PLR 201622008 (5/27/2016): Rev. Rul. 2002-22 and Put Option

This is a private letter ruling under Rev. Proc. 2002-22, holding that an undivided fractional interest in real property will not constitute an interest in a business entity for purposes of qualification as eligible relinquished property under I.R.C. § 1031(a). The distinguishing factor in this ruling is that the real property is subject to a put option, which is generally prohibited under Section 6.10 of Rev. Proc. 2002-22.

The taxpayer in the ruling owns a commercial office building ("Property") that will be triple net leased to an unrelated party (the "New Co-Owner"). The lease will be a bona fide lease for tax purposes, with fair market rent, not determined, in whole or in part, based on the income or profits derived by any person.

Contemporaneous with entering into the triple net lease, Taxpayer and New Co-Owner will enter into an Option Agreement under which Taxpayer will have an option to sell any or all of its interest in the Property to New Co-Owner at any time before the fifth anniversary of the effective date of the Option Agreement (the Put). Within six months of executing the triple net lease and the Option Agreement, Taxpayer may exercise its right under the Put to sell a % tenancy-in-common interest in the Property to New Co-Owner. If Taxpayer exercises the Put with respect to a part of its interest in the Property, it may exercise the Put again with respect to another part of its interest in the Property and continue to do so until all interests in the Property are transferred or the Put expires at the end of five years.

Under the Option Agreement, New Co-Owner will also have an option to acquire the entire remaining interest then held by Taxpayer beginning on the seventh anniversary of the effective date of the Option Agreement, and ending x days later (the Call). The purchase price for the exercise of the Put or the Call will be based on the fair market value of the Property at the time of the execution of the Option Agreement, increased at each anniversary date of the execution of the Option Agreement by b% of the then-current exercise price, as increased by any prior b% increases. Taxpayer represents that b% is a reasonable appreciation factor for the Property. Neither co-owner will provide financing to the other co-owner to acquire a tenancy-in-common interest in the Property.

The ruling reasoned that the prohibition on a put option in Rev. Proc. 2002-22 did not apply to these facts. This was because the Put in the ruling was for property that was held by Taxpayer prior to entering into the proposed transaction. The prohibition in Rev. Proc. 2002-22, however, only applies to a put to sell an existing undivided interest that was previously acquired by the taxpayer.

The structure in this ruling appears to allow the Taxpayer to sell off percentage interests in the Property when the Taxpayer has found suitable replacement property. The Taxpayer simply exercises the Put, thus forcing the New Co-Owner to purchase the percentage interest, and treats the sale as relinquished property in an exchange. When the Taxpayer locates additional replacement property, the taxpayer exercises another Put. The New Co-Owner, who most likely would prefer to own the whole Property, will have the right to acquire any remaining interest after seven years.

As an additional variation under Rev. Proc. 2002-22, the Co-Ownership Agreement will not contain a provision causing the owner of a co-owner that is a disregarded entity to be liable for an advance. Nevertheless, to secure such an advance repayment obligation, the Co-Ownership Agreement will provide that each co-owner grants each other co-owner a lien against such granting co-owner's interest in the Property and the rents and income therefrom and the leases thereof.

As a further expansion of Rev. Proc. 2002-22, any management agreement with the related party manager will provide for a d% improvement construction management fee times the costs of tenant improvements. Such fee will relate to construction of improvements to common areas of the Property. This does not appear to be considered non-customary services with respect to the Property.