

## Section 7701(a)(2)--Partnership Defined

•Undivided fractional interest in commercial rental real estate does not constitute interest in business entity (P.L.R. 200327003).

A company (Y) intends to acquire a fee interest in commercial real property (the "Property") with its own funds. The Property will be free of liens. Y will lease the Property to a single corporate tenant (the "Lessee"). Rents under the lease will be at fair market and will not depend on the income or profits derived by any person from the leased Property. The lease will be a triple net lease, under which the lessee is responsible for all costs related to the Property, including real estate taxes, maintenance, insurance, and repair (the "Lease").

After it acquires and leases the Property, Y will create and sell undivided fractional interests in the Property at fair market value to no more than 35 persons, including itself if it retains an interest (the "Co-Owners"). Some or all of the Co-Owners intend to acquire their interests as replacement property under §1031. Y will continue to hold an interest in the Property until all fractional interests are sold, which may take 18 months or more. Neither Y nor any person related to Y will finance any portion of the purchase price of a fractional interest. Each Co-Owner will hold legal title to the Property as a tenant-in-common under local law.

The Co-Owners will not hold themselves out as partners to third parties, conduct business under a common name, or file a partnership income tax return. The only activities of the Co-Owners (or any person related to the Co-Owners ) with respect to the Property will be activities that would not prevent an amount received by an organization described in §511(a)(2) from qualifying as rent under §512(b)(3)(A).

Each Co-Owners will enter into a co-tenancy agreement ("Co-Tenancy Agreement") that will govern the relationship among the Co-Owners. The Co-Tenancy Agreement will provide that any sale of the entire Property, any lease or re-lease of a portion or all of the Property, any negotiation or renegotiation of any indebtedness secured by any blanket lien, and the appointment of any manager must be approved by the unanimous vote of the Co-Owners. For all other actions, only the approval by holders of more than 50 percent of the undivided fractional interests is required. Income and expenses are allocated among the Co-Owners in proportion to their individual ownership interests in the Property. A Co-Owner may, at any time, sell, finance, or otherwise create a lien on the Co-Owner's own interest, subject to the Co-Tenancy Agreement, provided that it does not create a lien on anyone else's interest. Any Co-Owner is free to sell, assign, or transfer all or part of its interest in the Property, subject to the Co-Tenancy Agreement. Finally, there is no waiver of partition rights among the Co-Owners.

Each Co-Onwer may, but will not be required to, enter into a management agreement (the "Management Agreement") with Management Company (also referred to as "Manager") to provide accounting, insurance monitoring, and lease monitoring activities for the Co-Owners. Management Company is part of a controlled group of corporations, within the

meaning of §1563(a), with Y. The Management Agreement provides that each Co-Owner who enters into the agreement retains Manager to act as the manager and oversee all administrative, operational, and management matters of the Property, which include the management of the Lease, obtaining of various consents when required, monitoring and enforcing the terms of the Lease, re-leasing the Property, maintenance of the Property, receiving and monitoring the rental revenue, paying expenses, distributing rental proceeds after the payment of expenses, sending notices of default, and otherwise overseeing collection efforts as required, monitoring the payment of taxes by the lessees, and inspecting the premises.


The Management Agreement provides that each Co-Owner agrees to be obligated for a proportionate share of all costs associated with the Property. Distributions of each Co-Owner's share of net revenues will be made quarterly. Any Co-Owner may terminate the Management Agreement provisions concerning accounting and distributions at any time and seek to collect its share directly from the tenant. If the Property operates at a loss or if capital improvements, repairs, or replacements are required, the Co-Owners must, on request, make the necessary payments in proportion to their individual ownership interests in the Property.

In addition, the Management Agreement provides that, no less often than annually, Manager will provide each Co-Owner with an annual notice of the renewal of the agreement. The notice must provide each Co-Owner with the opportunity to exercise the Co-Owner's right to terminate the agreement, which can be done at any time with 60 days notice. Otherwise, the Management Agreement will continue in force until the sale of the entire fee interest in the premises by each Co-Owner. Any advance made by Manager on behalf of a Co-Owner will be on a recourse basis and must be repaid within 30 days. Each Co-Owner is obligated to pay a fee set at fair market value for the services provided. The fee is payable regardless of whether rents are actually collected. Manager is authorized to offset the costs of operating the Property against any revenues derived from the Property before distributing each Co-Owner's proportionate share of net income. Finally, the books and records relating to the Property will be maintained as the principal office of the Manager.

The IRS noted that Rev. Rul. 75-374 holds that co-ownership of an apartment building that produces rental income does not constitute a partnership. Rev. Rul. 79-77 concludes that the transfer of a commercial office building subject to a net lease to a trust with three individual beneficiaries results in the trust being classified as a trust and not a business entity.

The IRS stated that, where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease of the property, and arranging for financing, courts have looked at the relationships not only among the co-owners but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership. The IRS discussed *Bergford v. Commissioner*, 12 F.3d 166 (9th Cir. 1993), involving co-ownership of computer

equipment by 78 investors, and concluding that the co-ownership arrangement constituted a partnership.

The IRS found that Y's co-ownership arrangement meets all the requirements of Rev. Proc. 2002-22 for an advance ruling as to whether an undivided fractional interest in rental real estate is not an interest in a business entity for federal tax purposes. After testing each aspect of Y's co-ownership arrangement against the text of Rev. Proc. 2002-22, the IRS concluded that an undivided fractional interest in the Property will not constitute an interest in a business entity under Treas. Reg. §301.7701-2(a) for purposes of qualification of the undivided fractional interest as eligible replacement property under §1031(a). 

### IRS Private Letter Rulings

PLR 200327003 - IRC Section 7701 - Definitions

IRC Sections 1362, 7701, 9100  
Document Date: [March 7, 2003](#)

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: 200327003

Release Date: 7/03/2003

Index Numbers: 1362.01-03;

9100.00-00

Person to Contact:

Telephone Number:

Refer Reply To: CC:PSI:3 PLR-165157-02

Date: March 7, 2003

Legend

Company =

Management Company =

Dear [redacted data]:

This letter responds to a letter dated November 21, 2002, and subsequent correspondence, requesting on behalf of Company a ruling that an undivided fractional interest in rental real property is not an interest in a business entity under § 301.77012(a) of the Procedure and Administration Regulations for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031(a) of the Internal Revenue Code.

## FACTS

According to the information submitted, Company intends to acquire a fee interest in commercial real property ("Property") with its own cash. There will be no liens on the Property. Company will lease the Property to a single corporate tenant ("Lessee"). Rent under the lease will be at fair market value and will not depend on the income or profits derived by any person from the leased Property. The lease will be a "triple net lease" under which the Lessee is responsible for all costs and expenses related to the Property, including real estate taxes, maintenance, insurance and repairs ("Lease").

After acquiring and leasing the property, Company will create and sell undivided fractional interests in the Property at fair market value to no more than 35 persons, including itself if it retains an interest ("Co-owners"), some or all of whom intend to acquire such interests as replacement property under § 1031. Company will continue to hold an interest in the Property until all fractional interests are sold, which may take up to 18 months or longer to complete. Neither Company nor any person related to Company will finance any portion of the purchase price of a purchaser's fractional interest. Each Co-owner will hold legal title to the Property as a tenant in common under local law.

The Co-owners will not hold themselves out as partners to third parties, conduct business under a common name, or file a partnership income tax return. Company represents that the only activities of the Co-owners (or any person related to the Co-owners) with respect to the Property will be activities that would not prevent an amount received by an organization described in

§ 511 (a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder.

Each Co-owner will enter into a co-tenancy ownership agreement ("Co-tenancy Agreement"), which will govern the relationship among the Co-owners. The Co-tenancy Agreement will provide that any sale of the entire Property, any lease or re-lease of a portion or all of the Property, any negotiation or renegotiation of any indebtedness secured by any blanket lien, and the appointment of any manager must be approved by unanimous vote of the Co-owners. For all other actions, only the approval by holders of more than 50 percent on the undivided fractional interests is required. Income and expenses are allocated among the Co-owners in proportion to their individual ownership

interests in the Property. A Co-owner may, at any time, sell, finance, or otherwise create a lien upon the Co-owner's own interest, subject to terms of the Co-tenancy Agreement, provided it does not create a lien on anyone else's interest. Any Co-owner is free to sell, assign, or transfer all or a part of its interest in the Property, subject to the terms of the Co-tenancy Agreement. Finally, there is no waiver of partition rights among the Co-owners.

Each Co-owner may, but will not be required to, enter into a management agreement ("Management Agreement") with Management Company ("Manager"), to provide accounting, insurance monitoring, and lease monitoring activities for the Co-owners. Management Company is an entity that is part of a controlled group of corporations, within the meaning of § 1563(a), with Company. The Management Agreement provides that each Co-owner who enters into the agreement retains the Manager to act as the manager and oversee all administrative, operational and management matters of the Property, which include the management of the Lease, the obtaining of various consents when required, monitoring and enforcing the terms of the Lease, re-leasing the Property, maintenance of the Property, receiving and monitoring the rental revenue and paying certain expenses, distributing the rental proceeds after the payment of expenses, sending notices of default and otherwise overseeing collection efforts as required, monitoring the payment of taxes by the lessee, and inspecting the underlying premises.

The Management Agreement also provides that each Co-owner agrees to be obligated for a proportionate share of all costs associated with the Property. Distributions of each Co-owner's share of net revenue will be made quarterly. Any Co-owner may terminate the Management Agreement provisions concerning accounting and distributions at any time and seek to collect its share directly from the tenant. If the Property operates at a loss or if capital improvements, repairs or replacements are required, the Co-owners shall, upon request, make necessary payments in proportion to their individual ownership interests in the Property.

In addition, the Management Agreement provides that not less than annually, the Manager will provide each Co-owner with an annual written notice of the renewal of the agreement. The notice shall provide each Co-owner with the opportunity to exercise the Co-owner's right to terminate the agreement, which can be done at any time under the agreement with just 60 days notice. Otherwise, the Management Agreement will continue in force until the sale of the entire fee interest in the premises by each Co-owner. Any advance made by the Manager on behalf of any Co-owner are on a recourse basis and must be repaid within a 30-day period following the advance. Each Co-owner is obligated to pay a fee set a fair market value for the services provided. The fee is payable irrespective of whether rents are actually collected. The Manager is authorized to offset the costs of operating the Property against any revenues derived from the Property before distributing each Co-owner's proportionate share of net income. Finally, the books and records relating to the Property will be maintained at the principal office of the Manager.

## LAW & ANALYSIS

Section 301.7701 -1 (a)(1) provides that whether an entity is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law. Section 301.7701(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented and leased does not constitute a separate entity for federal tax purposes.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate.

Section 1.761-1 (a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under §§ 301.7701-1, 301.7701-2, and 301.7701-3.

In Rev. Rul. 75-374, 1975-2 C.B. 261, the Service concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. In addition, in Rev. Rul. 79-77, 1979-1 C.B. 448, the Service concluded that the transfer of a commercial office building subject to a net lease to a trust having three individuals as beneficiaries was a trust for federal tax purposes and not a business entity.

Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among co-owners, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership. For example, in *Bergford v. Commissioner*, 12 F.3d 166 (9th Cir. 1993), seventy-eight investors purchased "co-ownership" interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the

equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement of the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). *Bergford*, 12 F.3d 169-170.

In Rev. Proc. 2002-22, 2002-14 I.R.B. 733, the Service provided certain conditions under which it would consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity for federal tax purposes. The conditions relate to tenancy in common ownership of the property, number of co-owners, no treatment of the co-ownership as an entity, co-ownership agreements, voting by co-owners, restrictions on alienation, sharing of proceeds and liabilities upon sale of the property, proportionate sharing of profits and losses, proportionate sharing of debt, options, no business activities by the co-owners, management and brokerage agreements, leasing agreements, loan agreements, and payments to sponsors. In addition, the revenue procedure sets forth a list of documents, supplementary materials, and general information required for a ruling.

Company's co-ownership arrangement satisfies all of the conditions set forth in Rev. Proc. 2002-22. Specifically regarding voting, § 6.05 of Rev. Proc. 2002-22 provides, in part, that the co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases of a portion or all of the property, or the creation or modification of a blanket lien. Any sale, lease, or release of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. Relating to hiring a manager, § 6.12 of Rev. Proc. 2002-22 provides, in part, that the co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee.

Company's Co-tenancy Agreement provides that any sale, lease, or re-lease of a portion or all the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, and the hiring of a manager, requires the unanimous approval of the Co-owners. All other actions on behalf of the co-ownership require the vote of those holding more than 50 percent of the undivided interests in the property. Company's Management Agreement, which the Co-owners may enter into, requires the manager to send a notice of

renewal to each Co-owner annually at which time each Co-owner could exercise its right to terminate the management agreement at any time with just 60 days notice. Although not an affirmative consent, the notice requirement in Company's management agreement containing the right of any Co-owner to terminate the agreement at any time with just 60 days notice satisfies the conditions in §§ 6.05 and 6.12 of Rev. Proc. 2002-22 regarding unanimous annual renewals of any management agreement.

Specifically regarding business activities, § 6.11 of Rev. Proc. 2002-22 provides that the co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511 (a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the property for less than 6 months.

Accordingly, the activities of Company and any person related to Company with respect to the property must be taken into account in determining whether the co-owners' activities are customary activities under § 6.11 of Rev. Proc. 2002-22. After acquiring and leasing the property, Company will create and sell undivided fractional interests in the Property at fair market value. Company will continue to own some undivided interests in the property until all are sold, which may take 18 months or longer to complete. During this period, the property will be leased to a lessee under a triple net lease, thereby limiting the activities by the Co-owners. In addition, Company represents that the only activities of the Co-owners, including Company, (or any person related to the Co-owners) with respect to the property will be activities that would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. Therefore, Company's activities in the capacity as a Co-owner during this period after acquiring and leasing the Property will not violate the condition regarding no business activity under § 6.11 of Rev. Proc. 2002-22.

## CONCLUSION

Based on the facts submitted and representations made, we conclude that an undivided fractional interest in the Property will not constitute an interest in a business entity under § 301.7701-2(a) for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031 (a).

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion concerning whether an undivided fractional interest in the Property otherwise qualifies as eligible replacement property under § 1031 (a) for federal tax purposes.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representative.

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.

Sincerely Yours,

JEANNE SULLIVAN

Senior Technician Reviewer, Branch 3

Office of Associate Chief Counsel

(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

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