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Date: July 15, 2008

TY:

LEGEND:

- Taxpayer =
- Corp A =
- Corp B =
- Location =
- Date 1 =
- Date 2 =
- Date 3 =
- \$Ax =
- \$Bx =
- \$Cx =
- \$Dx =
- \$Ex =
- \$Fx =
- \$Gx =
- \$Hx =
- \$Ix =
- \$Jx =
- \$Kx =
- \$Lx =
- \$Mx =
- Year 1 =

Dear

This responds to your request for a private letter ruling, dated April 23, 2008, regarding the application of § 1031(a) of the Internal Revenue Code to your proposed transaction. The specific questions you have raised are whether the properties exchanged are of like kind, whether build-to-suit construction affects the application of § 1031, how the basis

of the replacement property is determined, and the manner in which gain is determined upon the receipt of boot.

FACTS:

Taxpayer, a limited liability partnership, leases its principal office space in a building owned by Corp A at Location. Corp A is a wholly-owned subsidiary of Corp B. Corp B is also headquartered at Corp A's building at Location. Both Taxpayer and Corp B need more office space. However, Corp A and Corp B are unwilling to allow Taxpayer to expand its occupancy of Location beyond limits established under their current lease (the Current Lease).

The Current Lease has a -year term that commenced on Date 1 with -year renewal options exercisable by Taxpayer. The initial term will expire on Date 3 unless Taxpayer exercises the first of its renewal options. During the original term of the Current Lease, Taxpayer has expended \$Ex for improvements to the leased space, all of which are owned by Taxpayer and used in its business. These improvements are amortized for federal income tax purposes over a 39-year or a 31.5-year period depending upon when the property was placed in service. The remaining unamortized balance of the leasehold improvements was about \$Gx on Date 2 (Taxpayer's last year end). If Taxpayer makes no additional expenditures on its current premises, it will have an unamortized balance for leasehold improvements of about \$Hx at the conclusion of the original lease term (Date 3).

Taxpayer has also acquired and placed in service substantial amounts of office furniture and equipment (hereafter office equipment) on the leased premises at Location. These properties constitute "§ 1245 property" within the meaning of § 1245 and are depreciated over periods of 5, 7, and 10 years, depending on their respective class lives. In addition, all such office equipment constitutes property in the same asset class within the meaning of §1.1031(a)-2(b)(1) of the Income Tax Regulations.

Taxpayer has spent about \$Dx on its office equipment, of which \$Kx, \$Jx and \$Ix are classified as 10-year, 7-year and 5-year property, respectively. Of these amounts, the cost of the 10-year property has been fully depreciated, so that its remaining basis is zero, although substantially all of the property remains in place and is in use today. The remaining unrecovered cost (as of Date 2) of the 7-year property is about \$Lx and of the 5-year property is about \$Mx. As with the 10-year property, much of the 7-year and 5-year property is still in use even though a portion of such property has been fully depreciated.

The transaction between Corp B and Taxpayer is motivated by each party's recent assessment of their space needs. Corp B has repeatedly asserted that it would like to use the space occupied by Taxpayer for its own purposes and would like to move more of its personnel into the space now occupied by Taxpayer. Consequently, Taxpayer has entered into negotiations to lease approximately square feet in a building

currently under construction (New Space). The New Space would meet present needs and additional expansion would also be available. At present, Taxpayer and the landlord of the New Space (New Landlord) have exchanged written drafts of proposed terms for an Agreement to Lease and for a new lease (the "New Lease").

As currently proposed, Taxpayer and the New Landlord will initially enter into the Agreement to Lease. Under the Agreement to Lease, New Landlord will construct the building and construct and install the leasehold improvements and office equipment to be used by Taxpayer in the New Space. Taxpayer currently expects that the building will be sufficiently completed in early Year 1 for construction of the leasehold improvements to begin. By that time, space will be available, for this purpose, in blocks of four floors every . It is anticipated that construction of the improvements and installation of the office equipment will be completed within after the last block of space is delivered. Upon completion of the leasehold improvements and installation of the office equipment, Taxpayer and the New Landlord will enter into the New Lease. The New Lease is expected to have an initial term of years with two renewal terms at Taxpayer's option (each from or years), with the rent to be set at the fair market rental value of the space at the time of renewal.

It is expected that \$Ax will be required for leasehold improvements and office equipment in the New Space. Of this amount about \$Cx will be spent on the leasehold improvements and the balance for office equipment. Of this \$Ax, Corp B will fund \$Bx. The New Landlord will provide the remaining \$Fx as a "tenant allowance."¹

Taxpayer and Corp B believe that Taxpayer's decision to enter into both the Agreement to Lease and the New Lease would achieve their respective objectives. Accordingly, they have entered into a Memorandum of Understanding (MOU) under which Corp B has agreed to cooperate with Taxpayer as it proceeds with its exchange. The exchange transaction will involve the following steps:

1. Taxpayer and New Landlord will enter into the Agreement to Lease providing for construction and installation of the leasehold improvements and office equipment, and obligating Taxpayer to enter into the New Lease upon satisfaction of the conditions therein. The Agreement to Lease will also provide that if the New Lease has not been entered into within after the date on which construction of leasehold improvements begins in the last block of the New Space, then Taxpayer will be required to deliver nonrefundable extension payments to extend the closing under the Agreement to Lease.

¹ For federal income tax purposes, improvements paid for by the landlord are generally considered the property of the landlord and improvements paid for by the tenant generally are considered the tenant's property. See § 1.167(a)-4. The office equipment provided from the tenant allowances by the New Landlord is not replacement property and is not to be factored in the exchange at issue because they are not derived from proceeds from the disposition of relinquished property.

Taxpayer will post a letter of credit to secure its obligation under the Agreement to Lease.

2. Taxpayer and Corp B will enter into a formal agreement under which Corp B will be required to provide up to \$Bx to the New Landlord or its wholly-owned subsidiary to be used to fund construction of leasehold improvements and office equipment installation at the premises leased under the New Lease.
3. Pursuant to the Agreement to Lease, the New Landlord, or its wholly-owned subsidiary, will enter into a construction contract with an independent construction company that will construct and install leasehold improvements. The plans and specifications for the leasehold improvements as well as all contracts will be prepared at Taxpayer's direction and will be subject to its approval. The construction of the leasehold improvements, the installation of office equipment and the disbursement of funds will all be subject to Taxpayer's approval. Taxpayer will provide any required assurances to the construction contractor and will indemnify the New Landlord for any liabilities under the construction contract other than the New Landlord's obligation to pay for the improvements with funds provided to it or its wholly-owned subsidiary. The funds provided to the New Landlord or its subsidiary will consist of up to \$Bx from Corp B and, if needed, additional amounts from Taxpayer.
4. Upon completion of the leasehold improvements and office equipment installation in the New Space, the exchange of the Current Lease (and leasehold improvements and office equipment) for the New Lease (and leasehold improvement and office equipment) will occur on the same day as follows:
 - (i) Taxpayer will transfer the Current Lease (together with the leasehold improvements and office equipment) at Location to a qualified intermediary (QI), as described in § 1.1031(k)-1(g)(4);
 - (ii) The QI will transfer the Current Lease (together with the leasehold improvements and office equipment) at Location to Corp B;
 - (iii) The QI will enter into the New Lease with the New Landlord and the New Landlord or its wholly-owned subsidiary will transfer to the QI the leasehold improvements and office equipment in the New Space; and
 - (iv) the QI will transfer the New Lease (with the leasehold improvements and office equipment) to Taxpayer and Taxpayer will become a party to the New Lease and assume all obligations under the New Lease.

APPLICABLE LAW & ANALYSIS:

Section 1031(a)(1) of the Code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1031(b) provides, in part, that if an exchange would be within the provisions of § 1031(a) if it were not for the fact that the property received in the exchange consists not only of property permitted to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Thus, the general requirements for deferral of gain under § 1031 are three-fold: (1) there must be an exchange of property; (2) the properties exchanged must be of like-kind; and (3) the property transferred and the property received in the exchange must be held for productive use in a trade or business or for investment. If cash or other property is received in the transaction the gain realized must be recognized to the extent of the amount of cash or the fair market value of the other property received.

In this case, Taxpayer is relinquishing through the QI a leasehold interest in real property and improvements (Old Office), along with office equipment, all of which are held for productive use in its trade or business, in order to receive through the QI a lease in newly developed real property, improvements (New Office), and new office equipment, all of which are to be held for productive use in its trade or business. Under the facts presented, Taxpayer requests a ruling that the properties transferred and received are of like kind and that § 1031 may apply even though its replacement property will be constructed under Taxpayer's direction. Taxpayer also requests rulings regarding the basis of the replacement properties and the gain to be recognized if § 1031 applies.

Like-kind determination

Section 1.1031(a)-1(b) of the Income Tax Regulations provides, in part, that as used in § 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

Section 1.1031(a)-1(c) provides, in part, that no gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate

for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate.

Consistent with these regulations, a leasehold interest in an office building at Location with permanent improvements to the relevant leased space within that building is of like kind to a leasehold interest in an office building at a different location that includes permanent improvements to the relevant leased space within that building. If the two leased locations vary in value or desirability or in lease terms, these are factors that relate only to the grade or quality of the properties exchanged and not to their kind or class.

With respect to personal property, § 1.1031(a)-2(b)(1) provides, in part, that depreciable tangible personal property is exchanged for property of a "like kind" under § 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class.

Section 1.1031(a)-2(b)(2) generally provides, in part, that property within a General Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674. These General Asset Classes describe types of depreciable tangible personal property frequently used in many businesses. The one listed General Asset Class relevant to the exchange at issue in this case is the first one listed in this paragraph, asset class 00.11, which includes office furniture, fixtures, and equipment.

In the present case, Taxpayer represents that the only personal property to be relinquished and received by Taxpayer in the exchange will be office equipment, all within asset class 00.11. Therefore, the personal property to be exchanged by Taxpayer is of like kind.

Build-to suit considerations

Section § 1.1031(k)-1(e)(1) provides, in part, that a transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under § 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. Further, a transaction that otherwise qualifies as a § 1031 exchange will not fail to qualify merely because all or part of the replacement property is built to the taxpayer's specifications. See *J.H. Baird v. Commissioner*, 39 T.C. 608 (1962).

Basis of the replacement property received in the exchange

Section 1031(d) provides, in part, that if property was acquired in an exchange described in § 1031 then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consists in part of the type of property permitted by § 1031, without the recognition of gain or loss, and in part of other property, the basis is allocated between the properties (other than money) received, and for the purpose of the allocation, there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange.

Under § 1031(d), if only like-kind property is transferred and received in the exchange, and the properties are of equal value, then Taxpayer would receive a transferred basis in the replacement property that is the same as the basis it had in the relinquished property. If money is received or if there is gain or loss in the transaction, the transferred basis may be increased or decreased as provided in this section. In the case of exchanges of multiple properties to which § 1.1031(j)-1 applies, as in the proposed transaction, the rules are slightly different.

Section 1.1031(j)-1(c) sets forth the exclusive method of basis computation for properties received in multiple property exchanges. It provides that in an exchange of multiple properties qualifying for nonrecognition of gain or loss under § 1031 and § 1.1031-1(j), the aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recognized by the taxpayer with respect to that exchange group, increased by the amount of the exchange group surplus or decreased by the amount of the exchange group deficiency, and increased by the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. The basis of each property received within the residual group (other than money) is equal to its fair market value.

Therefore the basis of property received by Taxpayer in the exchange will be determined on a property-by-property basis beginning by first ascertaining the basis of each property transferred in the exchange and adjusting the basis of each property in the manner provided in § 1.1031(j)-1(c).

Receipt of boot

As previously stated, under § 1031(b), if an exchange would be within the provisions of § 1031(a) were it not for the fact that the property received in exchange consists not only of property permitted to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

However, the transaction described in the facts of this case is an exchange of multiple properties, which is governed by § 1.1031(j)-1. Under § 1.1031(j)-1, even though the properties exchanged are of like kind and no cash is received in the exchange, it is still possible that some of the gain realized from the transaction must be recognized. For example, assume a taxpayer exchanges Property A and Property B for Property C and Property D. The fair market values of the exchanged properties are as follows:

Property A	\$100	Property C	\$85
Property B	<u>\$250</u>	Property D	<u>\$265</u>
Total	\$350		\$350

Assume also that Property A is of like-kind to Property C (but not to Property D), Property B is of like-kind to Property D (but not Property C), and the exchanging taxpayer has a \$0 adjusted basis in Property A and B. In this example, even though there is an exchange of like-kind properties worth \$350, the taxpayer is considered to have received \$15 of non-like kind property. That is, since Property A, with a fair market value of \$100, was exchanged for Property C, which is worth \$85, the exchanging taxpayer is considered to have received \$15 worth of Property D for Property A and Property D is not of like-kind to Property A. Consequently, in accordance with the rules of § 1.1031(j)-1, the taxpayer has \$15 of gain that is not deferred under § 1031. In the present case, reference to § 1.1031(j)-1 must be made to determine the amount of realized gain that is not deferred by Taxpayer under § 1031.

RULINGS:

1. Taxpayer's leasehold interest in Old Office is of like kind to Taxpayer's replacement leasehold interest New Office. Also, the personal property (consisting exclusively of office equipment) at Old Office is of like kind to the personal property (also consisting exclusively of office equipment) at New Office.
2. Taxpayer's exchange will not fail to qualify for nonrecognition of gain or loss under § 1031 merely because the owner of the replacement property is, at Taxpayer's direction, constructing improvements to the replacement property at the time such property is identified as replacement property.
3. The basis of property received by Taxpayer in the exchange will be determined on a property-by-property basis beginning by first ascertaining the basis of each property transferred in the exchange and adjusting the basis of each property received in the manner provided in § 1.1031(j)-1(c).
4. If Taxpayer receives money or non like-kind property (taking into account the provisions of § 1.1031(j)) in connection with the exchange of like-kind property, gain must be recognized in an amount, under § 1031(b), not in excess of the sum

of such money and the fair market value of such other property received by Taxpayer.

CAVEATS:

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

In this connection we specifically note that Taxpayer's legal position is based on an implied assumption that it is not the owner of the replacement property before the exchange closes. We express no opinion as to who is the owner of the replacement property prior to the exchange. However, if the taxpayer is considered the owner before closing, the transaction will not qualify as a like-kind exchange.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Michael J. Montemurro
Branch Chief, Branch 4
(Income Tax & Accounting)