

Other Interests in Real Property and Mixed Use Exchanges

In addition to a fee interest in real property, certain other interests in real property may be exchangeable as replacement property. The IRS has generally looked to State law to determine whether the interest in the property is treated as real property or as personal property. *Aquilino v. United States*, 363 U.S. 509 (1960). However, the characterization of an interest under State law is not dispositive of whether a real property interest under State law qualifies for IRC §1031 purposes. *Koch v. Comm.*, 71 T.C. 54, 65 (1978). For §1031 purposes, courts have also made the determination of whether an interest is real property or personal property based on the nature and character of the property, as well as the extent of the property interest. *Peabody Natural Resources Co. v. C.I.R.*, 126 T.C. 261 (2006).

Oil, Gas, and Mineral Rights: Courts look to the underlying nature of the right. If the right is perpetual, such as an easement or a royalty interest, it is generally real property for §1031 purposes. An overriding royalty interest in minerals for a city lot constituted a like-kind exchange. *Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941). Whereas if the right is merely a production payment or a "carved out" right, it is not a real property interest for §1031. The assignment of a carved-out oil payment right for a fee interest failed to qualify for exchange treatment even though State law characterized the oil payments as a real property interest. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). "The main distinction between the two transactions is the duration of the interests—an overriding royalty interest continues until the mineral deposit is exhausted whereas a carved-out oil payment right terminates usually when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received." *Koch v. Comm.*, 71 T.C. 54, 65 (1978). In an exchange of gold mines for coal mines, the coal mines were subject to supply contracts that were considered contracts for the sale of goods and, as such, personal property under State law. However, for §1031 purposes the court concluded that the supply contract payments also created equitable servitudes that were part of the bundle of rights incident to the ownership of the coal mines and, as such, were also real property interests under State law. Thus their inclusion in the exchange of the real property did not constitute boot. *Peabody Natural Resources Co. v. C.I.R.*, 126 T.C. 261 (2006).

Water Rights: In states where water rights under State law are real property rights, the perpetual water rights are like-kind to a fee interest and qualify for exchange treatment. Rev. Rul. 55-749, 1955-2 CB 295. Water rights in perpetuity have been distinguished from a right to a specific amount of water for a limited period, with the distinction in nature and character based on an analogous mineral rights holding. *Wm. Fleming and Bessie M. Fleming et. al. v. Comm.*, 241 F.2d 78 (5th Cir. 1957).

Options and Contracts: There is little precedent to determine whether the character of an option to purchase or sell real property is personal property or real property for §1031 purposes. A contract right to sell or purchase real property has been held like-kind to a fee interest. *Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979); *Biggs v. C.I.R.*, 632 F.2d 1171 (5th Cir. 1980).

Easements and Conservation Easements: An exchange was upheld where taxpayer granted a perpetual easement and right of way to a power company and acquired a fee interest. Rev. Rul. 72-549, 1972-2 C.B. 472. Agricultural conservation easements in perpetuity that are real property interests under State law are like-kind to a fee simple. PLR 9851039. A perpetual conservation easement and a perpetual scenic conservation easement each characterized as real property interest under State law have both been held like-kind to a fee simple interest. PLRs 9601046, 9621012. Perpetual stewardship easements granting land use development credits were exchanged for fee interests. PLRs 200651018, 200651025. Development rights were successfully acquired in exchange for the sale of a fee simple interest in the relinquished property. PLR 200805012.

Cooperative Apartments: Under New York Law, a cooperative interest was an interest in personal property and did not qualify as a real property interest for purposes of IRC §2515. Rev. Rul. 66-40, 1966-1 CB 227. However, a later private letter ruling stating that the status of stock ownership in a New York cooperative apartment was evidenced by stock and a long term proprietary lease and, since the primary use of the property was as real estate, the exchange of the cooperative for a condominium was allowed. PLR 200137032. Two other private letter rulings in California held that an Exchanger's interest as a shareholder in a cooperative would not fall within the definition of §1031(a) excluding stocks. PLRs 8810034, 8445010. In all three letter rulings, Exchangers

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Other Interests in Real Property and Mixed Use Exchanges (Continued)

had converted their cooperative interest to a condominium interest in the same property. A statutory amendment in 2008 to §1031 provides that the stock of a ditch company that manages irrigation of agricultural land, and is organized as a cooperative under State law, is like-kind to real property.

Timber Rights: In some states, standing timber is considered an interest in real property and can be exchanged for any other interest in real property, such as an apartment complex or a retail mall. *Anderson v. Moothart*, 198 Or. 354, 256 P.2d 257 (1953) and *Cary A. Everett*, T.C.M. 1978-53. If the timber is being sold subject to a cutting contract, however, which requires that the timber be removed from the land within a reasonable time, this may be considered a personal property interest under applicable State law and not be of like-kind to real property for purposes of an exchange. A personal property exchange is still possible, but the “like-kind” requirement for personal property exchanges limits the replacement property to cut timber. *Oregon Lumber Company v. Commissioner*, 20 T.C. 192 (1958).

Leasehold Interests: A lease with 30 years or more remaining to run, including renewal options, is considered to be of like-kind to a fee interest in real estate, whereas a lease with a term of less than 30 years is not of like-kind to real estate for exchange purposes. *Century Electric Co. v. C.I.R.*, 192 F.2d 155 (8th Cir. 1951); Treas. Reg. §1.1031(a)-1(c) and Rev. Rul. 78-72, 1978-1 C.B. 258. A “carve out” of a lease interest does not qualify for exchange treatment. Therefore, a fee owner of real property cannot exchange a “carve out” 30-year lease in that property for a fee interest in a replacement real property. Rev. Rul. 66-209, 1966-2 C.B. 299. This is in contrast to an exchange of real property that is “subject to” a long-term lease, which is still treated as real property for purposes of qualifying for an exchange since this is equivalent to the lessor’s reversionary interest. Rev. Rul. 76-301, 1976-2 C.B. 241.

Undivided Interests: Another issue arises when there is a partition of property between co-owners, or when co-owners of the same property desire to exchange their undivided interest in the whole property for an exclusive fee interest in a portion of the same property. These transactions have been allowed and accorded favorable exchange treatment. Rev. Rul. 79-44, 1979-1 C.B. 265; Rev. Rul. 73-476, 1973-2 C.B. 300. The IRS has issued guidance for reviewing the viability of using an exchange to acquire a tenancy in common (or fractional ownership) interest in a replacement property where there are a large number of co-tenants in a co-tenancy arrangement. Rev. Proc. 2002-22. The main issue for the IRS is that the large number of co-tenants in the replacement property may cause the ownership structure to be recharacterized as a partnership, which would be disallowed as replacement property for exchange purposes because an interest in a partnership is, by statute, ineligible for exchange treatment.

Mixed Uses and Mixed Asset Classes: Exchangers hold properties for various reasons, such as for investment, personal use, primarily for sale, or use in their trade or business. In these situations, tax and legal advice is necessary to allocate sale and purchase prices to the appropriate qualified and non-qualified property portions of the exchange. In *Sayre v. U.S.*, 163 F. Supp. 495, the court ruled that any reasonable allocation would be acceptable. There is no requirement that the property be surveyed or partitioned to achieve this dual tax purpose. An allocation could be determined, for example, by an appraisal based upon the number of units or the relative square footage of the units. It is important to note that the proceeds from the sale of the qualified exchange portion of the relinquished property must be used to purchase qualified replacement property and not be used toward the purchase of that portion of the replacement property that will be used for personal purposes, otherwise it will be considered taxable as boot. For example, an Exchanger relinquishes the family homestead and the surrounding ranch, a mix of personal use and business use. The Exchanger can take advantage of the principal residence capital gain tax exclusion (subject to specific limitations) under IRC §121, while simultaneously pursuing an exchange of the ranch portion of the property under IRC §1031. (Refer to Brief Exchange on: “Converting a Principal Residence to Minimize Taxes by Combining IRC §1031 and §121”). Even if all the property qualifies for an exchange, there are transactions that may involve more than one asset class (for example, the sale of a hotel). In those situations, it is also necessary to allocate sale and purchase prices among the asset classes involved. Even though the transaction may be evidenced by a single contract for a single price, for tax purposes, each asset class must be evaluated separately for determining compliance with all the requirements of a §1031 exchange.

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