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TRENDS IN REAL ESTATE AND TITLE INSURANCE

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Navigating the Brier Patch

When §1031 funds are a contributing source of capital in a commercial real estate transaction, the resulting ownership structure presents challenges.

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THE INVESTMENT funds created in "like-kind" exchange transactions under §1031[1] have increasingly provided a valuable capital source to real estate operators deriving their primary capital from non-§1031 sources. The resulting ownership structure presents numerous financing, economic, legal, liability and operating issues and challenges that would not otherwise be a factor if §1031 funds were not a contributing source of capital to the underlying transaction.

This article identifies these issues and discusses available mechanisms for addressing them.

Background

It was estimated that approximately $90 billion in capital is currently being invested annually in commercial real estate transactions by investors taking advantage of the benefits of §1031.[2] This is obviously a significant amount of capital.

Given the current strength of the commercial real estate market and the increased acceptance of §1031 transactions by investors (based in no small measure upon increased clarity from the Internal Revenue Service), the amount of capital invested in commercial real estate transactions from §1031 investors will assuredly continue to increase for the foreseeable future.

Section 1031 allows an owner of business or investment real estate (the "Exchangor" or "§1031 investor") with a low tax basis to realize the property's value while allowing the Exchangor to defer the payment of any capital gains tax that would otherwise be payable if the property were sold. Section 1031 requires the Exchangor to exchange its real estate for "like kind" replacement property.[3]

Thus, the Exchangor cannot exchange interests in an entity that owns real estate for real estate, or for interests in an entity that owns real estate. I.R.C. §1031(a)(2)(D). Therefore, although the Exchangor has great flexibility as to the type of real estate exchanged for, the Exchangor is subject to substantive limitations on deal structure.

In commercial real estate transactions comprised entirely of non-§1031 capital, the real estate is customarily owned through an entity in the form of a limited partnership or a limited liability company. In order to manage risks to lenders, such entities are generally required to be single purpose entities having certain bankruptcy remote characteristics.

An ownership structure comprised of a limited partnership or a limited liability company has the attributes and flexibility to address many of the financing, economic, legal, liability and operating issues that are presented in a transaction involving multiple third-party investors. Unfortunately, this ownership structure does not comply with §1031's requirement that the §1031 investor own and exchange for a direct interest in the real estate.

Consequently, transactions involving §1031 capital and non-§1031 capital have generally been structured through tenancy-in-common ownership regimes in which each investor's interest is owned through a direct tenancy-in-common estate in the underlying real estate. A tenancy-in-common estate is an ownership estate that has its origins in common law but has been codified in many states.[4]

Tenants-in-common under common law have a concurrent possessory right to the real estate, though co-tenants may have unequal shares in the co-tenancy. In general, co-tenants of commercial real estate have a full range of ownership rights but often enter into a co-tenancy agreement with the other co-tenants to coordinate the exercise of these ownership rights. In non-§1031 situations, these co-tenancy agreements are substantially similar to partnership agreements and limited liability company operating agreements, and may even create an arrangement that is taxable as a partnership under the Code.

The Internal Revenue Service has generally recognized that a tenancy-in-common estate qualifies for a "like kind" exchange under §1031. Rev. Proc. 2002-22. In that Revenue Procedure, the IRS outlined certain attributes of a tenancy-in-common ownership regime that distinguishes it from an ownership interest in a "business entity" and thus, that make it compliant with the requirements of §1031.

Some of the key attributes identified by the IRS are that:

(i) The co-tenants must hold title to the real estate as a tenant in common

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(ii) The co-tenants must retain certain voting rights over the approval of management matters and transfer of interests in the real estate (including leasing and the creation of liens).

(iii) Each co-tenant must have the right to transfer, partition and encumber such co-tenant's undivided interest in the real estate without the agreement or approval of any person, although, restrictions on such rights that are required by a lender and that are "consistent with customary commercial lending practices are not prohibited." And,

(iv) Each co-tenant must share in all revenue and costs relating to the real estate in proportion to such co-tenant's undivided interest in the real estate.
Rev. Proc. 2002-22.

Myriad Issues Are Raised

While Revenue Procedure 2002-22 provides that generally a tenancy-in-common regime satisfies the basic requirements of direct ownership of real estate that is imposed by §1031, such an ownership regime presents numerous issues that would not be otherwise present where two or more non-§1031 investors hold title to the real estate through a customary limited partnership or limited liability company. These issues can broadly be categorized as financing, economic, legal, liability and operating issues.

A. Financing Issues. One of the attributes identified by the IRS in Revenue Procedure 2002-22 is that the co-tenants must "share in any indebtedness secured by a blanket lien in proportion to their undivided interests." Rev. Proc. 2002-22. Because of this requirement, each co-tenant is named as a co-borrower under the loan, thus resulting in joint and several responsibility among the co-tenants for the performance of all loan obligations.

This joint and several relationship creates the risk that one co-tenant's acts or omissions could result in a default under the loan, thus placing the other non-defaulting co-tenant's undivided interest in the real estate in risk of foreclosure or being subject to the lender's exercise of any of its other remedies. For example, indirect equity transfers of a particular co-tenant, or a co-tenant's failure to deliver required financial statements, could engender a loan default notwithstanding the other co-tenants' diligent compliance with all of the applicable loan requirements.

In particular, with respect to transfers, loan documents often permit indirect equity transfers up to a certain threshold amount so as not to effect a "change in control" (e.g. transfers of not greater than 50 percent). In a limited partnership or limited liability company structure, the transfers of partnership or membership interests are governed by the applicable partnership or operating agreement that impose restrictions that would not otherwise be present in a co-tenancy regime.

These risks can be minimized but not eliminated in the co-tenancy agreement among the co-tenants.

First, the co-tenants may designate one of the co-tenants as the "managing co-tenant" and may charge such managing co-tenant with the responsibility of managing the day-to-day affairs of the co-tenancy on behalf of all of the co-tenants. Such responsibilities would include complying with all reporting and other property level requirements set forth in the loan documents.

Second, the co-tenancy agreement should designate the managing co-tenant as the sole party authorized to make requests and otherwise interact with the lender or loan servicer.

Third, in loan transactions where the borrower is a co-tenant, secured lenders prohibit the bringing of a partition action while the loan is outstanding or alternatively require a co-tenant desiring to partition to offer to sell its interest to the other co-tenant with the requirement that the other co-tenant have the affirmative obligation to acquire such interest.

While the right of partition is inherent to the existence of a co-tenancy, it is generally a waivable right and Revenue Procedure 2002-22 recognizes permissible restrictions on the right to partition to the extent such waiver is required by a lender and is consistent with customary commercial lending practices. Rev. Proc. 2002-22.

Additionally, the IRS has expressly recognized the concern to secured lenders presented by the right of partition that is inherent in a co-tenancy. Accordingly, Revenue Procedure 2002-22 specifically allows for a co-tenant to have a right of first offer in the event another co-tenant desires to transfer its co-tenancy interest in the underlying real estate. Rev. Proc. 2002-22.

However, these risks cannot be eliminated or marginalized to the same extent they would be in a limited partnership or limited liability structure.

For example, in a limited partnership or limited liability company situation, the transfer of entity interests can clearly be limited under the law, whereas in a tenancy-in-common, a managing co-tenant may not have the clear right to prevent an impermissible transfer by the other co-tenant.

Likewise, a third-party creditor of a partner or a member is not legally entitled to lien partnership or limited liability company assets, whereas a creditor of a tenancy-in-common may assert liens against a tenancy-in-common interest. Moreover, co-tenants can do little to prevent the insolvency of another co-tenant.

B. Economic Issues. As noted above, the Internal Revenue Service identifies the proportionate sharing of profits and losses generated by the underlying real estate as a key attribute to a permissible tenancy-in-common regime under §1031. This requirement vitiates the ability of the §1031 investor and non-§1031 investor to have disproportionate sharing of profits, net capital proceeds and losses, including sponsor promotes and other preferred returns that have become common in the marketplace.

Although it might be possible to structure an incentive management fee arrangement, the party that would otherwise be entitled to a promote distribution would not be able to maintain the underlying character of the distribution that is important if derived from a refinancing or sale.

Similarly, the distribution of casualty and condemnation proceeds would be distributed between the co-tenants in accordance their respective undivided co-tenancy interest and not in accordance with any disproportionate waterfall that the co-tenants may otherwise desire to implement.

C. Legal and Liability Issues. As noted above, the tenancy-in-common regime creates lien risks that would not otherwise be present in a limited partnership or limited liability company ownership structure.

Due to the fundamental nature of a tenancy-in-common, there is the risk that a judgment lien or other lienable claims may be filed against the overall real estate due to the acts or omissions of one of the co-tenants.

This exposure to such liens is not present in an ownership structured as a limited partnership or limited liability company. The creditor at issue may, by moving to foreclose its lien, further compound the legal risk of the co-owners as they may be forced to buy-in the claim or interest being sold rather than find themselves with an unknown third-party co-owner and a default of the transfer restrictions under their loan documents.

Another legal risk arising from a tenancy-in-common regime is the increased risk to tax audits.

Because separate tax returns are filed for each co-tenant, there is the risk that these tax returns may be inconsistent, thus increasing the risk to an audit. Although this risk could be minimized by requiring that each co-tenant use common accountants for the preparation of its returns as well as requiring mutual review of the other co-tenants' tax returns and filings prior to submission to the applicable taxing authorities, most co-tenants have substantial other investments and are unwilling to agree to these restrictions.

D. Operating Issues. Because the real estate is owned jointly by the co-tenants in a co-tenancy regime, all leasing documents, service contracts, permits, licenses and other agreements, documents and items to which the owner of the real estate is a counterparty would need to be executed by all co-tenants.

As noted above, the designation of one of the co-tenants as a "managing co-tenant" having certain managerial responsibilities identified in the co-tenancy agreement is a means of unifying the operation of the co-tenancy to resemble that of a limited partnership or limited liability company to the same extent. However, such a designation might not work for all purposes without an actual power of attorney, an instrument that all co-tenants may be uncomfortable signing.

Moreover, it is important to insure that the limitations and allocation of managerial responsibilities set forth in the co-tenancy agreement do not run afoul of the parameters outlined in Revenue Procedure 2002-22.

In particular and as identified above, Revenue Procedure 2002-22 requires that each co-tenant retain certain voting rights over the approval of management matters and transfer of interests in the real estate, including in respect of leasing and the right to transfer, partition and encumber such co-tenant's undivided interest in the real estate without the agreement or approval of any person, although, restrictions on such rights that are required by a lender and that are "consistent with customary commercial lending practices are not prohibited." Rev. Proc. 2002-22.

Although more precise guidance on the limitations will develop over time, it is anomalous in a commercial real estate investment to permit an investor that would otherwise be a passive limited partner with substantially no management rights to have approval over leasing and other operational matters. The exercise of these rights can lead to unanticipated disputes and can deadlock the operations of the investment group.

Unwinding the Deal

Multi-investor real estate investments typically have buy-sell, drag along and other mechanisms that permit the investors to unwind the arrangement if there is a deadlock among the investors or one or more of them is otherwise impelled to force an exit.

Such arrangements do not work well in a §1031 co-investment situation, at least for some period of time, because the essential raison d'être of the §1031 investor is that it has successfully deferred its gain arising from the sale of the real estate that is the subject of the exchange transaction. Thus, in simple terms, the §1031 investor does not want to be forced into an early recognition of that deferred gain or, alternatively, to be forced to invest more capital in order to buy out its co-investors. Of course, at some point in time, the use of some unwind mechanism may become appropriate.

While the §1031 investor must hold the new investment property (i.e. the tenancy-in-common interest) for investment or use in its trade or business for some appreciable period of time, it need not hold it for the full term of its investment. Thus, the co-tenants might agree upon a "call" requirement whereby, after the passage of an agreed period of time (we leave it to tax counsel to ponder how long is sufficient), a co-tenant may elect to have the co-tenancy collapsed into a partnership or limited liability company.

This arrangement has its own challenges—transfer taxes, lender approval, new title policies and the like—but it may provide a desired exit strategy from the co-tenancy without recycling the §1031 investor.

Conclusion

Market forces and increased clarity from the IRS have fostered a burgeoning market for §1031 transactions in the commercial real estate market. Such factors have also led to an increasing number of transactions involving §1031 capital and non-§1031 capital in recent years.

As discussed above, this mix of §1031 capital and non-§1031 capital results in a permissible capital structure under §1031 but presents numerous challenges and limitations that would not otherwise be present in a traditional structure comprised entirely of non-§1031 capital. In this regard, the co-tenancy structure that the IRS recognized in Revenue Procedure 2002-22 as a generally acceptable mechanism for the co-existence of §1031 capital and non-§1031 capital has limitations that affect the ability to render a §1031 investor's capital investment as a truly passive investment.

While these limitations and challenges create a brier patch of issues that investors are not customarily faced with, if the §1031 capital is important to a successful investment, this brier patch is one that can be carefully navigated. This can be accomplished through an understanding of the boundaries that the IRS has outlined for tenancy-in-common regimes and an appreciation of the issues and challenges that are presented.

1. All section references in this article are to sections of the U.S. Internal Revenue Code of 1986, as amended (Code).

2. Beth Mattson-Teig, "Bidding Wars Raise Stakes," National Real Estate Investor, Nov. 1, 2005.

3. The actual requirements of §1031, the definition of "like kind" property, the use of forward and reverse exchanges and other such matters are not the subject of this article. For a general overview of §1031 transactions and the requirements of §1031 see Roger M. Roisman and David Schulder, "The 'Like Kind Exchange' Tax Deferral Mechanism May Not Always Be the Perfect Choice," New York Law Journal, April 11, 2005, at p. 2; Jeffrey A. Wietharn, "Deferred Like-Kind Exchanges under Internal Revenue Code Section 1031," 68 J. KAN. B.A. 32, August 1999; David P. Goad and J.F. Howell, III, "Section 1031 Like-Kind Exchanges," 68 TEX. B.J. 824, October 2005.

4. See N.Y. E.P.T.L. §6-2.1 et seq.