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Tenancies in common in commercial real estate

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The form of ownership known as a tenancy in common (TIC) has existed for centuries. In a TIC, multiple owners are listed on the deed to the property with each owner's exact percentage interest recited. So a typical TIC deed would recite "to Jim as to 25%, Mary as to 50% and Jamal as to 25%." As a law student I studied old English case law resolving disputes as to which part of the property each of the TICs is entitled to farm and which TIC should pay what expenses. The TIC form of ownership is far from irrelevant in today's commercial real estate market. Due primarily to the Internal Revenue Code rules on Section 1031 exchanges, TICs remain an essential tool for minimizing taxes for sellers of commercial real estate.

Section 1031 of the IRS permits the deferral of income tax on the sale of an investment property if the seller exchanges the property for a replacement investment property within certain strict timeframes. But Section 1031 does not apply to partnership or LLC membership interests - only to transfers of direct interests in real estate. The selling entity must purchase the replacement property in its own name (or in a single member LLC owned 100% by the seller). But it's hard to match the sale price for the property being sold to the purchase price of the property being acquired through the exchange. Hence, the TIC structure permits the taxpayer to buy part of the replacement property thereby greatly expanding the properties available to the taxpayer to defer the taxes due. For example, the seller of a $5 million property could buy a 10% TIC interest in a $50 million property.

The IRS, however, wants to make sure that the TIC structure is not a camouflaged partnership interest so it issued Revenue Procedure 2002-22 (Rev Proc) giving guidance as to how TICs need to be structured to make sure the exchange counts as a direct interest in real estate. While government regulations can be confusing and duplicative, the Rev Proc has been a model of clarity. It gives simple, plain English guidelines to TICs to make sure they qualify as a direct owner of the new real estate. The Rev Proc requires that the TICs unanimously consent to leases, mortgages and other major decisions. It permits a management agreement with a property manager but the term of the management agreement is limited to a year before it must again be unanimously renewed by the TICs. Perhaps the most problematic Rev Proc requirement is that a TIC's percentage interest can't be diluted because of the failure to make a required capital call. Dilution in those circumstances is treated as a hallmark of a partnership interest and therefore an indication that the TIC interest is not a true direct interest in real estate. In short, in my example above, following the Rev Proc results in the 10% direct owner receiving many more rights than available to a minority investor in the typical LLC agreement.

The LLC laws in both New York and Delaware, however, permit outside managers with no economic interest in the LLC to be appointed to manage the LLC subject to the terms of the LLC agreement. Recently, tax counsel has approved of the concept of the appointment of outside LLC managers in a Section 1031 TIC context. Back to our example: Mary, the 50% owner, wants to control all leasing decisions. Jim and Jamal could create single member LLCs to own their respective interests and appoint Mary as a manager of their LLCs. Each LLC agreement would grant the right to Mary to approve leases. While there is risk of future IRS review of these arrangements, most experts believe the appointment of Mary as a manager of Jim and Jamal's LLCs with the power to approve leases would not violate the Rev Proc - the exchanging LLC would still be approving leases, the fact that Mary has been vested with the right to approve leases should not disqualify the LLC under the Rev Proc.

Note that the appointment of Mary as a manager does not solve the issue of dilution after the failure to contribute required capital. That part of the Rev Proc remains a key issue. Note that any dilution would be quite complex in any event since the respective percentages of the TICs would need to be changed by a deed, not a mere action of the manager of an LLC in the typical LLC agreement.

Of course, the complexity of the agreements governing the TICs and the respective LLCs require that counsel is comfortable with the Rev Proc, LLC laws and the laws of tenancies in common dating back to when deeds were written with quill pens.

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