



Property 2 =

Dear :

This is in response to your request for a private letter ruling dated July 20, 2007. Specifically, you have asked us to rule that the Development Rights described below are like kind, for purposes of § 1031 of the Internal Revenue Code (“Code”), to the fee interest in Property 1 that Taxpayer will, using a QI, sell to a third party.

## FACTS

Taxpayer is a subchapter C corporation that owns Property 1 and Property 2 located in City. Taxpayer uses the cash method of accounting and a calendar taxable year. Taxpayer intends to transfer its fee interest in Property 1 (“Relinquished Property”) to a QI pursuant to an exchange agreement that Taxpayer indicates will meet the deferred like-kind exchange provisions of Treas. Reg. §1.1031(k)-1. QI will sell the Relinquished Property to a third-party purchaser in an arm’s-length transaction. QI will use part of the cash proceeds from this sale to purchase Development Rights (“Replacement Property”) from a third-party seller. QI will transfer Development Rights to Taxpayer. Taxpayer will cause Development Rights to be recorded with respect to Property 2, which lies within Special Area of City and, according to Taxpayer, is otherwise eligible for use of Development Rights. Development Rights will permit Taxpayer (or its lessee) to develop Property 2 with greater floor space than would otherwise have been allowed if Property 2 does not have Development Rights. When Development Rights are applied to Property 2, the floor area permitted to be constructed on that property will be increased by the increased floor area carried by Development Rights.

Special Area is in that part of City characterized by a disused Line. On Date, the City Council of City approved Ordinances, which include certain zoning text and map amendments that re-zoned the area around Line to create Special Area, a new zoning district. The rezoning was designed to provide opportunities for new residential and commercial development, facilitate the reuse of Line, and enhance the neighborhood’s art district. To encourage the preservation of light and air around Line, Ordinances created Line Corridor, which is a narrow area surrounding Line within Special Area. Ordinances permit the owners of property within Line Corridor, termed the “granting site,” to transfer their Development Rights, equivalent to the base floor ratio for the property, to a designated the “receiving site” within a subarea in Special Area.

Under Ordinances, Development Rights are as-of-right and not discretionary, meaning that they exist permanently rather than at the discretion of a city agency or other decision-making authority. Development Rights must be verified by filings with City’s

Department of City Planning (“DCP”). DCP may require recording of certain easements as a condition of the transfer of Development Rights on certain properties. Evidence of such filings and DCP approval must be submitted to the City Register before the transfer document can be recorded and indexed against the granting and receiving sites. Certified copies of such filings must be submitted to DCP, and notice of receipt of the certified copies by the DCP is a pre-condition to the issuance of any building permit for the development or enlargement on a receiving site.

Sections of State Z Tax Statute (and the corresponding sections of State Z regulations), define “real property” to include “every estate or right, legal or equitable, present or future, vested or contingent, in lands, tenements or hereditaments, including buildings, structures and other improvements thereon, which are located in whole or in part within [State Z].” Sections of State Z Tax Statute further define an “interest in real property” to include “title in fee, a leasehold interest, a beneficial interest, an encumbrance, development rights, air space and air rights, or any other interest with the right to use or occupancy of real property or the right to receive rents, profits, or other income derived from real property.” See also Local Ruling, which noted that a transfer of development rights is subject to State Z gains tax as a “transfer of real property.”

State Z General Municipal Law generally defines “development rights” as “the rights granted to a lot or parcel of land under a zoning ordinance or local law respecting permissible use, area, bulk or height of improvements executed thereon. Development rights may be calculated and allocated in accordance with such factors as area, floor area, floor area ratios, height limitations or any other criteria including assessed valuation that will effectively quantify a value for the development right in a manner that will carry out the objectives of this article.” State Z General Municipal Law further defines “Transfer of development rights” to mean “the process by which development rights are passed from one lot or parcel to another.”

Taxpayer represents that it will receive no tax credits or direct incentive of any kind from State Z or City in connection with the subject transaction.

You have requested a ruling that Development Rights are like kind, for purposes of § 1031, to the fee interest in Property 1 that Taxpayer will, using a QI, sell to a third party.

## LAW AND ANALYSIS

Section 1031(a)(1) 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.

Treas. Reg. § 1.1031(a)-1(b) provides, in part, that the words “like kind” refer to the nature or character of the property and not to its grade or quality. One kind or class of

property may not 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. Properties to be exchanged tax free under § 1031 must be of the same kind or class. Treas. Reg. § 1.1031(a)-1(c) sets forth examples of properties that will be considered like kind. The most relevant examples pertain to real estate and provide that a taxpayer who is not a dealer in real estate may exchange city real estate for a ranch or farm, a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate.

Whether property constitutes real or personal property generally is determined under state or local law. See, e.g., Rev. Rul. 77-414, 1977-2 C.B. 299 (Development right in agricultural land constitutes “interest or right” in real property under local law). The types of property rights and interests that constitute interests in real property and may be considered like kind to real property for purposes of § 1031 are broad. For instance, in Rev. Rul. 55-749, 1955-2 C.B. 295, land was exchanged for perpetual water rights, which are considered real property rights under the applicable state law. The ruling holds that the fee interest in the land and the water rights in perpetuity are sufficiently similar to constitute like kind property for § 1031(a) purposes. In addition, Rev. Rul. 72-549, 1972-2 C.B. 472, holds that an easement and right-of-way, both of which were permanent, granted to an electric power company are properties of like kind to both real property with nominal improvements and real property improved with an apartment building. Similarly, in Rev. Rul. 68-331, 1968-1 C.B. 352, a leasehold interest in a producing oil lease extended until the exhaustion of the deposit that it held for productive use in the taxpayer’s trade or business was exchanged for the fee interest in an improved ranch to be held for the productive use in the taxpayer’s business. The revenue ruling holds that the exchange was an exchange of real property of a like kind under § 1031(a) since both the leasehold interest and the fee interest are continuing interests in real property. See also Notice 2005-57, 2005-2 C.B. 267, which, in Q&A 8, noted that a tobacco quota is considered an interest in land; and, under Q&A-11, the Owner thereof may defer gain or loss from the termination of a quota by entering into a like-kind exchange pursuant to § 1031 and the regulations thereunder.

In this case, Taxpayer proposes to acquire Development Rights as its replacement property for purposes of § 1031(a) and to transfer such rights to Property 2, which Taxpayer already owns. In Rev. Rul. 68-394, 1968-2 C.B. 338, the Service noted that for purposes of § 1031(a), it is not material that the property acquired by the taxpayer as the replacement property is on property already owned by that taxpayer so long as it is acquired in an arm’s-length transaction. In Rev. Rul. 68-394, land held by the taxpayer for investment was condemned for a state freeway. The taxpayer owned adjacent land that he had leased to a second party to use and develop as a mobile trailer park site. For purposes of replacing the condemned property, the taxpayer used part of the condemnation proceeds to purchase the outstanding leasehold on the adjacent land. The lease still had 45 years to run at the time of purchase. After acquisition of the

leasehold, the taxpayer used the land as a mobile trailer park site. The purchase of the outstanding leasehold was an arm's length transaction. The ruling notes that for purposes of reinvesting condemnation proceeds under § 1033(g) of the Code, Treas. Reg. § 1.1033(g)(1)(a) refers to Treas. Reg. § 1.1031(a)-1 for guidance in determining whether the replacement property is property of like kind. Since, under the § 1031 regulations, the exchange of a leasehold interest in real estate with 30 years or more to run for real estate qualifies as a like kind exchange for purposes of § 1031(a), the ruling holds that the acquisition of a leasehold interest with more than 30 years to run following the condemnation of unimproved real estate would likewise qualify as replacement property of like kind for purposes of § 1033(g), even though the leasehold interest was on property already owned by the taxpayer.

For purposes of determining if Taxpayer's proposed transaction qualifies as a like-kind exchange under § 1031(a), it is thus immaterial that Development Rights to be acquired by Taxpayer will be used merely to enhance the real property already owned by Taxpayer. More important is whether Development Rights constitute interests in real property under the state and local laws of State Z. Although it is unclear whether Development Rights are treated as interests in real property for all purposes of State Z law, it is clear that Sections of State Z Tax Statute and the regulations thereunder cited by Taxpayer do treat Development Rights as an interest in real property.

Moreover, the various sections of the local Ordinances cited by Taxpayer provide that Development Rights are as-of-right and not discretionary, meaning that they exist permanently rather than at the discretion of a city agency or other decision-making authority. As such, these rights appear to be analogous to perpetual rights. Similarly, Taxpayer represents that a deed transfer is similar to the perfecting of Development Rights, which involves an actual transfer of rights from one property to another. For instance, the transfer of Development Rights must be verified by filings with City's DCP, which may require recording of certain easements as a condition of the transfer of Development Rights on certain properties. Evidence of such filings and DCP approval must be submitted to the City Register before the transfer document can be recorded and indexed against the granting and receiving sites. Certified copies of such filings must be submitted to DCP, and notice of receipt of the certified copies by the DCP is a pre-condition to the issuance of any building permit for the development or enlargement on a receiving site. Also, Development Rights are subject to City and State Z transfer taxes in the same manner as a deed transfer.

Thus, while the Tax Statutes of State Z do not explicitly state that Development Rights are granted in perpetuity, such rights do arise out of an interest in the underlying real estate. Moreover, as indicated by the submission, City Ordinances do not set an expiration date for Development Rights, and thus they are effectively perpetual in nature. Based on the above authorities and the facts and representations that were submitted, and assuming that Development Rights are, by virtue of State Z law and local law cited by Taxpayer, an interest in real property, we conclude that Development

Rights that Taxpayer intends to acquire as replacement property will be considered like kind, for purposes of § 1031, to the fee interest in Relinquished Property.

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. We express no opinion whether the proposed transaction qualifies in all other respects for tax deferral under § 1031 beyond what is expressly stated in the above ruling. Specifically, no opinion is expressed with respect to whether the proposed transaction meets the deferred like-kind exchange requirements of Treas. Reg. § 1.1031(k)-1.

The rulings contained in this letter are based upon information and representations submitted and accompanied by a penalty and 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.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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.

Sincerely,

William A. Jackson  
Branch Chief, Branch 5 Office of Chief Counsel  
(Income Tax & Accounting)

cc: