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Keeping the Cabin in the Family: A Guide to Joint Ownership and Use

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I. Introduction

Why do some family cabins serve as a magnet that pulls the family together, and others become the family battleground, both literally and figuratively? One reason that the transfer of the cabin can be more difficult than other property transfers between family members is that it typically involves a property with multiple uses, often located in environmentally pristine areas, and tends to embody the family's values and sense of identity. Cabins are often located in desirable areas where the property values have increased at a rate far beyond the family's other assets. Cabins also often represent a large percentage of a family's financial holdings, posing unique estate tax and liquidity issues for the senior generation. For the junior generation, keeping a cabin in the family poses financial issues, and brings with it the challenge of reaching a consensus among family members as to how to deal with this.

This article outlines some of the estate planning tools for transferring the family cabin. Transferring the property is relatively easy compared to maintaining harmony among its owners following the transfer. Methods of management and organization to accomplish this more daunting task are also discussed below.

II. Creating a Master Plan

Before a plan to transfer the family cabin to the next generation can be implemented, the family needs to reach a consensus as to what will be done with it. A plan imposed by a senior generation upon the junior generation is almost always doomed to fail. The most successful plans involve detailed and thoughtful advanced planning involving both generations.[1]

The first step in creating a master plan is to interview the family. Ideally, a neutral third party facilitator or mediator trained in this style of communication would conduct interviews of each family member.[2] The interview process is an opportunity for each family member to express his or her wishes and apprehensions with respect to the property. The neutral third party should prepare a report summarizing the findings, identifying areas of consensus, if any, and pointing out areas where feelings and opinions diverge. This report can be shared with the family members and used by the members of the senior generation and their attorney to begin to develop the master plan.

In some cases, the family members can make decisions with respect to the property jointly. Ideally, a series of family meetings would be held by a facilitator to resolve areas of dispute, further define areas of agreement, and continue building a consensus. Of course, the use of a facilitator in estate planning is not going to be accepted by all clients. At a minimum, the lawyer could offer to distribute a survey to family members. As a result of the facilitator's work or the lawyer's survey, the senior generation may discover that some or all of the members of the younger generation have no interest in retaining the cabin. They also may be able to determine the apprehensions of those who do want to retain the cabin, and resolve those issues before the cabin becomes a battleground.

continued on next page

Table of Contents

Keeping the Cabin in the Family: A Guide to Joint Ownership and Use ... 1
Tenancy in Common Fractional Interest Programs ... 8
Document Integrity in the Electronic Age ... 18
Recent Developments: Probate and Trust ... 20
Recent Developments: Real Property ... 21
How To Reach Us ... 24

continued from previous page

Keeping the Cabin in the Family: A Guide to Joint Ownership and Use

Often, the next step in developing a master plan is the creation of a mission statement to address the family's goals and values with respect to the cabin. Issues to address in the mission statement could include: (1) What is most important to the family about the cabin? (2) What does the family value most about how it uses the cabin? (3) How would the family like to see the ownership of the cabin affect the ways the various members interact?

It may be determined that the property should be divided for different purposes rather than transferring all of the property to the next generation as part of the master plan. Different uses may include: (1) development; (2) conservation; and (3) residential use. Estate planning techniques to accomplish each of these objectives are discussed below.

III. Development of Property

As part of the master plan, the family may decide to sell some of the property to raise funds to maintain what is remaining, and/or to reduce the ongoing costs of maintaining the property. The proceeds can be set aside in a trust to maintain the property, or transferred with the cabin into any of the entities discussed below for ongoing management of the cabin.

IV. Conservation and Preserving Open Space

Frequently, families determine that certain portions of their land should be preserved as open space, and may choose to restrict development or other uses. There are several ways this can be accomplished.

a. Conservation Easements

One common way to restrict development is with a conservation easement. A conservation easement is a permanent restriction on the use of privately owned land that promotes land conservation by preventing most types of land development.[3] The Internal Revenue Code permits income and gift or estate tax deductions for a grant of a conservation easement over certain real property.[4] The Treasury Regulations set forth detailed requirements for deductibility.[5] Typically, a conservation easement reduces the value of the underlying property, thus reducing transfer tax costs.

There is a three-prong test to determine whether a gift is a qualified conservation contribution:

i. The property contributed must be a "qualified real property interest." In other words, it must be a perpetual interest in land.[6]

ii. The property must be donated to a "qualified organization" that will enforce the easement and has a commitment to protecting the conservation purposes of the donation.[7]

iii. The gift must be exclusively for "conservation purposes,"[8] which means that it must satisfy one or more of the following three purposes:

(1) Preservation of land areas for recreation or education of the general public;

(2) Preservation of a natural habitat of fish, wildlife or plants; and/or

(3) Preservation of open space, including farmland and forestland, for the scenic enjoyment of the public, or pursuant to a clearly delineated federal, state or local conservation policy that will yield a "significant public benefit."

Few families want to open up their land for use by non-family members. So, preservation of a natural habitat and preservation of open space are more likely to be useful conservation purposes than preservation of land for use by the general public.

A family may want to convey a conservation easement yet retain certain development rights over the property. There are two ways to accomplish this: The "reservation method" and the "carve-out method." The reservation method permits the grantor to convey an easement over an entire parcel, and reserve a right to develop a discrete number of lots (e.g., one single-family dwelling for every 40 acre parcel) on the property. The carve-out method permits the grantor to carve out specific portions for development. The carve-out method allows the parcels not subject to the easement to be developed, and often enhances the market value of these parcels because of their proximity to the parcels subject to the conservation easement. Both methods may be useful in the development of the family's master plan.[9]

b. Direct Gifts to Charity

In some cases, it may make sense for the family to contribute land that is environmentally sensitive directly to a charity that will hold and protect it. A direct gift eliminates the cost and complication of establishing a conservation easement. It will also entitle the donor or donors to either an income and gift tax deduction for an inter vivos gift or an estate tax deduction at death.

Many parts of the country have local land trusts or land banks, which are nonprofit organizations established to protect and preserve valuable open space and environmentally sensitive land. A land trust or land bank can either take title in fee simple or hold a conservation easement over property.

Where property is contiguous with public land, it may also be possible to donate the property to a government agency. However, there are limitations. For example, Congress determines the boundaries of national parks, and donations of real property are only permissible within those boundaries. Thus, even where land is contiguous with public land for National Park purposes, a land bank may be a more feasible donee.

continued on next page

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continued from previous page

Keeping the Cabin in the Family: A Guide to Joint Ownership and Use

c. Gifts to a Charitable Entity

Another method of making a charitable gift is through the use of a private foundation or a supporting organization. A charitable contribution gift and a related income tax deduction are permitted for the value of an inter vivos charitable gift.[10] If the contribution is made at death, an estate tax deduction is allowed for the value of the contribution.[11]

i. Private Foundations

A private foundation is a charitable entity that may be controlled by the family members and is exempt from income tax under I.R.C. §501(c)(3). The foundation would need to be established and operated to use the property exclusively for charitable or educational purposes that will confer a benefit upon the public and *not the donors or their family members*. Public uses include hiking and riding trails, and open spaces that can be viewed by the public.

Private foundations are subject to strict regulation and scrutiny by the IRS, and are generally limited to passive grant making to public charities, which are to receive distributions of income from the foundation. Among the many compliance limitations that apply to private foundations and their donors, the donor family will not be able to use or have access to the donated property in any manner that is more advantageous than the public's access to the property.

The tax benefits of a private foundation are somewhat restricted. However, in spite of the many technical compliance requirements, in the appropriate situation the private foundation can provide a family with considerable flexibility in its charitable giving. The family of a private foundation donor may control the management of the foundation. Specifically, the foundation could use the funds to perpetuate the preservation of environmentally sensitive or pristine land.

ii. Supporting Organizations

A "supporting organization" is another form of family foundation, which is described under I.R.C. §509. Generally, the tax benefits of a supporting organization are more generous than those of a private foundation, but the donor does not retain as much management or control over the use of the donated property. While more costly to establish, a supporting organization offers significantly greater freedom from technical compliance requirements and is often the preferred charitable vehicle.

A supporting organization could be funded, in part, with a portion of the family's real property intended to be set aside for conservation purposes. The supporting organization could then support another charity, such as a state or local public park agency, land trust, historical society or conservation organization, by donating the land to a supported charity and/or providing funds for the supported charity to conduct conservation programs on the land.

V. Transferring the Cabin from the Senior Generation to the Junior Generation

Once the portions to be set aside for preservation and development (if any) have been identified, the linchpin of the master plan is transferring the cabin to succeeding generations.

a. Outright Gifts

An outright gift to the younger generation (or to a trust for its benefit) will transfer the value of the property and all future appreciation, thereby reducing the taxable estate value of the senior generation.[12] If the gift is given as undivided interests in real property, it may also be possible to apply minority and other discounts to further reduce the value of the gift for gift tax purposes.

Under current law, the annual exclusion from gift tax allows an individual to transfer up to $11,000 per year, per donee, without

continued on next page

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Keeping the Cabin in the Family: A Guide to Joint Ownership and Use

incurring any gift tax consequences.[13] Accordingly a married couple may transfer up to $22,000 to each of their children (or other third parties) annually free of gift tax. In addition to the annual exclusion, an applicable credit of $555,800 allows each taxpayer to transfer $1,500,000 free of federal gift tax during life or at death.[14]

Gifts at death are entitled to a full stepped-up tax basis to date-of-death fair market value.[15] Inter vivos gifts, on the other hand, only retain a carry-over basis equal to the basis in the hands of the donor, plus the amount of gift tax paid on the appreciation.[16] Thus, in a nontaxable estate, it may be best to retain property until death in order to take advantage of the stepped-up basis.

b. Qualified Personal Residence Trusts

One estate planning technique that can be effective for transferring real estate between family members is the qualified personal residence trust or "QPRT."[17] A QPRT permits a homeowner to make a gift of a personal residence (i.e., a primary residence and/or a vacation home, along with a reasonable amount of surrounding property) to a trust for the benefit of children or other beneficiaries at a reduced gift tax cost.[18] The grantor may reserve the right to live in the house for a number of years (a "reserved term of years"). During the trust term, the grantor may use the residence rent-free. Upon expiration of the trust term, the residence is distributed to the remainder beneficiary or beneficiaries (usually the grantor's children), or continues in trust for their benefit.

The value of the gift is the fair market value of the residence at the time of transfer to the QPRT, decreased by the value of the reserved term of years (determined according to IRS tables).[19] Generally, a longer reserved term produces a correspondingly lower value of the gift for gift tax purposes. The grantor consumes a portion of his or her applicable credit when the transfer is made to the QPRT (or, if the applicable credit has been exhausted, the transfer is subject to gift taxes that year). At the end of the trust term, the residence passes to or for the benefit of the children with no further gift or estate tax consequences. As a result, all appreciation that occurs during the trust term is "shifted" to the children free of gift or estate tax.

There are three main drawbacks to the QPRT. First, the residence passes to the children (or other beneficiaries) outright or in further trust upon the expiration of the reserved term of years. If the grantor wishes to continue to occupy the residence at the end of the reserved term, the grantor must pay rent to the beneficiaries. Second, if the grantor fails to survive the term of years, the entire value of the trust's interest in the residence at the grantor's death will be included in the grantor's estate for estate tax purposes. The effect will generally be the same as if the QPRT had not been established. Third, QPRT property is not entitled to the step-up in basis that would otherwise be available at the time of the transferor's death, because the stepped-up basis is available only if the property is included in a decedent's estate.[20]

c. Other Types of Trusts

i. Irrevocable Trusts

An irrevocable trust (other than a QPRT) can be a vehicle for giving a home to a younger generation during the senior generation's lifetime. The trust can name beneficiaries and grant others the power to expand the number of beneficiaries. Parents can give their children and grandchildren (or others) annual exclusion gifts in the trust owning the real estate or larger lifetime gifts that consume a portion of their applicable exclusion amount.

For most families an irrevocable trust is not the preferred arrangement. Duration may be limited by the applicable rule against perpetuities. Where a house is intended to be held in trust for future generations, the trust is often established with an endowment to cover future expenses. However, as the value of the property increases (which it often does in desirable vacation spots), the endowment may prove to be insufficient to cover expenses. Furthermore, trust terms can be difficult to amend when unanticipated changes of circumstance or desires warrant. Similarly, ownership interests cannot be adjusted over time to account for unequal contributions of money or labor. Also, it is difficult to add new owners who are not lineal descendants of the trust founder.

Trusts also raise fiduciary duty issues. Typically, one generation would be the lifetime beneficiaries of the trust. They may also serve as trustees and make certain decisions that would benefit them individually over the interests of the remainder beneficiaries, violating the fiduciary duty of loyalty. Many of these issues may be avoided by using other types of entities.

ii. Revocable Trusts

The senior generation may consider using a revocable trust to transfer ownership of the cabin at a later date. A revocable trust offers the senior generation an opportunity to plan for the management of the cabin without making those plans final because the grantor or grantors retain the right to revoke or amend the trust. Typically, the parents would serve as the initial trustees and they would name their successors, should they become unable to serve or choose to resign. Upon the death of the grantor or grantors, the trust would become irrevocable and continue for the next generation, or it could terminate and distribute its assets to named beneficiaries pursuant to its terms.

For a senior generation starting to plan to transfer the cabin but not willing to make those plans irrevocable, the revocable trust is an excellent first step.

d. Family Limited Liability Companies

Formation of a family LLC (or family limited partnership)[21] may provide a useful vehicle for transferring a cabin to younger generations. The business purpose of the LLC would be the ownership and management of valuable real estate.

continued on next page

continued from previous page

Keeping the Cabin in the Family: A Guide to Joint Ownership and Use

Management of an LLC may be by all of the members who vote by percentage interests. Alternatively, one or more managers may govern an LLC. A manager form of LLC permits the transfer of ownership interests to other family members while maintaining control in one or only a few. Thus, Mom and Dad could name themselves as managers and retain the right to decide the use of the home, make repairs and improvements, and, in general, run the home as they wish. At the same time, they may give significant portions of the value of the home to the next generation.

Gifts of LLC interests can be structured with very favorable tax results. Mom and Dad each may give up to $11,000 per year to each other family member ($22,000 in total). If the gift is to come within the annual gift tax exclusion, only a small percentage interest can be given to each recipient in each year. Small annual gifts become significant ownership interests, however, if repeated over a number of years. As an alternative, the senior generation may gift an amount in excess of the gift tax annual exclusion. The excess uses part of the lifetime gift tax exemption amount (currently $1,500,000 per donor).[22]

Valuing a percentage interest gift is a two-step process. The first step is to value the company property, *i.e.*, the vacation home (and other assets owned by the LLC). This is done by obtaining an appraisal from a competent real estate appraiser. The second step is to value the fractional membership interest that constitutes the gift. This requires a second appraisal by a person qualified to value fractional interests in business entities. The second appraisal takes into account the facts that the asset is a minority interest, it lacks control, and little, if any, market exists for such an interest. The result of the second appraisal is likely to be a discounted value of 20% or more from the proportionate share of the total value. Thus, the membership interests typically can be transferred on a very favorable gift tax basis

In addition to gift or estate tax benefits, gifts of LLC interests over time provide for the gradual and orderly transfer of responsibility and management. At the same time, the senior family members may retain significant control over management by naming themselves as managers of the LLC. The LLC agreement may also contain transfer restrictions to prevent the sale to an outside party without unanimous consent of the members.

An LLC can protect its underlying assets from the claims of creditors in the event of a lawsuit, the bankruptcy of a member, court judgment, tax lien, or from claims of a non-family member spouse in the event of divorce. The limited liability company also offers the added advantage of limited liability for its members, even if all of the members are involved in management.

Unlike trusts, LLCs can have perpetual existence. The controlling documents are much easier to amend than a trust agreement. It is also possible to alter LLC ownership, whereas it is not usually an option with trusts.

The main disadvantage of the LLC is the potential loss of the exclusion of the capital gain on sale under I.R.C. §121[23] upon a later sale of the property. This exclusion is not available if the cabin is sold as an asset of an entity such as an LLC. In addition, in order to establish an LLC, there are legal fees that some families may not want to incur, and there will be ongoing legal and accounting fees to maintain the entity. Because the LLC operating agreement may be amended or even terminated if all of the members agree, there may be less long-term certainty than the senior generation would prefer.

Finally, LLCs can be used to "freeze" the value of the property interests retained by the senior generation.[24] Chapter 14 of the Internal Revenue Code and the regulations thereunder impose detailed restrictions on how LLC interests may be structured to insure that the appropriate value is attributed to the senior family members when they have transferred LLC interests to younger family members.[25] This type of transaction transfers property that is *not likely* to appreciate to the senior generation, while transferring an interest in the same property that is *likely* to appreciate to descendants, either simultaneously or shortly after the first transfer.

e. Sales to Family Members

In addition to the transfer techniques discussed above, property can be sold by the senior generation to members of the next generation.[26] A sale eliminates appreciation in value of the property from the estate of the senior family member. Sales can be structured as outright sales for cash, installments sales, an installment sale with a self-canceling installment note that will cancel on the death of the senior family member, or an exchange for a private annuity.

VI. Ongoing Management of the Cabin

a. Written Agreements

Once the property transfer method has been decided upon, the family will need to put into place a mechanism to manage the property, resolve conflicts, and facilitate maintenance of the property.[27] This agreement may be in the form of, for example, a joint venture agreement, LLC operating agreement, trust agreement, contract, tenancy in common agreement, or bylaws. For most families, an agreement where all members have consented to the terms tends to be more successful than an agreement imposed upon them by the senior generation, whether under a trust or other form of binding contract.

b. Issues to be Addressed

In order to assure the smooth operation of the vacation home for the extended family, the agreement needs to facilitate ongoing use and resolve issues that may arise. The following is an outline

continued on next page

continued from previous page

Keeping the Cabin in the Family: A Guide to Joint Ownership and Use

of only some of the issues that should be addressed in the agreement.[28]

i. A schedule for use of the cabin.

ii. Determine whether outsiders should be allowed to use the cabin, on what basis (*e.g.,* will outsiders only be allowed to use the cabin when accompanied by a family member/owner), and whether they will be charged rent.

iii. Establish rules applicable during the time that the cabin is in use.

iv. Determine how maintenance and repairs are to be handled.

v. Establish annual membership dues or rent (normally equal in amount per member).

vi. Levy special assessments (generally proportionate to percentage ownership interests) if annual membership dues are insufficient.

vii. Establish usage fees (to reflect actual use of the property by members). The use of membership dues, special assessments, and usage fees allows the managers to spread the financial burden among members in a manner that reflects differing amounts of use and differing percentage ownership interests. This promotes fairness between those who frequently use the property and those who are unable to enjoy it regularly.

viii. If there are to be a manager or managers, who should serve in that role? Should a successor manager be identified? If multiple families own the property, should there always be a manager from each family?

ix. Determine whether outsiders can become owners.

x. Determine whether family members should be allowed to withdraw. If they are allowed to withdraw, what value will they receive? (A withdrawal may place a definite financial burden on the remaining members.)

xi. Determine how to handle the periodic replacement of improvements such as a dock or a deck.

xii. Determine how ownership rights may be transferred and how to deal with the financial crisis of an owner (bankruptcy, judgment, tax lien, marital dissolution) resulting in a lien against the property.

xiii. Establish a procedure to resolve future disputes.

c. Suggested Terms

The following is a collection of terms that have worked for other families in the ongoing management of their cabins.

i. A family manager shall be appointed to do the following: (1) maintain the property in its current condition (capital improvements to be made only with authorization unless urgent or to protect the property); (2) maintain insurance with specified coverage and limits; (3) pay taxes and other specified charges; (4) lease the property, with specific authorization, to tenants; (5) keep records and render accountings at specified times; and (6) take reasonable compensation and reimbursement of reasonable expenses. The beneficiaries have a duty to reimburse promptly all proper expenses assessed by the manager, with appropriate conditions relating to various classes and amounts of capital expenditures.

ii. The beneficiaries have rights of contribution among themselves.

iii. The right of use and occupancy is allocated by a procedure, which could include any of the following: (1) drawing of straws; (2) rotation; (3) authority of the manager; (4) bid; or (5) some other mechanism (e.g., length of travel, age, lottery).

iv. Transfer of beneficial interests to anyone who is not a descendant (or, in some cases, a spouse of a descendant) is prohibited, except: (1) under a right of first refusal; (2) by gift or bequest to a descendant of a certain common ancestor; or (3) by transfer to anyone else, but subject to a condition subsequent by which the family can buy the interest from the transferee.

v. Withdrawals may be permitted, but to discourage a withdrawal that is motivated primarily by the desire to cash in on inflated real estate values, the payout might be at a reduced value (e.g., 80% of market value) and be extended over several years (e.g., over 10 years at a below market interest rate).

vi. The members may be given the right to purchase an interest that goes outside the family as the result of a divorce or bankruptcy.

vii. Owners may be given the right to vote on unusual events such as obtaining a mortgage for the property, leasing the property to a nonmember selling the property, and amending the rules or operating agreement, in the case of a cabin held in an LLC.

continued on next page

continued from previous page

Keeping the Cabin in the Family: A Guide to Joint Ownership and Use

viii. To provide a check against arbitrary management, the owners should be given the right to call a meeting to review the decisions of the manager.

d. Family Homeowners Associations

If several residences have been built on the family property, or there is a possibility that several could be built, the family ought to consider the formation of a homeowners association to facilitate the ongoing management of the family property. A homeowners association is a formal legal entity created to maintain common areas and facilities, and enforce common covenants and restrictions. A homeowners association is especially useful where the family intends to create or retain common facilities such as a dock or swimming pool. Generally, the procedure to create a homeowners association is to subdivide the property, and cause each lot to be subjected to a set of common restrictions and covenants.

The covenants could: (1) identify common open space and common use facilities; (2) restrict or limit development of the affected parcels; (3) provide guidelines for, or a mechanism to review, construction and development; (4) establish aesthetic and design standards; (5) establish use restrictions; (6) establish penalties to encourage compliance; and (7) restrict transfers or create rights of first refusal if an owner wishes to sell, or if their interest is subject to a bankruptcy or other type of lien.

A homeowners association can be formed as a partnership, LLC, or a not-for-profit association. Typically, each lot owner is required to be a member.[29] A homeowners association is funded by dues or assessments from the owners. If organized as a not for profit entity, it can qualify for an income tax exemption for revenue received from its members under I.R.C. §528.

The rules and regulations of the homeowners association could be established by the senior generation before transferring the property to the junior generation. Or, the junior generation could jointly develop its own association rules.

VII. Life Insurance and Irrevocable Life Insurance Trusts

In situations where it is available, life insurance can provide an effective means of creating a fund to support maintenance and other expenses associated with cabin ownership.[30] Taxation of life insurance proceeds can be avoided under present law if a trust, instead of the insured, owns the policy.[31] The insurance trust, if established as part of a master plan to transfer ownership of a cabin, can provide that the policy proceeds will continue to be held in the trust and used to maintain the cabin and to cover related expenses.

VIII. Planning Ahead

Finally, for the client who is still in the planning stages of purchasing a second home, there is an excellent article outlining important considerations in connection with this purchase.[32]

IX. Conclusion

The family cabin is an asset that often serves as a symbol of a family's history, emotions and values, a focus of all that is good in the family. It is important to recognize that the cabin also embodies negative emotions for some family members. While some cabins are likely to be retained by succeeding generations, others are likely to be sold because the younger generation has no emotional attachments to it, can't agree on how to retain it, or simply can't afford it. Understanding the attitudes toward the cabin held by various family members and building consensus is critical in order to assist the family in developing a master plan to transfer and to continue to happily own the cabin, if that is the goal.

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1 *See* James S. Sligar, *Estate Planning for Major Family Real Estate Holdings*, 133 Trusts & Estates 148 (Dec. 1994) for a comprehensive discussion of master plans.

2 *See* Olivia Boyce-Abel, *When to Use Facilitation or Mediation in Estate and Wealth Transfer Planning*, Family Office Exchange, Vol. 9 No. 35 (1998) for a discussion of the role of a facilitator.

3 For a comprehensive analysis of conservation easements and their uses, *see* Russell J. Speidel, *The Use of Conservation Easements, Land Trusts, and Community and Private Foundations in Charitable Giving and Estate Planning*, Real Property, Probate & Trust Section of the Washington State Bar Association Midyear (#03704B, June 2003).

4 I.R.C. §§170(h), 2055(f) and 2522.

5 Treas. Reg. §1.170A-14.

6 Treas. Reg. §1.170A-14(b)(2).

7 I.R.C. §170(h)(3) and Treas. Reg. §1.170A-14(c)(1).

8 *See* I.R.C. §170(h)(1)(C) and §170(h)(4).

9 Robert J. Petix, Jr., *Postmortem Conservation Easements: Substantial Estate Tax Savings*, 30 Estate Planning 273, 276 (2003).

10 I.R.C. §170(h) and §2055.

11 I.R.C. §2522.

12 Mark B. Edwards, *Protecting the Castle: A Manual for Defenders of the Keep*, 32nd Annual Philip E. Heckerling Institute on Estate Planning, University of Miami Law Center at 12 (1998).

13 I.R.C. §2503(b).

14 The exclusion is scheduled to increase in phases (for estate tax, but not gift tax purposes) to $3.5 million by year 2009, and expire in 2010. I.R.C. §2010 and I.R.C. §2505. Gifts qualifying for the annual exclusion do not use up any portion of the donor's remaining applicable credit. Once a taxpayer has used up his or her applicable credit, gifts are subject to federal tax pursuant to a graduated and cumulative rate of gift tax. I.R.C. §2501. Assets transferred at death, in the excess of the taxpayer's remaining applicable credit, are subject to estate tax at the same graduated rates applicable to gifts. I.R.C. §2502 and I.R.C. §2001(c). In some states, including Washington, there may also be a state estate tax over and above the amount owed at the federal level. EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001 Pub.L. No. 107-16) phases out the I.R.C. §2011 credit for state death taxes. The unified credit allowable through the year 2011 under I.R.C. §2010 is set forth below:

Year(s)	Federal Exclusion	Federal Unified Credit
2004 – 2005	$1,500,000	$555,800
2006 – 2008	$2,000,000	$780,800
2009	$3,500,000	$1,455,800
2010	Repeal	Repeal
2011	$1,000,000	$345,800

Some states define their state estate tax as an amount equal to the maximum federal credit for state death taxes paid. In those states, no additional state estate tax would be due. Others have defined the state tax by reference to a federal credit based on a specific amount of federal tax exemption. In these states, additional estate tax may be due if the federal credit amount exceeds the state credit amount. *See* David Keene and Marcia K. Fujimoto, *EGTRRA's Changes to the State Death Tax Credit: Good News for Some Estates, Bad News for Some States*, 81 Taxes 23, 25 (Nov. 2003).

continued on next page

Tenancy in Common Fractional Interest Programs

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The tenancy in common fractional interest program ("TIC Program") is a relatively new and rapidly growing segment of the real estate industry. TIC Programs allow real estate companies to free up significant amounts of equity captured in commercial properties without sacrificing control and ongoing management rights. Smaller 1031 investors once condemned to finding identically-sized replacement properties—more often than not in a mad dash to beat a 45-day identification and 180-day closing period imposed by IRS regulations—now have the ability to pool funds and purchase large commercial properties. The TIC Program offers such investors an opportunity to escape the drudgery of day-to-day management of their commercial properties by purchasing a tenant in common interest in larger, professionally managed properties. The broker-dealer community, which is often the conduit between TIC Program sponsors and 1031 investors, also views the TIC Program as an enormous opportunity and has begun to position itself to serve as a clearinghouse for investors in managing their investment portfolios. As with all burgeoning industries, there are tremendous opportunities and risks that accompany the TIC Program. While many practitioners will be reminded of the days of syndicated limited partnerships when evaluating the relative merits and risks of the TIC Program, there is no denying the dramatic and continuing growth of the TIC Program industry across the country.[1]

The TIC Program is premised on a complex ownership arrangement and is therefore typically suited for an institutional grade commercial property. In fact, most TIC Programs usually involve property that is subject to a triple net lease with a single tenant or subject to a master lease with multiple subtenants or may involve multiple leases managed by someone other than the tenants in common pursuant to a management agreement.

Under a typical TIC Program, the sponsor owns or has acquired the right to purchase the subject property and seeks to sell some portion of its equity in the property or to find equity to buy the property. The sponsor sells undivided tenancy in common interests to investors looking for replacement properties pursuant to Section 1031 of the Internal Revenue Code ("Code"). The sale typically occurs through the retail broker-dealer community which receives commissions (often called the "sales load") from the sponsor. Rather than sell partnership or membership interests to investors, the sponsor sells undivided fee interests allowing the investors to claim under Section 1031 of the Code a deferral of their capital gains tax liability accrued upon sale of the formerly owned properties. The replacement property is owned by multiple tenants in common that pool funds with other similarly situated investors to acquire property worth far more than any single investor could acquire by merely reinvesting the proceeds from his or her own relinquished property. The day-to-day responsibility for the commercial property is typically allocated back to the sponsor or its affiliate through a master lease or management agreement. The rights and obligations of the tenants in common are governed by the master lease or a tenancy in common agreement. The lender has a deed of trust on property owned by multiple tenants in common. Although relatively straightforward in theory, negotiating and documenting a TIC Program transaction is quite complicated due to the large number of complex technical issues inherent in TIC Program transactions.

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Keeping the Cabin in the Family: A Guide to Joint Ownership and Use

15 I.R.C. §1014(a).
16 I.R.C. §1015.
17 *See* Edwards, *supra* at 15-21 and Kevin M. Flatley, *Estate Planning Strategies for Real Estate*, 27 Estate Planning 222, 223 (2000).
18 I.R.C. §2702.
19 Treas. Reg. §25.2702-5.
20 I.R.C. §1014(a).
21 Sligar at 55.
22 *See supra* note 1 and accompanying text.
23 The Taxpayer Relief Act of 1997, Pub.L. No. 105-34, amended I.R.C. §121 (formerly providing a one-time exclusion of gain from sale of a principal residence by an individual who has attained age 55) to permit exclusion of up to $250,000 of gain by an individual or $500,000 by a married couple on the sale or exchange of a principal residence, if the property was a principal residence for 2 of the last 5 years.
24 Sligar, *supra* at 54.
25 Treas. Reg. §25.2701.
26 Sligar, *supra* at 55.
27 *See* Louis H. Hamel, *Keeping a Vacation Home in the Family for Younger Generations*, 23 Estate Planning 123 (March/April 1996) for an analysis of the managerial issues and suggested planning techniques.
28 *See* Ken Huggins & Judith Huggins Balfe, *How to Pass It On: The Ownership and Use of Summer Houses* (1999) at ch. 5.
29 *See http://www.oxfordconsulting.net/terminology.htm* for a discussion of the structure and terminology used in connection with the formation and governance of homeowners associations (last visited January 26, 2004).
30 For a comprehensive analysis of life insurance trusts and their uses, *see* Howard M. Zaritsky & Stephan R. Leimberg, *Tax Planning With Life Insurance: Analysis With Forms* (2002) and Sebastian V. Grassi, Jr., *Income, Gift and Estate Tax Aspects of Crummey Powers After the 2001 Tax Act, Part 1*, 18 Probate & Property 37 (Jan./Feb. 2004).
31 I.R.C. §101(a).
32 Liz Pulliam Weston, "*10 Tips for happy second-home ownership: Many families dream of a cabin in the woods or a house at the beach. But the costs and aggravation can be more than you expect,*" *http://moneycentral.msn.com/content/Banking/Homebuyingguide/P61924.asp* (last visited Jan. 26, 2004).

continued from previous page

Tenancy in Common Fractional Interest Programs

Traditional Concerns with a Tenancy in Common

While the tenancy in common ownership structure has existed for some time, it has not traditionally been a favorable mechanism for the ownership and operation of commercial real estate; particularly with the advent of the limited liability company structure authorized under RCW 25.15 *et seq.* and other similar structures. The principal factor in supporting LLC usage over tenancy in common includes consolidation and appointment of a management authority (*i.e.*, an LLC manager), pass-through tax treatment, and liability protection. Lenders also prefer limited liability companies over tenancies in common for a myriad of reasons, including ease of foreclosure, limitation of bankruptcy actions by creation of single-purpose "bankruptcy remote" entities, centralization of management, etc.

In contrast, property owned by tenants in common is actually owned by multiple people or entities.[2] Therefore, a tenancy in common is technically not an entity. Rather, each tenant in common owns an undivided interest in the whole property and has a right to possess and enjoy all of the property, subject to the rights of the other tenants in common. Each tenant in common interest is freely alienable and therefore must be subjected to the lien of any deed of trust if a lender seeks to encumber the entire property. Accordingly, a lender must insist that all of the tenants in common execute or otherwise assume the deed of trust. Each tenant in common has the right to seek partition of the property in kind (actual physical division of the property) or by sale, and each tenant in common is fully liable for any liabilities that arise as a result of the ownership of the property, including environmental liabilities.

IRC Section 1031

Despite the inherent problems with owning commercial property in a tenant-in-common structure, TIC Programs are quickly gaining steam due to compelling tax deferment benefits offered under Section 1031 of the Internal Revenue Code. Section 1031 allows an owner of real property to defer gain (and the immediate obligation to pay capital gains tax thereon) by exchanging the real property held for productive use in a trade or business or for investment for "like kind" real property. The exchange allows the investor to defer gain at the time of the exchange even if the property has significantly appreciated in value. For example, an owner of a $2,000,000 multi-family project may exchange the project for a small shopping center of equal or greater value without the immediate obligation to pay capital gains tax. The owner's tax basis in the multi-family project (the "relinquished property") becomes the owner's tax basis in the shopping center (the "replacement property"). The built-in gain is effectively deferred until the sale of the replacement property occurs unless the owner elects to consummate a subsequent exchange pursuant to Section 1031. It is important to note that an interest in a limited liability company, partnership, corporation or similar entity does not qualify as "like kind" property under Section 1031.[3]

1031 Disadvantages: Time Contraints, Like Property Issues, Replacement Value

The tax deferment benefits offered by Section 1031 can provide a significant advantage to owners of commercial real estate. However, use of Section 1031 requires compliance with numerous regulations and imposes certain limitations. Most real estate practitioners know, for example, about the 45-day and 180-day requirements.[4] An owner selling real estate and complying with the various Section 1031 requirements (such as making sure that any sales proceeds are held with a "qualified intermediary" so that the owner does not have constructive receipt of the sales proceeds) must additionally identify replacement property within 45 days of the closing of the relinquished property and must close the purchase of the replacement property within 180 days of the relinquished property closing. Many owners find it very difficult to find suitable replacement property within 45 days. Section 1031 offers some flexibility to owners by allowing the owner to identify up to three properties.[5] However, finding an appropriate replacement property that meets the needs of the owner can take a significant amount of time. The 180-day closing period is also problematic. Often times, replacement property transactions don't close as scheduled due to delays in procuring equity and debt financing, due diligence review, environmental problems, etc. Section 1031 provides little to no accommodation for such delays. If the owner does not comply with the 45- and 180-day deadlines, the right to defer gains on the sale of the relinquished property is lost. Generally, the capital gains tax on a non-Section 1031 sale of real property is 15% of the total capital gains realized by the owner. This dynamic has forced many owners into a desperate scramble to find replacement properties.

In addition to the 45-day and 180-day requirements, Section 1031 requires that the replacement property be of equal or greater value. Typically, owners don't sell relinquished properties with the intent of procuring additional cash to buy a replacement property with a significantly greater value. Thus, the Code's allowance for the acquisition of a replacement property with a greater value is not particularly useful for most people. Accordingly, Section 1031 is often used by owners to acquire replacement property with a value approximately equivalent to the relinquished property. However, if the owner is merely acquiring another property with a value equivalent to the property the owner previously owned, the owner might not be gaining much.

TIC – Owner Benefits

TIC Programs offer the chance to mitigate many of the traditional problems associated with Section 1031, as well as address other owner goals, such as elimination of active

continued on next page

continued from previous page

Tenancy in Common Fractional Interest Programs

management, use of deferred gains to further leverage real estate value, and diversification of real portfolios by product mix, location, etc. TIC Program sponsors seek to provide investors with a menu of readily available TIC Program opportunities in order to soften the difficulties presented by the 45-day and 180-day rules and the practical necessity of finding identically-sized replacement properties. TIC Program sponsors view their programs as a way to enable significantly more like-kind exchange transactions than would otherwise occur but for the current limitations under Section 1031. The rapid growth in TIC Programs provides strong evidence that a vast, untapped market might exist for TIC Programs under Section 1031.

If we return to our earlier example of the $2,000,000 multi-family project, it is clear that Section 1031 would allow an exchange for another investment property worth $2,000,000 or more in value. Such a project could not be exchanged outright for a $20,000,000 office building, however, Section 1031 would allow the owner to (i) exchange the $2,000,000 project for a 10% undivided interest in the $20,000,000 office building, or (ii) exchange the $2,000,000 project for undivided interests in an office building in Atlanta, a shopping center in Cleveland and a warehouse facility in Spokane. Moreover, the exchange might allow the owner to trade a management-intensive multi-family project for an institutional grade property with stable rents and professional management or for multiple properties diversified by product mix (multi-family, industrial, office, retail) or diversified by location (an emerging market in California, a stable market in Boston, etc.). As noted before, the exchange could not occur if the owner was acquiring an interest in the partnership or LLC that owned the office building, shopping center or warehouse. Rather, the exchange can occur only if the owner is acquiring a tenant-in-common interest.

TIC Program – Is It a Partnership or Not?

Until 2002, (see further discussion below), there was very little guidance from the IRS about the viability of the TIC Program. The most obvious risk for any TIC Program investor was a determination by the IRS that the TIC Program transaction constituted a partnership for tax purposes and therefore would fail to qualify for tax deferment under Section 1031. Recent court and IRS guidance notwithstanding, no clear or objective standard has yet been established to describe when a joint participation or arrangement, in particular a tenancy in common, will not be classified as a partnership for federal income tax purposes. Therefore, such determination must be evaluated on a case-by-case basis pursuant to the facts and circumstances of each case.

A partnership is defined as "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and is not a corporation, trust or estate."[6] The regulations provide in relevant part:

> 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 therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent… However, the joint undertaking merely to share expenses is not a partnership… [M]ere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.[7]

In *Commissioner v. Culbertson*,[8] the Supreme Court indicated that a partnership exists when:

> considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.[9]

Since *Culbertson*, the parties' intent has been the key factor in determining whether a particular arrangement constitutes a partnership for tax purposes. The relevant inquiry post-Culbertson is not whether there is evidence of intent to be treated as a partnership for state law or tax purposes, but rather, whether there is evidence of intent to carry on a business or venture for joint economic gain. Thus, a partnership may be found to exist for income tax purposes even where there is an expressed intention not to form a partnership.[10]

The IRS previously considered the treatment of tenant in common interests in Rev. Rul. 75-374. In this Ruling, the IRS concluded that a two-person co-ownership of an apartment building rented to tenants did not constitute a federal tax partnership. The co-owners employed an agent to manage the apartments. The agent collected rents; paid property taxes, insurance premiums, and repair and maintenance expenses; and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The IRS further concluded that the agent's activities were not sufficiently extensive to cause the co-ownership to be characterized as a partnership for federal income tax purposes.

The conclusion reached by the IRS in Rev. Rul. 75-374 is in contrast with several court decisions in which a co-ownership arrangement was found to be a tax partnership. For example, in

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continued from previous page

Tenancy in Common Fractional Interest Programs

Bergford v. C.I.R., 12 F.3d 166 (1993), 78 investors purchased "co-ownership" interests in computer equipment. The equipment was subject to a seven-year net lease. The investors authorized the manager to arrange financing, collect rents, purchase and lease the equipment, apply rents to notes used to finance the equipment and advance funds to participants on an interest-free basis. The agreement allowed the investors to decide by majority vote whether to sell or lease the equipment at the end of the initial lease term. An investor could assign his or her interest in the property subject to a number of conditions, including obtaining the manager's consent.

The *Bergford* court held that the co-ownership arrangement was a partnership for tax purposes. In reaching this conclusion, the court emphasized the limitations on each investor's ability to sell, lease, or encumber either his or her interest or the underlying property, as well as the manager's effective participation in both profits (through a remarketing fee of 10% of the equipment resale price) and losses (through advances). In *Madison Gas & Electric Company v. C.I.R.*, 633 F.2d 512 (1980), the court held that a co-generation operation conducted by three utilities as tenants in common was a partnership for tax purposes because the parties shared expenses and divided the jointly produced property among themselves. Two other courts reached similar conclusions where a promoter/manager maintained a significant economic interest in the property that was sold to co-owning investors.[11]

Rev. Proc. 2002-22: Guidance for the TIC Program

Despite the case law and IRS guidance to-date addressing the partnership/real estate issue, there has been little meaningful direction or guidance with regard to whether an investor's acquisition of a tenancy in common interest (pursuant to a TIC Program) qualified as "like kind" property. In fact, the distinction between a partnership and a tenancy-in-common remains unclear. For example, both structures have co-ownership of property and a division of the income generated from the property. A co-tenancy exists where the owners' activities are limited, for example, to maintaining the property, renting the property, etc. A partnership exists when the investors join together capital or services with the intent of conducting a business or enterprise and sharing the profits and losses. As seen in partnerships, there often will be situations in which one of the partners acts on behalf of the other partners. In a co-tenancy, each co-owner can act on behalf of and bind only himself or herself. A partnership frequently will engage in business operations, whereas a co-tenancy in real estate usually involves the mere passive ownership of property in which the co-owners benefit from rent and appreciation in the value of the property. As a result, the distinction between a partnership and a tenancy-in-common remains unclear.

In 2002, the IRS provided further direction with the issuance of Revenue Procedure 2002-22 (Rev. Proc. 2002-22). Rev. Proc. 2002-22 created legitimacy in the TIC Program industry and ignited the dramatic growth over the past 3 years. Rev. Proc. 2002-22 outlines 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 issues 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 IRS 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 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; rather 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.

Guidelines

1. Each co-owner's interest in each parcel is identical to that co-owner's interest in every other parcel.
2. Each co-owner's percentage interests in the parcels cannot be separated and traded independently.
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.

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 when the Conditions are not satisfied if the facts and circumstances clearly warrant a favorable ruling.

Condition

.01 *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

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Tenancy in Common Fractional Interest Programs

under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

.02 *Number of Co-Owners*. 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.

.03 *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 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.

.04 *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 (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).

.05 *Voting*. 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 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.

.06 *Restrictions on Alienation*. 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.

.07 *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 sales proceeds must be distributed to the co-owners.

.08 *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-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.

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

.10 *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 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

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Tenancy in Common Fractional Interest Programs

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.

.11 *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 (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 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.

.12 *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. 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.

.13 *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). 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.

.14 *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.

.15 *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.

An extensive discussion of Rev. Proc. 2002-22 and its applicability to typical TIC Programs that are currently in the marketplace is beyond the scope of this article. Some practitioners dismiss Rev. Proc. 2002-22 as nothing more than mere guidelines for letter ruling requests. Other practitioners note that some of the specific guidelines relating to certain aspects of TIC Programs are not relevant to the fundamental partnership/co-ownership issue or practical given the operational requirements of commercial properties. The IRS specifically stated that Rev. Proc. 2002-22 does not establish law or rules for the treatment of tenant in common ownership arrangements; however, it is likely that the guidelines in Rev. Proc. 2002-22 have become and will remain a "safe harbor" for the proper structuring of TIC Programs.

continued on next page

continued from previous page

Tenancy in Common Fractional Interest Programs

Securities Laws: Their Application to the TIC Program

TIC Programs are complicated enough given the tax issues posed by current law and Rev. Proc. 2002-22. However, there are other complicated issues including the application of federal and state securities laws. Because of the pooling nature of the TIC Program, properties are typically subject to management agreements or master leases that address the leasing, management, and operations of the property. A critical issue in the TIC Program industry is the effect of laws that govern the scope of the disclosure obligations to investors and laws that govern the registration, licensing and compensation of individuals who are compensated in connection with TIC Program transactions. Under federal securities law, an investment is considered a security if it is an "investment contract." The United States Supreme Court has held that an investment contract is an investment of money in a common enterprise, with profits derived solely from the efforts of others. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

In two different no-action letters in 1999 and 2000, the SEC noted that TIC interests in § 1031 real estate, subject to a master lease agreement, are securities. (*See* 2000 SEC No-Act. LEXIS 824 (Aug. 23, 2000)(Corporation Finance) and 1999 SEC No-Act. LEXIS 83 (Jan. 19, 1999)(Market Regulation).) In the no-action letter requested from the Division of Corporation Finance in 2000, the proposed activity was specifically described as selling replacement property to owners of real estate held for investment, or for trade or business purposes, in a 1031 TIC Program structure. The SEC did not argue that the activity only involved real estate investments and not securities, and so it could not offer that individual the no-action ruling.

The offering of undivided interests in real estate, together with a management contract or subject to a master lease, is likely an offering of securities in the nature of investment contracts, where the circumstances indicate that the purchasers will acquire the property with the expectation of realizing profits from the efforts of other persons, or where the purchasers enter into a management agreement for the operation of the properties and the sharing of profits.

Some people have argued that because a 1031 TIC Program includes an interest in real estate for 1031 exchange purposes, it cannot be a security for federal or state securities law purposes. While it is theoretically possible to construct a 1031 TIC Exchange that is not a security under federal or state securities laws, such an example is extremely limited in scope. The typical 1031 TIC Program structure involves passive investment with profits generated from the efforts of third parties, such as a master lease or management contract of the property. The critical issue, as the United States Supreme Court has observed, is whether the success of the enterprise is dependent upon third-party efforts. If it is, then it is a security for federal and state securities law purposes. Thus, a 1031 TIC Program would likely not be a security only if the tenants in common undertake every activity necessary for the investment to generate a profit and do not delegate or contract to any third party any of the activities necessary to generate a profit.

The U.S. Supreme Court appeared to resolve this issue recently in *SEC v. Edwards*, No-02-1196 (540 U.S. ______) (2004). This case involved a payphone sale-leaseback scheme in which 10,000 people invested $300 million. The sponsors sold payphones to the public and leased them back with a site lease, management agreement and guaranteed return promise. The SEC brought an enforcement action claiming that the investment scheme was an "investment contract" that required compliance with registration requirements. The Supreme Court agreed with the SEC's position and many people in the TIC Program industry believe that *Edwards* confirms that TIC Programs constitute the sale of securities.

Given that the SEC will likely insist that TIC Programs are subject to federal securities laws, it is prudent for any sponsor to comply with registration exemption and disclosure obligations. Generally, sponsors today will only sell TIC Program interests to accredited investors and rely on Regulation D to avoid registration of the TIC Program.

TIC Program: Requiring Licensed Professionals

Since TIC Programs are considered securities, there are significant federal and state securities law compliance issues to be considered. First, any firm involved in recommending, offering or selling such investments must be a licensed broker-dealer with the National Association of Securities Dealers (NASD) and state securities regulators in every state in which the firm operates or the client resides. Second, any individual who recommends, offers or sells these investments in return for a commission must be licensed as a securities professional—a registered representative—with the SEC, the NASD and the states, and must be associated with a licensed broker-dealer. Any unlicensed individual or firm involved in recommending, offering or selling these investments is likely in violation of federal and state securities laws.

Some have argued that a person who receives compensation for referring investors who ultimately invest in a 1031 TIC Program need not be a registered representative, because that person is an agent of the issuer. Under certain very limited circumstances, there is an exemption from registration as a securities professional for a person who acts solely as the agent of the issuer. Rule 3a4-1 under the Securities Exchange Act states that an associated person of an issuer of securities is not deemed a broker as long as all the requirements set forth in that rule are kept, and the securities are sold in a certain way. One core requirement demands that the person in question "is not compensated in connection with his participation by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities."

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Tenancy in Common Fractional Interest Programs

Broker-dealers and their registered representatives are extensively regulated. Securities regulators impose detailed rules and regulations regarding record-keeping, the suitability obligations of the registered representative and the parallel supervisory obligation of the firm, and the duty to disclose all material information to investors relating to compensation paid arising out of the recommended investments, as well as any other conflict of interest.

James Dawson, the regional head of the NASD in Seattle has expressed the NASD's strong interest in developing the TIC Program industry and maintains that TIC Programs involve the sale of securities and can only be sold by licensed brokers-dealers. There is, however, a clear conflict between the SEC's and the NASD's position about TIC Programs and general state law requirements that stipulate anyone selling "real estate" must have a real estate license issued by the relevant state.[12] It is unclear how this conflict will be resolved. Some say that anyone selling TIC Programs must have both a broker-dealer license and a real estate license. Recently, the Tenant-in-Common Association, a national industry group, has approached the SEC staff to resolve the apparent conflict but has not yet received any response. It is likely that this issue will remain unresolved in the short-term.

Financing Complexities and Lender Requirements

The need for TIC Program financing is growing. Many lenders are dealing with the inherent complexity of TIC Programs and struggling to address multiple ownership issues, management issues, partition rights and other issues inherent to TIC Programs. Many lenders today originate loans for ultimate pooling and sale to the secondary market as commercial mortgaged back securities ("CMBS"). Lenders are quite concerned about whether their loans can be sold on the secondary market and CMBS lenders are working closely with the secondary market rating agencies to develop TIC Program underwriting standards. Delegated Underwriter/Servicer ("DUS") lenders that work with Fannie Mae and Freddie Mac have refused to process TIC Program loans citing the need to develop appropriate underwriting standards. Some portfolio lenders, such as life insurance companies, are exploring the viability of TIC Program loans.

The financeability of TIC Program properties is one of the most significant challenges facing the TIC Program industry. There are few projects that can be financed solely with equity. Most owners believe that effective use of leverage is an important ingredient to long-term asset value. TIC Programs will be forced to find market rate financing that is competitive with financing available to other institutional owners of commercial real estate. Otherwise, TIC Program properties will be burdened by a higher debt load and affect the owners' ability to offer market lease rates and generate the best possible returns. The most competitively priced loans are generally offered today through the conduit (CMBS) or DUS lending markets. Some portfolio lenders are available but the inherent limitations imposed on any one portfolio lender make it difficult for any one portfolio lender to service the debt financing needs for multiple TIC Programs. Since the DUS lenders have pulled back from TIC Programs, TIC Programs must generally be able to satisfy CMBS secondary market requirements to obtain necessary debt financing. A few of the lending issues and solutions for TIC Programs are described below.

(i) Borrowing Entities

Lenders who make loans to TIC Programs must address the multiple ownership issue. As mentioned earlier, each tenant in common has an undivided interest in the property. A lender will require that each tenant in common to execute the loan documents including the deed of trust or assumption agreement to effectively encumber the entirety of the property. The lender cannot be in a position where less than all of the tenants in common are in default or where the lender can only foreclose on a portion of the undivided interests in the property rather than the whole property. Lenders will require that each tenant in common be jointly and severally liable for all of the obligations under the loan documents although most CMBS loans will be non-recourse loans, subject to certain carve-out guaranties. Lenders will impose single purpose entity requirements on each tenant in common and insist that each investor create a limited liability company ("SPE") to take title to the investor's interest in the property and own nothing else other than its tenancy in common interest in the property. A tenant in common's joint and several liability should not adversely affect the actual investor since the SPE will be the entity executing the loan documents and the SPE owns nothing more than the tenant in common interest in the property. Moreover, most CMBS loans will be non-recourse.

In response to sponsors' concern over a 1031 investor acquiring an interest in an SPE rather than actual fee title, the IRS has provided guidance indicating that an SPE is a disregarded entity for purposes of satisfying the "like kind" requirements of Section 1031.[13]

Most CMBS lenders will impose other SPE requirements on TIC Programs depending on the size of the loan and the leverage ratios. Some lenders will require each SPE to be a Delaware limited liability company. Other lenders will require, for loans in excess of $20,000,000, a bankruptcy-remote corporate manager for each SPE, which corporate manager must have an independent director in an attempt to avoid bankruptcy filings. Current law allows the trustee for the bankruptcy estate for any one tenant in common to sell the entire property and divide the proceeds among the tenants in common in accordance with their respective percentage interests. In addition, the bankruptcy of any one tenant in common can stay the foreclosure action by the lender against the property. The bankruptcy risk is multiplied by the

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Tenancy in Common Fractional Interest Programs

number of tenants in common. The overall bankruptcy risks facing a lender force the lender to require that each tenant in common satisfy all of the rating agency requirements to the same extent as if it were the single borrower. As a result, TIC Programs will have to structure investor participation in accordance with all applicable SPE requirements.

(ii) Underwriting

Lenders making loans for TIC Programs will typically underwrite each tenant in common. However, standards will vary dependent upon the overall leverage ratio, the size of the loan, the size of individual percentage interests for tenants in common, etc. Most sponsors will negotiate the underwriting standards with lenders to limit the impact on prospective investors since most CMBS loans will be non-recourse. Minimum underwriting standards require litigation, lien and bankruptcy searches for investors. Lenders are primarily concerned about the ability of individual tenants in common to contest a foreclosure action, file a bankruptcy proceeding or take other actions which obstruct a lender from pursuing its remedies. As a result, lenders are quite concerned about an investor's prior credit or litigation history. Some lenders will impose additional underwriting standards and also require a review of financial statements and tax returns. Prudent sponsors will try to limit underwriting of investors and require time limits from lenders to accommodate the strict Section 1031 time periods applicable to investors.

(iii) Guaranties

Most lenders who provide non-recourse financing insist on non-recourse carve-out guaranties that impose personal liability in the event of fraud, environmental liabilities, misappropriation of insurance proceeds, rents or reserve funds, voluntary bankruptcy, partition actions and violations of due on transfer provisions. Some sponsors will request that only its principals be required to execute the guaranties. Other sponsors try to avoid guaranties that would apply to actions solely within the control of the individual tenants in common, *i.e.*, violation of due on transfer provisions, violation of SPE requirements, voluntary bankruptcy and partition actions, etc. Lenders will often want guaranties from the individual investor that owns the SPE to control an investor's possible bad behavior. Some lenders seek to require any tenant in common to waive its inherent right to partition the property. Unfortunately, this waiver is in direct conflict with Rev. Proc. 2002-22. As a result, most lenders will make the partition action an event of default which is permissible under the Rev. Proc. as a "customary lending practice" or otherwise trigger conversion of the loan from non-recourse to recourse under the carve-out guaranties. Prudent sponsors will also address the partition right by creative call options or similar tactics.

(iv) Centralized Management

Lenders do not want to deal with multiple tenants in common. The lender typically has no relationship with the individual investors. Moreover, the lender is quite concerned about the effective functioning of a property that is left to the hands of a disparate group of investors who have no prior relationship or any other connection. Accordingly, lenders are highly motivated to make sure that a master lease or management agreement stays in place to centralize management functions with the original sponsor or its affiliate. Other lenders require lockbox arrangements to ensure that property rentals are applied first to debt service, taxes, insurance and required maintenance reserves. Most lenders require centralized notice provisions for all tenants in common.

There are a multitude of other issues affecting TIC Program loans, including concerns about the number of investors, the obligations of investors to make "capital calls" or otherwise feed a project when necessary, requisite legal opinions, such as non-consolidation, Delaware non-dissolution, bankruptcy and enforceability, accredited versus non-accredited investors, and investor transfer rights. Lenders, sponsors and investors will continue to work through the issues in an attempt to standardize TIC Program loan requirements in the future.

Conclusion

The introduction of TIC Programs is a rather new development in the commercial real estate industry. TIC Programs offer many advantages to owners of commercial real estate that seek to pull out equity in projects without losing management control. TIC Programs also offer investors the opportunity to convert management-intensive properties for larger properties that are professionally managed, to diversify real estate holdings and to avoid some of the customary limitations of Section 1031. There are significant issues involved in the structuring of TIC Programs, as described in this article. Moreover, the industry faces many of the problems that affected the syndication business, including unscrupulous sponsors more interested in fees than investors, heavy "sales load" problems, tax risks for an improperly structured program, and poor disclosure about the asset performance, (including financial health of project tenants, competition, financing risks, etc.). The number of TIC Programs, sponsors and investors is growing and practitioners have another interesting challenge before them in addressing and resolving many of the issues facing the industry.

* * *

Postscript... Important New Development from the IRS

On July 20, 2004, shortly before this article was published, the Internal Revenue Service issued Revenue Ruling 2004-86. This recent Revenue Ruling could potentially be an important development in the TIC Program industry. The Revenue Ruling

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continued from previous page

Tenancy in Common Fractional Interest Programs

analyzes the use of a Delaware Statutory Trust ("DST") to hold title to property, but nevertheless permits investors to satisfy IRC Section 1031 requirements. Essentially, this recent Ruling addresses whether an investor can satisfy IRC Section 1031 by acquiring beneficial interests in a trust, rather than fee title to the property.

For months, members of TICA and the Investment Program Association sought further guidance on the use of a Delaware Statutory Trust to address one of the more problematic issues affecting the TIC Program industry; namely, the financing complexities inherent in an ownership structure involving multiple owners, rather than one ownership entity. Many of these financing complexities and solutions are addressed above. Nevertheless, the TIC Program industry continues to press for a more efficient financing vehicle than the multiple owner scenario. The IRS finally responded to those requests on July 20, 2004.

A Delaware Statutory Trust (DST), authorized under Del. Code Ann. Title 12, Sections 3801-3824, is an unincorporated association recognized as an entity separate from its owners. Beneficial owners of the DST are entitled to the same limitations on personal liability as afforded to shareholders of a Delaware corporation. In addition, there exist prior IRS Revenue Rulings which provide that a grantor of a trust (who is treated as the owner of an undivided fractional interest of a trust under Section 671 of the Code) is considered an owner of the trust assets which are attributable to that undivided fractional interest of the trust for federal income tax purposes. In contrast, there are prior cases which conclude that when participants in any venture, including an entity which is considered a trust under state law, form the venture to avail themselves of the benefits of that venture for valid business purposes such as profit generation, then the venture will be a separate business entity for federal tax purposes.

In Revenue Ruling 2004-86, the IRS discussed whether the DST at hand should be classified as a trust or a business entity for federal income tax purposes. After analyzing the facts, the IRS concluded that the DST was an investment trust and should be classified as a trust under Procedure and Administration Regulations Section 301.7701-4(c)(1).

After concluding that the DST was a trust for tax purposes, the IRS determined that an investor's acquisition of an interest in the trust constitutes an exchange of like kind property and qualifies under Section 1031 of the IRC. The IRS noted that the investor should be treated as the grantor of the trust because the investor owned an aliquot portion of the trust. Since the owner of an undivided fractional interest of a trust is considered an owner of the trust assets for federal income tax purposes, the investor is treated as owning an undivided fractional interest in the property owned by the trust. Thus, the investor was effectively acquiring "property" when it acquired an undivided interest in the trust.

The IRS drew its conclusions using several very important and limiting assumptions. The IRS noted that a DST would not be considered a "trust" and therefore would be considered a separate entity for federal tax purposes, if the trustee of the DST had significant managerial powers, including the power to vary the investment of the DST beneficiaries. If the DST was considered a separate entity for tax purposes, then any investor's acquisition of an interest in the DST would not qualify for Section 1031 treatment.

The IRS distinguished a DST as a "trust" from a DST that is classified as a separate tax entity for tax purposes based on a number of factors, including the power to renegotiate or refinance debt, the power to renegotiate a master lease affecting the property, the power to make more than minor non-structural modifications to improvements located on the property, and the power to accept additional contributions from beneficiaries that would constitute additional trust assets, etc.

The IRS limited its conclusions to a fact pattern involving a TIC Program Sponsor who obtained a 10-year permanent loan and entered into a 10-year master lease with a tenant based on a fixed rental amount which was not subject to any fluctuation except for a CPI or similar escalator. The TIC Program Sponsor then transferred the property to a DST which sold interests to investors pursuant to Section 1031 exchanges. The Trustee of the DST could not be affiliated with the TIC Program Sponsor or the master tenant. The IRS appeared to require that the Trustee could not modify the lease or the underlying financing, could not accept additional funds from investors for cash shortfalls or significant tenant improvements, could not purchase other assets, etc. The IRS concluded that if the Trustee had such powers it effectively had the power to vary the investment of the DST beneficiaries and take advantage of market variations to improve the investment of the investors. Accordingly, the DST would then have to be considered a separate business entity for federal tax purposes.

Tax and legal professionals are just beginning to explore the overall ramifications of Revenue Ruling 2004-86. Some professionals have already concluded that the ruling offers financing flexibility only for a very few deals that satisfy the strict fact pattern and assumptions used by the IRS. These professionals view the Revenue Ruling as quite limited in its practical effectiveness based on the needs of many commercial properties. Other professionals are hopeful that the Revenue Ruling might be useful for other TIC Program opportunities such as loan assumption transactions which were previously unavailable to multiple ownership structures.

I am actively involved in discussions with a number of national tax and legal experts in assessing the full impact of Revenue Ruling 2004-86 and encourage members of the Washington State Bar Association to contact me for further developments and discussion about the Revenue Ruling or any other issues mentioned in this article. I can be reached at *dvaughn@cairncross.com.*

continued on next page

Document Integrity in the Electronic Age

by Jody M. McCormick, Witherspoon, Kelley, Davenport & Toole, P.S., and
Brian Danzig, Lane Powell Spears Lubersky LLP

It is a transactional lawyer's worst nightmare. You represent the seller of timberland. You participate in the drafting of a purchase and sale agreement, which is heavily and contentiously negotiated. The parties finally come to terms. The closing documents are prepared, reviewed, executed and delivered. Only after closing do you learn that the buyer revised the purchase and sale agreement (the page with the property description) to include 4,000 additional acres (the "Disputed Property"). So as to go undetected, the buyer's lawyer had manipulated the margins of the revised page in the agreement so that when you looked at the next page in the agreement (the page you thought contained all of the last-minute changes), you could not tell that any other changes had been made without reading the revised agreement word for word. After nine years of litigation, including a lengthy and costly trial in which you are a witness and an appeal, your client's new lawyers successfully reform the contract to omit the Disputed Property.

This case actually happened.[1]

In an electronic age, it is easy for an unscrupulous party to manipulate documents. Documents are drafted collaboratively. They are e-mailed, revised, e-mailed, finalized and e-mailed again. Technology promotes efficiency. It saves time and money. All parties and their lawyers will likely have an electronic version of the transaction documents on their computers to be revised (or manipulated) at will.

The purpose of this article is threefold. First, it is to raise awareness of the risk. Many lawyers take a "hands-off" approach to word processing as it is viewed as a secretarial function. Lawyers may not give much thought to or may not know the format in which a document is delivered electronically. As discussed in more detail below, the format in which a document is delivered can increase the level of document manipulation risk. Second, it is to make some suggestions as to how you might better advise your client about and protect your client from document manipulation. Finally, it is to open dialogue. As quickly as technological protections are developed, marketed and implemented, systems are designed to circumvent these protections. Document protection and integrity are issues that require continued attention. Lawyers should discuss with their colleagues and their clients the risks and the tools that can help mitigate those risks.

If you: (1) represent the party drafting the documents; (2) transmit them via facsimile; (3) are responsible for making all changes to the documents; and (4) print final hard copies off of your computer for execution, this article will not be helpful to you. However, if you use e-mail to transmit drafts or final documents, the following are some suggestions that you may wish to consider to lessen the risk that your client will fall victim to eleventh hour unauthorized revisions to legal documents that have transaction altering effects:

1. Start with a Master Document

If you are fortunate enough to be the lawyer charged with the responsibility of drafting the documents, you will have a starting point from which to gauge all subsequent revisions. Keep your first draft and all subsequent drafts. Resist the urge to make changes to the original document. Save all subsequent drafts as new documents on your computer. When you have final versions of the documents, you can then compare the first drafts with the final versions to make certain no unintended changes were made to the documents.[2]

If you are not drafting the transaction documents, ask to see compared documents containing all revisions to the documents using one of the comparison programs mentioned above or create your own master documents for comparison to the final documents by either scanning onto your computer system the first drafts and the final versions for comparison or by acquisition of a PDF conversion program.

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Tenancy in Common Fractional Interest Programs

1 According to the Tenant-in-Common Association (TICA), which is a new national industry group of TIC Program sponsors, broker-dealers and lenders, TIC Programs accounted for approximately $167 million in raised equity transactions in 2001. In 2004, TICA expects more than $2 billion in raised equity transactions for the year. Although these figures are a small portion of the overall real estate industry, the sheer growth in the TIC Program, coupled with its inherent advantages, may foretell a significant change in the way commercial real estate is held in the future.

2 For excellent discussions of the tenancy in common, please see (i) § 1.28 and § 1.31 of Professor William B. Stoebuck's *Real Estate Property Law* (1995) and (ii) Chapter 9 of *The Washington Real Property Deskbook* written by Professor John W. Weaver.

3 I.R.C. § 1031(a)(2)(D).

4 Treas. Reg. § 1.1031(k)-1.

5 *Id.*

6 I.R.C. § 761(a); § 7701(a)(2).

7 Treas. Reg. § 301.7701-1(a)(2).

8 337 U.S. 733 (1949); *see also*, *Commissioner v. Tower*, 32 U.S. 280 (1946).

9 *Id.* at 742.

10 *See Wheeler v. Commissioner*, 37 T.C.M. 883 (1978); *Luna v. Commissioner*, 42 T.C. 1067 (1964); G.C.M. 36436 (Sept. 25, 1975).

11 *Bussing v. Commissioner*, 88 TC 449 (1987); *Alhouse v. Commissioner*, TCM 1991-652.

12 *See*, for example, RCW 18.85 and 18.86 *et seq.* and WAC 308-124.

13 Rev. Proc. 2002-22 and 2002-69.

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Document Integrity in the Electronic Age

2. Use PDF

Unless prior changes in documents formatted in Microsoft Word are properly accepted, it may be possible for the recipient of the documents to reveal the documents' history or "meta data" – meaning any changes in the documents that you may have made prior to delivery of the initial drafts. Imagine the embarrassment (not to mention the client confidences you may reveal) if you use a form from a prior transaction as the basis of the transaction in question and the other side can see all the changes you made in preparation of the initial draft of the document. This can be avoided by converting your documents to a PDF format.

A document in portable document format or PDF format is essentially a snapshot or a photocopy of a document that you can send electronically. The recipient cannot reveal document history. Generally, the recipient cannot alter the document absent special software. There are several PDF programs available commercially.

At a *very minimum*, final documents should be transmitted only in PDF format.

3. Do Not "Accept Changes" Unless You Can Do An Independent Comparison

A party may deliver suggested changes to a Microsoft Word document in red-line format. Microsoft Word allows you to "accept changes" thereby incorporating them into the latest or final version of the document. It will also incorporate any other changes made to the document even if they don't appear in redline. For example, if an unscrupulous party wanted to surreptitiously alter a provision, he or she could change the provision, prior to engaging Track Changes and then make several changes in redline. You, of course, would focus only on the redline changes and would not discover the surreptitious change unless you studied the entire agreement or compared it electronically to a prior version.

To avoid this, have your assistant make the acceptable changes to your master document (saved under a new file name, of course). Therefore, you are in control of all changes made to the transaction documents.

Another way to manage this process is to save the revised draft as a new document on your computer and only then accept the changes. To insure that all revisions are actually shown, you can then use your own comparison software to compare the redraft against the preceding draft. One advantage to this method is that the redraft becomes the newest draft of the master document. By using your comparison software on the next draft, you will be able to show the other party each of the changes you may have made to their redraft.

4. Transmit Final Signature Pages Only to the Parties

Once you have finalized the documents, transmit only signature pages to the parties for signature with the agreement that you are authorized to attach the final version of the documents (the one that you compared as shared with the other side of the transaction) to the signatures. To be sure you have authority to attach the final version of the transaction documents to the executed signature pages; you might send an e-mail that reads as follows:

Jody M McCormick/WKDT
06/22/2004 08:49 AM
To john.lawyer@lawfirm.com
cc myclient@realproperty.com
bcc
Subject Final Documents

Attached you will find the final version and separate signature pages of the Purchase and Sale Agreement. If the Purchase and Sale Agreement meets with your approval, please have your client execute the signature pages and return them to me. By execution of the signature pages, your client authorizes me to attach the text of the final version to said signature pages. Feel free to contact me should you have any questions or concerns about the foregoing.

[ATTACH P&S Agreement Sig Pages.pdf]
[ATTACH P&S Agreement Final.pdf]

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fax (509) 458-2717
jmm@wkdtlaw.com

5. Review Final Documents

Finally, if all else fails or if you do not have the technology available to you to implement some of the above suggestions, you are left doing it the "old fashioned" way and reading each word of the final version of the documents before your client signs.

You can pick and choose from the above suggestions. Not all need to be implemented. For example, if you implement suggestion 1, suggestion 3 is unnecessary. Additionally, there are undoubtedly other ways to maintain document integrity. In the spirit of the final goal of this article, to encourage dialogue, we invite you to share your experiences with document integrity issues and your suggestions for resolving these issues. If there is enough of a response, we will run a follow up article on this topic. Please e-mail your comments or suggestions to Jody M. McCormick at *jmm@wkdtlaw.com*. She will understand if you attach the text of your e-mail in a PDF formatted document!

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1 *See, Pioneer Resources, LLC v. D.R. Johnson Lumber Co.,* 187 Or. App. 341, 68 P.3rd 233 (2003).

2 There are several commercially available programs that allow you to compare various versions of a document showing both stricken and inserted language.

Recent Developments

Probate and Trust

by Colonel F. Betz, Perkins Coie LLP, Seattle

WASHINGTON COURT OF APPEALS, DIVISION II

Vandercook v. Reece, 120 Wash.App. 647 (March 2004, Div. 2)

Summary: Notwithstanding the probate court's erroneous reliance on its own recollection of testimony from the parties' dissolution trial, a community property agreement was effectively rescinded because both parties' actions showed an objective manifestation to rescind one prong of the three-pronged agreement.

Facts: Arthur and Bertalee Reece were married in 1947 or 1948, and remained married until Arthur's death in 2002. Bertalee died shortly after Arthur. In 1981, the couple executed a three-pronged community agreement. In 1991, they each executed a will leaving his or her property to the other or, if the other did not survive, to the same contingent beneficiary.

On October 10, 2001, the couple separated. On November 4, 2001, Bertalee executed a new will leaving all her property to another individual. On November 30, 2001, in conjunction with the dissolution proceeding, Arthur and Bertalee agreed to a restraining order preventing each of them from changing their will without agreement of the parties or further order from the court.

On April 19, 2002, Arthur executed a new will leaving all his community property to an individual other than Bertalee. Two weeks prior to their dissolution trial, on or about July 2, 2002, Arthur and Bertalee agreed to vacate the restraining order, validate any new will that either might already have made, and to manifest their agreement in a formal court order.

According to the judge's later recollection of the dissolution trial, Arthur and Bertalee both testified that they did not intend the community property agreement to be enforced. After the dissolution trial, the court adjourned until a final written decree could be prepared for signature.

Arthur died on August 2, 2002, before the court had entered a final written decree. A few days after Arthur's death, his new will was submitted for probate. The personal representative of Arthur's estate, Vandercook, asked the probate court to declare that Arthur and Bertalee had rescinded the community property agreement prior to Arthur's death.

The probate judge, the same judge presiding over the dissolution trial, noted and relied in part on its own memory of testimony that Arthur and Bertalee had given at the dissolution trial. The judge granted the personal representative's motion, declaring that the community property agreement had been rescinded.

The personal representative of Bertalee's estate appealed the probate court's decision, claiming the probate court erred by relying on its memory of oral testimony given at the dissolution trial.

Discussion: ER 201 sometimes permits a court to take judicial notice of court records. The existence of such records (as opposed to the truth of the contents of the allegations contained therein) is "not subject to reasonable dispute…" The Court of Appeals reasoned that this rule does not extend to a judge's memory of oral testimony from a prior case, the accuracy and contents of which are subject to reasonable dispute. The judge should have been a witness in order to admit his testimony. Thus, the Court of Appeals held that the probate court was not entitled to rely on its memory of oral testimony given at the dissolution trial.

The Court of Appeals, however, continued to analyze whether the probate court's error was harmless or prejudicial. An evidential error is harmless if, without it, the trial court would necessarily have arrived at the same conclusion. Thus, the controlling question was whether the record, viewed independently from the probate judge's recollection, showed beyond reasonable dispute that Arthur and Bertalee rescinded their community property agreement before Arthur died.

A community property agreement is rescinded if and when the parties agree to rescind it. To determine if an agreement is rescinded, Washington courts follow the objective manifestation theory of contracts. Since Arthur and Bertalee agreed to a court order in the dissolution case to validate their new wills, which were inconsistent with the testamentary prong of the community property agreement, they each objectively manifested and communicated to the other their intent to rescind the community property agreement. Thus, the probate court's erroneous reliance on its own memory of the dissolution trial testimony was harmless.

Recent Developments

Real Property

by Scott B. Osborne, Preston Gates & Ellis LLP, Seattle

One of the things that makes the practice of law interesting is to see the different approaches that lawyers take to solving similar problems and how courts deal with these approaches. Two recent cases decided by the Washington State Court of Appeals illustrate how taking what appear to be similar paths to the same goal can end up with vastly different results.

Both *Alby v. Banc One Financial,* 119 Wn.App. 513, 82 P.3d 675 (2003), and *Niemann v. Vaughn Community Church,* 118 Wn.App. 824, 77 P.3d 1208 (2003), deal with an attempt by a grantor of a deed to real property to restrict the use of the property following the conveyance. One approach was successful in allowing the grantor to retain control of the property; the other failed in an attempt to restrict the use of property for church purposes.

Alby, supra, involved what was essentially a gift of a residence to a relative. In 1991, Eugene and Susan Alby sold a house on a real estate contract to their niece, Lorri Brashler, and her husband. The sale price was $15,000, but the value of the house was at least $100,000. Both the real estate contract and subsequent fulfillment deed contained the following restriction:

> RESERVATION in favor of Grantors, their heirs and assigns, an automatic reverter, should the property conveyed herein ever be mortgaged or encumbered within the life time of either Grantor.

The real estate contract also contained a right of first refusal in favor of Alby in the event the niece decided to sell the property.

In 1999, Brashler encumbered the house with two deeds of trust, one securing a debt of $92,000 and the other securing a debt of $17,250. The Brashlers defaulted on the debts in 2000, and the holder of the first deed of trust mortgage foreclosed. The holder of the second deed of trust, Banc One, acquired the property at the trustees sale, and demand that Brashler vacate the premises or pay rent. "She refused to do either." *Alby, supra,* at p. 517.

At this juncture in the proceedings, Susan Alby reappeared. Her husband had died, and she had moved to Nebraska. She initiated a quiet title action, claiming that the property immediately reverted to her in 1999 when the first encumbrance was recorded. The trial court dismissed this claim, finding that the reversion upon encumbrance, and another reversion upon subdivision, constituted an unreasonable restraint on alienation of the property in violation of public policy, and were void. Alby appealed.

The Court of Appeals, Division III, reversed. Under Restatement (Second) of Property: Donative Transfers (1983) §4.2(1), a restraint purporting to forfeit the estate of the grantee that "will terminate at the end of a life (or a reasonable number of lives) in being at the time of the transfer[] is valid." *Alby, supra,* at p. 519. The court noted that the interest of Brashler in the property did in fact vest upon the conveyance, and that interest could be freely conveyed, albeit subject to the encumbrance restriction. The court also rejected the argument that the restriction was an unvested conditional remainder:

> We will not give effect to a provision in a deed that restricts the grantee's right to dispose of the property, unless the deed also includes some mechanism for disposing of the property if the grantee violates the restricting condition. [citations omitted] . . .
>
> The conveyances in [cases cited by Banc One] simply say "thou shalt not alienate." They do not say "or else." As we read these cases, it is the omission of "a provision for reversion, or the like" that renders these restrictions unenforceable restraints on alienation. . . .
>
> The Alby-Brashler deed contains an automatic reverter to the grantor in the event the grantee encumbers the property. This automatic reverter is the necessary "or else" mechanism. It ensures that this property's entire bundle of sticks is presently alienable by *somebody* – just not by Ms. Brashler acting alone. Nothing prevents a potential buyer from consulting the recording system (provided by the state to protect third parties in precisely such a case), discovering the deed provisions, bargaining with Ms. Brashler for her fee simple determinable interest, and then negotiating with Ms. Alby for her reversion interest. The low probability that Ms. Alby would part with her interest at any price does not create a restraint on alienation. She at all times had the *power* to sell her interest.
>
> *Aldby*, supra, pp. 520-522.

Similarly, the court rejected the argument that a restraint on the right to encumber constituted an unreasonable restraint on alienation. The language in the deed served a legitimate purpose of preserving the Alby's right to reacquire during their lifetime a home that they had essentially given to their niece. No public purpose would be served by "depriving the Albys of the right to convey a determinable fee at a fraction of the value of the unconditional fee." *Id.,* p. 525.

The success of the Albys in retaining control of their house through a deed reservation is contrasted to the lack of success of a church in attempting to restrict the future use of its property in *Niemann, supra.* In 1949, the Emmanuel Congregational Church of Vaughn merged with the Vaughn Community Church ("VCC"), and conveyed to the VCC its church property in 1956. The deed contained the following restriction:

continued on next page

continued from previous page

Recent Developments: Real Property

> "TO HAVE AND TO HOLD said property for the perpetual use of Protestant Evangelical Churches of the Community of Vaughn, Washington.

In 1999, members of VCC voted to sell the property in order to build a new church. One of the members of the congregation objected and sued to enforce the use restriction in the deed. The trial court held that VCC held the property in a charitable trust its own benefit and the benefit of others, and that the individual had standing to challenge the sale. The trail court apparently found that VCC had the equitable power under trust doctrine to dispose of the property in furtherance of the interests of the church/

In a somewhat confusing, and poorly constructed opinion, the Court of Appeals, Division II, affirmed the trial court by invalidating the restriction. The court's analysis did not focus on the effectiveness of the original restriction, but rather made its determination by application of RCW 49.60.224. That statute invalidates any provision in a deed which "purports to forbid or restrict the conveyance … thereof to individuals of a specified … creed."

The court noted that the restriction would have the effect of restricting the sale of the property to only those that observed the Protestant Evangelical creed:

> VCC persuasively concludes that the deed language forbids sale to many different people, even many who fall within the classes protected by RCW 49.60.224; therefore, the statute applies and mandates that the restrictive deed language shall be void.
>
> *Niemann, supra,* at p. 834.

Having reached this conclusion, which presumably decided the disputed issue, the court went on to discuss various trust theories that could be applied to reach the same result.

Assuming the court's application of RCW 49.60.224 was correct, even the approach taken in the *Alby, supra,* transaction would not be sufficient to preserve the use restriction. Even if an enforceable automatic reverter upon sale for non-Protestant Evangelical purposes had been included in the deed to VCC, the application of the statute would void the restriction. Applying the statute in this manner implies that it is virtually impossible to condition a gift of real property in Washington to a specific use associated with a religious organization. On July 7, 2004, the Supreme Court has accepted review of the *Niemann, supra,* case.

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