

Revenue Procedure 2002-22

Rev. Proc. 2002-22 specifies the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity, within the meaning of §301.7701-2(a) of the Treasury Regulations.

With the publication of Rev. Proc. 2002-22, the IRS has established guidelines and conditions under which it will issue rulings to taxpayers. This revenue procedure applies to co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common.

Rev. Proc. 2002-22 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 Rev. Proc. 2002-22 are not intended to be substantive rules and are not to be used for audit purposes. The guidelines and conditions set forth in Rev. Proc. 2002-22 do not establish any particular “law” or “rule” for the treatment of TIC ownership arrangements, they merely set forth the circumstances under which the IRS is prepared to rule favorably when presented with a particular case. Cases that do not meet all the requirements and conditions of Rev. Proc. 2002-22 may nonetheless qualify as proper TICs for tax purposes under their particular facts and circumstances.

Guidelines

Section 4 of Rev. Proc. 2002-22 sets forth three “guidelines” for submitting ruling requests; if these guidelines are not met, the IRS will generally not consider the request.

<u>Guideline</u>	<u>Application to Project</u>
1. each co-owner’s interest in each parcel is identical to that co-owner’s interest in every other parcel	Each 1031 Investor will acquire a single undivided interest in a single parcel. The Owner believes that its cash flow guaranty to 1031 Investors does not result in any co-owner having an interest that is not identical to that of every other co-owner because the guaranty represents an adjustment of the purchase price paid by the 1031 Investor for its UI.
2. each co-owner’s percentage interests in the parcels cannot be separated and traded independently	Because the Project consists of only a single parcel, this requirement is inapplicable.
3. the parcels of property are properly viewed as a single business unit. For this purpose, contiguous parcels are treated as a single business unit.	Because the Project consists of only a single parcel, this requirement is inapplicable.

Conditions for Obtaining Rulings

In addition to the Guidelines set forth in Section 4 of Rev. Proc. 2002-22, the IRS will not ordinarily consider a ruling request unless the fifteen Conditions described in Section 6 are satisfied. Nevertheless, the IRS may grant favorable requests even where the Conditions are not satisfied if the facts and circumstances clearly warrant a favorable ruling.

<u>Condition</u>	<u>Application to Project</u>
01. <i>Tenancy in Common Ownership.</i> Each of the co-owners must hold title to the Property (either	• each UI Investor holds title through a disregarded entity as a tenant in common under Nevada law.

Condition	Application to Project
<p>directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.</p>	<p>Title to the property as a whole is not held by any entity.</p>
<p>.02 <i>Number of Co-Owners.</i> The number of co-owners must be limited to no more than 35 persons. For this purpose, "person" is defined as in §7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.</p>	<ul style="list-style-type: none"> • there will be no more than 35 persons (as defined in Rev. Proc. 2002-22) that will own the Project.
<p>.03 <i>No Treatment of Co-Ownership as an Entity.</i> The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under the revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.</p>	<ul style="list-style-type: none"> • no partnership or corporate tax return will be filed on behalf of the UI Investors; • the UI Investors will not conduct business under any name; • no agreement will be executed identifying the UI Investors as partners or members of any business entity; • the UI Investors will not hold themselves out as partners or members of a business entity; and • the UI Investors will not hold their interests through a partnership or corporation prior to their acquisition of title in their own names.
<p>.04 <i>Co-Ownership Agreement.</i> The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of the revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).</p>	<ul style="list-style-type: none"> • no co-ownership agreement will be executed by the UI Investors; and • a right of first offer to purchase at fair market value is granted to Owner in the event a 1031 Investor elects to sell its UI or exercise any partition right.
<p>.05 <i>Voting.</i> 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</p>	<ul style="list-style-type: none"> • the UI Investors retain the approval of any disposition of the Property, subject to the Option to Purchase which is permitted by Section 6.10 of the revenue procedure; • any modification of the mortgage against the

Condition	Application to Project
<p>re-lease 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. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with Section 6.05 of the revenue procedure may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.</p>	<p>property must be approved by the UI Investors. Each UI Investor will approve the terms of any refinancing of the Loan pursuant to the terms described in the Investor LLC Operating Agreement and the Grant Deed/Buyer Acknowledgement or be required to execute or otherwise consent to any permanent loan deed of trust or other loan documents; however, it is unclear if such “pre-approval” of a refinancing loan satisfies the requirements of .05;</p> <ul style="list-style-type: none"> • since the Property is subject to a Master Lease, certain of these conditions may fall within the authority of the Master Tenant, and might not apply to the UI Investors, including: <ul style="list-style-type: none"> • hiring of any property manager; however, it is unclear if this complies with .05; • negotiation of any management contract; • negotiation or renegotiation of any lien secured by the Master Tenant’s interest in the Property; • no “global” power of attorney is granted by the UI Investor to any person; • all of the 1031 Investors approve the Master Lease by agreeing to take subject to the Master Lease; and • the Special Manager may execute loan documents on behalf of the Investor LLCs if the loan satisfies certain conditions previously approved by the 1031 Investors; however, it is unclear if this satisfies .05.
<p><i>.06 Restrictions on Alienation.</i> In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the Property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See section 6.14 of the revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the Property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.</p>	<ul style="list-style-type: none"> • the UI Investors will be subject to no restrictions on transfer, partition or encumbrance except for those required by the Lender, consistent with customary commercial lending practices and except for a right of first offer to purchase granted to the Owner in the event of sale or exercise of partition rights; and • the Master Tenant, Seller and Optionee have the option to purchase a UI at 50% of fair market value as liquidated damages for a 1031 Investor’s default under the Master Lease, Buyer Acknowledgement Agreement or Option to Purchase. It is unclear if the 50% discount violates the requirements of “fair market value” in .06.
<p><i>.07 Sharing Proceeds and Liabilities upon Sale of Property.</i> If the Property is sold, any debt secured by a blanket lien must be satisfied and the</p>	<ul style="list-style-type: none"> • upon any sale of the Project, the Loan would be paid off (or assumed by the buyer) and the remaining proceeds distributed to the UI Investors in

Condition	Application to Project
remaining sales proceeds must be distributed to the co-owners.	accordance with their percentage undivided interests; provided that it is unclear if the commission payable to APD which is an affiliate of the Owner will violate .07.
<p><i>.08 Proportionate Sharing of Profits and Losses.</i> Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.</p>	<ul style="list-style-type: none"> • all revenues and expenses of the project are shared in proportion to the undivided interests of the UI Investors; • the Master Tenant is responsible for all Project operating expenses, without recourse to the UI Owners; • neither the other 1031 Investors nor Owner nor APM will advance funds to any UI Investor; and • the Master Tenant may advance funds to the UI Investors to pay debt service, taxes insurance and repairs. It is unclear if this advances right is prohibited by .08;
<p><i>.09 Proportionate Sharing of Debt.</i> The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.</p>	<ul style="list-style-type: none"> • the Loan is allocable to the UI Investors in proportion to their undivided interests.
<p><i>.10 Options.</i> A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.</p>	<ul style="list-style-type: none"> • Option to Purchase (held by 1031 Xpress) is priced at the fair market value of the undivided interest; and • the UI Investors do not possess an option to sell (put option) their undivided interests to anyone.
<p><i>.11 No Business Activities.</i> 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</p>	<ul style="list-style-type: none"> • it does not appear that activities will be conducted with respect to the Project other than those customarily performed in connection with the maintenance and repair of rental real property, although it is unclear if the Master Tenant's right to make alterations, repairs, renovations, improvements and additions violates the "customary" activity requirements of .11.

<u>Condition</u>	<u>Application to Project</u>
<p>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.</p>	

<p><i>.12 Management and Brokerage Agreements.</i> 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. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.</p>	<ul style="list-style-type: none"> • the Master Tenant engages a property manager directly. The co-owners will not enter into a management agreement with APM; however, it is unclear if the agreement requires annual approval of the UI Investors or if the requirements of .12 apply where the Master Tenant engages the Property Manager; • the Management Agreement between APM and Master Tenant requires APM to maintain a Project bank account for the collection and deposit of rents; • net revenues are expected to be disbursed to UI Investors within 30 days of the end of each month; • the management fee payable to APM does not depend on income or profits but is calculated on the basis of gross collected revenues; and • the fee reflects the Owner's determination of the fair market value charges for APM's services.
<p><i>.13 Leasing Agreements.</i> All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.</p>	<ul style="list-style-type: none"> • the rent payable under the Master Lease represents the Owner's determination of the fair market value for the use of the Property (the 3% retention by the Master Tenant is in consideration of the Master Tenant's assumption of responsibility for all operating expenses of the Project); however, it is unclear if the rent satisfies the "fair market value" requirements of .13; • the rent paid by the Master Tenant is not determined with reference to the income or profits from the property (a fixed percentage of receipts is acceptable); and
<p><i>.14 Loan Agreements.</i> The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any</p>	<ul style="list-style-type: none"> • the Lender is an independent commercial lender, not related to Owner, APM, Master Tenant or any other UI Investor.

lessee of the Property.	
<p>.15 <i>Payments to Sponsor.</i> Except as otherwise provided in the revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.</p>	<p>The amounts received by Owner from the sale of UI pursuant to this 1031 Exchange Offering reflects the Owner's determination (based on an M.A.I. appraisal) of the fair market value of the undivided interests sold, and does not depend in any way upon the income or profits derived from the Project.</p>