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In this article, Levin-Nussbaum looks at an IRS private letter ruling concerning a section 1031 exchange and tenancy-in-common interests in a commercial office building, and she discusses how the IRS's analysis of put and call options could be relevant to the renewable energy industry.

The IRS ruled in LTR 201622008 that the taxpayer's contemplated sales of tenancy-in-common interests (TICs) in a commercial office building would not be considered interests in a business entity under reg. section 301.7701-2(a) and, therefore, were not precluded from being considered eligible relinquished property in a like-kind exchange under section 1031.[1]

A TIC is the nomenclature used for an undivided interest in real property; but the concepts discussed in the ruling apply equally to personal property, including interests in renewable energy projects in which investors in large projects may desire to own direct interests in the project rather than interests in a joint venture or other business entity.

Reg. section 301.7701-2(a) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits, but the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. On its face, one would expect a TIC to be considered a co-ownership interest in property. However, labels do not control and, when all facts of a situation are considered, there can be a fuzzy line between what constitutes sharing profits in a business arrangement and splitting revenue and costs from co-ownership of property.

The facts of the ruling are generally consistent with mere co-ownership of property and not an arrangement in which the parties carry on a joint venture for profit. However, the put and call arrangements between the parties make this ruling more notable than a typical TIC transaction.

The taxpayer had previously acquired the entire fee interest in a commercial office building, which would be leased to an unrelated third party under a triple net lease. The owner's proposed transaction involved entering into an option agreement with an unrelated counterparty under which the owner would have a put right to sell the counterparty the fee interest in the property or an undivided interest in the property (of a size to be determined by the owner) at any time during the first five years of the agreement. The owner could exercise the put by selling the counterparty a TIC in the property on one date, then exercise the put again later to sell another TIC in the property to the counterparty, and could do so as often as the owner desired until the five-year period expired. The exercise price for the put on any date would be calculated using a predetermined formula, which would be the product of the fair market

[1] If the TICs were considered interests in business entities, they could not be considered eligible relinquished property because interests in business entities are not eligible for like-kind exchange treatment.

value of the property on the effective date of the option agreement increased annually by a fixed percentage factor (agreed on by the parties on the effective date), multiplied by the percentage interest in the property sold. The owner represented that the percent factor was a reasonable appreciation factor for the property. If the owner had any remaining interest in the property after the expiration of the put, on the seventh anniversary of the effective date, the counterparty had a call option to purchase that remaining interest. The exercise price under the call was also determined using the percent factor formula.

Upon the sale of any TIC in the property, the owner and counterparty would enter into a co-ownership agreement. Under the co-ownership agreement, key decisions regarding the property (for example, leasing, any debt financing resulting in blanket liens across the entire property, entering into a management agreement) would require approval by the owner and counterparty. The owner and counterparty would both share revenue generated by the property and be obligated to pay all costs associated with the property pro rata in proportion to their TICs in the property. Unless prohibited by the lender, each would be free to partition its interest in the property (that is, bring an action to sever the property in a manner that results in each party owning an individual property interest). Further, the owner represented that neither the owner nor counterparty would file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying himself as a member of a business entity, or otherwise hold himself out as a member of a business entity with the other party; and the co-ownership agreement would be consistent with these representations.

The ruling is provided under Rev. Proc. 2002-22,[2] which states the conditions that a taxpayer must satisfy to receive a ruling that undivided interests in rental real property are not interests in a business entity.[3] To that end, the IRS specifically notes the following:

- The requirements in section 6.05 of Rev. Proc. 2002-22 were satisfied (that is, that the co-owners 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) because the co-ownership agreement would require unanimous approval by the TIC holders of those events.
- The terms under which a management agreement could be entered into would satisfy the requirement under section 6.12 of Rev. Proc. 2002-22 that a management agreement with an agent must be renewable no less frequently than annually; this was so even though the agreement would provide for automatic renewal until there was written notice not to renew.
- The owner represented that the co-owners' activities would be limited to customary activities regarding the property, which satisfied the requirement under section 6.11 of Rev. Proc. 2002-22 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).

As noted above, other than the put and call, the facts of the ruling appear to be straightforward and generally consistent with a co-ownership arrangement. Thus, it appears likely that the taxpayer sought the ruling to confirm that interests in the property could qualify as relinquished property for like-kind exchange purposes (that is, not be considered interests in a business entity) notwithstanding the put and call features of the arrangement.

[2] Rev. Proc. 2002-22, 2001-1 C.B. 733.

[3] It is important to note that the conditions under Rev. Proc. 2002-22 are the requirements for obtaining an advance ruling, and the scope of the revenue procedure is limited to a request regarding co-ownership of rental real property (other than mineral interests) in an arrangement classified under local law as a tenancy in common. Rev. Proc. 2002-22, section 3. By its terms, "the guidelines set forth in th[e] revenue procedure are not intended to be substantive rules and are not to be used for audit purposes." *Id.*

Section 6.10 of Rev. Proc. 2002-22 provides the rules governing put and call options. Regarding put options, section 6.10 provides: "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."[4] The IRS concludes that the owner's put in LTR 201622008 did not violate this condition because it was not a put option to sell a co-owner's undivided interest to another co-owner. According to the IRS:

> That is not what will happen in this case, and the put option in this case will not cause the fractional interests in the *property* to constitute interests in a business entity. The *Taxpayer's* put option in this case is not an option to sell an existing undivided interest that was previously acquired by the *Taxpayer*. Rather, the put option is an option to sell property held by the *Taxpayer* prior to entering into the proposed transaction. The purpose of the put prohibition is not applicable to this case.[5]

At first it seems difficult to reconcile the sentence describing the put as not being a prohibited put option under section 6.10 because it is not an option to sell an existing undivided interest that was "previously acquired by the Taxpayer" (the second sentence quoted) with the immediately succeeding sentence describing the put as being different from such prohibited put options because it is an option to sell property held by the taxpayer before entering into the proposed transaction (the third sentence quoted). In other words, it seems like the second quoted sentence says the put is permissible because it *is not* an option to sell previously acquired property, whereas the third quoted sentence seems to say that the put is permissible because *it is* an option to sell previously acquired property. How can both be true? There is an explanation. The third quoted sentence distinguishes the put from a prohibited put under section 6.10 because it is an option to sell property that the taxpayer owned *before* entering into the proposed transaction. In other words, by saying in the third quoted sentence that section 6.10 does not apply to options to sell property acquired in a prior transaction, the IRS appears to suggest that the *previously acquired* requirement referenced in the second quoted sentence is intended to mean that a put is only prohibited if it is with respect to a property interest acquired in the proposed transaction.

The IRS also adds the word "existing" to describe what constitutes a prohibited put under the revenue procedure (a requirement that is not expressly included in the revenue procedures), which is consistent with the concept that the put condition applies only if the sale right was acquired for an undivided interest that was *previously acquired* by the taxpayer. LTR 201622008 does not explain the reason for adding this requirement, but it seems justified under the facts because the put condition applies only to options to sell undivided interests to one of the listed prohibited persons. In this case, there would not be a prohibited person until the put was exercised. Thus, there could not be a prohibited put option without an existing TIC. Alternatively, the IRS may have considered the use of the word "acquire" as somehow implying that the TIC must be created by the time the taxpayer acquires the put option to sell that TIC. Thus, in the second quoted sentence, the IRS may have been focused on the fact that the owner would hold the entire fee interest in the property when the option agreement was executed (that is, there would not be an *existing* undivided interest when the owner acquired the put). The fact that the third quoted sentence further distinguishes the put from those prohibited under the revenue procedure based on the fact that the owner acquired the property before entering into the proposed transaction suggests, as noted above, that the IRS uses the words "previously acquired" in the second quoted sentence to mean previously acquired in the proposed transaction — that is, the put condition in section 6.10 applies only if the option is for an undivided interest in property that both (a) existed when the taxpayer acquired the option and (b) was acquired by the taxpayer in the proposed transaction.

[4] *Id.* at section 6.10.

[5] *Id.* (emphasis in original).

Thus, the put in LTR 201622008 was not subject to the put condition in section 6.10 of Rev. Proc. 2002-22. When the owner and counterparty executed the option agreement, the owner acquired an option to sell the counterparty all or part of the property. This option included the right to sell a TIC in the property, but there was no *existing* TIC. The TIC would be created only when the owner exercised the put. Arguably, a second exercise of the put could be considered to fall within the put preclusion under section 6.10.[6] Unfortunately, the IRS does not explain why this feature of the put did not implicate the put condition under Rev. Proc. 2002-22. The reason might be that the IRS viewed the put condition as being a day 1 analysis despite the owner's right to successively exercise the option. It would also have been helpful if the IRS had included some discussion of the purpose of the put prohibition and why that purpose was inapplicable to the facts involved in this ruling.

LTR 201622008 raises some interesting questions about the call option requirements under Rev. Proc. 2002-22. After stating that the purpose of the put prohibition is inapplicable, the IRS goes on to say, "Regarding the exercise price, though section 6.10 of Rev. Proc. 2000-22 requires that the exercise price be the fair market value at the time of exercise, the b% appreciation factor adequately approximates the fair market value of the *Property*." This sentence does not expressly reference the call and would appear to be a continuation of the preceding discussion of the put. However, it is reasonable to assume that the IRS is referring to the exercise price of the call because put options, if prohibited under section 6.10 of Rev. Proc. 2002-22, are prohibited at any exercise price. Moreover, this single sentence is the only place in LTR 201622008 that the IRS considers the call option condition under Rev. Proc. 2002-22, and this condition needed to be satisfied for the IRS to issue LTR 201622008.

Section 6.10 of Rev. Proc. 2002-22 provides that call options are permissible as long as "the exercise price for the call option reflects the FMV of the property *determined as of the time the option is exercised*."[7] For the call option in LTR 201622008, the exercise price would be determined by applying an appreciation factor that was fixed as of the effective date to the fair market value of the property also determined as of the effective date. The IRS concluded that the FMV requirement was satisfied because the appreciation factor *adequately approximated* the FMV of the property. The only factual basis for the IRS's conclusion was the owner's representation that the percent factor was a reasonable appreciation factor for the property. Thus, the IRS effectively concluded that a *predetermined* estimate of how much the FMV of the property would escalate each year could satisfy a standard that was phrased using words that seemed to require valuation *at the time of exercise* — that is, that a reasonable estimate of projected FMV at the time of exercise was essentially the same thing as (or could at least satisfy a standard based on) an actual FMV valuation made at the time of exercise.[8] Certainly, the concept of *approximate* FMV is not by itself at odds with the wording of section 6.10. For example, valuation experts often express FMV as a range of values. Also, the wording of the sentence requires only that the exercise price *reflect* FMV, not that it be equal to FMV. However, as discussed in more detail below, there is a difference between approximations of FMV that

[6]For example, if the owner were to exercise the put for a 20 percent TIC in year 2, the right to exercise the put to sell the remaining 80 percent TIC could be considered a put option *acquired* in year 2. Such a subsequently acquired put option would appear to fit within the proscription, as there would have been an *existing* TIC (the 80 percent TIC) and an existing co-owner in year 2, when the owner acquired the put for the 80 percent TIC, and the put for the 80 percent TIC was acquired in the *proposed transaction*.

[7]Rev. Proc. 2002-22, section 6.10 (emphasis added). For this purpose, the FMV of a co-owner's undivided interest in a property is equal to the FMV of the entire property multiplied by the co-owner's percentage interest in the property. *Id.*

[8]One practitioner has followed this strict interpretation and stated that Rev. Proc. 2002-22 prohibits call options when the exercise price is a fixed amount determined at the time the TIC was created. Terrence F. Cuff, "Research Can Prevent an Investment in a Ticky Tacky TIC," 33 *J. Real Est. Tax'n* 170 (2006). *See also* Cuff, "Issues in Section 1031 Exchanges for Real Estate Investment Trusts," 31 *J. Real Est. Tax'n* 113 (2004) (guidelines under Rev. Proc. 2002-22 appear to prohibit a call option with a pre-agreed purchase price or a purchase price determined by a formula that does not result in FMV). However, whether this view is correct is not clear and the IRS concluded to the contrary here. The revenue procedure would have been clearer if the call option language was the same as that in Rev. Proc. 2007-65, which expressly permits the purchase price to be determined before exercise as long as that predetermined price is one "that the parties reasonably believe, based on all facts and circumstances at the time the price is determined, will not be less than the fair market value of the [p]roperty at the time the right may be exercised." Rev. Proc. 2007-65, 2007-2 C.B. 967, section 4.05, *as revised by* Announcement 2009-69, 2009-40 IRB 475.

are reasonable projections but still include the risk of market fluctuations, and *at the time* approximations of FMV, reflecting the concept that FMV is some range of values, but which are based on then-current market conditions.

The IRS's conclusion in LTR 201622008 is interesting for the renewable energy industry because to satisfy the "service contract" safe harbor under section 7701(e)(4), there cannot be a purchase option at "a fixed and determinable price (other than for fair market value)."[9] There is some discussion (described below) of this purchase contract rule in the blue book for the Deficit Reduction Act of 1984,[10] the IRS has not issued any formal guidance interpreting this aspect of the service contract safe harbor.[11] Practitioners have debated whether the existence of any purchase option other than one exercisable at FMV determined at the time of exercise would preclude falling within the ambit of the safe harbor — that is, the FMV requirement under section 7701(e)(4) should be read the same as the call option condition under Rev. Proc. 2002-22, even though the parenthetical in section 7701(e)(4) does not include the words *determined as of*. This interpretation is based on the view that FMV by definition is a valuation determined at the time of exercise (as opposed to a projection of FMV). Practitioners also contrast the wording of section 7701(e)(4) with the wording of other tax guidance in which the FMV requirements for purchase options have been phrased in terms such as "at least equal to FMV" or "not reasonably projected to be less than FMV," and they are concerned about the absence of similar language (that is, Treasury and the IRS know how to specify that fixed price options at reasonably projected FMV are permissible, and would have done so here if that was intended).

Others consider a purchase option at the *greater of* FMV and a fixed price to be consistent with the safe harbor.[12] This more lenient interpretation seems reasonable given that the greater of FMV and a fixed price ensures that the price is not "fixed and determinable." In addition, this formulation should mean (absent other factors) that there is neither a requirement or an expectation that the option be exercised.[13]

One might argue that the IRS's conclusion in LTR 201622008 supports the more lenient interpretation of the purchase option rule for purposes of the service contract safe harbor (that is, the *other than at* FMV exception should be construed as permitting, under appropriate facts and circumstances, a fixed price purchase option at projected FMV). Such appropriate facts and circumstances might be those establishing that the purchase price was reasonably expected to be approximately equal to FMV at the time of exercise, as the owner's representation that the percent factor was a reasonable appreciation factor for the property was sufficient to satisfy the standard under Rev. Proc. 2002-22. In other words, if the IRS concluded that a predetermined formula that was reasonably expected to result in

[9] Section 7701(e)(4)(A)(iv).

[10] Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," JCS-41-84, at 51-52 (Dec. 31, 1984) (referred to as the blue book). While blue books are technically not legislative history because they are prepared by the staff of the JCT after the legislation has been enacted, many courts have relied on blue books in connection with analyzing a tax statute. *See, e.g.*, *Federal Power Commission v. Memphis Light, Gas and Water Division*, 411 U.S. 458, 471-472 (1973) (describing a blue book as a "compelling contemporary indication" of a tax statute's effect on certain powers of the Federal Power Commission); *Miller v. United States*, 65 F.3d 687 (8th Cir. 1995) (blue book "highly indicative of what Congress did, in fact, intend); *McDonald v. Commissioner*, 764 F.2d 322, 336-337 n.25 (5th Cir. 1985) (although not directly representative of legislators' views at the time of enactment, "the Joint Committee's views, however, are entitled to great respect."); and *Robinson v. Commissioner*, 119 T.C. 44, 74 (2002) (JCT staff summary was provided to members of Congress "for reference before Congress enacted TRA 1986, and consequently it is part of the history of the legislation); *But see Redlark v. Commissioner*, 106 T.C. 31 (1996) (blue book disregarded because not corroborated by the legislative history), *rev'd*, 141 F.3d 936 (9th Cir. 1998) (reversed on the substantive issue; relevance of the blue book was not addressed). In a 2014 case, the Supreme Court described blue books as being "commentaries" on recently passed legislation and quoted a 2011 nontax case for the proposition that such "post-enactment legislative history" (a contradiction in terms) is not a "legitimate tool of statutory interpretation." *United States v. Woods*, 571 U.S. 310, 134 S. Ct. 557, 568 (2013) (citation omitted). The Court did, however, leave open the possibility that a "blue book, like a law review article, may be relevant to the extent it is persuasive." *Id.*

[11] In a private ruling, the IRS held that the safe harbor was met notwithstanding a purchase option excercisable by a municipality in part through repayment of the then outstanding project bonds. LTR 8749045. The exercise price was then FMV, but the interest rate on the bonds was fixed.

[12] *See, e.g.*, Toby Cozart, "Equipment Leasing: Benefits and Burdens," *BNA Portfolio* 545-2d A-132 (2009); Heather Cooper, Joel Hugenberger, and William Friedman, "Commercial Solar Power Purchase Agreements: 6 Key Points,"' Law360 (Apr. 6, 2017).

[13] It should be noted that the author does not intend for this article to express any view regarding the FMV purchase option rule under section 7701(e)(4). The purpose of the article is to discuss LTR 201622008, and the discussion of section 7701(e)(4) is solely to give context to the discussion of whether LTR 201622008 provides any useful guidance to the open question regarding what, if any, purchase options will not preclude the availability of the service contract safe harbor.

an exercise price approximately equal to FMV at the time of exercise was sufficient when the wording expressly required an at-the-time FMV determination, a fixed-price purchase option for an amount that was reasonably expected to be approximately equal to FMV (whether determined by formula or not) should also be sufficient when the language is silent on the issue (that is, in the service contract safe harbor).[14]

The problem with that argument, however, is that it is undercut by two examples in the blue book illustrating when a purchase option determined using a formula is considered a fixed-price purchase option for purposes of section 7701(e)(4)(iv). The blue book describes a "fixed or determinable price purchase or sale option" as being a put or call option that is exercisable "at either a pre-established price or at a price that is determinable pursuant to a formula."[15] For option prices determined using a formula, the blue book states that a put or call option will not be treated as a fixed-price purchase option "if the selling price is determinable pursuant to a formula which the parties, when agreeing to it, reasonably expected would produce a number approximately equal to fair market value at the time of exercise."[16] While the blue book does not apply to the call condition in section 6.10 of Rev. Proc. 2002-22, the statement appears to echo the IRS's conclusion in LTR 201622008 that the call condition under Rev. Proc. 2002-22 was satisfied because the appreciation factor was reasonably expected to result in an exercise price approximately equal to FMV. However, the two examples in the blue book of purchase options determined using a predetermined formula suggest a more limited interpretation of the exception for a purchase option determined using a fixed formula than the approach taken by the IRS in LTR 201622008.

Here is what the blue book says about when an option using a fixed formula is eligible for the exception under the service contract safe harbor (that is, when it is considered an option to purchase at FMV) and when it is not:

> An option to purchase in 15 years for 50 percent of original cost is treated as an option at a fixed or determinable price. An option to purchase at a price derived by a formula which incorporates rents then paid by taxable entities for the use of the same or similar property and then-prevailing interest rates is not treated as an option at a fixed or determinable price, so long as the price actually determined approximates fair market value at the time of exercise.[17]

One could argue that it is reasonable to assume that is true, as the examples are intended to show that only certain types of formulas satisfy the exception, and here the difference is that the formula in the second example takes into account then-current market conditions. Under this interpretation, if the examples in the blue book applied to the FMV *determined at the time* condition described in Rev. Proc. 2002-22, the percent factor would not be the type of formula that could satisfy a FMV determination (that is, it is like the 50 percent depreciation example). Thus, it would be difficult to use the IRS's conclusion in LTR 201622008 to support a similar interpretation of the purchase option rule under section 7701(e)(4).

While LTR 201622008 may be interesting for many reasons, it does not fill the gap needed regarding the FMV purchase option requirement

[14] It is also interesting that the IRS did not avoid addressing whether the call satisfied the condition in the revenue procedure by taking the same approach as it did with the put. There is no express wording in section 6.10 of Rev. Proc. 2002-22 limiting the put option preclusion to options to sell existing undivided interests acquired in the proposed transaction. If the IRS could add this limitation for put options, it could have added it for call options and found that the call was not subject to the FMV rule because the property was acquired by the owner in a prior transaction. While this arguably might suggest a willingness on the part of the IRS to venture into taxpayer-friendly territory in the context of issuing guidance interpreting an FMV purchase option requirement, the ruling does not provide sufficient basis to support an argument for a similar interpretation of the FMV purchase option requirement under section 7701(e)(4). Without any explanation in the ruling for the IRS's deviation from what otherwise seems to be a clear requirement, it is difficult to rely on the IRS's conclusion outside the context of Rev. Proc. 2002-22. There could be policy reasons that affected the outcome here that would not apply elsewhere. Moreover, the conclusion is made in the context of a private letter ruling.

[15] Blue book, *supra* note 10, at 51.

[16] *Id.* The blue book discussion of service contracts is part of the section on tax-exempt leasing, and there are many cross-references where standards regarding purchase options are relevant in both contexts. *See, e.g., id.* at 52 (an option that satisfies the "disqualified lease" standard for real estate leased to a tax-exempt entity also satisfies the purchase option element of the service contract safe harbor). A complete analysis of the various factors described in the blue book as relevant to section 7701(e)(4) would be beyond the scope of this article.

[17] *Id.* at 51-52.

under section 7701(e)(4), an area in which guidance would be helpful in planning for the renewable energy industry. Unfortunately, no such guidance is expected soon. ■