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Exchanging property you didn’t know you had - by Pamela Michaels

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In the Northeast and especially New York City, properties with views sell at a significant premium. Developers and long term owners work to ensure that their views are unrestricted. The means of doing so often involves the purchase of air rights from adjacent property owners thereby ensuring that no structure can be erected which blocks the views of owners within a building.

Air rights, also known as “development rights,” are defined as unused rights to develop a property to the extent permitted under state or local law. As states and municipalities have acted to restrict and regulate new construction, the value of air rights/development rights has skyrocketed. In recent years, some states and local governments have adopted rules permitting unused development rights to be transferred to another parcel. These air rights/development rights can then be used to construct improvements, such as a building with greater floor space or height than would be permitted in the absence of those air rights/development rights. Accordingly, a taxpayer who owns excess air rights/development rights may reap a substantial financial windfall by selling the Transferable Development Rights (TDRs) to the owner of another parcel who desires to develop the other parcel.

Of course, where there is a potential gain, there is a potential tax and the question arises whether gain resulting from a sale of TDRs can be deferred by exchanging TDRs for a fee interest in real property under IRC Section 1031. More precisely, are TDRs like-kind to a fee interest in real property? In PLR 200805012, the Internal Revenue Service (IRS) addressed that question squarely. The IRS noted that “[t]he types of property rights and interests that constitute interests in real property...for purposes of §1031 are broad” and that “[w]hether property constitutes real or personal property generally is determined under state or local law.” The IRS went on to analyze the two issues commonly addressed in a real property like-kind analysis:

(i) The nature of the rights represented by the TDRs (e.g., whether TDRs constitute an interest in real property), and

(ii) The duration of the rights obtained under the TDRs.

In determining whether the TDRs constituted an interest in real property, the IRS noted that certain tax statutes in the state in which the TDRs were located treated TDRs as real property. “Although it is unclear whether development rights are treated as interests in real property for all purposes” of state law, it was clear that sections of state’s tax statute and regulations “treat development rights as

an interest in real property." Moreover, a local administrative agency had held that a transfer of development rights was subject to state gains tax as a transfer of real property. The IRS also noted that, similar to a deed, the transfer of development rights was subject to transfer taxes imposed by both the city and state in which the TDRs were located. Accordingly, the IRS found that the TDRs in question constituted an interest in real property under the state's laws.

The IRS then considered the duration of the rights obtained under the TDRs, because interest in real property must be of sufficient duration to be considered like-kind to a perpetual fee interest in real property. The IRS found that "various sections of the local ordinances cited by taxpayer provided 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."

As a final matter, the IRS considered whether the taxpayer's use of the TDRs to benefit a property already owned by the taxpayer presented a problem in the exchange. Citing Revenue Ruling 68-394,1968-2 C.B.338, a case in which a taxpayer acquired a tenant's leasehold interest on property he already owned as replacement property for certain other property that was condemned, the IRS concluded that "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."

Given the IRS's analysis above, it would appear that a taxpayer could sell development rights for other like-kind real property just as easily as the taxpayer might purchase development rights as replacement property. (See, e.g., PLR 8141112 in which taxpayer sold agricultural land development rights to state as relinquished property.) Thus, in certain instances, residual development rights should be considered for exchange in the event that the taxpayer does not plan to use them in the future. Of course, any such transaction should be considered only after careful consideration of local laws governing TDRs in the jurisdiction in which the taxpayer owns investment property. A taxpayer may not rely upon a private letter ruling, so caution is warranted and competent tax advice should be obtained in connection with any such transaction.

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