12-2-2005

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Recommended Citation
Available at: http://lib.dr.iastate.edu/aglawdigest/vol16/iss23/1
Exchanging Fractional Interests in Property

**-by Neil E. Harl**

For years, since 1984,1 interests in a partnership have been considered ineligible for like-kind exchange treatment.2 A partnership can, of course, exchange assets with another individual or entity but *partnership interests are not like-kind.*3 In 1997, the Internal Revenue Service ruled that, in some circumstances, fractional interests in otherwise eligible property may be deemed a partnership with the result that the exchange is not like-kind.4 That development produced an outcry from taxpayers and tax practitioners with IRS agreeing to study whether undivided fractional interests should be considered eligible for like-kind exchange treatment.5

Although several private letter rulings were issued indicating that fractional interests in property, often under conventional tenancy in common ownership, were eligible for like-kind exchange treatment,6 rulings continued raising the question of eligibility of fractional interests for like-kind exchange treatment.7

In 2002, the Internal Revenue Service attempted to address the issue and quell the controversy.8 That move has been only partly successful.

**The nature of the problem**

A 1997 private ruling illustrates the nature of the problem as viewed by the Internal Revenue Service.9 In that ruling, two brothers owned ten rental properties in co-ownership. Because of disagreements between the brothers, and a desire to further their individual estate planning objectives, the brothers proposed to exchange their interests in the properties such that, after the exchanges, one brother would own six properties and the other brother would own three properties.10 The co-ownership pattern before the exchanges was fairly typical – except for the fact that management of the properties was performed by a property management corporation owned by the brothers and the fact that for the prior five years all net income and losses relating to the properties were reported on a Form 1065, partnership income tax return.11 The ruling states that “. . . we believe that. . . filing of partnership tax returns for several years indicates an intention to be taxed as a partnership” with the holding of the ruling that the co-ownership pattern “. . . constitutes a partnership . . . rather than a mere co-ownership.”12 That was the outcome notwithstanding the recital of the passage in the regulations13 that a joint undertaking merely to share expenses is not a partnership.14

**The IRS guidance issued in 2002**

In 2002, IRS issued a revenue procedure, not providing a bright line test on the issue but...
addressing the circumstances under which advance rulings would be issued in situations involving co-ownership of rental real property in an arrangement classified under local law as a tenancy in common. If the conditions identified in the revenue procedure are satisfied, it is believed that the transaction would not be treated as involving partnership interests.

Here are the 15 conditions identified in the 2002 revenue procedure for an advance ruling –

1. the title to the property is held in tenancy-in-common (rather than by an entity);
2. the number of co-owners is 35 or fewer;
3. the co-owners must not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying the co-owners as partners, shareholders or other members of a business entity or otherwise hold itself out as a partnership or other form of business entity;
4. the co-owners may enter into a “limited co-ownership agreement” that may run with the land (e.g., an agreement specifying that a co-owner must first offer the co-ownership interest to the other co-owners);
5. the co-owners retain the right to approve the hiring of any manager, sale or other disposition, lease or the creation of a blanket lien;
6. each co-owner must have the rights of transfer, encumbrance and partition without the approval of others;
7. if the property is sold, any debt must be satisfied before distribution of the proceeds to the co-owners;
8. each co-owner must share in all revenues generated by the property and all costs in proportion to the co-owner’s interest;
9. the co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interest;
10. a co-owner may issue an option to purchase the co-owner’s undivided interest (a “call” option) if the price for the call option reflects fair market value of the property as of the time of exercise of the option;
11. the co-owners’ activities must be limited to those “customarily performed” in connection with maintenance and repair of the property;
12. the co-owners may enter into management or brokerage agreements;
13. all leasing agreements must be bona fide leases for federal tax purposes and reflect the fair market value for use of the property;
14. the lender, if any, with respect to the debt encumbering the property or debt incurred to acquire the co-ownership interest, must not be a related person; and
15. payments, if any, to a “sponsor” for the acquisition of the co-ownership interest and the fees paid must reflect fair market values and may not depend on income or profits derived from the property.

Election to be excluded from partnership treatment
Authority is contained in the statute for a co-tenancy arrangement to be excluded from partnership treatment and not to be deemed a partnership. That election, however, is limited to fact situations where the arrangement is for investment purposes and not for the active conduct of a trade or business.

In conclusion
The safest approach, in planning for like-kind exchanges involving fractional property interests, is to take into consideration all 15 of the conditions specified in the revenue procedure but especially to avoid using a partnership (or corporate) income tax return as a convenience in reporting expenses and revenues.

Footnotes
6. Rev. Rul. 73-476, 1973-2 C.B. 300 (exchange of tenancy in common interests in real property for a fee simple interest in real property was like-kind). See, e.g., Ltr. Rul. 9807013, Nov. 13, 1997 (receipt of replacement property by entity owned by limited partnership was treated as receipt of real property by partnership; qualified for non-recognition of gain under I.R.C. § 1031(a)(2).
7. FSA Ltr. Rul. 9951004, Sept. 3, 1999 (transaction deemed to be sale of partnership interest, not like-kind exchange).
10. Id.
11. Id.
12. Id.
16. See Ltr. Rul. 200327003, March 7, 2003 (undivided fractional interest in property eligible for like-kind exchange; not an interest in business entity). See also Ltr. Rul. 200513010, Dec. 6, 2004 (undivided fractional interest in property was not partnership; involved co-tenancy agreement and unanimous agreement required for sale, lease or re-lease).