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TY:

LEGEND:

Taxpayer	=
Buyer	=
Date 1	=
Date 2	=
Date 3	=
$x	=
$y	=
$z	=

Dear

This responds to your request for a private letter ruling, dated May 7, 2008, regarding the application of § 1031(a) of the Internal Revenue Code to your proposed transaction. The specific question raised is whether residential density development rights under recorded restrictive covenants are of like kind to other interests in real estate.

FACTS:

On Date 1, Taxpayer entered into a contract (Contract) to sell certain parcels of land to Buyer. Some of the parcels have already been sold under the Contract and others have not.

The land use entitlement for the parcels sold and to be sold to Buyer, and certain other parcels owned by Taxpayer and not included in the sale, are determined under the Phased Development Site Plan (PDSP) submitted to and approved by the governing County Board. The PDSP permits the parcels sold (or to be sold) to Buyer to be developed as approximately residential housing units and hotel units. It also permits the parcels retained by Taxpayer to be developed as residential housing

units and for other uses. None of the parcels to be sold to Buyer or retained by Taxpayer is dealer property described in § 1221(a)(1).

The Contract gives Taxpayer a put option, entitling it to transfer to Buyer (subject to approval of an amendment to the PDSP by the County Board) some or all of the residential development rights (rights to construct residential units) permitted under the PDSP for the parcels retained by Taxpayer. The Contract also provides that if by exercise of the put Taxpayer transfers to Buyer the right to construct more than residential units, then Buyer would be required to transfer to Taxpayer the right to construct some, or all, of the hotel units now approved for the parcel sold to Buyer. Such transfers would result in Buyer being able to increase the density on the parcels being acquired under the Contract by up to residential units and Taxpayer decreasing the density on its retained parcels by the same number of residential units. Such transfers may also enable Taxpayer to increase the density on its retained parcels by up to hotel units and require Buyer to decrease the density on the parcels acquired under the Contract by the same number of hotel units. The sale of the land is not contingent on the transfer of any land use rights and if none of such rights are transferred, the Contract price for the land is not affected.

Taxpayer can exercise its put anytime after Date 2, but before Date 3. If the put is exercised, Taxpayer must record in the land records a perpetual restrictive covenant running with the land in favor of the county, confirming the reduction in the number of residential units that may be built upon the parcels included within the PDSP retained by Taxpayer. If Taxpayer does not exercise the put, it can develop its retained parcels to the extent of all or any portion of the land use rights not transferred. For purposes of this ruling request, the land use rights that are a part of the put option and the aforementioned perpetual restrictive covenant are collectively referred to as "Development Rights".

Under state law, the Development Rights constitute interests in real estate. The Contract sets a purchase price for the transfer of the Development Rights based on the portion of the residential units that are transferred. For the first units transferred, the price is $x for each unit transferred; for the next units, the price is $x for each unit transferred, less a credit of $y for each hotel unit construction right transferred to the parcels retained by Taxpayer; for the next units transferred, the price is $z for each unit. On each January 1 after Date 1 until the final payment for the Development Rights, the price and credit increase by an amount equal to 6.75%, which is a negotiated escalator reflecting the passage of time and the likely increase in density values over time.

The purchase price is payable if and when Taxpayer exercises its put and after local county approval of the PDSP modification is obtained. Taxpayer intends to exercise such rights and use the sales proceeds from the Development Rights (the relinquished property) to acquire like-kind replacement property. Taxpayer's replacement property

will include a fee interest in real estate, a leasehold interest in real estate with 30 years or more remaining, and land use rights for hotel units (which may be received in the event Taxpayer transfers Development Rights for more than residential units). The form of the transaction will be a deferred like-kind exchange, using the qualified intermediary safe harbor provided under § 1.1031(k)-1(g)(4) of the Income Tax Regulations. The steps in the transaction, to the extent outlined above, conform to the rules of that safe harbor. Payment for the Development Rights will be made to a qualified intermediary within the meaning of § 1.1031(k)-1(g)(4), in order to facilitate a like-kind exchange under § 1031.

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 1.1031(a)-1(b) of the 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 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 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; (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; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

Not all interests defined as real property interests for state law purposes, are of like kind for purposes of § 1031. Although the Service generally looks to state law in determining what property rights constitute real property interests, such classifications are not necessarily determinative of what real property interests are of like kind to other real property interests under federal income tax law. That determination is a matter of federal, not state, law. For example, even if a short-term lease (any lease having a term of less than 30 years with extensions) is an interest in real property under state law, it is not of like kind to a fee interest in real estate. However, as noted above in §1.1031(a)-1(c)(2), long-term leasehold interests in real estate with 30 or more years to run are of like kind to other real estate.

A number of revenue rulings provide a basis for holding that Development Rights in land are of like kind to real estate. 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 a water right in perpetuity are sufficiently similar to constitute property of like kind under § 1031.

In Rev. Rul. 59-121, 1959-1 C.B. 212, the taxpayer granted an easement of indefinite duration over specified portions of its land. The grantee of the easement intended to construct a dam and reservoir on the land and to use portions of the land for the deposit of industrial waste. While the taxpayer retained mineral rights and rights to otherwise enjoy the land and any buildings thereon, the taxpayer was prohibited from interfering with the easement granted. The revenue ruling provides that, since "the easement is with respect to land, it constitutes an interest in real property", and the proceeds derived from the sale of the easement constitute proceeds from the sale of an interest in real property.

Finally, Rev. Rul. 72-549, 1972-2 C.B. 472, holds that an easement and right-of-way 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.[1]

Rev. Rul. 68-331, 1968-1 C.B. 352, pertains not to an easement, but to a leasehold interest in a producing oil lease extending until the exhaustion of the deposit. This lease was held for the productive use in the taxpayer's trade or business and was exchanged for the fee interest in an improved ranch to be held for productive use in the taxpayer's business. The revenue ruling holds that the exchange was an exchange of real property of like kind under § 1031 because both the leasehold interest extending to the exhaustion of the deposit and the fee interest are interests in the land that are not limited to any set time, duration or value amount.

In this case, Taxpayer proposes to exchange Development Rights for a fee interest in real estate, a leasehold interest in real estate of 30 years or more remaining, and land use rights for hotel units. The new rights for hotel units will be applied to property Taxpayer already owns.[2]

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[1] On the other hand, where a right or interest arising out of real estate is for a term of something less than "in perpetuity," (or for less than thirty years in the case of a land lease) and where the interest is defined in terms of a specific sum of money, such an interest is not deemed of like kind to a fee interest in real property. *See Commissioner v. P. G. Lake, Inc., et al.,* 356 U.S. 260 (1958), *rev'g Wm. Fleming et al. v. Commissioner*, 241 F.2d 78 (5th Cir. 1957) (holding that assignments of oil payments are not of like kind to a ranch, but were akin to payments against the principal owed on an installment obligation for real estate with interest).

[2] Rev. Rul. 68-394, 1968-2 C.B. 338, holds that acquiring an additional interest in property already owned by the exchanging taxpayer (in the revenue ruling, the 45-year lease burdening the fee interest already held) will constitute a valid replacement with like-kind property so long as the taxpayer acquires it in an arm's length transaction. In the present case, since the exchanging entities are unrelated to each other,

The Development Rights will be in perpetuity and are directly related and requisite to Taxpayer's interest, use and enjoyment of the underlying land. The Development Rights are also interests in real property under state law. In effect, Taxpayer will exchange one set of Development Rights (pertaining to residential density) for other development rights (pertaining to hotel development). Some of the Development Rights will also be exchanged for another fee interest in land, and another long-term leasehold interest in additional real property.

RULING:

Based on the facts submitted and the representations made, we rule as follows:

The Development Rights to be transferred by Taxpayer as relinquished property are of like kind, for purposes of § 1031 of the Code, to a fee interest in real estate, a leasehold interest in real estate with 30 years or more remaining at the time of the exchange and land use rights for hotel units (which Taxpayer will receive if the Development Rights it transfers are for more than residential units).

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.

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.

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we have no reason to believe that the exchange, including the acquisition of replacement property, is other than an arm's length transaction.

The ruling contained in this letter is based upon information and representations submitted by 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)

Enclosure

cc: