

Other Interests In Real Property and Mixed Use Exchanges

Certain interests in real property, such as natural gas pipelines, may be exchangeable for a fee interest in real property. The IRS has historically looked to State law as a relevant factor in determining 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 properties as real or personal property under State law is not determinative of whether the properties qualify as like-kind for IRC §1031 purposes. That ultimate determination relies upon an analysis of the nature and character of the property as well as the extent of the property interest (i.e. perpetual or limited). *Koch v. C.I.R.*, 71 T.C. 54, 65 (1978); *Peabody Natural Resources Co. v. C.I.R.*, 126 T.C. 261 (2006); ILM 201238037.

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 traded for a city lot constituted a like-kind exchange. *Commissioner v. Crichton*, 122 F2d 181 (5th Cir. 1941). 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. C.I.R.*, 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 that treat water rights as real property rights, perpetual water rights are like-kind to a fee interest and may be exchanged for other real estate. 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. *Fleming v. C.I.R.*, 241 F2d 78 (5th Cir. 1957); *Wiechens v. U.S.*, 228 F.Supp.2d 1080 (D.Ariz.2002); LTR 200404044.

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: An interest in a cooperative apartment may be exchanged for a fee interest in any other type of real estate. Although ownership in a cooperative apartment is evidenced by stock and a long term lease, the IRS has reasoned that the primary use of cooperatives is as real estate and that coops are treated as real estate under various state statutes. PLRs 200137032, 200631012. Private letter rulings held that an Exchanger’s interest as a shareholder in a California cooperative would not fall within the definition of §1031(a) excluding stocks. PLRs 8810034, 8445010.

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Options and Contracts: Although two early cases have been interpreted to support that an option to sell or purchase real property is like-kind to a fee interest, many tax advisors are uncomfortable with that position since the contract right does not become a real estate interest until it is exercised. *Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979); *Biggs v. C.I.R.*, 632 F.2d 1171 (5th Cir. 1980).

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.

Leasehold Interests: A lease with 30 years or more remaining to run, including renewal options, is considered to be like-kind to a fee interest in real estate, but a lease with a term of less than 30 years is not. *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 underlying 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 interests 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 structuring a co-tenancy (tenancy in common or fractional ownership) arrangement in a Replacement Property where there are a large number of co-tenants. *Rev. Proc. 2002-22*. The structuring risk is that the IRS could recharacterize the co-tenancy arrangement as a partnership, viewing the interest being exchanged as a partnership interest rather than a fractional interest in real estate. This would cause exchange treatment to be disallowed because an interest in a partnership is ineligible under §1031.

Mixed Use and Mixed Asset Exchanges: 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, (S.D. W. VA. 1958) 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. 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 purchase of non-like kind or personal use assets, otherwise the expenditure will create taxable boot. For example, an Exchanger relinquishes the family homestead and the surrounding ranch, a mix of personal use and business use assets. The Exchanger can take advantage of the principal residence capital gain tax exclusion under IRC §121 for the home, and pursuing an exchange of the ranch portion of the property under IRC §1031. Proceeds allocated to the ranchland may only be used to acquire more investment or business use real estate; they may not be used to acquire a more expensive primary residence.