrower does not feature prominently in cases that have considered whether a financing arrangement created a tax partnership. Thus, the basis for this condition is uncertain. Perhaps the IRS is concerned that a TIC co-owner, through the related party, would obtain a disproportionately large share of the TIC arrangement's revenue and bear a disproportionately small share of the TIC arrangement's costs if the TIC co-owner was related to the lender. Because the common-law definition of tax partnership does not appear to rely upon lending from a related party to determine whether a TIC arrangement is a tax partnership, noncompliance with this condition may not cause the arrangement to lose its TIC status.

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122. *Id.*

123. *Id.* § 6.13 (allowing rents to be based on a fixed percentage of receipts or sales but prohibiting rent from being based on a percentage of net income from the property, cash flow, increases in equity, or similar arrangements).

124. *See, e.g.*, Harlan E. Moore Charitable Tr. v. United States, 9 F.3d 623 (7th Cir. 1993) (holding that a sharecropping arrangement was not a tax partnership); Place v. Comm'r, 199 F.2d 373 (6th Cir. 1952) (holding that arrangement between husband and wife was a lease, not a partnership).

125. Rev. Proc. 2002-22, § 6.14.

126. *See, e.g.*, Bowe-Burke Mining Co. v. Willcuts, 45 F.2d 394 (D. Minn. 1930) (finding that financing arrangement was not a tax partnership); Joe Balestrieri & Co. v. Comm'r, 177 F.2d 867 (9th Cir. 1949) (holding that financing arrangement was not a tax partnership); Haley v. Comm'r, 203 F.2d 815 (5th Cir. 1953) (holding that arrangement was a tax partnership and not a financing arrangement); Arthur Venneri Co. v. United States, 340 F.2d 337 (Ct. Cl. 1965) (holding that financing arrangement was not a tax partnership); Baily v. United States, 350 F. Supp. 1205 (E.D. Pa. 1972) (holding that arrangement was a tax partnership and not a financing arrangement); Allison v. Comm'r, 35 T.C.M. (CCH) 1069 (1976) (holding that financing arrangement was not a tax partnership); Hunt v. Comm'r, 59 T.C.M. (CCH) 635 (1990) (holding that arrangement was a tax partnership and not a financing arrangement).

(o) Condition 15: Payment to Sponsors

The final condition of Rev. Proc. 2002-22 requires that any payment to a sponsor for an interest in the property must reflect the fair market value of the interest and may not depend on the income or profits derived from the property.[127] This condition is consistent with the central characteristic of a TIC that revenue and expenses must be shared by the TIC co-owners in proportion to their ownership interests in the property.[128] In many real estate ventures, the sponsor procures property, brings investors together, manages the property, and then assists with the disposition of the property. Instead of receiving traditional compensation for such services, sponsors receive a promote from operations or a capital event related to the property.[129] This condition prohibits such arrangements. Because such arrangements violate proportionate sharing of revenue and expenses, they would most likely cause a TIC arrangement to be a TICnership.

2. *Noncompliant TIC Arrangements & TICnerships*

The preceding discussion of the conditions in Rev. Proc. 2002-22 illustrates the features a TIC arrangement must have to comply with the revenue procedure and provides some indication of which conditions are essential to TIC classification. Conditions that are most closely related to the central characteristics of TICs are essential to TIC classification. Indeed, arrangements that do not comply with the conditions in Rev. Proc. 2002-22 should consider whether the deviations affect the central characteristics of a TIC.[130] For instance, deviations should reflect the TIC co-owners' undivided interests in the entire property, should not affect the TIC co-owners' proportionate shares of rents and obligations for expenses, impede TIC co-owners' right to transfer interests in or partition the property, and should not prevent TIC owners from participating in the management of the property. Features of a TIC arrangement that deprive it of the central characteristics of a TIC undermine TIC status. The following discussion presents several features of TIC arrangements that could deprive the arrangements of the central characteristics of a TIC and cause (or possibly cause) such arrangements to become TICnerships. Most are arrangements the Author has seen in practice or has heard about from others who practice in this area or participate in continuing education programs that discuss TICs, so these are active features that advisors and property owners should be careful to avoid. The list is illustrative and is not intended to be exhaustive.

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127. Rev. Proc. 2002-22, § 6.15.
128. *See supra* Parts II (defining the central characteristics of a TIC), III.A, IV.B.1(h).
129. *See supra* note 31.
130. *See supra* Part II (defining the central characteristics of a TIC).

(a) Disproportionate Profit-Sharing

Proportionate sharing of revenue and expenses by the TIC co-owners of property is a central characteristic of a TIC. TIC co-owners own undivided interests in property,[131] so they have a right to a proportionate share of the revenue from the property. No characteristic of a TIC is more fundamental or essential to TIC classification than proportionate sharing of the property's revenue. Because the nature of undivided interests in property only entitles the owner to revenue from that interest, any feature of a TIC arrangement that deviates from proportionate sharing of revenue indicates the arrangement is not a TIC, making it a TICnership.

The requirement for proportionate sharing of revenue and expenses prohibits TIC co-owners from paying a promote or other disproportionate shares of profit to a manager or other co-owner. Promote payments and other profit-sharing arrangements are common features of real estate joint ventures. For instance, with many real estate ventures, the investors will receive a return of capital and a preferred return at a fixed rate. After those amounts are distributed, the sponsor (or manager) receives some percentage of the remaining distributable capital, which percentage is greater than the sponsor's (or manager's) interest in the property, as a promote. The promote deviates from proportionate sharing of revenue and jeopardizes TIC classification. Thus, TIC co-ownership arrangements that include disproportionate sharing of profit do not come within the definition of TIC.[132]

(b) Disproportionate Cost-Sharing

Disproportionate cost-sharing arrangements demonstrate a disregard for TIC co-owners' ownership of undivided interests in property and therefore deviate from the required proportionate sharing of expenses, and they undermine TIC classification. Disproportionate cost-sharing arrangements can take various forms. To illustrate, if a TIC agreement provides that one TIC co-owner will fund renovations or capital reserves as part of a co-ownership arrangement, the TIC co-owners would not share expenses proportionately. If TIC co-owners are not proportionately obligated for the costs of co-owned property, they would appear to own something other than undivided interests in the property, and their TIC classification would be jeopardized.

131. *See supra* Part III.A.

132. As discussed below, managers might be able to take an equity interest in a TIC co-owner entity and receive a promote through that separate entity, instead of at the TIC level. *See infra* Part VII.B.6.

(c) Put Options Skew Profit- and Loss-Sharing

Fixed-price options can skew profit- and loss-sharing, moving TIC arrangement away from proportionate sharing of profits and losses.[133] For instance, an in-the-money fixed-price call option allows the holder to acquire an interest from another TIC co-owner and claim the difference between the option price and the fair-market price of the interest, which makes profit-share disproportionate.

Despite the deleterious effect that fixed-price options have on TIC classification, they are attractive to some property owners. For instance, some section 1031 investors may be unable to acquire their target replacement property within the 180-day exchange period in section 1031(a)(3). To obtain the time needed to close on their target replacement property, those investors might be willing to acquire an interest in a TIC arrangement if they could put the interest back to the arrangement's sponsor when they were ready to close on their target replacement property. If such an arrangement did not alter proportionate sharing of the property's revenue, it would allow the section 1031 investor to park cash with the sponsor long enough to secure the acquisition of other real property that is more compatible with the investor's acquisition preferences. Perhaps the prohibition against put options in condition 10 of Rev. Proc. 2002-22 contemplated this type of arrangement. Even if it did not, a fixed-price put option would eliminate proportionate share of revenue and expenses and jeopardize the TIC status of a TIC arrangement. A fixed-price put option can also skew management and voting rights towards the holder of the option. Thus, fixed-price options undermine TIC classification.

(d) Disproportionate Debt-Sharing

If one TIC co-owner disproportionately assumes the obligation to pay a loan that is secured by a blanket lien on the property, that disproportionate sharing of debt skews the sharing of revenue and expenses. To illustrate, assume one TIC co-owner guarantees a loan secured by a blanket lien on the property. If the property of a TIC arrangement underperforms, the property is sold at a loss, and the sale proceeds are insufficient to cover the amount of the loan, the guarantor must satisfy the guaranteed debt. The guarantor bears the amount of loss equal to the difference between the value of the property and the amount of the outstanding loan balance, which loss is not borne by the other TIC co-owners. The loss borne by the guarantor undermines proportionate sharing of losses.

Additionally, the guarantee by one TIC co-owner of a loan secured by a blanket lien also suggests that the parties have included that guarantee in their arrangement, which would cause the arrangement to extend beyond a mere

133. *See* Borden, *Fixed-Price Put Options*, *supra* note 19.

co-ownership arrangement. To illustrate, a person would not guarantee the liability secured by another person's property without some type of remuneration. If that remuneration is not explicitly provided for, then it would be baked into the arrangement, bringing entity features into the arrangement.[134] Thus, disproportionate sharing of liabilities causes a TIC arrangement to lose a central characteristic of a TIC and jeopardizes its TIC classification.

(e) Reserves

Joint ventures often provide for the maintenance of reserve accounts for operations, property maintenance, and improvements or renovations. Recall that the twelfth condition of Rev. Proc. 2002-22 allows the manager of a TIC to maintain a common bank account to receive rents and offset expenses against those revenues but requires the manager to distribute net revenues within three months after receipt.[135] The maintenance of a common reserve account would be a deviation from that condition and would most likely create disproportionate sharing of revenues and expenses or manifest the existence of a TIC arrangement that is separate from its owners. Funds in a common reserve account can be used to cover expenses that TIC co-owners would otherwise be obligated to cover. In the absence of such an obligation, the TIC co-owners would not share losses in proportion to their undivided interests in the property. That disproportionality is magnified if one TIC co-owner or the sponsor funds the reserve account because that person then bears the costs paid from the reserve account.[136] A common account is an entity feature, suggesting that the TIC co-owners are pooling their resources to undertake business together, and the creation of an entity separate from the members is inconsistent with TIC treatment.[137] Thus, a reserve account for a TIC arrangement jeopardizes the arrangement's TIC classification.

(f) Separation of Ownership & Control

A fundamental attribute of separate entities is that they separate management from ownership through various mechanisms, including management arrangements that survive transfers of ownership and the owners' delegation of authority to one or more managers.[138] Such separation is most obvious in publicly traded companies that have thousands of shareholders who delegate management of the companies to professional

134. *See infra* Part VI.A.4.

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

136. *See infra* Part V.A.2(b)(1).

137. *See supra* Part IV.B.2(g).

138. Jensen, *supra* note 64, at 381 (listing the following as entity attributes: (1) a name for the separate entity; (2) a continuous life separate from that of its owners; (3) the right to contract; (4) the power to acquire, manage, and dispose of both personal and real property; (5) sole liability for torts; and (6) the right to sue and be sued).

managers. The ownership of such corporations is separated from management. That same concept often applies to real estate investments. Sponsors raise capital, procure property, manage the property, and then negotiate and execute the disposition of property, and most investors have a passive role in the venture. With such arrangements, management is separated from ownership. By contrast, a central characteristic of a TIC is that the TIC co-owners, each of whom holds an undivided interest in property, have the right to share possession of the property with the TIC co-owners.[139] That right vests each TIC co-owner with a voice regarding the use and management of the property. A forfeiture of rights pertaining to possession erodes the central characteristics of a TIC.

The fifth and twelfth conditions of Rev. Proc. 2002-22,[140] which require unanimous TIC co-owner approval for some actions and annual renewal of management contracts, appear to target the separation of management from ownership. These conditions ensure that TIC co-owners stay connected to the management of the property by requiring them to reconsider the manager's reappointment annually and to participate in other decisions related to the ownership and management of the property. Arrangements that separate management from ownership undermine TIC classification.

(g) Treating an Arrangement as a Separate Entity

A central characteristic of a TIC is that TIC co-owners must own undivided interests in the property.[141] Owning interests in property indirectly through an entity such as a partnership or an LLC would obviate this central characteristic of a TIC. Courts and the third condition of Rev. Proc. 2002-22 recognize that actions that obviate this characteristic include filing a tax return, holding the arrangement out to others as a partnership or corporation, and maintaining books and records as though the TIC arrangement were a separate entity.[142] To avoid separate entity classification, TIC co-owners and their advisors should use care in drafting TIC documents. Anyone who does entity work but has little experience with ownership of undivided interests should be particularly careful when drafting TIC documents. Such persons may be prone to include language in TIC documents that treats or refers to the TIC arrangement as a separate entity. The following are examples of language that could creep into TIC documents if the parties do not exercise care:

- "*Each tenancy-in-common interest being referred to herein as an "Interest" and all Interests being referred to jointly as the 'Tenancy.'*" By referring to the TIC arrangement as the Tenancy, the

139. *See supra* text accompanying note 27.
140. Rev. Proc. 2002-22, § 6.12.
141. *See supra* Part II (defining the central characteristics of a TIC).
142. *See supra* text accompanying note 61; Rev. Proc. 2002-22, § 6.03.

language gives the arrangement existence separate from the TIC co-owners.

- "*This Agreement reflects the entire understanding and agreement with respect to the Tenancy.*" This language suggests that the Tenancy exists separate from the TIC co-owners. Notice how that language differs from the following language that refers to TIC co-owners: "The Agreement reflects the entire understanding and agreement among the TIC co-owners." This latter language leaves no doubt that the agreement is among the TIC co-owners and does not pertain to a separate entity.
- "*The determination of any fees to be paid by the Tenancy to the property manager.*" This language again gives life to something separate from the TIC co-owners. The TIC co-owners, not a separate entity, should be paying the property manager, as each TIC co-owner pays a proportionate share of those expenses.
- "*No co-owner shall have any authority to act or assume any obligations or responsibility on behalf of the Tenancy.*" This language also refers to something that appears to be separate from the TIC co-owners. This is the type of language one might expect to find in a manager-managed LLC that strips management authority from members and vests it in a manager.[143]
- "*The day-to-day management of the Tenancy, including . . . shall be the responsibility of the Property Manager.*" This language also appears to derive from the operating agreement of an LLC, which vests the management of the company in a manager. Because no separate entity exists in a TIC, more appropriate TIC language would provide that the manager is managing the property.
- "*The designated co-owner shall have the authority to interface with the lender, and receive notices from the lender, on behalf of the Tenancy.*" This language continues the reference to the Tenancy as something that has existence separate from the TIC co-owners.
- "*If any co-owner violates this agreement, such co-owner shall and hereby agrees to indemnify the Tenancy from and against all costs.*" If the arrangement were a TIC, and not a separate entity, more appropriate language would require TIC co-owners to reimburse other TIC co-owners. In fact, violation of the agreement may harm a single co-owner without doing harm to the property or other TIC co-owners. For example, failure to follow through with an offer to purchase property from a co-owner who had threatened to partition the property could harm that co-owner without harming the property or other TIC co-owners.

143. *See, e.g.*, N.Y. STAT., ch. 34, art. 4, § 408(a) (2014).

- "*The Property Manager shall maintain records and accounts of all operations and expenditures of the Tenancy and provide annual reports with respect to the operations of the Tenancy to each co-owner.*" As stated above, the courts and the IRS consider maintaining separate books and accounts for a TIC arrangement to be an entity characteristic that jeopardizes a TIC arrangement's TIC status.[144] This language appears to clearly provide that the manager will maintain such prohibited records and accounts. It also refers to operations of the Tenancy as an entity separate from the TIC co-owners.
- "*The Tenancy's account shall be maintained in the name of the Property Manager, as agent of the Tenancy, and the cash funds of the Tenancy shall be kept in such account.*" Contrast this language, which refers to the Tenancy's account, with the language from the twelfth condition of Rev. Proc. 2002-22, which refers to a common account.[145] That distinction is not minor, and the keeping of cash in an account of the Tenancy undermines the central characteristics of a TIC because doing so treats the arrangement as a separate entity.[146]

This analysis of entity-type language shows the nuances and differences between TICs and TICnerships. These nuances are not trivial, and the use of the proper language is evidence that the drafters understand the unique nature of TICs. More importantly, language that refers to the TIC co-owners as the parties to a TIC or other arrangement does not jeopardize the classification of the arrangement of a TIC. Including TIC co-owners in the decision-making process and ensuring that they are accounted for in structuring the TIC arrangement is critical in preserving TIC classification. Parties need to enter TIC arrangements knowing that they are forfeiting the ease and efficiency of conducting business through a separate entity when they choose TIC status.

(h) Excessive Business Activity

A fundamental part of the definition of tax partnership is the conduct of activity to "carry on a trade, business, financial operation, or venture."[147] The IRS has ruled that providing customary tenant services does not cause a co-ownership arrangement to become a TICnership.[148] The IRS identifies the following as customary tenant services: "heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning of public areas."[149] It identifies the following as additional services: "attendant parking, cabanas, and gas, electricity, and other utilities provided . . . to

144. *See supra* text accompanying notes 61, 141.
145. Rev. Proc. 2002-22, § 6.12.
146. *See supra* Part IV.B.2(e).
147. Treas. Reg. § 301.7701-1(a)(2); *supra* text accompanying note 52.
148. Rev. Rul. 75-374, 1975-2 C.B. 261. The IRS also cites to section 511(a)(2) and section 512(b)(3)(A) (relating to activities that do not cause amounts received by certain tax-exempt entities from qualifying as rent) for permitted activities.
149. *Id.*

tenants" for extra charge.[150] The IRS ruled that furnishing of additional services will render a co-ownership arrangement "a partnership if the additional services are furnished directly by the TIC co-owners or through their agent."[151] A person who is not a TIC co-owner may, however, provide additional services if the other person is "solely responsible for determining the time and manner of furnishing the services, bears all the expenses of providing these services, and retains for its own use all the income from these services."[152] Thus, a person who provides such additional services to tenants of co-owned property cannot divide the profits from those services with the TIC co-owners without jeopardizing the arrangement's TIC status.[153]

Consider how restricting the direct and indirect business activity of TIC co-owners is consistent with the central characteristics of a TIC. Real property generates income from rents, and with many lease arrangements, the owners of the property must provide customary tenant services to ensure that the property remains habitable.[154] The IRS recognizes this reality and provides that services directly related to renting property for the purpose of generating rental income are part of co-owning the property, and such services relate to the generation of rental income from the property. Additional services create a source of income that is separate from the property, so joint activity to provide additional services deviates from the concept of co-owning property and moves towards carrying on a business or venture separate from the property.[155] Thus, if TIC co-owners provide services, either directly or through an agent, above and beyond customary tenant services, the arrangement becomes a TICnership. TIC co-owners can avoid this result by (1) limiting the services that their tenants receive;[156] (2) allowing another party to perform services for tenants and retain the profits from those services;[157] or (3) creating a master-lease structure pursuant to which the TIC co-owners triple-net lease the property to a master tenant who manages the property and leases it to tenants.[158]

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150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. If property is triple-net leased, the tenant accepts responsibility for performing customary tenant services.

155. *See* Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717, 757–63 (2009) [hereinafter, Borden, *Aggregate-Plus Theory*]; Bradley T. Borden, *Partnership Tax Allocations and the Internalization of Tax-Item Allocations*, 59 S.C. L. REV. 297, 306–09, 312–16 (2008) [hereinafter Borden, *Tax Allocations*].

156. *See* Rev. Rul. 75-374.

157. *Id.*

158. *See infra* Part VII.B.5 (discussing the Propco-Opco structure).

(i) Restrictions on Alienation

The central characteristics of a TIC provide that the TIC co-owners, each of whom owns an undivided interest in the property, have a right to transfer the interest and to demand partition of the property.[159] These characteristics prohibit TIC co-owners from imposing transfer restrictions on the undivided interests held by the TIC co-owners. Without such restrictions, TIC co-owners cannot control who becomes a TIC co-owner of interests in the property. With the other central characteristic that requires all TIC co-owners to participate in the management of the property, TIC co-owners may end up co-owning property with people who have very different objectives for the property. The IRS has indicated that it will consider ruling on the classification of TIC arrangements that allow TIC co-owners (1) to offer their interests for sale to other TIC co-owners at fair market value before exercising a right to partition;[160] (2) to grant other TIC co-owners the right of first offer (the right to have the first opportunity to purchase the co-ownership interest) before transferring the interests;[161] and (3) to grant other TIC co-owners the option to acquire their interests at fair market value.[162] The IRS has privately sanctioned buy-sell agreements that allow the parties to negotiate the terms of the sale of the initiating TIC co-owner's interest and to proceed with what is sometimes referred to as a "Texas shootout."[163]

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159. *See supra* text accompanying note 14.
160. Rev. Proc. 2002-22, 2002-1 C.B. 733, §§ 6.04, 6.06.
161. *Id.* § 6.06.
162. *Id.* § 6.10.
163. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2008-29-012 (Mar. 17, 2008) ("The buy-sell procedure is as follows. The Co-owner desiring to transfer or sell (the initiating Co-owner) must give the other Co-owner (the responding Co-owner) a pre-offer notice that includes an initial due diligence disclosure (including, but not limited to, the most recent physical inspection report of the physical condition of the Property prepared by a professional building inspector not affiliated with the initiating Co-owner; the most recently prepared environmental report on the Property; a current rent roll; and a current profit and loss statement for its interest in the Property) and shall provide written notice of the initiating Co-owner's intent to sell its interest in the Property (a pre-offer notice). For a period of 30 days (the pre-offer period) the parties are to negotiate in good faith the terms of the sale or transfer and to obtain certain other inspections of the physical condition of the Property. If the Co-owners do not reach agreement during the pre-offer period, the initiating Co-owner may serve a formal offering notice on the responding Co-owner at a stated dollar amount. The purchase price shall be the stated dollar amount less that portion, corresponding to the seller's percentage interest in the Property, of the principal balance and accrued interest outstanding on the closing date of any loan secured by the Property which is assumed by the purchaser. The responding Co-owner has 90 days to elect to sell its interest or to purchase the offering Co-owner's interest in the Property for the purchase price in the offering notice. If the responding Co-owner does not exercise either option within the option period, then the responding Co-owner is conclusively deemed to have elected to sell his interest in the Property in accordance with the terms of the offering notice. Closing will occur 150 days after the date of the offering notice."); I.R.S. Priv. Ltr. Rul. 2008-26-005 (Mar. 17, 2008) (ruling privately with respect to a provision similar to the one ruled upon in Priv. Ltr. Rul. 2008-29-012); I.R.S. Priv. Ltr. Rul. 2006-25-009 (June 23, 2006) (ruling privately with respect to a provision similar to the one ruled upon in Priv. Ltr. Rul. 2008-29-012). BRADLEY T. BORDEN, LLCS AND PARTNERSHIPS: LAW, FINANCE, AND TAX PLANNING, § 7.08[B][4] (2019) (providing language similar to that in the private letter rulings that has been used in operating agreements of

Because transferability and the right to partition are central characteristics of a TIC, those rights cannot be taken from TIC co-owners in a TIC arrangement that must be classified as a TIC. The types of buy-sell provisions that the IRS has sanctioned in Rev. Proc. 2002-22 and private letter rulings require that the other TIC co-owners be able to procure the funds needed to purchase a selling co-owner's interest at fair market value. Thus, TIC co-owners can control who becomes a member of a TIC only if they have sufficient funds to acquire a selling co-owner's interest at fair market value. Because relationships and financial situations can change over time, parties entering into TIC arrangements may be concerned about being in such arrangements for an extended period.

C. UNATTRACTIVENESS AS EVIDENCE OF A TIC

Investors who are considering investing in a TIC arrangement should be made fully aware of the central characteristics of a TIC. As they become aware of those characteristics, an expected response would be that they find such characteristics unattractive, and most property owners will prefer not to enter into TIC arrangements. In fact, such awareness of the unattractive aspects of a TIC, and the discomfort that accompanies them, provide evidence that the arrangement is a TIC. If those unattractive features are removed or do not exist, a TIC arrangement is likely to be classified as a TICnership. Thus, the existence of unattractive features and the hesitancy of informed parties to enter into such TIC arrangements are evidence that the arrangement is a TIC. In other words, if parties want to enter into a TIC arrangement because it has attractive features, the arrangement probably is not a TIC, and if parties do not want to enter into the TIC arrangement or remain in it long-term, the arrangement is more likely to be a TIC. TIC co-owners' disdain for the characteristics of a TIC arrangement thus becomes evidence that the arrangement is a TIC.

V. TAX TREATMENT OF TICS & TICNERSHIPS

Investors transferring or receiving interests in a TIC arrangement as parts of transactions intended to qualify for section 1031 nonrecognition want their property interests to be classified as real property for section 1031 purposes. For those investors, the tax preferences of an arrangement being classified as a TIC are obvious. In many other situations, parties to a TIC arrangement may not know before a tax issue arises whether the preferred entity classification would be TIC or TICnership. The tax classification of an arrangement can affect tax consequences related to operations or with respect to transactions that alter the ownership of the property or rights in the

LLCs to break deadlock); Louis T.M Conti, Lisa R. Jacobs & Steven N. Leitess, *Deadlock-Breaking Mechanisms in LLCs—Flipping a Coin is Not Good Enough, but is Better than Dissolution*, BUS. L. TODAY, Mar. 2017, at 1.

property. This Part explores the tax treatment of TICs and TICnerships to provide a basis for considering the tax consequences that may arise in different situations.

For federal income tax purposes, the primary distinction between TICs and partnerships is that TICs have no existence separate from the TIC co-owners, but a partnership is an entity separate from the co-owners. That distinction is relevant both in terms of tax treatment of operations of TICs and partnerships and in transactions between partners and partnerships and among partners and transactions among TIC co-owners.

Because a TIC arrangement is not an entity separate from its co-owners, it has no revenue, no expenses, no profits or losses, no balance sheet, and no income statement. All of the revenue, expenses, gains, and losses related to the property held by TIC co-owners in a TIC arrangement belong to the TIC co-owners in proportion to their undivided interests in the property. Those items must be recognized by each TIC co-owner in proportion to their respective interests in the property. Each TIC co-owner can maintain a balance sheet showing the co-owner's interest in the property and proportionate share of liability secured by a blanket lien on the property or a liability secured by the co-owner's undivided interest. Each TIC co-owner can also prepare an income statement with the co-owner's share of revenue and expenses of the property. Each TIC co-owner uses the revenue and expenses from the co-owner's undivided interest to compute tax income from the property.

By contrast, tax partnerships are entities separate from the partners. Tax partnerships compute profits and losses and prepare balance sheets and income statements. A tax partnership's balance sheet shows the members' capital account balances, which represent the members' equity in the tax partnership. Tax partnerships also compute taxable income and allocate their tax items to the members as agreed upon by the members and provided for in the tax partnership's governing documents. Even though tax partnerships do not pay tax, tax law recognizes them as separate from the members. Thus, the tax treatment of operations of TICs and tax partnerships differ.

TIC co-owners cannot transact with the TIC (because there is no such thing as a TIC separate from the TIC co-owners for federal income tax purposes); they can only transact with each other. By contrast, partners can transact with partnerships (because partnerships are entities separate from the partners for federal income tax purposes) in employment arrangements, lending arrangements, leasing arrangements, and property transactions, and partners can transact with each other. Tax law has rules governing transactions between partners and partnerships and among partners, but because TICs have no existence separate from the TIC co-owners, tax law does not have specific rules governing transactions among TIC co-owners or between TIC co-owners and other parties. General tax principles apply to such transactions.

A. TAX TREATMENT OF TICS & TIC CO-OWNERS

Multiple persons owning undivided interests in real property is essential for a co-ownership arrangement to be classified as a TIC.[164] The undivided interests give each TIC co-owner an ownership interest in the whole property.[165] Tax law recognizes that the owner of an undivided interest in property has a legal right to the revenue earned by that undivided interest in real property and has obligations to pay expenses associated with the undivided interest.[166] Notice that owners of TIC interests do not have rights to the profits of the TIC arrangement because an arrangement classified as a TIC does not exist separate from the TIC co-owners and would not have separate gross income or deductions.[167] Thus, the taxation of operations of an arrangement classified as a TIC is straightforward. Taxation of transactions related to property held in an arrangement classified as a TIC raises numerous issues.

1. *Taxation of TIC Operations*

TIC co-owners own undivided interests in property and can trace the revenue and expenses from their TIC interests. Thus, income and expenses of property held by TIC co-owners in an arrangement classified as a TIC must be proportionately allocated to each TIC co-owner based upon the TIC co-owner's ownership interest in the property. This central characteristic of a TIC informs both the classification of TIC arrangements and the taxation of TICs.

First, if TIC co-owners of a TIC arrangement are unable to trace income exclusively from the property to the TIC co-owners, the arrangement is not a TIC and should be classified as a TICnership. For instance, if the income of a TIC arrangement includes income from additional services (i.e., services that are not customary rental services) provided by the TIC co-owners, the TIC co-owners cannot trace their income as coming exclusively from the property.[168] Such an arrangement therefore would not be a TIC. Second, if an arrangement is a TIC, any deviation from proportionate sharing would generate tax items (such as compensation income or expenses) for the TIC co-owners whose proportionate sharing of revenue and expenses are affected by the arrangement. For instance, consider how the assignment-of-income doctrine could apply to such arrangements.

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164. *See supra* text accompanying note 14.
165. *See supra* text accompanying notes 14, 105.
166. *See supra* text accompanying notes 106–108.
167. Any profits to which a TIC co-owner is entitled derives from the property, not from the TIC arrangement. *See supra* text accompanying notes 147–158; Taylor v. Brindley, 164 F.2d 235, 240 (10th Cir. 1947) ("The relationship may be involuntary, and does not contemplate a joint venture or joint profit.").
168. *See supra* Part IV.B.2(h).

(a) The Assignment-of-Income Doctrine

The assignment-of-income doctrine (also often referred to as the fruit-of-the-tree doctrine[169]) is a fundamental part of federal income taxation.[170] That doctrine provides that income from a property must be recognized by (i.e., included the gross income of) the tax owner of the property and cannot be assigned to another person.[171] If an arrangement is a TIC, each TIC co-owner owns an undivided interest in the co-owned property and must recognize revenue and expense associated with that interest.[172] If an arrangement is a TIC and revenue and expenses are not shared in proportion to ownership interests, the assignment of income doctrine requires determining who should recognize the income and then determining how to tax the disproportionate item received by the other TIC co-owner. Example 1 illustrates this principle.

Example 1: Kyeong-mo and Majer are equal TIC co-owners of Kyma Apartments, which they treat as a TIC. Kyma Apartments has $300,000 of revenues and $220,000 of expenses. Kyeong-mo and Majer agree that $180,000 of the revenue will be paid to Kyeong-mo and $120,000 will be paid to Majer, and they will each be responsible for $110,000 of the expenses. They agree to pay a disproportionately large amount of revenue to Kyeong-mo because he manages Kyma Apartments.

Assuming the arrangement is a TIC, each of Kyeong-mo and Majer are entitled to $150,000 of revenue from Kyma Apartments, and each should report that amount as gross income. Assuming the revenue comes from rents, they would each report $150,000 of gross income from rents.[173] The $30,000 that Kyeong-mo receives in excess of the $150,000 to which he has a legal claim does not derive from his interest in Kyma Apartments. Instead, it appears to be compensation paid by Majer to Kyeong-mo for managing the property. Thus, Kyeong-mo would have $30,000 of compensation income,[174] and Majer should have a $30,000 deduction related to her interest in the property.[175]

169. *See, e.g.*, 1 MERTENS L. FED. INC. TAX'N § 5.1 ("The "fruit of the tree" doctrine first enunciated in Lucas v. Earl also applies to the assignment of income. That is, the underlying property and not just the income from the underlying income-producing property must be transferred before the validity of an assignment is recognized.").

170. Lucas v. Earl, 281 U.S. 111, 115 (1930) ("[W]e think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.").

171. Blair v. Comm'r, 300 U.S. 5 (1937).

172. *See supra* text accompanying notes 14, 164–167.

173. I.R.C. § 61(a)(5).

174. *Id.* § 61(a)(1).

175. *Id.* § 162.

(b) Reclassifying the Arrangement

If the TIC co-owners do not have a proportionate share of revenues and expenses of a property held in a TIC arrangement, they run the risk that the arrangement will be recast as a TICnership. By disregarding a central characteristic of a TIC, the TIC co-owners may be estopped from arguing that the arrangement was a TIC, not a TICnership.[176] Example 2 illustrates this risk.

> **Example 2**: Assume the same facts from Example 1, but, instead, Kyeong-mo reports $180,000 of rental income and Majer reports $120,000 of rental income. The arrangement does not have the central characteristic of a TIC (proportionate sharing of revenue), so it cannot be a TIC. Indeed, the co-owners, by allocating revenue disproportionately, treat the arrangement as a separate entity that has a pool of income to allocate to its members. The TIC co-owners have, in effect, agreed that Kyeong-mo's services are part of the arrangement's resources along with the Kyma Apartments, and the arrangement's revenues derive from both Kyeong-mo's services and Kyma Apartments, and they agree to divide that revenues to reflect those dual sources of revenue.[177]

2. *Taxation of TIC Transactions*

The TIC co-owners of a TIC arrangement own undivided interests in the property and the rights and obligations associated with those interests.[178] Any transaction that changes the TIC co-owners' rights and obligations associated with their undivided interest could be a taxable event. For instance, if a TIC co-owner acquires an undivided interest in property, and the co-owner's undivided percentage interest changes, that change in interest often will be a taxable event. Tax law's fundamental realization principle typically governs such transactions.

(a) The Realization Principle

For an item to be included in a taxpayer's gross income, it typically must be realized.[179] If a property owner goes from owning something to owning something else or receiving something in exchange, the property owner typically realizes gain or loss equal to the difference between the amount

176. *See supra* note 62. Borden, *Federal Definition*, *supra* note 50, at 1000–01 (identifying estoppel as one of the tests courts use in deciding whether an arrangement is a tax partnership).

177. *See* Borden, *Tax Allocations*, *supra* note 155, at 306–09.

178. *See supra* text accompanying note 14.

179. Comm'r v. Glenshaw Class Co., 348, U.S. 426, 431 (1955) (finding that received punitive damages were gross income because they created "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").

realized and the adjusted basis.[180] Taxpayers typically must recognize gain or loss that results from that change from owning something to owning something else.[181] Example 3 illustrates the general application of the realization principle.

> **Example 3:** Landowner owns Rawland (vacant land) and subdivides and transfers a subdivided lot of Rawland to Builder in exchange for Builder improving the portion of Rawland that Landowner retains. Landowner's transfer of the lot to Builder in exchange for the improvements (materials and services) is a realization event,[182] and Landowner would recognize gain or loss on the transfer of the lot to Builder.[183] Landowner would also have an expense, which in this situation, because the lot paid for improvements to the land, would appear to have to be capitalized and added to the adjusted basis of the portion of Rawland that Landowner retained.[184] Builder would recognize compensation income equal to the value of the land received for her services and income from the sale of materials equal to the excess of the value of the land received in exchange for the materials over the cost of the materials.[185]

(b) Application of the Realization Principle to TICs

Because TICs are not entities separate from the TIC co-owners, any transactions that occur with respect to property in such arrangements are transactions between or among the TIC co-owners. The realization principle applies to owners of TIC interests who transfer (knowingly or unwittingly) portions of their undivided interests in property for services or other property. For instance, if construction or renovations are to be done on property owned

180. I.R.C. § 1001(a) (requiring realization of gain on the sale or other disposition of property), (c) (requiring realized gain to be recognized, i.e., reported on a tax return); Treas. Reg. § 1.61-1(a) (providing that income can be "realized in any form, whether in money, property, or services"); *but see* Treas. Reg. § 1.1001-1(a) (providing that gain or loss is realized when there is an "exchange of property for other property differing materially either in kind or extent," leaving open the possibility that some exchanges of property are not realization events).

181. I.R.C. § 1001(c).

182. *See* Treas. Reg. § 1.1001-1(a).

183. I.R.C. § 1001(a); Int'l Freighting Corp., Inc. v. Comm'r, 135 F.2d 310, 313 (2d Cir. 1943) (holding the services received in exchange for the property were "money's worth" and therefore amount realized within the definition of section 1001(b), which defines amount realized as the sum of money received and the fair market value of property received).

184. I.R.C. §§ 263(a)(1) (disallowing a deduction for capital expenditures such as amounts paid for new buildings or for permanent improvements or betterments), 1011(a) (providing that the adjusted basis of property is the basis determined under section 1012 and adjusted as provided in section 1016), 1012(a) (providing that the basis of property is the cost), 1016(a)(1) (providing that adjustments are made for expenditures properly chargeable to capital accounts).

185. *See* I.R.C. §§ 61(a)(1), (3), 1001(a), 1001(b) (providing that amount realized on the sale or other disposition of property includes the fair market value of property received); Treas. Reg. § 1.61-2(d)(1) (providing that gross income includes the fair market value of property or services received in exchange for services).

by TIC co-owners, each TIC co-owner would be responsible for a proportionate share of the costs of the improvements.[186] Any arrangement that deviates from that basic structure would either create a taxable event or undermine the classification of the arrangement as a TIC. Example 4 provides basic facts to which the fundamental tax principles can be applied on transfers of undivided interests in property by TIC co-owners. The discussion that follows applies the fundamental tax principles.

Example 4: Four individuals (Investor 1, Investor 2, Investor 3, and Sponsor) agree to join together to purchase property that costs $1,000,000 and then complete $200,000 of renovations. Each party will invest $300,000 in the project and have a one-fourth interest in the completed project. They are considering alternative ways to structure the purchase and renovations.

- Alternative 1—Proportionate Purchase: Investor 1, Investor 2, Investor 3, and Sponsor each pay $225,000 for one-fourth undivided interests in the property and pay $50,000 toward the improvements.
- Alternative 2—Disproportionate Purchase: Investor 1, Investor 2, and Investor 3 each pay $300,000 to acquire one-fourth undivided interests in the property, and Sponsor pays $100,000 for her one-fourth undivided interest and pays for and constructs $200,000 of improvements or funds a $200,000 reserve account for improvements.

Analysis of Alternative 1—Proportionate Purchase: Alternative 1 provides the parties the opportunity to form a TIC arrangement as a TIC and construct the improvements without incurring tax on transactions among the co-owners. Each TIC co-owner owns an undivided interest in property and pays a proportionate share of the costs to construct the improvements. As the construction happens, the co-owners' proportionate interests in the property and the improvements remain constant. Each TIC co-owner remains obligated to pay a proportionate share of the construction costs as construction occurs, so the co-ownership arrangement does not have a construction reserve account.[187] Thus, under Alternative 1, each TIC co-owner purchases an undivided interest in the property and pays for a portion of the improvements.

186. *See supra* text accompanying 105–106.

187. Perhaps each TIC co-owner agreed to deposit funds in separate accounts to be held in reserve to ensure the funds' availability for the construction, but the TIC co-owners do not maintain a construction reserve in a separate account.

Assuming the improvements are constructed after the parties acquire their undivided interests in the property, the amount the Investors set aside as construction reserves and use to construct improvements cannot qualify for section 1031 nonrecognition.[188] Thus, Alternative 1 provides valid section 1031 replacement property only to the extent of the cost of the undivided interests in the property. If all the parties do not need to maximize the costs of their undivided interests for section 1031 purposes, they might consider some version of Alternative 2, but they could be disappointed in the tax outcome of that choice.

Analysis of Alternative 2—Disproportionate Purchase: Consider two different forms the transaction might take for federal income tax purposes: (1) the purchase is recast to treat each TIC co-owner as owning a proportionate interest in the property and share of the improvements reserve (recast purchase) or (2) the parties are treated as acquiring unequal undivided interests in the property and then exchanging undivided interests for construction of the improvements (property-for-improvements exchange). The following discussion illustrates that this latter structure results in a taxable transaction.

(1) Recast Purchase

The recast purchase scenario would place Investor 1, Investor 2, Investor 3, and Sponsor in the same situation at the time of purchase—each would be deemed to own a one-fourth interest in the property and to hold $50,000 (one-fourth of $200,000) of cash in reserves. That result could be obtained by treating the parties as entering into the transaction described in Alternative 1, with each TIC co-owner acquiring an equal undivided interest in the property and holding $50,000 of cash in reserves for improvements. Obtaining this treatment could be difficult for the parties because the form of the transaction deviates from this structure. Investor 1, Investor 2, and Investor 3 each paid $300,000 to purchase their undivided interests, and Sponsor promised to construct the improvements. The parties probably could not argue against their chosen form.

Alternatively, Investor 1, Investor 2, and Investor 3 could each be treated as acquiring a 30 percent interest in the property with their $300,000 investment, and Sponsor could be treated as acquiring a 10

188. *See* I.R.C. § 1031(a)(3); Bloomington Coca-Cola Bottling Co. v. Comm'r, 189 F.2d 14 (7th Cir. 1951). Perhaps the investor could structure the acquisition of the improvements as part of an improvements exchange if the improvements had been constructed prior to the investor's acquisition of the undivided interest. *See, e.g.*, BRADLEY T. BORDEN, TAX-FREE LIKE-KIND EXCHANGES, ¶¶ 6.1 (describing third-party improvements exchanges), 6.2 (describing leasehold improvements exchanges), 6.3 (describing deferred improvements exchanges); Bradley T. Borden, *New Safe Harbor Promotes Reverse Exchanges*, 66 PRAC. TAX STRAT. 68 (2001) (introducing the concept of leasehold improvements exchanges).

percent interest in the property for $100,000. Immediately following the purchase, Sponsor could be treated as acquiring a 5 percent interest in the property from each of the Investors for $50,000, so all four parties end up with a 25 percent interest in the property plus $50,000 in reserves.

Consider the tax treatment of these two different structures. First, if any of the Investors are using section 1031 proceeds, they would have $50,000 (the amount deemed placed in reserves) of taxable boot.[189] Because section 1031 requires gain recognition on the first dollars of boot received until the amount of boot equals realized gain,[190] all $50,000 of boot deemed received by the Investors could trigger gain recognition for any Investors seeking section 1031 nonrecognition.[191] Thus, if the acquisition is recast to treat each party as purchasing a 25 percent undivided interest in the property and placing funds in reserve, the Investors could recognize $50,000 of gain at closing.

Second, the transaction could be recast as an acquisition of 30 percent undivided interests by the Investors, followed by each of them selling 5 percent undivided interests in the property to Sponsor. Under this scenario, the 5 percent undivided interests mostly could not qualify as valid replacement property because the Investors would be deemed to acquire them with the intent to transfer them to Sponsor,[192] so the $50,000 5 percent undivided interest would be taxable boot.[193]

Assuming, however, the Investors used section 1031 proceeds to acquire the 30 percent undivided interest and the transaction otherwise qualified for section 1031 nonrecognition, the Investors would take exchanged bases in their undivided interests in the property.[194] If the undivided interest qualified as valid section 1031 replacement property, upon the deemed sale of the 5 percent interests to Sponsor, the Investors would recognize gain equal to the difference between the $50,000 deemed received from Sponsor and the basis they have in the transferred 5 percent undivided interest. For instance, if Investor 1 took a $90,000 exchanged basis in her 30 percent undivided interest acquired as part of a section 1031 exchange, she would apportion $15,000 of that basis to the 5 percent

189. Boot is money or property that does not qualify as valid replacement and results in taxable gain to a party seeking section 1031 nonrecognition.

190. I.R.C. § 1031(b).

191. The analysis of Alternative 2 assumes that any investor who does an exchange had a basis of $90,000 in the relinquished property, so, if the exchanger receives $50,000 of boot, the entire amount will be taxable under section 1031(b).

192. *See* I.R.C. § 1031(a)(2) (excluding property held primarily for sale from the application of section 1031 nonrecognition).

193. *Id.* § 1031(b).

194. *Id.* § 1031(d).

undivided interest she is deemed to transfer to Sponsor,[195] and she would recognize $35,000 of gain on that transfer.[196] This result is better than the 5 percent undivided interest being treated as boot because this result allows the exchanger to offset some of the consideration received with exchanged basis in the property. Nonetheless, the 5 percent undivided interest most likely would not qualify as valid replacement property because of the deemed immediate transfer, so the value of that 5 percent undivided interest most likely would be boot when the Investor receives it.[197]

(2) <u>Property-for-Improvements Exchange</u>

If the acquisition is not recast and each of Investor 1, Investor 2, and Investor 3 acquires a 30 percent undivided interest in the property and Sponsor acquires a 10 percent interest in the property, the construction of the improvements will be a taxable transaction.[198] After the improvements are completed, each TIC co-owner will have a 25 percent undivided interest in improved property worth $1,200,000, so Investor 1, Investor 2, and Investor 3 will go from owning an undivided interest in raw land to owning an undivided interest in developed property. As Sponsor pays for and completes the improvements, shares of the undivided interests in the property held by Investor 1, Investor 2, and Investor 3 transfer to Sponsor in exchange for Sponsor funding and completing the improvements. Each of Investor 1, Investor 2, and Investor 3 receive a 25 percent undivided interest in the improvements being constructed in exchange for shares of their undivided interests in property. Sponsor receives undivided interests in property from the Investors in exchange for funding and completing the improvements. As a result of the transaction, Investor 1, Investor 2, Investor 3, and Sponsor each end up with a 25 percent interest in the property and improvements after the improvements are constructed. Thus, the Investors each would transfer 5 percent undivided interests to Sponsor in exchange for Sponsor constructing improvements in which the

195. Treas. Reg. § 1.61-6(a) (requiring basis to be equitably apportioned among several parts). Basis must be allocated based upon the fair market value of property. *See* Fairfield Plaza v. Comm'r, 39 T.C. 706, 712 (1963). With undivided interests acquired in a single purchase, the value of the undivided interest would be spread evenly over the entire undivided interest, so 20 percent of the basis of the entire undivided interest should be apportioned to 20 percent of the undivided interest the TIC co-owner acquires. The 5 percent undivided interest that the investors transferred is one-sixth of the 30 percent undivided interests they acquired (5% ÷ 30%), and one-sixth of the $90,000 exchanged basis is $15,000.

196. Gain equals the excess of the $50,000 amount realized in the form of services and construction services received over the $20,000 adjusted basis the Investor had in the transferred 5 percent undivided interest.

197. *See, e.g.*, Regals Realty Co. v. Comm'r, 127 F.2d 931, 934 (2d Cir. 1942) (holding that property acquired with intent to sale did not qualify as valid section 1031 property).

198. *See supra* notes 180–186 and accompanying text.

Investors each end up owning a 25 percent undivided interest. Because the improvements being constructed cannot qualify as section 1031 replacement property,[199] this transfer of property interest for improvements would be a taxable transaction.

A 25 percent undivided interest in the improvements is worth \$50,000 (\$200,000 × 25%), so each of Investor 1, Investor 2, and Investor 3 transfer \$50,000 of their undivided interests (i.e., 5 percent undivided interest in the \$1,000,000 property) to Sponsor in exchange for \$50,000 of improvements constructed on property in which the Investors own undivided interests. Sponsor would realize compensation income for completing the improvements and realize ordinary income to the extent the value of the property interests received exceed the cost of the materials.[200] The Investors would not be allowed to deduct the amount deemed paid for improvements,[201] their bases in the undivided interests in the improvements received would be the amount they included in gross income upon receipt of the improvements.[202]

The tax consequences to Investor 1, Investor 2, and Investor 3 would depend upon whether they had attempted to have the acquisition of their undivided interests qualify for section 1031 nonrecognition. Because the ending ownership structure was contemplated at the time the Investors acquired their undivided interests in the property, they would likely be deemed to have acquired the 5 percent undivided interest in the property with the intent to transfer it in exchange for the improvements. Consequently, the 5 percent undivided interests would be taxable boot and not be valid exchange property.[203] Alternatively, if the 5 percent undivided interest qualified for section 1031 nonrecognition, the construction of the improvements would not qualify for section 1031 nonrecognition.[204] Thus, the Investors would be required to recognize any deferred gain associated with the interests in the property they transfer in exchange for the improvements.[205] As with the situation above, the more likely outcome for the Investors seeking section 1031 nonrecognition is that the acquisition of the 5 percent undivided interest would not qualify as valid section 1031 replacement property.[206]

If any investors purchased undivided interests with non-section 1031 money and took a section 1012 cost basis in the undivided interest, they

199. *See supra* note 188.
200. *See supra* notes 174, 185.
201. I.R.C. § 263(a).
202. Treas. Reg. § 1.61-2(d)(2)(i).
203. *See supra* note 192 and accompanying text.
204. *See supra* note 188 and accompanying text.
205. *See supra* note 190 and accompanying text.
206. *See supra* text accompanying note 193.

would likely have little or no realized gain on the transfer of the undivided interest for improvements.[207] The value of the property likely would not increase significantly between the time the Investors acquired the undivided interests and the date they transferred it to Sponsor. On the other hand, any Investor who used exchange proceeds to acquire the interest in the property and took a section 1031(d) basis in the property would recognize gain on the transaction because improvements constructed on property owned do not qualify as replacement property.[208] Any Investors who purchased their undivided interests with non-section 1031 funds would take a cost basis in the 5 percent undivided interest and likely recognize little or no gain on the transfer of the interest in exchange for a share of the improvements.[209]

(3) Property-for-Reserves Transaction

A similar result would obtain if the Investors purchased undivided interests in the property and gave Sponsor ownership credit for agreeing to provide improvements capital or fund a reserve account. For instance, Investor 1, Investor 2, and Investor 3 could each pay $300,000 for a 25 percent undivided interest in the property, and Sponsor could pay $100,000 and promise to fund a $200,000 reserve account for a 25 percent undivided interest. This structure could be treated as each of the four TIC co-owners acquiring a 25 percent undivided interest in the property for $250,000 and contributing $50,000 to the reserve. It could also be treated as each of the three Investors acquiring a 30 percent undivided interest in the property and transferring a 5 percent undivided interest to Sponsor in exchange for a 25 percent share of the reserves.

The tax consequences of the different ways to treat the transaction should be the same. If the Investors are treated as contributing to the reserves, then the $50,000 will be taxable boot to any exchanger attempting to do a section 1031 exchange. As recast, this transaction is the same as the Investors contributing proceeds to the reserve account.[210] If the Investors are treated as selling 5 percent undivided interests to Sponsor for a share of the reserves, the 5 percent undivided interests most likely would not be valid section 1031 exchange property,[211] so they would have boot upon acquisition of them. If the 5 percent undivided interests could qualify as valid section 1031 exchange property, the deemed transfer of the interests would be taxable, and the Investors would recognize gain

207. Any gain would be attributable to appreciation in value between the time the undivided interest was acquired and the transfer of the interest for improvements.
208. *See supra* text accompanying note 188.
209. *See supra* note 207 and accompanying text.
210. *See supra* text accompanying notes 189–191.
211. *See supra* text accompanying notes 192–193.

equal to the difference between the share of reserves deemed received and the basis in the undivided interests.[212]

The transaction should not be taxable to Sponsor. Because Sponsor only pays cash, Sponsor should take a basis in the acquired undivided interests in the property equal to the amount paid for those undivided interests.[213] By contrast, Sponsor has ordinary compensation income if Sponsor receives the undivided interests in exchange for arranging or providing construction services.[214] Thus, the structure under this Alternative 2 can affect the tax consequences to Sponsor, but the structure does not appear to affect the Investors.

(4) <u>Promote to TIC Sponsor</u>

A TIC arrangement with a promote for the sponsor is a TICnership and cannot be a TIC.[215] Example 5, for illustrative purposes only, demonstrates how the disposition of property held in a TIC arrangement would be taxed if the TIC co-owners granted a promote to a sponsor co-owner.

<u>Example 5</u>: Investor 1, Investor 2, Investor 3, and Sponsor are equal TIC co-owners of property worth $1,200,000 with a basis of $1,200,000. They agree that Sponsor will manage the property and that upon disposition of the property, proceeds will be paid proportionately to the TIC co-owners until they have received a return of their capital and a return on their capital in the form of a preferred return. Any proceeds in excess of those amounts will be paid 40 percent to Sponsor, and the remaining 60 percent will be paid equally to the four co-owners. Assume the TIC co-owners sell the property for $2,000,000 and pay $1,600,000 ($400,000 each) to the TIC co-owners as return of capital and return on capital. They pay $160,000 of the remaining $400,000 to Sponsor as a promote, and the remaining $240,000 (the residual) to the members in proportion to their ownership interests ($60,000 to each).

Assuming for the sake of analysis that this arrangement would be classified as a TIC (which the classification rules do not appear to allow[216]), each member would share in the revenues in proportion to their ownership interests. Thus, tax law would treat each of them as receiving $500,000 of the sale proceeds ($2,000,000 × 25%). The $1,200,000 of basis should be disbursed evenly across all undivided interests, so the

212. *See supra* text accompanying notes 194–197.
213. I.R.C. § 1012.
214. *See supra* text accompanying note 200.
215. *See supra* text accompanying notes 131–132.
216. *See supra* text accompanying notes 131–132.

basis of each co-owner's undivided interest should be $300,000 ($1,200,000 × 25%),[217] so each TIC co-owner would have $200,000 of gain. Tax law would treat each of the three Investors as paying $53,333 to Sponsor to cover their equal shares of the $160,000 promote. The $160,000 deemed received by Sponsor from the other TIC co-owners would most likely be compensation taxed to Sponsor as ordinary income and potentially subject to self-employment taxes.[218] The Investors would capitalize the $50,000, which would have the effect of reducing the amount realized on the sale of their interests.[219] Because the Investors would be deemed to receive services from Sponsor in exchange for the deemed transfer of their undivided interests in the property to Sponsor, the deemed transfers would satisfy the exchange requirement,[220] and gain recognized on those deemed transfers would not qualify for section 1031 nonrecognition.

B. TAXATION OF TICNERSHIPS

TICnerships, in contrast to TICs, are partnerships for federal income tax purposes, so tax law treats them as entities separate from the TIC co-owners,[221] i.e., tax law treats TICnerships as separate from the TICners. Tax law thus treats TICnerships as owning property and holding capital and recognizes that they can hire employees and enter into other transactions.[222] For federal income tax purposes, each TICner has an indirect (as opposed to a direct) ownership in a TICnership's property and capital and can transact with the TICnership.[223] Once a TIC arrangement is a TICnership, TICners can take advantage of the partnership tax allocation rules and share profits and losses and distribute earnings in any manner they desire, and tax law grants significant leeway to members of tax partnerships regarding the allocation of tax items.[224]

217. If any of the TIC co-owners used section 1031 exchange funds to acquire an undivided interest, the adjusted basis of their interest would be less. If the acquisition of the property were structured as the acquisition of TIC interests with exchange proceeds followed by a contribution of the undivided interests to a partnership, the partnership would take the exchanger's basis in the contributed property under section 723 and, under section 704(c), any built-in gain from the sale of that interest should be allocated to the exchanger who contributed it to the partnership.

218. I.R.C. §§ 61, 1401, 1402; Treas. Reg. 1.61-2(a), (d).

219. Treas. Reg. § 1.263(a)-1(e)(1).

220. *See* Treas. Reg. § 1.002-1(d).

221. Partnership taxation includes both entity and aggregate features, so, with respect to some issues, tax law treats partnerships as entities separate from their partners and, with respect to other features, as an aggregate of the partners. *See* Borden, *Aggregate-Plus Theory*, *supra* note 155.

222. *See, e.g.*, I.R.C. §§ 702, 703, 707, 721, 723, 731.

223. *See* Borden, *Aggregate-Plus Theory*, *supra* note 155, at 762–80.

224. *See* Borden, *Tax Allocations*, *supra* note 155, at 335–36.

1. *Taxation of TICnership Operations*

Tax partnerships determine tax items such as income, gain, loss, and deductions; compute entity-level taxable income; and allocate those items to their members.[225] The nature of tax partnerships requires such entity-level determinations, and the flowthrough regime requires allocation rules to govern how taxable income and other tax items will be allocated to the members.[226] Partnership-tax allocation rules grant the members of tax partnerships significant latitude in allocating tax items to the members, but the economic benefits and burdens of partnership tax items should follow tax allocations.[227] Otherwise, such items should be allocated in accordance with the partners' interests in the partnership.[228]

The nature of tax partnerships is that they are an amalgam of co-owned property and services with income sourcing from property and services in amounts that cannot be determined separately.[229] For instance, TIC co-owners of property who provide services to tenants that exceed customary tenant services may not be able to separate the income generated by rent from the income generated from the additional services. The income of such an arrangement is an amalgam of income from property and income from services provided by the TIC co-owners (the services could be provided by an agent of the TIC co-owners to the same effect). Because the TIC co-owners of such an arrangement have indirect ownership in the property and rights to the benefits of the services and some members provide services, economic items of the arrangement cannot be traced directly from specific assets or operations of the tax partnership to specific members of the arrangement.[230] The amalgamation of services and property within the partnership makes tracing from a single partnership item to a partner impossible, so tax partnerships require a separate accounting regime to govern the computation and allocation of partnership tax items.[231]

The partnership tax rules in Subchapter K of the Internal Revenue Code fill that need. Subchapter K allows for the efficient pooling of resources and allocation of tax items that cannot be directly traced from their sources to property co-owned or services provided by the co-owners.[232] Thus, the partnership tax rules require an entity-level determination of taxable income or loss and other tax items and allow for member-determined allocations within certain parameters.[233]

225. I.R.C. §§ 701, 702, 703, 704.
226. *See* Borden, *Tax Allocations*, *supra* note 155, at 335–36.
227. I.R.C. § 704(a), (b); Treas. Reg. § 1.704-1(a), (b)(2)(ii).
228. I.R.C. § 704(a), (b).
229. *See* Borden, *Tax Allocations*, *supra* note 155, at 302.
230. *See id.* at 317.
231. *See id.* at 302.
232. *See id.* at 303–09, 333–38.
233. *Supra* text accompanying note 225.

The rules governing the taxation of partnership operations also help account for profit-sharing arrangements that deviate from proportionate sharing or revenue and expenses. To illustrate, TIC co-owners may agree that one TIC co-owner (the sponsor) will manage the property and receive a disproportionate share of the revenue on the disposition of the property (in the form of a promote). Such an arrangement combines the co-owned property and the sponsor's services, deviating from the central characteristics of a TIC, and the TIC co-owners' income derives from both the property and the services.[234] Because tracing income from its source is not possible in such a situation, the partnership tax regime allows the TIC co-owners to allocate the revenue to the TIC co-owners pursuant to their agreement.[235] Example 6 illustrates that if such an arrangement were taxed as a TIC, the revenue would have to be allocated proportionately to the co-owners, who would then be deemed to pay a portion of their share of the revenue to the sponsor.

Example 6: The general facts are the same as the facts in Example 5, but the arrangement is properly classified as a TICnership in this Example 6. Investor 1, Investor 2, Investor 3, and Sponsor are equal TIC co-owners of property worth $1,200,000 with a basis of $1,200,000. They agree that Sponsor will manage the property and that upon disposition of the property, proceeds will be paid proportionately to the TIC co-owners until they have received a return of their capital and a return on their capital in the form of a preferred return. Any proceeds in excess of those amounts will be paid 40 percent to Sponsor, and the remaining 60 percent will be paid equally to the four co-owners. Assume the TIC co-owners sell the property for $2,000,000 and pay $1,600,000 ($400,000 each) to the TIC co-owners as return of capital and return on capital. They pay $160,000 of the remaining $400,000 to Sponsor as a promote, and the remaining $240,000 (the residual) to the members in proportion to their ownership interests ($60,000 to each).

The gain on the sale of the property would be $800,000 ($2,000,000 amount realized over $1,200,000 basis).[236] Assuming the property was held for at least one year, the gain could be long-term capital gain taxed at favorable rates.[237] The gain would consist of $400,000 paid out in preferred return ($1,600,000 return of capital and return on capital over $1,200,000 basis), $160,000 promote paid to Sponsor, and $240,000 divided equally among the co-owners. If gain were allocated according to

234. *See supra* text accompanying notes 229–231.

235. *See* I.R.C. § 704(a), (b); Borden, *Tax Allocations*, *supra* note 155, at 336.

236. I.R.C. § 1001(a).

237. I.R.C. §§ 1(h) (providing tax rates), 1231(a)(1) (providing that gain from the sale of property held for use in a trade or business for more than one year, I.R.C. § 1231(a)(3), (b)(1), is long-term capital gain).

the payments, each Investor would have $160,000 of gain ($100,000 of preferred return and $60,000 of the residual), and Sponsor would have $320,000 of gain ($100,000 of preferred return, $160,000 of promote, and $60,000 of the residual).

This Example 6 and Example 5 illustrate that the operations of a TICnership are taxed differently from the revenue and expenses of property held in a TIC arrangement classified as a TIC.

Another significant aspect of partnership taxation is that it allocates partnership liabilities to the partners, which has the effect of giving them basis in their interests in the partnership.[238] Such allocations can be important if the arrangement specially allocates items of loss or makes disproportionate distributions (actions that TIC co-owners cannot do).[239] The parties' preference for one regime over another may not be evident when they acquire property together but may manifest later when decisions must be made regarding the tax treatment. Nonetheless, the structure of the arrangement (for example, allocating tax items disproportionately) could dictate the classification of the arrangement and the applicable tax regime. The TIC co-owners should consider that outcome when structuring their co-ownership arrangement.

2. *Taxation of TICner-TICnership Transactions*

Because tax partnerships exist as entities separate from their partners, tax law must account for transfers to partnerships from partners (contributions) and from partnerships to partners (distributions). Tax law also must account for transfers between and among partners. As a general rule, tax law allows for the efficient formation of tax partnerships and restructuring of ownership in tax partnerships.[240] Efficient formation and ownership restructuring typically means that contributions to and distributions from tax partnerships are tax-free, so realized gain or loss is deferred until the contributed or distributed property is sold.[241] Transfers between and among partners of a tax partnership are, however, typically taxable, whether direct or indirect, through a series of contributions and distributions.[242] Example 7

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238. *See id.* § 752.

239. *See* Bradley T. Borden, Joseph Binder, Ethan Blinder & Louis Incatasciato, *A Model for Measuring the Expected Value of Assuming Tax-Partnership Liability*, 7 BROOK. J. CORP. FIN. & COM. L. 361, 364 (2013).

240. *See* Borden, *Exchange Requirement*, *supra* note 4, at 469–74.

241. I.R.C. §§ 721, 722, 723, 731, 732.

242. I.R.C. §§ 704(c)(2), 707, 737, 741; *but see* Bradley T. Borden, Douglas L. Longhofer, Martin E. Connor, Natassia Shcherbatsevich, *A Financial Analysis of Disguised Sales of Partnership Interests*, TAX NOTES FED., July, 2021, at 381 (discussing the various types of transactions that could raise the prospect of the disguised-sale rules applying to transactions among partners); Bradley T. Borden & Douglas L. Longhofer, *The Effect of Like-Kind Property on the Section 704(c)*

demonstrates the application of these rules, providing a juxtaposition against the other rules.

Example 7: Investor 1, Investor 2, Investor 3, and Sponsor each contribute $300,000 to an LLC to be treated as a partnership for federal income tax purposes. The LLC acquires property for $1,000,000 and constructs $200,000 of improvements on the property. During the construction and at the completion of the improvements, each of the Investors and Sponsor have an indirect interest in the property and the improvements. Even if Sponsor constructs the improvements in Sponsor's capacity as a partner for no other consideration, there is no taxable event for any of the Investors or Sponsor.[243]

The parties could also agree that the Investors and Sponsor will receive a return of their capital and a preferred return, with Sponsor taking a promote equal to 40 percent of any distributions in excess of the return of capital and preferred return. The partnership tax rules recognize that the parties are contributing capital and services, so it allows them to agree on how the partnership will allocate income and deductions, within reason.[244] The gain allocated to all of the members of the LLC could retain the character of the gain determined at the LLC level,[245] and the partners' shares of the capital gain could be in proportion to the distributions of profit.[246] Such treatment allows Sponsor to manage the construction of improvements and operation and disposition of the property and recognize capital gains on the disposition of the property.

The partnership tax rules also allow Investors to acquire property as TIC co-owners in an arrangement that is classified as a TIC and then contribute their TIC interests to a tax partnership. After the interests are contributed to the tax partnership, a sponsor can join the tax partnership and take an interest in the profits of the tax partnership. Example 8 illustrates the tax rules governing such transactions.

Example 8: Investor 1, Investor 2, and Investor 3 each acquire a 30 percent undivided interest in property for $300,000, and Sponsor acquires

Anti-Mixing Bowl Rules, 27 TAX MGT. REAL EST. J. 131 (2011) (analyzing the rules that allow tax-free transfers of like-kind property between partners and their partnership).

243. I.R.C. §§ 721, 722, 723. If, however, Sponsor receives a capital interest in the LLC in exchange for providing services, Sponsor could recognize compensation income equal to the amount of the interest received. *See* Treas. Reg. 1.721-1(b)(1). *But see* Rev. Proc. 93-27, 1993-2 C.B. 343 (providing a safe harbor for allowing service-providers to receive profits-only interests tax-free).

244. *See supra* text accompanying notes 229–233.

245. I.R.C. § 702(b).

246. *Id.* § 704(a), (b).

a 10 percent undivided interest in the land for $100,000. Following the acquisition, each party contributes their undivided interests in the land to an LLC that they will treat as a partnership for federal income tax purposes. Sponsor also contributes $200,000 for a reserve fund and agrees to oversee the construction of improvements on the property and to manage it. The parties could also agree that the Investors and Sponsor will receive a return of their capital and a preferred return, with Sponsor taking a promote equal to 40 percent of any distributions in excess of the return of capital and preferred return.

The parties should recognize no gain or loss on the formation of the LLC.[247] If any of the Investors used section 1031 exchange proceeds to acquire their interests in the property, the LLC should take their exchanged basis in the contributed undivided interests.[248] Upon the sale of the property, any built-in gain attributable to the exchanged basis should be allocated to the contributing member,[249] and other gain should be allocated according to the LLC operating agreement.[250] The character of the allocated gain should reflect the character of the gain recognized by the LLC,[251] so all of the members could recognize long-term capital gain on the disposition of the property.

Tax law provides generally that neither TICnership nor a TICner would recognize gain or loss on distributions of property from the TICnership to the TICner.[252] If the distribution liquidates the TICner's interest in the TICnership, the TICner would take a basis in the property equal to the TICner's basis in the TICnership at the time of the distribution.[253] Otherwise, the TICner will take the basis the TICnership had in the property, limited by the TICner's basis in the TICnership.[254] The TICner's basis in the TICnership is reduced by the amount of basis of the distributed property.[255] The TICner's holding period in distributed property typically includes the holding period of the TICnership.[256] If the basis the TICner takes in distributed property differs from the basis the TICnership had in the property, the basis of the remaining TICnership's property may be adjusted to account for that difference.[257]

247. *Id.* § 721.
248. *Id.* § 723.
249. *Id.* § 704(c).
250. *Id.* § 704(b).
251. *Id.* § 702(b).
252. *Id.* § 731(a), (b).
253. *Id.* § 732(b).
254. *Id.* § 732(a).
255. *Id.* § 733(2).
256. *Id.* § 735(b).
257. *Id.* § 734(b) (applying if a section 754 election is in effect).

C. SUMMARY OF DIFFERENCES IN TAX TREATMENT

The discussion in this Part illustrates that TICs and TICnerships are taxed differently. The difference is driven by necessity. TIC co-owners of a TIC own direct undivided interests in co-owned real property, and no separate entity exists, so taxable income cannot be computed at the entity level. By contrast, tax partnerships must have a separate existence to allow for the computation of taxable income at the entity level and for the allocation of that taxable income and other tax items to its members. Such a tax regime is necessary when tax items cannot be traced directly from their source to an ownership interest in that source.

The discussion also demonstrates that the classification of TIC arrangement affects the tax consequences of transactions. If an arrangement with disproportionate sharing of revenue were to be treated as a TIC for tax purposes (which treatment does not appear to be appropriate[258]), the disproportionate sharing of revenue must be accounted for as transactions between or among TIC co-owners.[259] Such treatment likely would result in the disproportionate share of revenue being treated as compensation income to the recipient.[260] Thus, sponsors who agree to receive a disproportionate share of revenue from the sale of property that the TIC co-owners treated as a TIC would have some ordinary income from the sale.[261] On the other hand, the parties could avoid such treatment of disproportionately shared income if the arrangement were a TICnership.[262]

D. EXCHANGES & PROXIMATE BUSINESS TRANSACTIONS

Perhaps the most significant difference in tax treatment is how tax law treats TIC interests for section 1031 purposes versus how it treats TICnership interests for section 1031 purposes. There are various types of transactions that would allow exchangers to convert an interest in a partnership or TICnership into a TIC interest prior to an exchange or to turn a TIC interest acquired as part of an exchange into a partnership or TICnership interest.[263] Any exchange that occurs in proximity to a contribution to or distribution from an entity treated as a tax partnership raises questions with respect to the section 1031 exchange requirement (did the exchanger become the owner of the exchange property?), the qualified-use requirement (did the exchanger hold the exchange property for productive use in a trade or business or for investment?), and the real-property requirement (is the interest an interest in

258. Such inappropriate tax treatment could occur if the TIC co-owners misclassify an arrangement. If they choose to treat a TICnership as a TIC, then they would most likely be required to follow the tax rules that apply to TICs.

259. *See supra* text accompanying notes 174–175.

260. *See supra* text accompanying note 174, 218.

261. *See supra* text accompanying note 174, 218.

262. *See supra* text accompanying notes 249–251.

263. *See infra* Parts VI.A, VI.B.

real property (i.e., a TIC interest) or an interest in a partnership (i.e., a TIC interest)). Questions related to these three requirements often arise because when an exchanger does an exchange in proximity to a business transaction, the exchanger often holds the exchange property for a very short period. Without the benefit of the section 1031 jurisprudence governing these transactions, an observer may be concerned that exchanges in proximity to business transactions may not satisfy the exchange requirement, the qualified-use requirement, and the real-property requirement.[264]

This article addresses the real-property requirement, establishing that authority supports treating an interest held momentarily as a TIC interest. Two companion articles, "The Section 1031 Qualified-Use Requirement" and "The Section 1031 Exchange Requirement," address the qualified-use requirement and the exchange requirement, respectively.[265] Those articles present the authority to show that an exchange in proximity to a business transaction can satisfy the exchange requirement and the qualified-use requirement even if the exchanger holds the exchange property for an instant.[266]

Nonetheless, for an interest in property to qualify for section 1031 nonrecognition, it must be real property at the time of the exchange, not a TICnership interest. The discussion that follows considers how TICnership classification can disrupt intended section 1031 exchanges by causing them to fail the real-property requirement. The discussion also shows how some acquisitions of TICnership interests may not adversely affect exchanges that intended to include such interests as replacement property. The challenge faced by every exchanger who holds an interest in a TICnership or partnership is ensuring that any such interest is an interest in real property at the time of the exchange.

VI. HOW TICNERSHIPS DISRUPT SECTION 1031 EXCHANGES

As a general rule, an interest in a tax partnership does not qualify as valid section 1031 relinquished property or replacement property.[267] Therefore, the acquisition or transfer of a TICnership interest as part of an intended exchange disqualifies the transaction from section 1031 nonrecognition. The following discussion considers how TICnership classification can affect the disposition side of a section 1031 exchange (i.e., the effect of relinquished property being treated as a TICnership interest) and how it can affect the acquisition side of a section 1031 exchange (i.e., the effect of replacement property being treated as a TICnership interest).

264. *See, e.g.*, Borden, *Qualified-Use Requirement*, *supra* note 4, at 467–69.
265. *See* Borden, *Qualified-Use Requirement*, *supra* note 4; Borden, *Exchange Requirement*, *supra* note 4.
266. *See* Borden, *Qualified-Use Requirement*, *supra* note 4, at 514–16, 519–22; Borden, *Exchange Requirement*, *supra* note 4, at 421–42.
267. Treas. Reg. § 1.1031(a)-3(a)(5)(C).

The following discussion demonstrates that the classification of an interest in a TIC arrangement is important for section 1031 purposes at the time of the acquisition or disposition of the interest. Thus, an interest that becomes a TICnership after acquisition is treated differently from an interest that is a TICnership interest at the time of acquisition. Similarly, an interest in a TIC arrangement that was a TICnership immediately prior to the transfer of such interest can qualify as valid section 1031 property if it is converted to a TIC interest prior to the transfer of such interest as part of the intended exchange.

A. DISPOSITION-SIDE TREATMENT

On the disposition side of a section 1031 exchange, the exchanger can qualify for section 1031 nonrecognition only if the exchanger transfers property the exchanger owned at the time of the disposition. If, at the time of the disposition, the exchanger owned, and therefore transferred, a TICnership interest, the exchanger would lose section 1031 treatment by transferring a property interest that is not real property. To obtain section 1031 treatment on the transfer of the interest, the exchanger may need to restructure TIC arrangements to cleanse the TICnership status and own an interest in real property for section 1031 purposes at the time of the transfer.

1. *TICnership Interest as Automatic Disqualifier*

The classification of an interest in a TIC arrangement as a TICnership interest automatically disqualifies the TICnership interest from qualifying as valid section 1031 relinquished property.[268] If a TICner disposes of a TICnership interest as part of an intended section 1031 exchange, the disposition cannot qualify for section 1031 nonrecognition because the TICnership interest is a partnership interest for federal income tax purposes. For an interest in property held in a TICnership to qualify for section 1031 nonrecognition, the TICnership must distribute a TIC interest to the TICner attempting to do an exchange, or the TICnership must complete the exchange.

2. *General Section 1031 Challenge Posed by TICnerships*

One prevalent reason exchangers enter into TIC arrangements is to provide an ownership arrangement in real property that allows TIC co-owners to exit the ownership arrangement through section 1031 exchanges upon disposition of the property.[269] A TIC interest received immediately prior to the disposition of property can qualify as valid relinquished property and provide for a clean exit from an ownership arrangement that was treated as a

268. *Id.*
269. *See supra* Part III.C.1.

tax partnership. Because TICnership interests do not qualify as valid relinquished property, TICners cannot merely transfer their TICnership interests as part of a section 1031 exchange. Instead, a TICnership must be unwound, i.e., the TICnership interests must be converted into TIC interests, to allow TIC co-owners to transfer property that is treated as real property for section 1031 purposes. Such unwinding can be complex because TICnership ownership is amorphous, especially when compared to arrangements such as LLCs that are formed by filing articles of organization with the secretary of state.

For property held by a separate entity to qualify as valid section 1031 relinquished property of a member of such entity, the entity must first distribute at least an undivided interest in such property to the member. If the property is held by an LLC, the LLC can distribute title to an undivided interest in its property to a member seeking to transfer a portion of property as part of a section 1031 exchange.[270] If property is held in a TICnership, the TICners hold legal title to undivided interests in the TICnership's property, so the TICnership cannot distribute property by transferring legal title to undivided interests in the property to the TICners. The TICners must devise some other means for accomplishing the distribution. Perhaps they could amend agreements among themselves to ensure that the TIC arrangement takes on the central characteristics of a TIC. By adopting the central characteristics of a TIC, a TICnership should become a TIC. If a TICnership becomes a TIC, presumably, the TICnership would be deemed to distribute all of its assets to the members in complete liquidation.[271] The TICnership would report that distribution on its tax return. For instance, if a TICnership with a single asset converts to a TIC, the TICnership should file a final tax return showing the distribution of the property to the TICners in complete liquidation of the partnership.

If the TICners were neither informed nor aware that their TIC arrangement was a TICnership, they may not have been filing partnership tax returns. In such a situation, they could not report the distributions of undivided interests in the property from the TICnership to the TICners. Despite the failure to file a partnership tax return, the IRS and courts could nonetheless classify the TICnership as a tax partnership and deny section 1031 nonrecognition on the disposition of the TICnership interest. Thus, the failure to properly identify the classification of a TIC arrangement can jeopardize the efforts of TIC co-owners to dispose of their interests in the property as part of a section 1031 exchange.

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270. *See, e.g.*, Bolker v. Comm'r, 760 F.2d 1039, 1041 (9th Cir. 1985); Mason v. Comm'r, 55 T.C.M. (CCH) 1134 (1988).

271. The entity-classification regulations treat an association that elects to be disregarded as distributing all of its assets to its member. Treas. Reg. § 301.7701-3(g)(1)(iii). Presumably, a similar rule would apply to conversions from TICnerships to TICs.

Features of a TIC arrangement such as disproportionate sharing of revenue and expenses or debt secured by a blanket lien on the property can cause a TIC arrangement to be a TICnership. The liquidation of such an arrangement will require removing those features, and the parties should consider the tax consequences of removing such features.

3. *Unwinding a TICnership with a Promote*

First, consider the tax aspects of converting a TICnership with a promote to a TIC. The conversion will require the TIC co-owners to eliminate the promote. In a typical distribution of property from an LLC, the members of the LLC would determine the percent of net proceeds that each member would receive if the property were sold and the proceeds distributed to the members. The members then cause the LLC to distribute undivided interests in the property to the members based upon percentages that match the percentage of proceeds they would receive in a sale and liquidation of the LLC. The partnership tax rules allow for the tax-free distribution of property from a partnership, but the members must consider whether the distribution will result in any section 752 deemed distributions as a result of shares of liability changing.[272] If there are no deemed distributions under section 752, the members should be able to liquidate the LLC tax-free by distributing undivided interests in the property to the members. The percentage of undivided interest distributed to a sponsor can be sufficient to cover the promote owed to the sponsor without triggering gain.

If a TIC co-owner is a sponsor and entitled to a promote on the disposition of property owned by a TICnership, converting a TICnership to a TIC would probably require the other TIC co-owners (investors) to transfer shares of undivided interests to which they hold title to the sponsor. If the arrangement were taxed as a TIC, those transfers would be taxable to the transferor investors and the sponsor.[273]

As described above, if an arrangement with a promote were to be classified as a TIC (which the law should not allow because the sponsor is entitled to a promote[274]), the TIC co-owners would be treated as transferring interests in the property to the sponsor or as receiving proceeds from the sale and paying them to the sponsor.[275] The transfer of the interests in the property in exchange for services would be a taxable event to the investors and the sponsor.[276] The deemed receipt of cash for the interest would also be a taxable event.[277] The TIC co-owners will avoid the tax on such a transfer if the

272. I.R.C. § 752; *see infra* notes 284–287 (discussing the section 752 rules for allocating partnership liabilities).
273. *See supra* text accompanying notes 189–197.
274. *See supra* text accompanying notes 30–31, 38–40, 127–129.
275. *See supra* text accompanying notes 216–220.
276. *See supra* text accompanying notes 200–209.
277. *See supra* text accompanying notes 194–197.

arrangement is a TICnership, which it should be if the arrangement includes a promote for the sponsor,[278] that they successfully convert to a TIC (including transferring title to undivided interests to the sponsor) before selling the property.[279]

Unwinding a TIC arrangement with a promote illustrates an interesting dichotomy of TIC arrangements. The parties obtain a better tax result if the arrangement is a TICnership because the investors do not have a deemed transfer of undivided interests to the sponsor prior to the sale to the buyer.[280] That result is good, but if the TIC co-owners do not convert the TICnership to a TIC before selling the property to the buyer, they will be transferring TICnership interests, and those interests will not qualify as valid section 1031 property.[281]

4. *Unwinding a TICnership with Disproportionate Debt-Sharing*

As discussed above, disproportionate sharing of a debt secured by a blanket lien on property held in a TIC arrangement could cause the arrangement to be a TICnership.[282] A TIC arrangement would have disproportionate debt-sharing if one of the TICners was liable for all or a disproportionate share of a blanket lien on the property through a guarantee, indemnity, or other arrangement. To convert such a TICnership to a TIC, the TICners would have to assume proportionate shares of the debt. The liability-sharing rules under section 752 of the partnership tax regime should apply to such arrangements.[283]

Under the partnership tax rules, members of tax partnerships typically share partnership nonrecourse liabilities in proportion to the shares of partnership profits.[284] Members share in partnership recourse liabilities based upon the economic risk of loss they assume with respect to the partnership liability.[285] Under the rules that allocate recourse liabilities, guarantees, indemnification arrangements, and other agreements in a partnership agreement or outside the partnership agreement can shift the risk of loss.[286]

278. *See supra* text accompanying notes 105–108, 131–132.

279. *See supra* Part IV.A.2.

280. *See supra* text accompanying notes 244–251.

281. *See supra* text accompanying notes 33–35.

282. *See supra* Part IV.B.2(d).

283. *See* I.R.C. § 752; Treas. Reg. §§ 1.752-1, -2 (providing rules for allocating partnership recourse liability among the partners), -3 (providing rules for allocating partnership nonrecourse liability among the partners).

284. Treas. Reg. § 1.752-3(a)(1)–(3) (providing for allocations of nonrecourse liabilities first in accordance with the partners' shares of partnership minimum gain, then in accordance to the amount of any taxable gain that would be allocated to the partners under section 704(c) to the extent of the amount that would be realized if the partnership's property subject to the nonrecourse liability were transferred solely in satisfaction of the nonrecourse liability, and then in accordance with the partners' shares of partnership profits).

285. *Id.* § 1.752-2(a).

286. *Id.* § 1.752-2(b)(3)(i).

For instance, a partner who guarantees a partnership liability generally would be treated as bearing the risk of loss of that liability.[287]

Outside the partnership regime, guaranteeing a loan does not necessarily create a liability for the guarantor.[288] Thus, if a TIC arrangement with disproportionate sharing of debt secured by a blanket lien on the property were not a TICnership, the guarantor may not be deemed to have liability for the debt in excess of the guarantor's proportionate share of the liability. Additionally, in the partnership context, if partners are jointly and severally liable for partnership recourse liability, the partnership tax liability-allocation analysis would consider the guarantor's right of subrogation against the other partners.[289] In a co-ownership arrangement, if more than one TIC co-owner jointly and severally signs the loan documents, the lender could seek repayment for the entire liability from any of those TIC co-owners who sign the loan documents. Nonetheless, a TIC co-owner who satisfies an entire loan might be able to seek payment of the other signers' share of the liability under a right of subrogation.[290] Thus, the guarantor's share of liability under state law could depend upon whether the TIC arrangement is a state-law TIC or state-law TICnership. It is possible for an arrangement to be a TIC under state law and a TICnership for federal income tax purposes.[291]

The interaction of state law and tax law makes determining the TIC co-owners' share of the liability for tax purposes a challenge. If the TIC arrangement is a TIC for state law purposes but a TICnership for federal income tax purposes, the guarantor may not have a right of subrogation, and the guarantor's share of the liability would include amounts attributable to the guarantee. If the TIC arrangement is a state-law TICnership and the guarantor has rights of subrogation, the guarantor's share of liability would appear to be in proportion to the guarantor's interest in the partnership. If one TIC co-owner of a TIC arrangement guarantees debt secured by a blanket lien on the co-owned property, the tax consequences of such share will

287. *Id.* § 1.752-2(f)(3).

288. *See, e.g.*, Putnam v. Comm'r, 352 U.S. 82 (1956) ("[U]pon the payment by the guarantor of the debt, the debtor's obligation to the creditor becomes an obligation to the guarantor, not a new debt, but, by subrogation, the result of the shift of the original debt from the creditor to the guarantor who steps into the creditor's shoes."); Nelson v. Comm'r, 281 F.2d 1 (5th Cir. 1960) (providing that a guarantor was not allowed an interest deduction for interest paid on a guaranteed loan because the interest was not owed on the liability of the guarantor); Landreth v. Comm'r, 50 T.C. 803, 813 (1968) ("The situation of a guarantor is not like that of a debtor who as a result of the original loan obtains a nontaxable increase in assets. The guarantor obtains nothing except perhaps a taxable consideration for his promise. Where a debtor is relieved of his obligation to repay the loan, his net worth is increased over what it would have been if the original transaction had never occurred. This real increase in wealth may be properly taxable.").

289. *See* Treas. Reg. § 1.752-2(f)(4).

290. *See, e.g.*, Allen v. See, 196 F.2d 608 (10th Cir. 1952) ("It is well settled that where one secondarily liable is called upon to make good on his obligation and pays the debt, he steps into the shoes of the former creditor. He becomes subrogated to all the rights of the creditor against the principal debtor, including the security given to secure the debt.").

291. Treas. Reg. § 301.7701-1(a)(1).

depend upon both the state-law classification and the tax classification of the TIC arrangement. Figure 3 presents the four different theoretical possibilities of classification: (1) state-law TIC, tax-law TIC; (2) state-law TIC, tax-law TICnership; (3) state-law TICnership, tax-law TICnership; and (4) state-law TICnership, tax-law TIC. Because, outside the partnership tax rules, tax law typically disregards guarantees, a conversion of a TICnership to a TIC would not appear to affect the parties' shares of liabilities. Because the partnership tax rules take guarantees into account, a change in the guarantee of a loan as part of a conversion of a TICnership to a TIC could result in deemed contributions and distributions.

Figure 3:
Co-Owners' Shares of Liabilities Based upon
State-Law & Tax-Law Classification of TIC Arrangement

	Tax-Law TIC	**Tax-Law TICnership**
State-Law TIC	<u>State Law</u>: Guarantor is liable only if loan is in default. <u>Tax Law</u>: Guarantee likely disregarded. Guarantor has proportionate share of liability. Guarantee must be accounted for. No gain or COD income on termination of guarantee.	<u>State Law</u>: Guarantor is liable only if loan is in default. <u>Tax Law</u>: Guarantee shifts disproportionate share of liability to guarantor under section 752 rules. Termination of guarantee would result in deemed contributions and distributions under the section 752 rules.
State-Law TICnership	<u>State Law</u>: Guarantor has right of subrogation against other TICners. <u>Tax Law</u>: Guarantee likely disregarded. Guarantor has proportionate share of liability. Guarantee must be accounted for. No gain or COD income on termination of guarantee.	<u>State Law</u>: Guarantor has right of subrogation against other TICs. <u>Tax Law</u>: Right of subrogation creates equal sharing of risk of loss, so liability is shared proportionately. No change in share of liability on termination of guarantee.

A TIC arrangement should not be treated as a TIC for federal income tax purposes if the TIC co-owners are not equally liable for debt secured by a blanket lien on the property.[292] This analysis disregards that classification reality to illustrate how disposition of undivided interests in such arrangements might be taxed if the TIC classification were respected. The analysis also demonstrates how TIC co-owners should account for dispositions of co-owned property if they have treated the TIC arrangement as a TIC for federal income tax purposes. Example 9 illustrates how tax law might treat dispositions of property held in such arrangements.

Example 9: Investor 1, Investor 2, Investor 3, and Sponsor each hold legal title to a 25 percent undivided interest in property. Investor 1, Investor 2, and Investor 3 each paid \$300,000 to acquire their undivided interests in the property, and Sponsor paid \$100,000 and agreed to secure financing to construct \$200,000 of improvements. The property is worth \$2,000,000, has an adjusted basis of \$1,200,000, and is subject to the \$200,000 liability that Sponsor procured and guarantees as part of the arrangement. The liability is secured by a blanket lien on the property. The parties have agreed that upon sale of the property, the liability will be repaid from Sponsor's share of the sale proceeds. After showing why disproportionate sharing liabilities secured by blanket liens affects revenue and loss sharing, the analysis examines the tax consequences of two scenarios related to this example.

(a) Disproportionate Liability Sharing Affects Shares of Revenues

Because Sponsor is liable for the entire loan that is secured by a blanket lien in the property, the parties do not share proportionately in the revenues and sales proceeds from the property. First, after the loan is repaid, the Investors net \$500,000 and the Sponsor nets \$300,000. Thus, they do not share proportionately in the proceeds following the repayment of the liability secured by a blanket lien. Second, if profits are computed based upon amounts invested and measured in terms of returns on investment, the Investor's' returns will differ from the Sponsor's return. The Investors each invested \$300,000 and received \$500,000 upon sale, so they each obtained a 66.667 percent return (\$200,000 ÷ \$300,000). Sponsor, on the other hand, invested \$100,000 and received \$300,000, so she received a 200 percent return (\$200,000 ÷ \$100,000). This disproportionate sharing of proceeds and differing returns suggest the arrangement is not a TIC.

292. *See supra* Part IV.B.2(d).

The arrangement also appears to be more than mere co-ownership because the Investors made their interests in the property available to secure the liability. In commercial transactions, property owners would not provide their property as security for a liability without being compensated for providing such security. If the Investors are not expressly compensated for providing the property as security, the arrangement takes on entity characteristics that indicate it is a TICnership. The arrangement appears to be a pooling of resources pursuant to which the Investors each contribute $300,000 and the Sponsor contributes $100,000 and agrees to procure the financing and oversee the construction. The Investors and Sponsor each receive one-fourth of any sale proceeds, but the Sponsor must use a portion of her proceeds to pay down the liability. As a result, the Sponsor's share of proceeds net of liabilities increases as the sales price of the property increases. To illustrate, if the property were to sell for $2,000,000, after repayment of the liability, the TIC arrangement would have $1,800,000 to pay to the Investors and Sponsor ("disbursable proceeds"). The Investors would each receive $500,000 on their one-fourth interests in the property, or 27.78 percent of the disbursable proceeds.[293] The Sponsor would receive $300,000 on her one-fourth interest in the property after repayment of the liability, or 16.67 percent of the disbursable proceeds.[294] Were the property to sell for $4,000,000, the arrangement would have $3,800,000 of disbursable proceeds, and the Investors would receive 26.32 percent of those proceeds,[295] and the Sponsor would receive 21.05 percent of those proceeds.[296] Thus, the Sponsor's share of distributable proceeds increases as the sales price increases, giving the Sponsor a disproportionate share of the sale proceeds. That disproportionate sharing of the proceeds shows that the Investors are compensating Sponsor for obtaining financing and managing the property. The arrangement is analogous to a promote and would cause the arrangement to fail to retain the central characteristics of a TIC, making it a TICnership.[297]

Considering the arrangement in this manner shows that it is akin to a partnership that borrows, provided that distributions will be made based upon some formula related to the arrangement's profitability. The arrangement should compute taxable income at the entity level and allocate it to the TIC co-owners according to the allocation rules.[298] None

293. The investors' percentage of disbursable proceeds equals $500,000 ÷ $1,800,000.
294. The Sponsor's percentage of disbursable proceeds equals $300,000 ÷ $1,800,000.
295. The investor's percentage of disbursable proceeds equals $1,000,000 ÷ $3,800,000.
296. The Sponsor's percentage of disbursable proceeds equals $800,000 ÷ $3,800,000.
297. *See supra* text accompanying note 31.
298. *See supra* Part V.B.1.

of the parties would be able to do a section 1031 with their shares of the proceeds without restructuring the arrangement prior to the sale.[299]

(b) Hypothetical Tax Treatment of a TIC with Disproportionate Debt-Sharing

If tax law were to respect the TIC classification and the disproportionate sharing of liability (in contradiction of the classification rules), upon sale of the property, Investor 1, Investor 2, and Investor 3 should have amount realized equal to the $500,000 they receive.[300] Sponsor should have amount realized equal to $300,000 on the sale plus the $200,000 of liability that is discharged.[301] Thus, each Investor and Sponsor will have $500,000 of amount realized. Assuming they each had a $300,000 basis in their interests, they would each realize $200,000 of gain on the transaction.[302] In this situation, all of the parties benefitted from the liability, but only Sponsor was liable for repaying it. The Sponsor in effect used the interests in the property held by the Investors to secure the liability, but the Investors did not share proportionately in the obligation to repay the loan. The Investors were not compensated for making their interests available for the loan, and the Sponsor was not compensated for procuring the financing. If the parties are unable to identify the consideration for the lending portion of the arrangement, tax law requires them to adopt the partnership tax rules.[303]

Now assume tax law respects the TIC classification but deems the TIC co-owners to share the obligation for the liability proportionately, consistent with the TIC arrangement having the central characteristics of a TIC. Upon sale of the property, each of the Investors and Sponsor would be deemed to receive their $500,000 share of proceeds net of their $50,000 equal share of the $200,000 liability relief. The net cash deemed paid to each TIC co-owner would be $450,000 ($500,000 – $50,000).

Because each of the Investors actually receives $500,000 and Sponsor only receives $300,000, tax law would appear to deem Sponsor as receiving $450,000 and transferring $50,000 to each of the Investors. That deemed payment from Sponsor to the Investors would appear to be in exchange for shares of their undivided interests. Any Investor who intended to do a section 1031 exchange upon sale of property would have to ensure that the proceeds from the deemed transfer are received by the Investor's section 1031 qualified intermediary.

299. *See supra* Part VI.A.2
300. *See* I.R.C. § 1001(b).
301. *See id.*; Treas. Reg. § 1.1001-2.
302. I.R.C. § 1001(a).
303. *See supra* text accompanying notes 231–235.

If an arrangement shifted liability disproportionately to a TIC co-owner in an arrangement that was classified as a TIC, the TIC co-owners' disposition of their TIC interests could trigger cancellation of indebtedness (COD) income or gain to the primary obligor.[304] The character of the recognized income would depend upon the nature of the transaction giving rise to the cancellation of liability.[305] For instance, the income could be cancellation of indebtedness income, compensation, or amount realized on the transfer of property, depending upon the parties' purpose for shifting the liability.[306] To illustrate, the TIC co-owners may agree with a developer that the developer co-owner will bear sole liability as a guarantor for a construction loan until the property is constructed and permanent financing is acquired to pay down the construction loan. When the permanent financing is obtained, all of the TIC co-owners will share in the obligation in proportion to their ownership interests. Thus, as a result of the refinancing, the developer is relieved of liability. The TIC co-owners may agree that they will take on liability for some of the permanent financing because the property, as improved, is of greater value, and the risk of being obligated under the loan is significantly less. The TIC co-owners would appear to assume a share of the obligation to pay the permanent loan to compensate the developer for completing the improvements. Such an assumption of liability would appear to be compensatory and could result in compensation income to the developer.

B. Acquisition-Side Treatment

The tax consequences of acquiring an interest in a TIC arrangement classified as a TICnership depend upon the situation under which the interest is acquired. For instance, the tax treatment of an acquisition of an interest that brings a TICnership into existence may qualify for section 1031 treatment, but the acquisition of an interest in an existing TICnership may not. Consider each such situation and several of their permutations.

304. *See* Gehl v. Comm'r, 50 F.3d 12 (8th Cir. 1995); Treas. Reg. § 1.1001-2.

305. *See, e.g., id.*; United States v. Centennial Sav. Bank FSB, 499 U.S, 573 (1991) (holding that cancellation of a bank's obligation to pay interest was payment of an early withdrawal penalty by the account holder); *Gehl*, 50 F.3d 12; Spartan Petroleum Co. v. United States, 437 F. Supp. 733 (D. S. Cal. 1977) (holding that cancellation of a dept was payment under a distributorship contract); Treas. Reg. § 1.1001-2 .

306. *Spartan Petroleum Co.*, 437 F. Supp. 733 ("[C]ancellation of indebtedness can be simply the medium through which other types of income arise. For example, if an employee owes his employer $100 and renders $100 worth of services for the employer in return for the employer's cancellation of the indebtedness, the employee has received personal service income of $100. Sec. 61(a)(1). That income is not cancellation of indebtedness income because the cancellation is merely the medium for payment of other income, and is not the source of the income itself. The same is true in a myriad of other contexts. For example, a corporation by cancelling a shareholder's indebtedness to it can confer a taxable economic benefit in the form of a dividend. E.g., Hash v. Commissioner of Internal Revenue, 273 F.2d 248, 250 (4th Cir. 1959).").

1. *Acquisition from Sole Owner*

A single buyer or multiple buyers can purchase interests in a real property TIC arrangement from the sole owner of real property. If the arrangement is a TIC following the acquisition of the interest, then the buyer (or buyers) will acquire and hold TIC interests. If the arrangement is a TICnership following the acquisition of the interest, then the buyer (or buyers) should be treated as acquiring an interest in real property and immediately contributing it to a TICnership in exchange for an interest in the TICnership.[307] Consider the application of this rule to separate TIC arrangements: one entered into by a single buyer and one entered into by multiple buyers.

(a) Acquisition of Interest from Sole Owner by Single Buyer

A TICnership interest acquired as intended replacement property generally could qualify for section 1031 treatment in limited circumstances. For instance, if an exchanger acquires a TICnership interest from the sole owner of property and the acquisition creates a TICnership, the exchanger should be treated as acquiring an interest in real property under *McDougal v. Commissioner* and Rev. Rul. 99-5.[308] In *McDougal v. Commissioner*, the Tax Court held that the transfer of an interest in property to someone who becomes a member of a tax partnership with the transferor is treated as a transfer of the property interest followed by the transferor and transferee contributing their interests to the tax partnership.[309] Under Rev. Rul. 99-5, if a buyer acquires an interest in an LLC from the sole owner of the LLC, the buyer is treated as acquiring an undivided interest in the LLC's property, and immediately thereafter, the buyer and the seller are treated as contributing their interests in the property to the LLC. Because the LLC has two members after the transfer of the deemed transfer of the interest and deemed contribution, the LLC becomes a tax partnership.[310] The transaction would thus be a so-called "swap-and-drop."[311] Based upon that authority, someone who acquires a TICnership interest should be treated as acquiring an undivided interest in the property, as evidenced by the deed, and then immediately transferring that undivided interest to the TICnership. As discussed below, courts have granted section 1031 nonrecognition to swap-

307. McDougal v. Comm'r, 62 T.C. 720, 725 (1974) ("When on the formation of a joint venture a party contributing appreciated assets satisfies an obligation by granting his obligee a capital interest in the venture, he is deemed first to have transferred to the obligee an undivided interest in the assets contributed, equal in value to the amount of the obligation so satisfied. He and the obligee are deemed thereafter and in concert to have contributed those assets to the joint venture."); Rev. Rul. 99-5, 1999-1 C.B. 434.

308. *See id.*

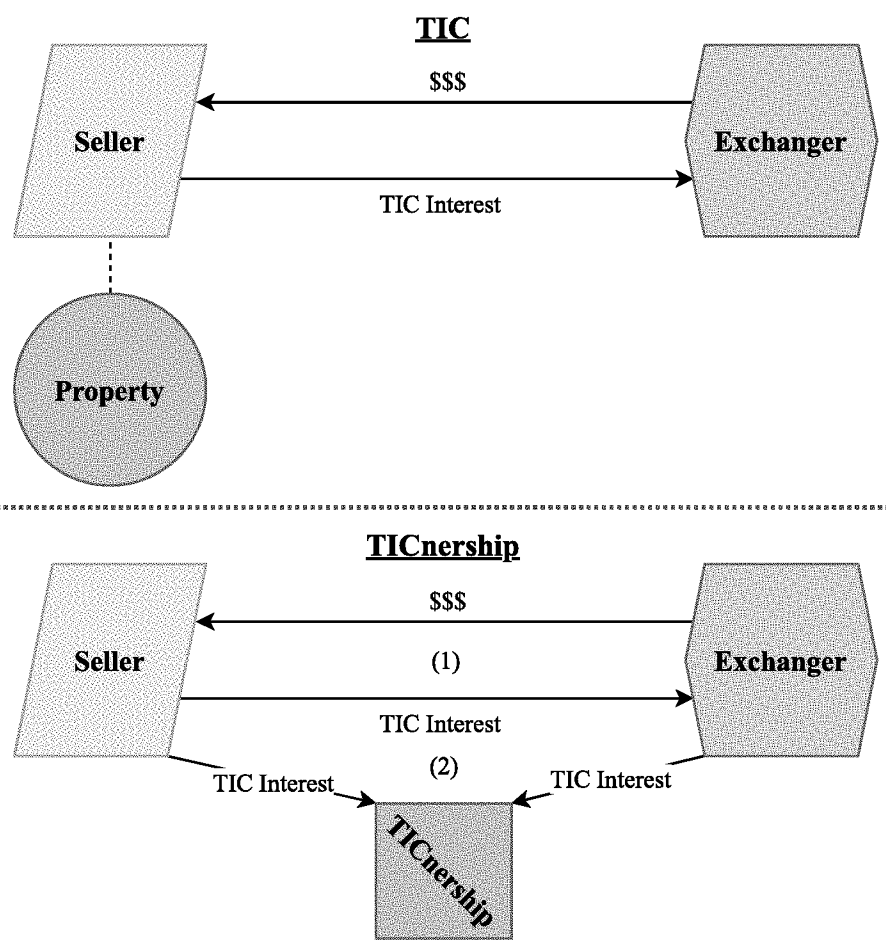
309. *McDougal*, 62 T.C. at 725.

310. Rev. Rul. 99-5.

311. *See* Bradley T. Borden, *Code Section 1031 Swap-and-Drops Thirty Years after* Magneson, J. PASSTHROUGH ENT., Jan.–Feb. 2016, at 11 (describing and discussing drop-and-swaps).

and-drops, and the authority supporting that treatment is very strong.[312] Figure 4 compares the structure of a transfer of a TIC interest that results in the formation of a TIC and one that results in the formation of a TICnership.

Figure 4: Acquisition from Sole-Owner Seller

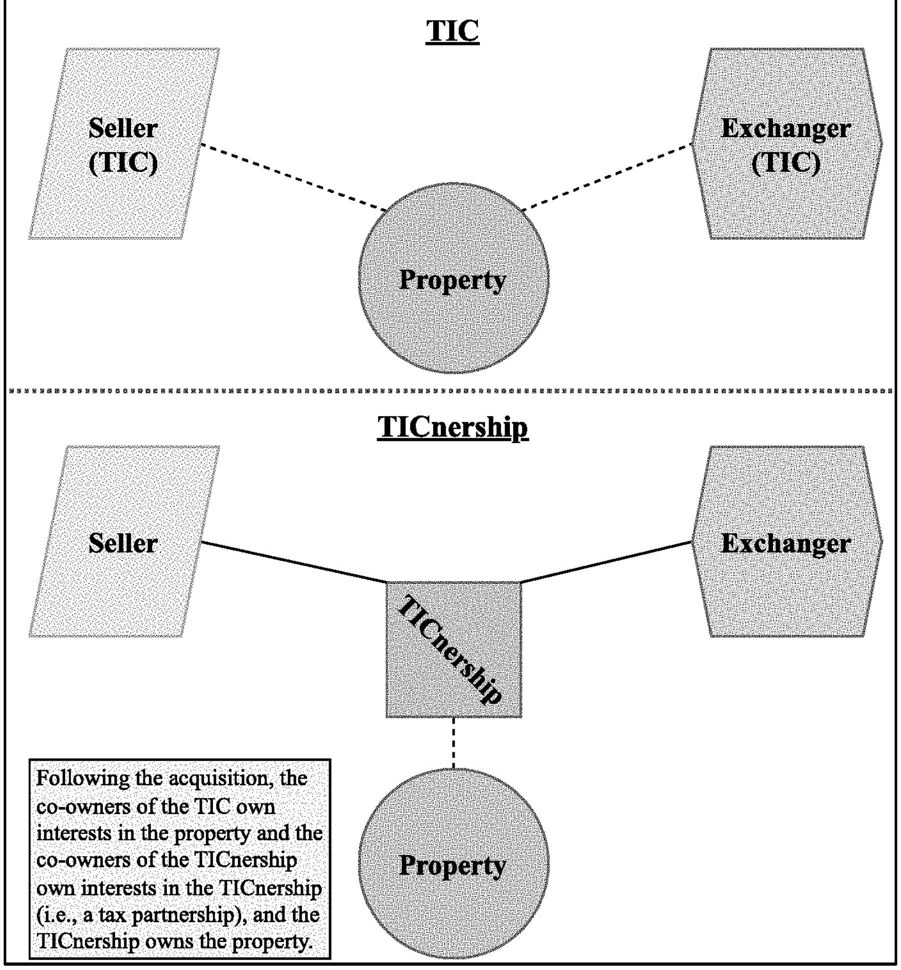


- If the arrangement following the transfer is a TIC, the Exchanger should be treated as acquiring real property.
- If the arrangement following the transfer is a TICnership, the transaction should follow <u>Rev. Rul. 99-5</u>: (1) the Exchanger should be treated as acquiring an interest in property; and (2) the Exchanger and Seller should be treated as contributing property to a new TICnership.

Figure 5 illustrates the ownership of the property following the transaction if the resulting arrangement is a TIC versus a TICnership.

312. *See infra* notes 317–322 and accompanying text.

Figure 5: Acquisition from Sole-Owner Seller (Post-Acquisition Tax Ownership)



Some practitioners may worry that the exchanger's deemed acquisition of a TIC interest and immediate contribution to a tax partnership could disqualify the property from being section 1031 replacement property because the transaction fails the exchange requirement, the qualified-use requirement, or the real-property requirement. Case law provides very strong support that the transaction satisfies the qualified-use requirement even though the exchanger is deemed to hold real property for just a moment.[313] The IRS, in Rev. Rul. 99-5, explicitly treats the buyer-contributor as acquiring an interest in real property, so the IRS provides explicit support for the real-property requirement (treating the buyer as acquiring an interest in

313. Borden, *Qualified-Use Requirement*, *supra* note 4.

the property).[314] The IRS also provides explicit support for the exchange requirement (treating the buyer as acquiring, i.e., becoming the tax owner of and then transferring the property interest). The IRS's position should allay concerns that the buyer-contributor does not acquire tax ownership of an interest in the property of the entity. Thus, there is very strong support that the buyer-contributor acquires an interest in real property to hold for productive use in a trade or business or for investment, even though the buyer-contributor's ownership is transitory (i.e., lasts for an instant).

(b) Acquisition of Interest from Sole Owner by Multiple Buyers

If the exchanger is one of multiple buyers who buys a TICnership interest from a single owner of property who retains an interest in the property, the principles in *McDougal v. Commissioner* and Rev. Rul. 99-5 should apply. Consequently, each buyer should be treated as buying an undivided interest in the property and immediately contributing the property interest to the TICnership along with the seller.

If the exchanger is one of multiple buyers who acquires a TICnership interest from a single seller who does not retain an interest, the principles of *McDougal v. Commissioner* and Rev. Rul. 99-5 should apply, and the

314. The IRS treats a qualified intermediary as acquiring and transferring property to facilitate the exchange. Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(A); Borden, *Exchange Requirement*, *supra* note 4, at 432–33. Thus, two IRS fictions overlap when an interest in an LLC is acquired from the sole member of the LLC as replacement property. Presumably, the qualified intermediary's deemed acquisition of the undivided interest in the property of the LLC under Rev. Rul. 99-5 and the qualified-intermediary rules and the deemed transfer of that property to the exchanger and the LLC under those rules would occur at the same time. The qualified intermediary would not become a member of the LLC because it transfers the property to the exchanger at the same time it transfers the property to the LLC. Thus, the exchanger would be deemed to receive an interest in the property of the LLC, not an interest in the LLC from the qualified intermediary. Furthermore, the qualified intermediary and the seller of the LLC interest would not intend for the qualified intermediary to become a member of the LLC for an instant, and they would not conduct any business together during the instant the qualified intermediary is deemed to own the property, so the qualified intermediary and the seller of the LLC would not form a tax partnership. *See, e.g.*, Comm'r v. Culbertson, 337 U.S. 733, 742 (1949) ("The question is . . . whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.") Torres v. Comm'r, 88 T.C. 702, 736 (1987) ("[F]or Federal tax purposes a partnership cannot exist unless the parties thereto have a good faith intent to PRESENTLY conduct an enterprise with a business purpose.") (emphasis in original); Sparks v. Comm'r, 87 T.C. 1279, 1282 (1986) ("A Partnership is formed when the parties to a venture join together capital and services with the intent of conducting presently an enterprise business." (citing Comm'r. v. Tower, 327 U.S. 280 (1946)); *see also infra* Part VII.A.1(b) (discussing the lack of activity for the instant property is held provides insufficient time for the parties to conduct the level of business activity required to create a tax partnership). Thus, the exchanger should not be treated as acquiring an interest in a tax partnership from the qualified intermediary if the replacement property is an interest in an LLC acquired from its sole member.

exchanger and other buyers should be deemed to acquire interests in the property and to contribute them to the TICnership. Because the seller does not retain an interest in the property, however, *McDougal v. Commissioner* and Rev. Rul. 99-5 are not directly on point. In the absence of that direct authority, perhaps the IRS and courts could treat the transaction as the buyers forming a partnership and causing the partnership to acquire the property. The parties might be able to avoid that treatment by acquiring interests in the property in a TIC arrangement that has the central characteristics of a TIC and then contributing the property to an LLC.[315]

2. *Acquisition Into Existing Multiple-Owner TIC Arrangement*

An interest in a multiple-member TIC arrangement would not qualify as a valid section 1031 replacement property if the arrangement is a TICnership because the interest would be a tax partnership interest, which is excluded from section 1031 treatment.[316] Exchangers seeking section 1031 treatment should exercise due diligence to ensure that a TIC arrangement they buy into is indeed a TIC and not a TICnership. If the arrangement that an exchanger buys into is a TICnership, the exchanger may consider multiple possible transactions and resulting transactions that may allow the buy-in to qualify as part of a valid section 1031 exchange. The permutations of acquisitions of TIC interests from a multiple-owner TIC arrangement are many. For instance, the exchanger could (1) acquire a TIC interest and become a TIC co-owner; (2) acquire a TIC interest and become a member of a TICnership; (3) acquire a TICnership interest that is not valid replacement property and become a TICner; (4) acquire a TIC interest from a TICnership and become a TIC co-owner with a TICnership; (5) acquire a TIC interest from a TICner doing a drop-and-swap; and (6) acquire a TIC interest from a TICner as part of a disguised sale of a TICnership interest. If an exchanger buys into a multiple-member TIC arrangement, one of these alternatives will occur. Exchangers and their advisors are best served by knowing what the arrangement is that the exchanger is buying into and structuring the acquisition in such a way that the exchanger's acquisition can qualify as part of a valid section 1031 exchange.

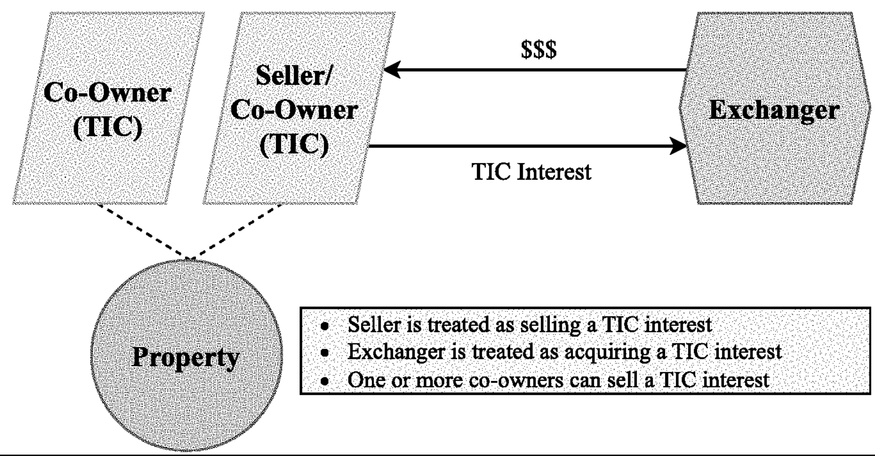
(a) Acquire a TIC Interest in an Arrangement that Remains a TIC

If a TIC arrangement is a TIC and not a TICnership, an exchanger can acquire a TIC interest in real property in such arrangement and become a TIC co-owner as part of a section 1031 exchange. The acquisition of such an interest should be able to qualify as valid section 1031 replacement property.

315. *See infra* text accompanying notes 344–353.
316. I.R.C. § 1031(a)(1); Treas. Reg. § 1.1031(a)-3(a)(5)(i)(C).

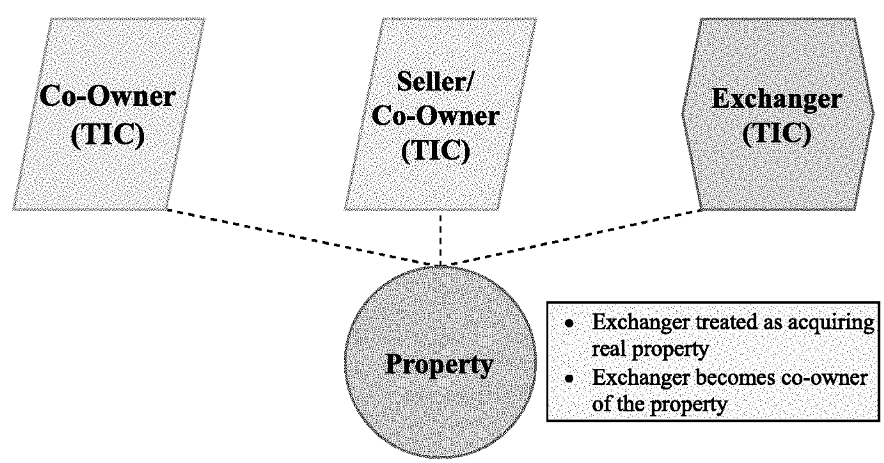
Figure 6 depicts the acquisition of a TIC interest from a TIC co-owner in a TIC arrangement that is a TIC for federal income tax purposes.

Figure 6: Acquisition from Multiple-Owner Arrangement (TIC Before & After)



Following the acquisition, the exchanger will be a TIC co-owner. A TIC interest in real property can be valid replacement property, so the transaction could qualify for section 1031 nonrecognition. Figure 7 depicts the ownership structure of a TIC arrangement that is a TIC for federal income tax purposes immediately after the exchanger's acquisition of a TIC interest.

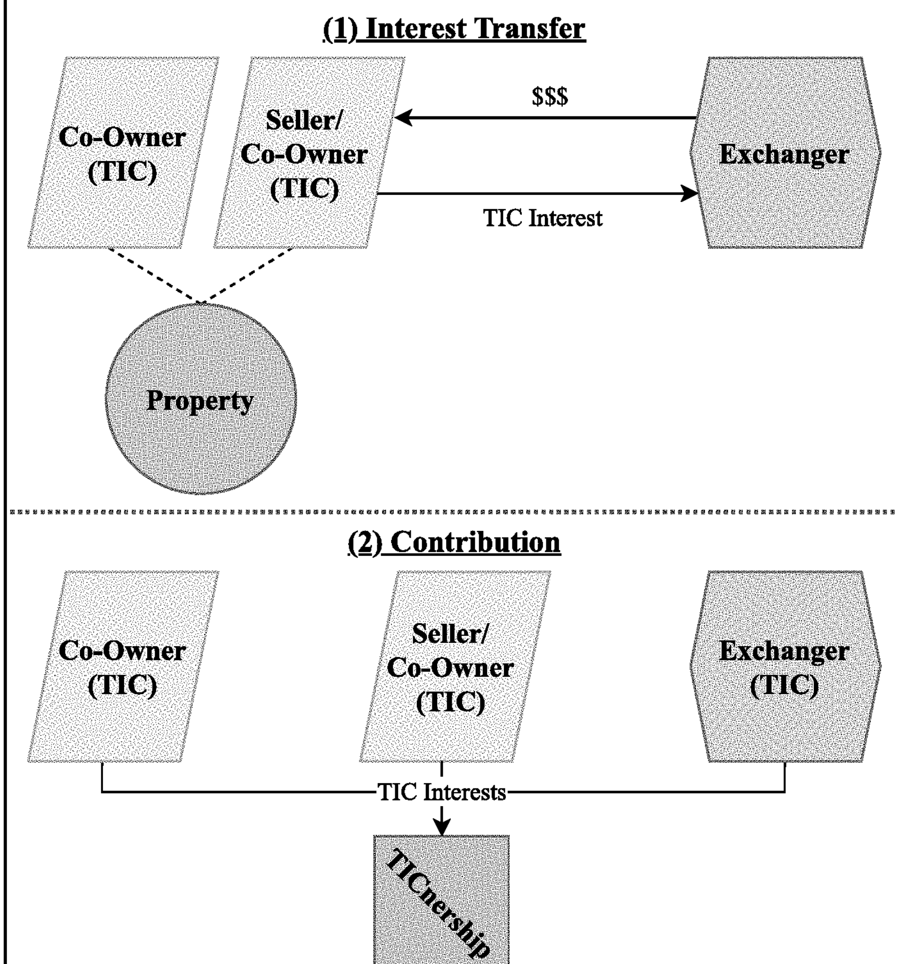
Figure 7: Acquisition from Multiple-Owner Arrangement (Post-Acquisition Structure)



(b) Acquire a TIC Interest & Become a Member of a TICnership

An exchanger might acquire a TIC interest from a TIC co-owner in a TIC arrangement that is treated as a TIC, but the parties may amend the TIC agreement when the exchanger becomes a TIC co-owner and cause the TIC arrangement to become a TICnership. Such a transaction should be treated as the exchanger acquiring an interest in the property and contributing it to a TICnership in exchange for a TICnership interest. Figure 8 depicts the transfer of the TIC interest and the co-owners' contributions of the TIC interests to a TICnership.

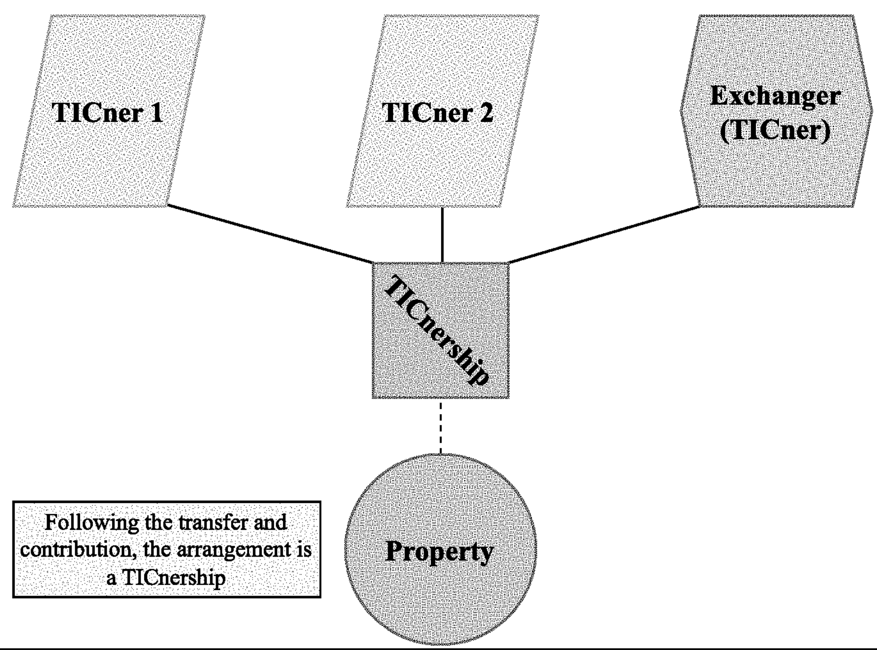
Figure 8: Acquisition from Multiple-Owner Arrangement (TIC Before & TICnership After)



- Seller is treated as selling a TIC interest
- Exchanger is treated as acquiring a TIC interest
- One or more co-owners can sell a TIC interest
- New co-ownership arrangement is a TICnership, with the sellers and purchaser treated as contributing TIC interests to TICnership

Following the acquisition and deemed contribution to the TICnership, the TIC co-owners will be TICners in the TICnership, as depicted in Figure 9.

Figure 9: Acquisition from Multiple-Owner Arrangement (Post-Acquisition Structure)



Even though the exchanger acquires and is deemed to immediately transfer the TIC interest into a TICnership, the exchanger should be able to satisfy the exchange and qualified-use requirements with this transaction.[317] The transaction is very similar to the facts in *Magneson v. Commissioner*.[318] In *Magneson v. Commissioner*, the exchanger received a TIC interest and immediately transferred it to a limited partnership for a general partner interest.[319] Because the TICnership is a default partnership, it would be a general partnership, and the exchanger's TICnership interest would be a general partnership interest.[320] Thus, the exchanger would be deemed to contribute the TIC interest to a general partnership for a general partnership

317. *See* Borden, *Qualified-Use Requirement*, *supra* note 4; Borden, *Exchange Requirement*, *supra* note 4.

318. Magneson v. Comm'r, 753 F.2d 1490, 1492 (9th Cir. 1985) (confirming exchanger acquired an undivided interest in real property and immediately contributed it to a limited partnership for a general partner interest).

319. *Id.*

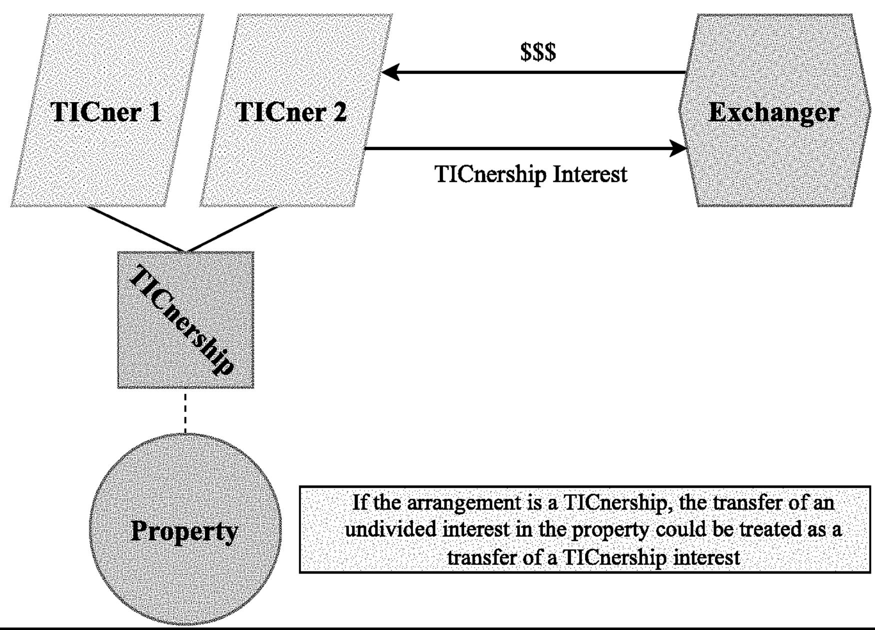
320. Uniform Partnership Act of 1997 §§ 102(11) (2015) (defining partnership as an association of two or more persons to carry on as co-owners a business for profit), comment (providing that the term "partnership" means domestic general partnership).

interest.[321] Because a TIC-to-TICnership transaction is similar to the transaction in *Magneson v. Commissioner*, advisors and exchangers who might otherwise be concerned about contributing property to a partnership shortly after exchange should take extra comfort from that similarity.[322]

(c) Acquire a TICnership Interest & Become a TICner

If an exchanger acquires an interest in a TICnership that has multiple TICners at the time of acquisition, the exchanger would acquire a TICnership interest that is treated as an interest in a tax partnership, and the acquisition would not qualify as part of a section 1031 exchange.[323] Figure 10 depicts an exchanger's acquisition of a TICnership interest in a multiple-member TICnership.

Figure 10: TICner Selling TICnership Interest (TICnership Before & After)



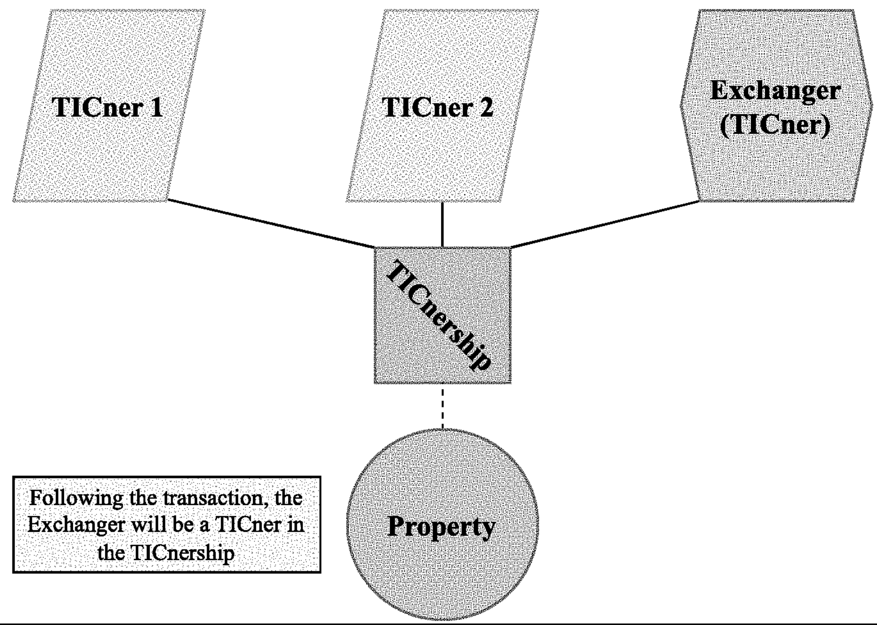
321. Treas. Reg. § 301.7701-3(g)(1)(iv) (providing that if a disregarded entity elects to be a corporation, the owner is deemed to contribute the assets of the disregarded entity to the corporation). Presumably similar rules would apply to the co-owners in a TIC that change their TIC arrangement to a TICnership by modifying its terms.

322. Based upon the long-standing authority governing the definition of real property as it relates to TIC arrangements discussed in this Article, the qualified-use requirement, and the exchange requirement, the Author is of the opinion that the authority supports contributing replacement property to a real estate partnership immediately after acquisition. Borden, *Qualified-Use Requirement*, *supra* note 4; Borden, *Exchange Requirement*, *supra* note 4. Consequently, the similarity of facts in the TIC-to-TICnership transaction to the facts in *Magneson v. Commissioner* has the same strong support that is available to other exchanges followed by contributions.

323. Treas. Reg. § 1.1031(a)-3(a)(5)(i)(C).

Following the exchanger's acquisition of the TICnership interest, the exchanger would be a TICner along with the other TICners, as depicted in Figure 11.

Figure 11: TICner Selling TICnership Interest (Post-Acquisition Structure)

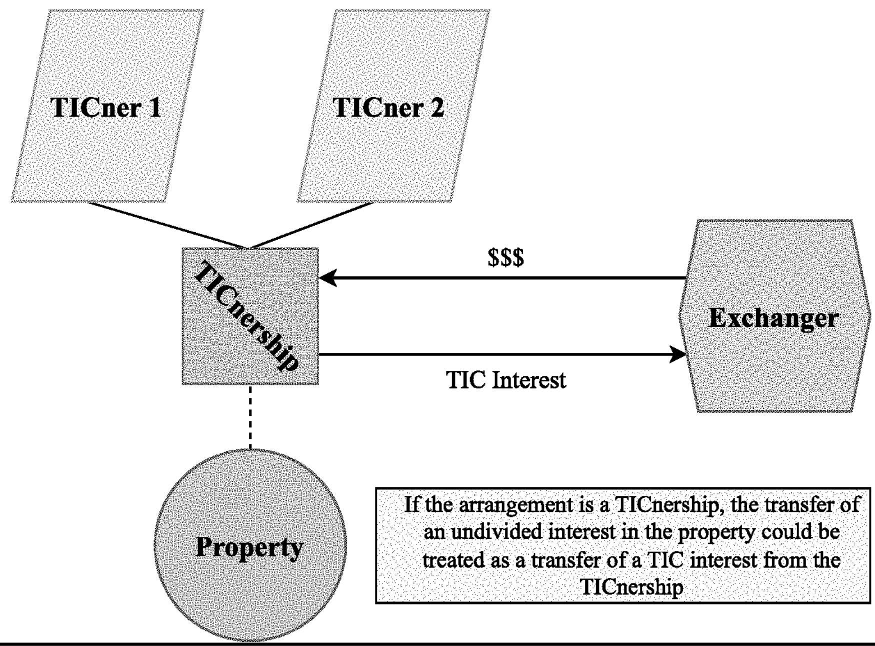


(d) Acquire a TIC Interest from a TICnership & Become a TIC with the TICnership

Because TICnerships are treated as separate from the TIC co-owners for federal income tax purposes, tax law should recognize that TICnerships can engage in transactions, including buying and selling undivided interests in property the TICnerships are deemed to own.[324] Thus, a TICnership could sell an undivided interest in the property it is treated as owning for federal income tax purposes. Figure 12 depicts a transfer of a TIC interest from a TICnership to an exchanger.

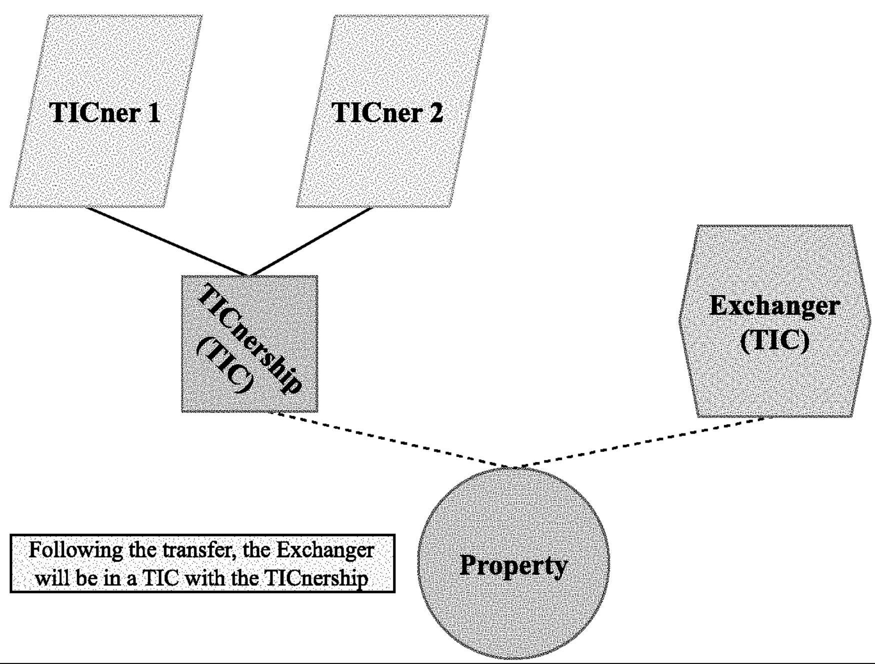
324. *See supra* text accompanying notes 221–224.

Figure 12: TICnership Selling TIC Interest
(TICnership Before with TIC After)



Following the transfer, the TICnership and the exchanger would be TIC co-owners of the property, as depicted in Figure 13.

Figure 13: TICnership Selling TIC Interest
(Post-Acquisition Structure)

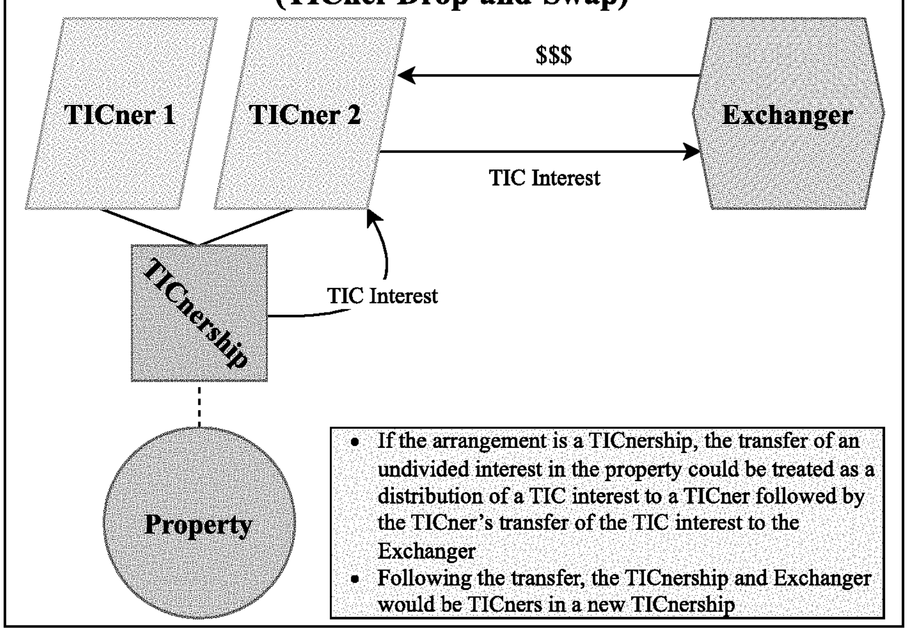


(e) Acquire a TIC Interest from a TICner Doing a Drop-and-Swap

If an arrangement is a TICnership, that TICnership could distribute an undivided interest in the property to a TICner, and the TICner could transfer the interest to an exchanger. The transferor TICner and TICnership may be interested in this structure to allow the transferor TICner to do a section 1031 exchange with the proceeds from the sale of the undivided interest to the exchanger. With respect to the transferor TICner, the transaction would be a distribution from the TICnership to the TICner followed by the TICner's transfer of the undivided interest in the property as part of a transaction the TICner intends to have qualify for section 1031 nonrecognition. If the distribution from the TICnership to the TICner is properly executed, the TICner should be able to satisfy the section 1031 exchange requirement just as any exchanger does with similar transactions in more traditional entities.[325]

If the arrangement between the exchanger and the TICnership becomes a TICnership, then the exchanger would be treated as acquiring an interest in property and contributing it to a new TICnership, with the other TICner being the original TICnership. From the exchanger's standpoint, the transaction should be a *McDougal v. Commissioner* or Rev. Rul. 99-5 transaction.[326] Figure 14 depicts this transaction.

Figure 14: TICner Selling TIC Interest (TICner Drop-and-Swap)

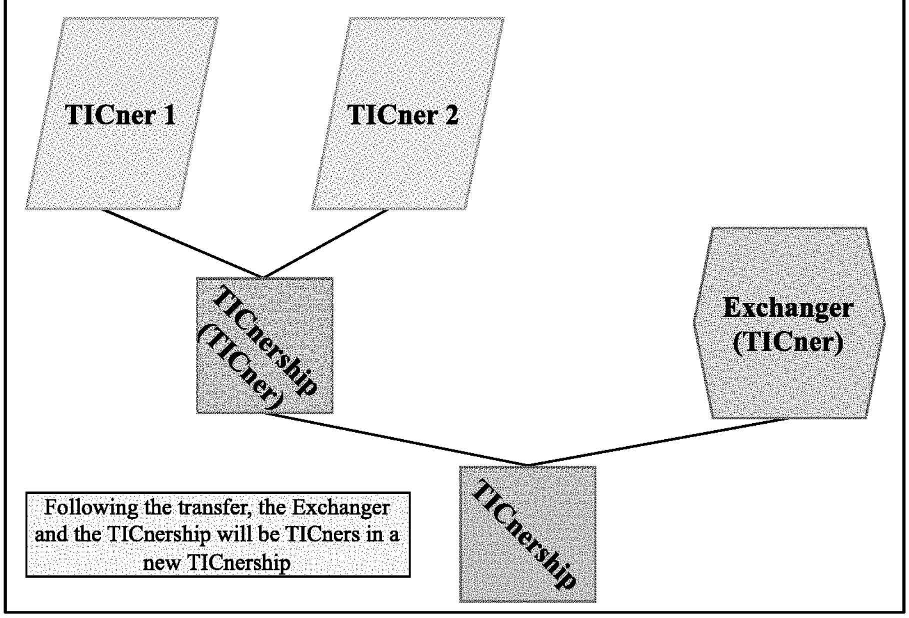


325. Borden, *Qualified-Use Requirement*, *supra* note 4; Borden, *Exchange Requirement*, *supra* note 4.

326. *See supra* text accompanying notes 308–315.

Following the transaction, the exchanger and the original TICnership will be TICners in a new TICnership. Figure 15 shows the resulting structure.

Figure 15: TICner Selling a TIC Interest (Post-Acquisition Structure)

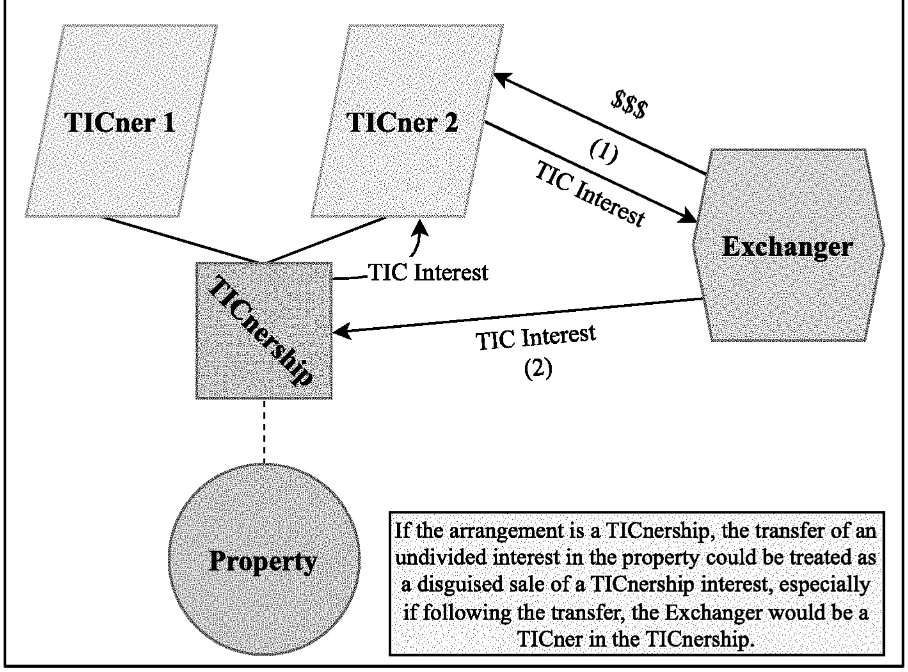


(f) Acquire a TIC Interest from a TICner as part of a Disguised Sale

In *Crenshaw v. United States*, a partnership distributed an undivided interest in property to a partner, the partner transferred the undivided interest in exchange for other property, and the buyer contributed the undivided interest back to the partnership.[327] The Fifth Circuit found that the transaction was a disguised sale of the partner's interest in the partnership.[328] A transfer of an undivided interest in property held by a TICnership could be a disguised sale under the principles of *Crenshaw v. United States* if the exchanger becomes a TICner in the TICnership that owns the property before and after the transaction. Because the courts can disregard the distribution, transfer, and contribution, the TICner may be deemed to sell and the exchanger may be deemed to acquire a TICnership interest, which would disqualify both parties from section 1031 nonrecognition. Figure 16 depicts a disguised sale of a TICnership interest.

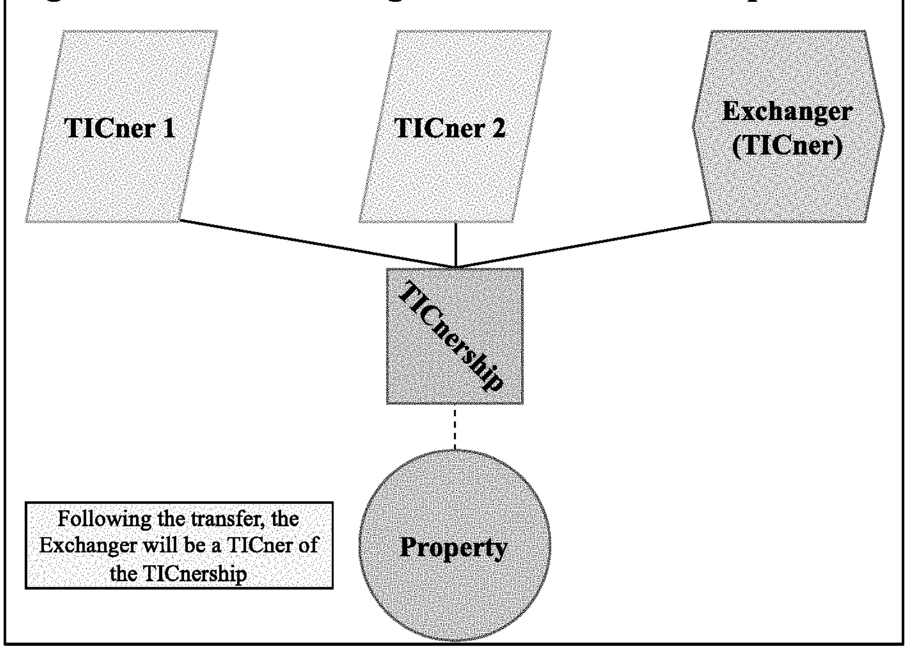
327. Crenshaw v. Comm'r, 450 F.2d 472, 474 (5th Cir. 1972).
328. *Id.* at 477–78; Borden, *Qualified-Use Requirement*, *supra* note 4, at 532–36.

Figure 16: Disguised Sale of TICnership Interest



Following the disguised sale, the exchanger would be a TICner in the TICnership, as depicted in Figure 17.

Figure 17: Result of a Disguised Sale of TICnership Interest



3. *Acquisition & Admission of Sponsor or Manager*

An exchanger could also consider acquiring a property interest in an entity disregarded as separate from the exchanger and then admitting a manager into that entity for a share of the profits. If the transaction is structured as the acquisition prior to the admission of the manager, then, under the court's adoption of a form-driven analysis, the exchanger should be deemed to acquire the property and contribute it to a partnership when the manager is admitted.[329] If the manager takes a profits-only interest in the entity, the admission of the manager should not be a taxable event.[330]

C. SUMMARY OF SECTION 1031 RISKS ARISING IN EXCHANGES OF TIC INTERESTS

On the disposition side of exchanges of interests in TIC arrangements, the transfer of an undivided interest in property held in a TIC arrangement that is classified as a TICnership does not qualify for section 1031 nonrecognition treatment.[331] A TICnership can be converted to a TIC prior to the transfer of an undivided interest in the property, and a transfer of an undivided interest as part of an exchange following that conversion should be treated as a distribution followed by an exchange.[332] The conversion from a TICnership to a TIC may require insightful changes to the documents governing the TIC arrangement, but with such efforts, the TIC co-owners should be able to unwind the TICnership and convert it to a TIC.[333] As part of such conversions, the parties should take into account the tax treatment that may accompany such unwinding.[334]

On the acquisition side of a section 1031 exchange, the exchanger should be certain that any interest in an existing TIC arrangement is treated as a TIC interest and not a TICnership interest. If the arrangement becomes a TICnership upon acquisition of an undivided interest in property, the exchanger must ensure that the TICnership forms after the acquisition.[335] The TICnership should be able to distribute undivided interests in property the TICnership is deemed to own.[336] The distributee TICner and the acquiring exchanger should both be able to make the transfer of the undivided interest in the property part of an exchange intended to qualify for section 1031

329. *See* Borden, *Exchange Requirement*, *supra* note 4, at 454–62.
330. *See* Rev. Proc. 93-27, 1993-2 C.B. 343 (providing for the tax-free treatment of the grant of most profits-only interests in a tax partnership); Bradley T. Borden, *Profits-Only Partnership Interests*, 74 BROOK. L. REV. 1283 (2009).
331. *See supra* text accompanying notes 267–268.
332. *See supra* text accompanying notes 269–271.
333. *See supra* text accompanying notes 269–271.
334. *See supra* text accompanying notes 252–256.
335. *See supra* Part VI.B.
336. *See supra* Part VI.B.2(e).

nonrecognition.[337] The parties must ensure, however, that the transaction is not merely a disguised sale of a TICnership interest.[338]

It is clear that TICs and TICnerships can cause headaches for parties to such arrangements and parties who are buying or selling interest in such arrangements. Tax law provides support for exchanges that occur in proximity to business transactions, so some exchangers will wonder why they end up in a TIC arrangement long-term. The next Part discusses best practices with respect to exchanges and proximate business transactions.

VII. TIC BEST PRACTICES

With the foundation established to this point in the Article, the analysis turns to enumerating best practices that advisors and property owners should consider when structuring TIC arrangements. A primary concern for TIC co-owners in many such arrangements is ensuring that the interest they transfer is real property for section 1031 purposes. TIC co-owners should be equally concerned about their rights and obligations with respect to their interest in the property and the rights and obligations of other co-owners. Those dual objectives help inform best practices for many TIC arrangements.

As discussed above, TIC arrangements frequently come into existence to provide property owners the opportunity to use an interest in such property as part of a section 1031 exchange.[339] Because such arrangements are tax-motivated, the TIC co-owners may not otherwise own the property in a TIC arrangement, and they may prefer not to include the central characteristics of a TIC in their arrangement. In such situations, the TIC co-owners can mitigate the effects of the central characteristics of a TIC by decreasing the time the arrangement is a TIC or by ensuring the arrangement has the central characteristics of a TIC.

If TIC co-owners are seeking an arrangement that has the central characteristics of a TIC, they can satisfy their tax needs with an arrangement that complies with Rev. Proc. 2002-22 and be in such an arrangement indefinitely. The discussion that follows considers the first type of arrangement—one in which one or more TIC co-owners seeks federal income tax classification as a TIC but wants to avoid or minimize the effect of the central characteristics of a TIC. The discussion first considers foundation principles and then considers best practices to reduce the effects of or work around the central characteristics of a TIC.

A. FOUNDATION PRINCIPLES

The foundation principles for TIC best practices center on the effects that the temporality of a TIC arrangement has on its classification, the relevance

337. *See supra* text accompanying notes 325–326.
338. *See supra* Part VI.B.2(f).
339. *See supra* Part III.B.

of the qualified-use and exchange requirements, and the primacy of form in the analysis.

1. *Temporality & TIC Classification*

One way to minimize the effects of the central characteristics of a TIC is to ensure that a TIC arrangement exists no more than the absolutely necessary amount of time needed to create a TIC for federal income tax purposes. The shortest amount of time that a TIC arrangement can exist is the time it takes for an exchanger to receive and transfer legal title to undivided interests in real property, which time can be instantaneous, with the transfer occurring immediately following an acquisition. Instantaneous acquisitions and dispositions of undivided interests in real property occur most frequently in so-called "drop-and-swap" and "swap-and-drop" transactions.[340] A drop-and-swap occurs when a tax partnership distributes undivided interests in property to partners, and the partners sell the interests; a swap-and-drop occurs when an exchanger acquires an undivided interest in property and contributes it to a partnership.[341]

The transfer of an undivided interest that occurs immediately after the acquisition raises questions of whether the arrangement was a TIC, whether the exchanger becomes the tax owner of the interest, and whether the exchanger holds the property for a qualified use.[342] Starting from the specific, the Ninth Circuit and the Tax Court have granted section 1031 nonrecognition to undivided interests acquired and immediately contributed to a partnership and to undivided interests distributed from a partnership to an exchanger and immediately exchanged.[343] To so hold, the courts were comfortable that the exchanger becomes the tax owner of property and that interests acquired were real property. Other authority supports that conclusion.

(a) Tax Ownership & Qualified-Use

Courts and the IRS look to the form of transactions to determine if the exchange becomes the owner of property for section 1031 purposes.[344] Case

340. *See* Borden, *Thirty Years after* Magneson, *supra* note 311 (describing and discussing swap-and-drops); Borden, *Thirty Years after* Bolker, *supra* note 46 (describing and discussing drop-and-swaps).

341. Both drop-and-swaps and swap-and-drops can occur with whole interests in property. *See, e.g.*, Bolker v. Comm'r, 760 F.2d 1039, 1041 (9th Cir. 1985) (granting section 1031 nonrecognition to a drop-and-swap of a single piece of property). This Article, because it covers TICnerships, focuses on transfers of undivided interests.

342. *See* Borden, *Thirty Years after* Bolker, *supra* note 46, at 27–28.

343. *See* Magneson v. Comm'r, 753 F.2d 1490, 1494–95 (9th Cir. 1985) (finding the exchanger received real property and contributed it to a partnership and granting section 1031 nonrecognition to a swap-and-drop); Mason v. Comm'r, 55 T.C.M. (CCH) 1134 (1988) (finding that partners received real property from the partnership and transferred it and granting section 1031 nonrecognition to a drop-and-swap).

344. *See* Borden, *Exchange Requirement*, *supra* note 4.

and law rulings establish that an exchanger can become the tax owner of property for section 1031 purposes even if the exchanger acquires property and immediately transfers it.[345] The courts also treat an exchanger who exchanges property in proximity to an exchange as satisfying the qualified-use requirement as a matter of law, regardless of the instantaneous transfer of exchange property immediately after receiving it.[346] Thus, exchangers can satisfy the exchange requirement and qualified-use requirement even though they receive and transfer section 1031 exchange property in proximity to a business transaction.

(b) Classification of an Ephemeral TIC

An ephemeral TIC is one that is formed to provide real property for a section 1031 exchange and then ceases to exist once that purpose is satisfied. A TIC formed as part of a drop-and-swap is an ephemeral TIC because it comes into existence when undivided interests are distributed and disappears as soon as the distributee TIC co-owners dispose of those interests. Some ephemeral TICs last no more than an instant when an exchanger receives an undivided interest in property at closing of the sale of the property and immediately transfers that interest.

The Author has given considerable thought to the proper classification of ephemeral TICs for several years.[347] One concern was that an ephemeral could not possess the central characteristics of a TIC.[348] Although that concept had intellectual appeal, the courts did not adopt it. For instance, in both *Magneson* and *Mason*, the courts accepted the real-property status of TIC interests that exchangers acquired and immediately transferred.[349] The legal reality from these cases outweighs any intellectual appeal to the contrary. Instead of looking for proactive efforts of the arrangement, such as revenue- and cost-sharing, courts accept evidence that ephemeral TICs do nothing to disrupt the central characteristics of a TIC. For instance, an at-closing ephemeral TIC (i.e., a TIC formed and discontinued at closing) cannot engage in prohibited business activities that extend beyond customary tenant services.[350] Thus, nothing would indicate that an ephemeral TIC is

345. *See id.*; *supra* text accompanying notes 308–313, 343.

346. *See* Maloney v. Comm'r, 93 T.C. 89, 98 (1989) ("A trade of *property A* for *property B*, both of like kind, may be preceded by a tax-free acquisition of *property A* at the front end, or succeeded by a tax-free transfer of *property B* at the back end."); Borden, *Qualified-Use Requirement*, *supra* note 4; *supra* text accompanying notes 319, 341, 343.

347. *See, e.g.*, Bradley T. Borden, *Twenty Things Real Estate Attorneys can do to Not Mess up a Section 1031 Exchange*, 36 PRAC. REAL EST. LAW. 33, 41–42 (2020) [hereinafter Borden, *Twenty Things*]; Borden, *Thirty Years After* Bolker, *supra* note 46, at 28; Bradly T. Borden, *Section 1031 and Proximate and Midstream Business Transactions*, 19 TAX MGT. REAL ESTATE J. 307 (2003).

348. *See* Borden, *Twenty Things*, *supra* note 347, at 41–42.

349. *See supra* note 343.

350. *See supra* text accompanying notes 147–155. Indeed, the Tax Court has stated: "The regulations and relevant case law indicate that the distinction between mere coowners and coowners who are engaged in a partnership lies in the degree of business activities of the coowners or their

anything other than a TIC. Because the courts treat at-closing ephemeral TICs as TICs for federal income tax purposes, there is strong authority for classifying at-closing ephemeral TICs as TICs.

The IRS also classifies ephemeral TICs as TICs in numerous contexts. First, as discussed above, in Rev. Rul. 99-5, the IRS treats a person who acquires an interest in a single-member LLC as acquiring interests in the LLC's property and immediately contributing it to a new partnership.[351] The partnership division and merger rules respect the "transitory ownership" of the partnership's assets in assets-up transactions, so they treat the partners as receiving property and immediately contributing it to another partnership.[352] When a corporation converts to a partnership, the entity-classification rules treat a corporation as distributing its assets to its shareholders and the shareholders as immediately contributing the assets to a new partnership.[353] Thus, there is support outside the section 1031 context for respecting the transitory ownership of property in restructuring transactions. If transitory ownership is respected, then the form of property transferred should also be respected. To help ensure that the form is respected and the transferred interests are treated as real property, exchangers are well advised to ensure that the form of the arrangement is a TIC, so exchangers should ensure that the TIC agreement memorializes the arrangement.

(c) Longer-Existing TICs May Increase the Likelihood of TICnership Classification

The authority supporting classifying ephemeral TICs as TICs is strong. Unless there is a valid non-tax reason for having longer-existing TICs, exchangers may increase the likelihood of a TIC arrangement being classified as a TICnership by extending the life of the TIC arrangement. For instance, the longer a TIC arrangement exists, the more time the TIC co-owners have to do things such as adopt disproportionate revenue- and expense-sharing, provide more-than-customary tenant services, and do other things that undermine the central characteristics of a TIC. If the plan is to form a TIC to accommodate an exchange with the understanding that the TIC will terminate by sale or contribution to another entity, extending the period of the TIC arrangement's existence does not appear to strengthen the classification of the arrangement as a TIC. The longer existence could, however, jeopardize the arrangement's TIC classification. Thus, exchangers appear to have

agents." Cusick v. Comm'r, 76 T.C.M. (CCH) 241, 243 (1998); *see also* Gilford v. Comm'r, 201 F.2d 735, 736 (2d Cir. 1953) ("[T]he mere holding of business property by tenants in common does not make such tenants partners in the tax sense, in the absence of any showing of an intention to become partners."). TIC co-owners who receive TIC interests at closing and immediately transfer them can do nothing more than merely hold those interests. They have no ability to conduct business activity in that space of time.

351. *See supra* text accompanying notes 308–312.

352. Treas. Reg. § 1.708-1(c)(3)(ii), (d)(3)(ii).

353. Treas. Reg. § 301.7701-3(g)(1)(ii).

nothing to gain but something to lose by extending the existence of a TIC arrangement beyond the instant required to establish tax ownership and the existence of a TIC.

On the acquisition side of TIC-arrangement transactions, a longer holding period could affect the tax treatment of TIC co-owners who do not use section 1031 proceeds to acquire TIC interests. As time passes between the acquisition of undivided interests in property and the contribution of the property to a tax partnership, the value of the undivided interests can change. If the contribution to the partnership would have any disguised-sale element for the investors who do not use section 1031 proceeds,[354] any increase in value could result in disguised-sale gain to such investors.

(d) Form Matters under Section 1031

Courts recognize that in the section 1031 context, the "formalistic difference between the two types of transactions must, at least on occasion, engender different results."[355] Courts have relied upon form in numerous cases that considered the exchange requirement when an exchanger's or exchange partners' ownership of exchange property was transitory, and they apply form equally to the classification of at-closing ephemeral TICs.[356] Thus, to help ensure that a TIC arrangement is classified as a TIC, the parties should ensure that arrangement does not have any features that would disrupt the central characteristics of a TIC, should ensure that TIC co-owners become owners of undivided interests in property, and memorialize the arrangement with a TIC agreement.

B. BEST-PRACTICE STRATEGIES

Based upon the foundation principles and disposition- and acquisition-side aspects of TIC classification, exchangers and their advisors should consider the following as best practices when forming TIC arrangements to accommodate section 1031 exchanges.

1. *Use Quick TICs*

Exchangers and their advisors should consider using a quick TIC. A quick TIC is an ephemeral TIC that comes into existence to accommodate an exchange and then ceases to exist. For instance, the TIC arrangement that comes into existence when an exchanger acquires an undivided interest and then contributes it to an LLC with other TIC co-owners is a quick TIC. A TIC arrangement that comes into existence and ceases to exist as part of an

354. *See* Treas. Reg. §§ 1.707-3, -4, -5 (governing disguised sales of property from a partner to a partner, including disguised sales arising when a partnership assumes liabilities of the partner upon transfer of property to the partnership).

355. Barker v. Comm'r, 74 T.C. 555, 561 (1980).

356. *See* Borden, *Exchange Requirement*, *supra* note 4, at 421–66; *supra* notes 342–343 and accompanying text.

at-closing drop-and-swap is a quick TIC. As discussed above, the law supports treating such arrangements as TICs for federal income tax purposes,[357] so exchanges and advisors should consider using quick TICs if the only purpose of the TIC arrangement is to accommodate a section 1031 exchange. Exchangers and advisors should also use care to ensure that the arrangement is a TIC in form.[358] If exchangers have to choose between a clean quick TIC and a long-term, messy TIC arrangement that risks being classified as a TICnership, they are better served using a clean quick TIC.

Advisors who reject the quick TIC in favor of a complex TIC arrangement appear to strain at gnats and swallow camels.[359] The authority supporting a quick TIC and section 1031 nonrecognition of exchanges in proximity to business transactions minimizes the tax risk of such transactions to "gnat" proportions.[360] On the other hand, the transaction costs, tax risks, and non-tax risks associated with many complex TIC arrangements are difficult "camels" to swallow in comparison.[361] There is no guarantee that most complex TIC arrangements will be respected as TICs, and many of them likely lack the central characteristics of a TIC. The acceptance of such disproportionately large risk is baffling. In fact, because the risks of a quick TIC are so low, any other arrangement would most likely not reduce risks but could increase risks. Thus, a complex transaction appears only capable of maintaining risk status quo or increasing risk.

2. *TIC-to-Partnership as Primary Position*

On the acquisition side of a transaction, a TIC arrangement can become a TICnership when the exchanger acquires a TIC interest.[362] In such situations, the exchanger may be able to rely upon *McDougal v. Commissioner* and Rev. Rul. 99-5 to argue that the transaction was an acquisition of an undivided interest in the property followed by a contribution to a TICnership.[363] Such a claim would be necessary; if an arrangement is a TICnership, the parties were not seeking an arrangement that has the central characteristics of a TIC, and they added features to the arrangement that caused it to be a TICnership, but they also sought to complete a section 1031 exchange with the acquisition.[364]

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357. *See supra* Part VII.A.1(b).

358. *See id.*

359. Matthew 23:24 ("Ye blind guides, which strain at a gnat, and swallow a camel").

360. *See* Borden, *Qualified-Use Requirement*, *supra* note 4; Borden, *Exchange Requirement*, *supra* note 4; Bradley T. Borden, *Tax-Law Analysis Applied to Section 1031 Exchanges & Proximate Business Transactions*, 18 J. CORP. FIN. & COM. L. 351 (2024) [hereinafter Borden, *Tax-Law Analysis Applied to Section 1031*].

361. In other contexts, observers have noted that complex arrangements that include side letters drive up transactions costs without providing a concomitant benefit. Fontenay & Nili, *Side Letter Governance*, *supra* note 97, at 958–61.

362. *See supra* Parts VI.B.1, VI.B.2(b)

363. *See supra* text accompanying notes 308–312, 315, 326.

364. *See supra* text accompanying notes 308–326.

If the parties run the risk of having to rely upon *McDougal v. Commissioner* and Rev. Rul. 99-5 to support a section 1031 reporting position, they should consider adopting a structure that is directly subject to those authorities. For instance, the parties could use a quick TIC and have the exchanger buy an undivided interest in property as part of an arrangement that is, in form, a TIC, and then the exchanger could immediately contribute the interest to an LLC. If replacement property is owned in a single-member LLC and the single owner will remain a part of the ownership structure, the exchanger could acquire an interest in the LLC in a transaction that qualifies for Rev. Rul. 99-5 treatment. With such a transaction, the exchanger would be treated as acquiring an undivided interest in the LLC's property and immediately contributing it to a newly formed partnership.[365] This structure works if the seller is the sole owner of an LLC that owns the target property and works only with the buyers who acquire interests in the LLC when the seller is the sole member. Thus, the structure could work for multiple exchangers who purchase interests from the single owner at the same time but would not work if multiple exchangers purchased interests in the LLC in seriatim.

3. *Elegant over Grotesque*

Lacking a firm understanding of the law supporting nonrecognition for section 1031 exchanges and proximate business transactions, some advisors create grotesque structures that appear designed to create a TIC while using various apparatus to eliminate the effects of the central characteristics of a TIC. Such apparatus can be expensive, create unattractive structures, and jeopardize the classification of the arrangement. The following discussion presents such a grotesque structure and follows that presentation with an elegant structure that enjoys the strong support of the law.

(a) Grotesque

Cautionary note: The following few sentences describe a grotesque structure in gory detail. For any reader who becomes queasy upon seeing or hearing about complex transactions with needless transactions, please feel free to skip this part of the Article.

An exchanger would like to use section 1031 proceeds to purchase an interest in property held by a developer, and the exchanger and developer would like the developer to obtain financing for and construct a building on the property. The exchanger's attorney erroneously believes that the exchanger must acquire and hold an undivided interest in the property for some period of time for the interest to satisfy the section 1031 qualified-use and exchange requirements. Because the law does not require property held for any period of time to satisfy the qualified-use and exchange

365. *See supra* text accompanying notes 308–326.

requirements,[366] the attorney randomly selects eighteen months as the holding period. Construction is planned to begin prior to the end of the eighteen months, the lender requires the developer to guarantee the loan, the developer insists that he have control over the construction process, and the developer will receive a promote. The parties agree to contribute their undivided interests in the property to an LLC at the end of the eighteen months.

The desired arrangement will not have the central characteristics of a TIC, so the attorney recommends drafting a simple TIC agreement that will only include the central characteristics of a TIC with multiple side agreements that will include the essential agreements between the parties. The documentation grows out of control and becomes incomprehensible and includes side letters and other agreements that override terms in the initial TIC agreement. To the extent the agreements reflect the parties' intent, they will cause the arrangement to be a TICnership. The TICnership will come into existence prior to the end of the eighteen months. If the TICnership comes into existence at the time the exchanger acquires an interest in the property, the exchanger could argue that *McDougal v. Commissioner* and Rev. Rul. 99-5 apply to the transaction, and the exchanger should be treated as acquiring a TIC interest and immediately contributing it to a TICnership.[367] If the TICnership forms sometime after the exchanger acquires the interest in the property, the exchanger would rely upon case law that allows an exchanger to acquire an undivided interest in property as part of a section 1031 exchange and transfer it to a tax partnership.[368]

The structure the attorney devised for this exchanger is revolting, and it requires the exchanger to rely upon the exact same authority it would have to rely upon if the attorney devised an elegant, simple structure. Because the support for section 1031 nonrecognition of at-closing exchanges and proximate business transactions is so strong, the tax risk of such exchanges is low.[369] Thus, advisors who go to such lengths to plan around such at-closing exchanges and proximate business transactions appear to be avoiding ghosts, goblins, and other apparitions, but the structures that result from such planning are truly ghoulish. Perhaps such putrid arrangements should, as a matter of law, be declared ineligible exchange property, or advisors should avoid such arrangements of their own volition by relying upon the rule of law

366. *See* Borden, *Exchange Requirement*, *supra* note 4; Borden, *Qualified-Use Requirement*, *supra* note 4.

367. *See supra* text accompanying 308–326.

368. *See supra* text accompanying notes 318–322.

369. *See* Borden, *Qualified-Use Requirement*, *supra* note 4; Borden, *Exchange Requirement*, *supra* note 4; Borden, *Tax-Law Analysis Applied to Section 1031*, *supra* note 360.

stated by the Tax Court that allows at-closing exchanges in proximity to business transactions.[370]

(b) Elegant

First, if the developer was the sole member of an LLC that owned the property, the attorney could have advised the exchanger to acquire an interest in the LLC that the developer owned. Under Rev. Rul. 99-5, the exchanger should be deemed to acquire an interest in the LLC's property and contribute it to a tax partnership. That transaction should satisfy the section 1031 exchange, qualified-use, and real-property requirements.[371]

Alternatively, the attorney could have advised the exchanger to enter into a TIC arrangement with the developer that complied with Rev. Proc. 2002-22, agree to contribute property to an LLC upon the occurrence of some contingency, and transfer interest to that LLC upon the occurrence of that contingency. Or the attorney could have advised the exchanger to acquire the undivided interest subject to the TIC agreement that complies with Rev. Proc. 2002-22 and immediately transfer the property to an LLC with the developer as the other member. Tax law provides very strong authority that both of these types of transactions satisfy the section 1031 exchange, qualified-use, and real-property requirements.[372]

4. *The Long-Term Clean TIC*

A TIC arrangement that complies with the Rev. Proc. 2002-22 conditions should be classified as a TIC.[373] If TIC co-owners are satisfied with the Rev. Proc. 2002-22 conditions, they can rest assured that their arrangement will be classified as a TIC if it complies with the conditions in Rev. Proc. 2002-22. If such a compliant TIC suits the co-owners' purposes, they do not need to add any fancy features to it. A simple, clean, compliant TIC arrangement can satisfy their needs and provide them with TIC classification. Such arrangements are not, however, suited for property that requires significant management, such as hotels and some apartments.

5. *Propco-Opco Structures*

If a quick TIC is not a viable alternative, and the property requires significant management services, the TIC co-owners may consider a Propco-

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370. *See* Maloney v. Comm'r, 93 T.C. 89, 98 (1989) ("A trade of *property A* for *property B*, both of like kind, may be preceded by a tax-free acquisition of *property A* at the front end, or succeeded by a tax-free transfer of *property B* at the back end."); *supra* Borden, *Qualified-Use Requirement*, *supra* note 4, at 530–32 (concluding that the Tax Court finds that an arrangement satisfies the qualified-use requirement as a matter of law with respect to exchanges in proximity to business transactions).

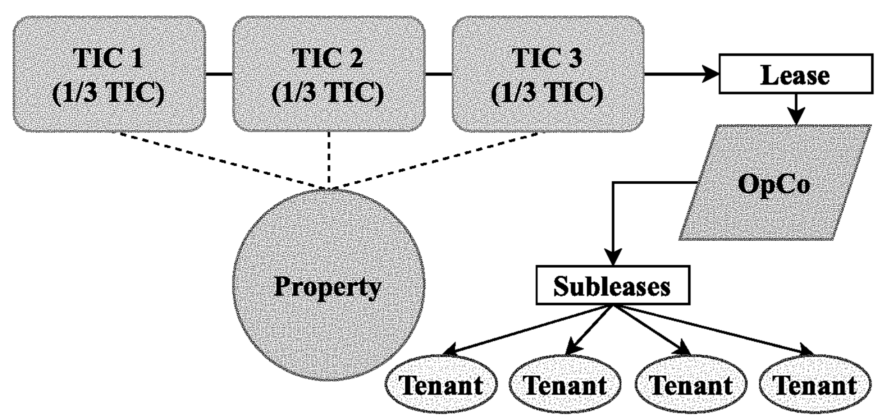
371. *See supra* text accompanying notes 340–346.

372. *See supra* text accompanying notes 340–352.

373. *See supra* text accompanying notes 81–87.

Opco structure. Under such structures, the TIC co-owners own property in a clean TIC arrangement that complies with the conditions in Rev. Proc. 2002-22. They then lease the property to an Opco, and the Opco subleases the property to tenants and provides services to those tenants. The Propco-Opco structure is common in the REIT context.[374] For the Propco-Opco structure to help preserve TIC status, the Opco must be respected as separate from the TIC co-owners and cannot be the agent of the co-owners. Tax law recognizes the separateness of entities from their owners if the ownership is structured properly.[375] If a Propco-Opco structure is combined with TIC co-owner-level profit sharing, as depicted in Figure 19 below, the parties must consider whether such profit-sharing would cause the Opco to be related to one or more TIC co-owners.[376] If so, the IRS may attribute the activities of any related TIC co-owners.[377] Figure 18 depicts the Propco-Opco structure.

Figure 18: PropCo-Opco Structure



374. *See, e.g.*, Bradley T. Borden, *Rethinking the Tax-Revenue Effect of REIT Taxation*, 17 FLA. TAX. REV. 527, 548–52 (2015) (describing the use of the Propco-Opco structure in the now-defunct REIT spinoff).

375. *See, e.g.*, Bramblett v. Comm'r, 960 F.2d 526 (5th Cir. 1992); Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982); Boyer v. Comm'r, 58 T.C. 316 (1972).

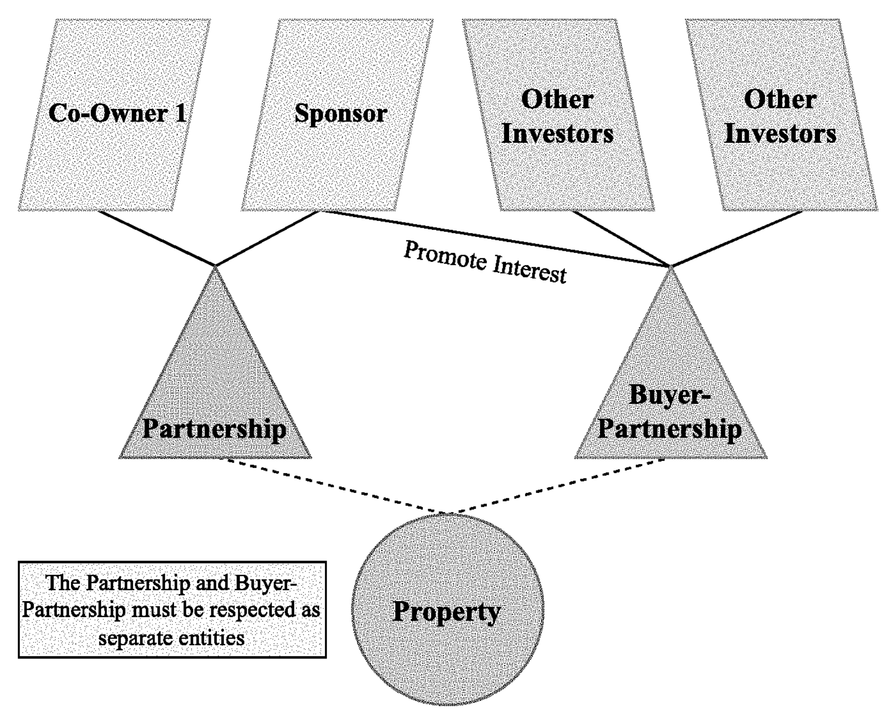
376. For instance, if TIC 1 in Figure 18 had a 30 percent promote in TIC 2 and TIC 3, and each TIC owned a one-third interest in Opco, TIC 1 could be deemed to own about 53 percent (one-third owned directly and 30 percent of one-third (30% × 33.33% = 10%) owned indirectly through each of TIC 2 and TIC 3) of the profits in Opco. *See* I.R.C. § 707(b)(1)(A) (providing that "a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership" are related). Furthermore, an Opco would be related to any TIC co-owner that directly owned more than 50 percent of the capital or profits interests in the Opco. Determining a partner's share of capital interest or profits interest can be challenging. *See* Bradley T. Borden, *Partnership-Related Relatedness: Measuring Partners' Capital Interests and Profits Interests*, J. PASSTHROUGH ENT. May–June 2019, at 21.

377. *See* Rev. Proc. 2002-22, § 6.11, 2002-1 C.B. 733 (providing that "in determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners").

6. *TIC Co-Owner-Level Profit Interest*

If the TIC co-owners of a TIC arrangement can accept all of the central characteristics of a TIC but want to provide the sponsor a disproportionate share of profits, they can consider providing the sponsor a profits interest in the entities that acquire TIC interests. For instance, if an LLC would like to acquire a TIC interest in an arrangement that provides the sponsor a promote, the LLC can consider admitting the sponsor as a member of the LLC and grant the sponsor a promote through that entity. Figure 19 depicts such an arrangement with the sponsor as a member of a partnership that acquired a TIC interest in property co-owned with another entity that the sponsor manages.

Figure 19: Promote at TIC-Owner Level



This structure is viable in limited circumstances. First, if the buyer has sold relinquished property as the first leg of an intended section 1031 exchange, the sponsor's joining the entity cannot alter the buyer's classification. For instance, if the buyer was a disregarded entity when it sold the relinquished property, the entity would become a tax partnership when the sponsor joined, and that would negate the exchange requirement.[378] On the other hand, if the buyer was a tax partnership when it sold the relinquished

378. *See* Treas. Reg. § 1.1002-1(d).

property, the sponsor could join the buyer-partnership without affecting its classification, and the buyer-partnership could complete the exchange by acquiring the TIC interest.

If the buyer-partnership holds multiple properties, its members may prefer not to have the sponsor join that entity because that would give the sponsor an economic interest in other properties. The parties might be able to resolve that concern by granting the sponsor tracking allocations related to the TIC interest, or it could distribute other properties and make the TIC interest its sole asset. Even if the buyer-partnership's other assets are newly acquired section 1031 replacement properties, the law supports respecting the section 1031 exchange prior to the distribution of the property.[379]

VIII. CONCLUSION

Section 1031 is a wonderfully beneficial provision of tax law. It stimulates economic activity and allows property to be put to its highest and best use.[380] It also motivates the formation of TIC arrangements. Tax-motivated TIC arrangements continue to proliferate, and, as they do, the percentage of such arrangements that are TICnerships undoubtedly is increasing. A TIC arrangement that lacks the central characteristics of a TIC can undermine a section 1031 exchange and place TIC co-owners in arrangements that they find unattractive. Best practices in creating TIC arrangements can help minimize both tax and non-tax risks that result from poorly structured TIC arrangements. Those best practices are founded on fundamental principles of section 1031 that allow the use of quick TICs and other arrangements that reduce complexity and other transaction costs and allow exchangers to move forward with confidence that simple, elegant transactions can obtain TIC classification. Advisors should establish a sound understanding and in-depth knowledge of the legal authorities so they can help their clients find the cleanest and most tax-efficient structure for their section 1031 exchanges and property holdings.

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379. *See, e.g.*, Maloney v. Comm'r, 93 T.C. 89 (1989) (granting section 1031 to an exchange preceding the distribution of the exchange property form the exchanger-corporation).

380. Bradley T. Borden, *Section 1031's Beneficial Effect on the Real Estate Life Cycle*, 37 REAL EST. J. 5 (2021) (showing how section 1031 allows property to be put at its highest and best by property owners who are specialized to manage the property at different stages of the life cycle of real estate).