

**REVENUE PROCEDURE 2002-22:
UNDIVIDED FRACTIONAL INTERESTS IN RENTAL REAL ESTATE**

The Internal Revenue Service issued Revenue Procedure 2002-22 on March 19, 2002 providing guidance in the context of undivided fractional interests (UFI) in real property. The purpose of the guidance is to establish a bright line test for determining generally whether an undivided fractional interest in rental real property is (i) an interest in a business entity (i.e. a partnership), or (ii) a tenancy in common, the central characteristic of which is that each owner is deemed to own individually a physically undivided part of the entire parcel of property.

The Rev. Proc. does not provide a safe harbor, and it is not a substantive statement of law, but rather specifies the conditions under which the Internal Revenue Service will consider a request for an advance ruling that a UFI in rental real property is not an interest in a business entity. The Rev. Proc. states that where a sponsor meets all of the conditions, the Service may decline to issue a ruling where appropriate and in the interests of sound tax administration. Alternatively, where the conditions of the Rev. Proc. are not satisfied, the Service may still consider a request for a ruling.

Following are the conditions for an advance ruling:

Tenancy in Common Ownership: Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law.

Number of Co-Owners: The number of co-owners must be limited to no 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, or hold itself out as a partnership or other form of business entity.

Co-Ownership Agreement: 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 before exercising any right to partition.

Voting: The co-owners must retain the right to approve the hiring of any manager, the sale of other disposition of the Property, any leases or a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or re-negotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management 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.

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Restrictions on Alienation: In general, each co-owner must have the rights to transfer, partition and encumber the co-owners 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.

Sharing Proceeds and Liabilities upon Sale of Property: If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sale proceeds must be 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 the co-owners undivided interest in the Property.

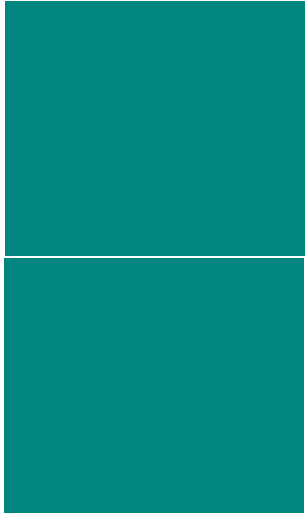
Proportionate Sharing of Debt: The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

Options: A co-owner may issue an option to purchase the co-owners 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-owners percentage interest in the Property multiplied by the fair market value of the Property as a whole (with no discount for minority interests). A co-owner may not acquire an option to sell the co-owners 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.

No Business Activities: The co-owners activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property. 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.

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 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. 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.

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 or receipts or sales).



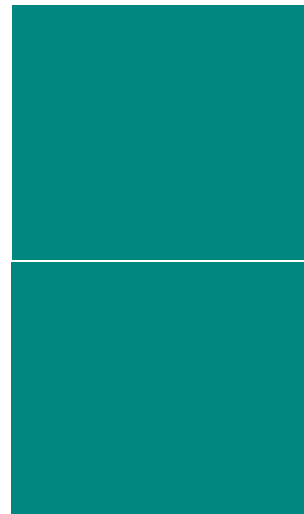
Loan Agreements: The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager or any lessee of the Property.

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.

While the Rev. Proc. is, in some ways, extremely generous, not many, if any, sponsors will meet all of the conditions contained in the Rev. Proc., and the Service may be compelled to issue rulings in the coming year. The issuance of rulings should provide some clarity and address those issues the Rev. Proc. leaves open to interpretation.

The Service has received many requests for rulings since March of 2002 and has issued, to date, only two private rulings:

PLR 200327003, issued March 7, 2003, and **PLR 200513010** (April 1, 2005). While neither ruling satisfies every provision of the Rev. Proc. both rulings contain elements that may be helpful to sponsors and investors considering acquiring TIC interests in property. *See pages 89 and 91 for a detailed discussion of both rulings.*



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