

are of “like kind”, within the meaning of § 1031 of the Internal Revenue Code (“Code”), to the Relinquished Property transferred by Taxpayer.

FACTS

Taxpayer is a State Z limited partnership. Taxpayer holds real property directly in its own name and through a series of single-member limited liability companies that are disregarded entities for federal income tax purposes. Taxpayer uses the accrual method of accounting and a calendar taxable year.

Taxpayer owns Property 1 located in City A, State Z, through one of its disregarded entities, DE 1. Taxpayer is the sole member of DE 1. Property 1 has been held for productive use in a trade or business or for investment within the meaning of § 1031 of the Code. Taxpayer intends to sell Property 1 and acquire TDRs as part of a like-kind exchange structured as a reverse exchange. Taxpayer owns Property 2 located in City B, State Z, through one of its disregarded entities, DE 2. Taxpayer is the sole member of DE 2.

As part of its intended reverse exchange, DE 2 loaned funds to an exchange accommodation titleholder (EAT) to purchase the TDRs. The initial closing for the TDR acquisition occurred on Date 1, with the EAT currently holding title to the purchased TDRs. To complete the reverse exchange, DE 1 will sell Property 1 through a qualified intermediary (QI), and the QI will transfer the sale proceeds to the EAT. The TDRs will be transferred directly from the EAT to DE 2. The EAT will use the proceeds it receives to pay back the loan from DE 2. Taxpayer plans to use the TDRs to enhance Taxpayer’s development project at Property 2 by increasing the floor area to an amount greater than would otherwise be permitted by zoning regulations.

The TDRs originate from an MOU between City B and District, dated Date 4. (“TDR MOU”). District recorded a Covenant Restricting Use of Land and Notice of Development Restrictions dated Date 2 with the County on Date 3. The TDR MOU establishes a mechanism to accommodate the District’s acquisition of three properties located in City B for development of a facility, public park, and related uses. The District will fund the acquisition and development of the property in part by the sale of transferable unutilized development rights related to the property to third party purchasers (“TDR Participants”). The TDR Participants will seek approval from City B to apply such transferred development rights to designated receiving sites to allow for additional floor area than would otherwise be permitted by zoning regulations. TDRs become permanent in the hands of the TDR Participants when a Certificate of Transfer of Development Rights is recorded.

Taxpayer's pre-application was approved by the City B Council on Date 5; the City B has approved the site of the Property 2 project as eligible for the use of TDRs. The Property 2 project consists of an office building, for which Taxpayer anticipates using X TDR units from District. The agreed upon purchase price for the X TDR units is \$Y. The Property 2 project, once constructed, will be held for the production of rental income by Taxpayer or by a disregarded entity owned solely by Taxpayer.

Taxpayer has represented that that transferable development rights are considered an interest in real property under State Z law and has cited statutes and case law supporting its representation.

LAW AND ANALYSIS

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

Treas. Reg. § 1.1031(a)-3 defines the term "real property" for purposes of § 1031 and the regulations under § 1031. Under § 1.1031(a)-3(a)(1), real property includes land and improvements to land and, under § 1.1031(a)-3(a)(5), an intangible interest in real property of a type described in § 1.1031(a)-3 (a)(1) is real property for purposes of § 1031. Section 1.1031(a)-3(a)(5)(i) further provides that intangible assets that are real property for purposes of § 1031 include land development rights. Finally, § 1.1031(a)-3(a)(6) provides that, with certain exceptions not relevant to Taxpayer's facts, property that is real property under State or local law is real property for purposes of § 1031.

In this case, Taxpayer proposes to acquire TDRs as its replacement property and to use such rights to enhance Property 2, which Taxpayer owned prior to its acquisition of the

rights, a structure similar to the one addressed in Rev. Rul. 68-394, 1968-2 C.B. 338. In Rev. Rul. 68-394, land held by a 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, in an arm's length transaction, the outstanding leasehold, with 45 years remaining, on the adjacent land. After acquisition of the leasehold, the taxpayer used the land as a mobile trailer park site.

Although Rev. Rul. 68-394 dealt with deferring gain under § 1033, § 1033 may apply when a taxpayer replaces condemned property with property that is of like kind, within the meaning of § 1031, to the condemned property. See § 1033(g). Since, under the § 1031 regulations, the exchange of a fee interest in real property for a leasehold interest in real property with 30 years or more to run qualifies as a like kind exchange, the ruling holds that the acquisition of a 30 year or more leasehold interest following the condemnation of unimproved real estate would likewise qualify as replacement property of like kind, even though the leasehold interest was on property already owned by the taxpayer. Consequently, in the present case, the TDRs may qualify as of like kind to Property 1 for purposes of § 1031, notwithstanding that Taxpayer intends to use the TDRs on land owned by Taxpayer prior to Taxpayer's acquisition of the TDRs. Compare Rev. Rul. 67-255, 1967-2 C.B. 270, holding that a taxpayer's construction on land already owned by the taxpayer did not constitute a like-kind replacement.

As discussed above, Treas. Reg. §§ 1.1031(a)-3(a)(5)(i) provides that land development rights are real property for purposes of § 1031. Moreover, Taxpayer represents that transferable development rights such as TDRs are real property under the laws of State Z and that the TDRs Taxpayer intends to acquire as replacement property become permanent in the hands of the purchaser when a Certificate of Transfer of Development Rights is recorded. Therefore, based on the above authorities and the facts and representations that were submitted, we rule that the TDRs are, within the meaning of § 1.1031(a)-1(b), of like kind to Property 1.

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 particular, we express no opinion as to whether the proposed transaction qualifies in other respects for tax deferral under § 1031 beyond what is expressly stated in the above ruling.

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.

PLR-102826-23

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

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,

Stephen J. Toomey
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: