

# AFFINITY REAL SOLUTIONS and REVENUE PROCEDURE 2002-22

The Internal Revenue Service recently issued Revenue Procedure 2002-22 (“Revenue Procedure”), which sets forth the conditions under which the Internal Revenue Service (“IRS”) will consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity. This determination is important because a tenancy in common interest must be considered an interest in real property in order to qualify as eligible property under Section 1031.

The following sets forth the conditions established by the IRS and how the interests (“Interests”) in the real property (“Project”) being sold by Affinity Real Estate Solutions, Inc. (“Affinity”) comply with these requirements.

**Tenancy in Common Ownership.** Each of the co-owners must hold title to the property as a tenant in common under local law and title to the property may not be held by an entity recognized under local law.

- The purchasers of Interests (“Tenants in Common”) will hold title to the Project as tenants in common.

**Limited Number of Co-Owners.** The number of co-owners must be limited to no more than 35 persons.

- Affinity will not sell Interests to more than 35 persons.

**No Treatment of Co-Ownership as an Entity.** 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 Tenants in Common Agreement provides that the co-owners will 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).

**Co-Ownership Agreement.** The co-owners may enter into an agreement that runs with the land. 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 before exercising any right to partition.

- The purchasers of Interests will enter into a Tenants in Common Agreement which includes a provision that in the event any co-owner elects to partition the Project, the other tenants in common may elect to purchase the Interest of the partitioning tenant in common at fair market value.

**Voting.** The co-owners must retain certain voting rights, including the hiring of a property manager, the sale or disposition of the property, approval of all leases or the creation or modification of any blanket lien. Any sale, lease, or 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.

- The Tenants in Common Agreement requires that more than 50% of the co-owners must approve all decisions; provided, however, that any sale, lease, or 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.

**Restrictions on Alienation.** Each co-owner must have the right 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.

- The Tenants in Common Agreement does not contain any restrictions on the transfer, partition or encumbrance of a co-owner's Interest. It is not certain what specific provisions will be required by a lender because the terms of a loan have not been specified.

**Sharing Proceeds and Liabilities upon Sale of Property.** When the Project is sold, any lien must be repaid and the remaining sales proceeds distributed to the co-owners.

- The Tenants in Common Agreement requires that in the event the Project is sold, any loan encumbering the Project must be repaid and the remaining sales proceeds distributed to the co-owners.

**Proportionate Sharing of Profits and Losses.** Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to their undivided interests. Neither the other co-owners, 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.

- The Tenants in Common Agreement provides that, except for real estate taxes to the extent that taxes are assessed at different rates for different Tenants in Common and for expenses or costs applicable to a Tenant in Common as opposed to the Project, all revenue and expense is shared in proportion to the Tenant in Common's Interest. Further, the Tenants in Common Agreement provides that a nonpaying Tenant in Common (and if the Tenant in Common is a disregarded entity, the owner of the Tenant in Common) shall reimburse the paying Tenant(s) in Common within 30 days the amount of any such payments plus interest thereon at the rate of ten percent (10%) per annum (but not more than the maximum rate allowed by law) until paid.

**Proportionate Sharing of Debt.** The co-owners must share in any indebtedness secured by the property in proportion to their undivided interest.

- It is anticipated that all co-owners will share in any indebtedness secured by the Project in proportion to their Interests.

**Options.** 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 Project determined as of the time the option is exercised. 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.

- The Tenants in Common Agreement provides a call option to the other Tenants in Common in the event a Tenant in Common files for bankruptcy or files for partition of the Project. There are no put options.

**No Business Activities.** The co-owner's may only engage in activities that are customarily performed in connection with maintenance and repair of rental real property (customary activities). 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 Project for less than 6 months.

- The Tenants in Common Agreement 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). It is not anticipated that Affinity will retain an Interest for 6 months or more.

**Management and Brokerage Agreements.** 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.

- There is no management or brokerage agreement contemplated.

**Leasing Agreements.** 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).

- Affinity believes the lease complies with this provision.

**Loan Agreements.** 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 lessee of the Property.

- The lender will not be related.

**Payments to Sponsor.** 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.

- Affinity believes that all payments and fees payable to Affinity comply with this requirement.

## **AFFINITY REAL SOLUTIONS**

6 VENTURE, SUITE 100, IRVINE, CA 92618

PHONE (888) 665-1031 FAX (888) 665-5956

[www.affinityrealsolutions.com](http://www.affinityrealsolutions.com)