Exchanging development rights in New York City

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Part 1 of 2

The Zoning Resolution of the City of New York recognizes two distinct types of development rights that are commonly bought and sold in the course of real estate transactions. There are Floor Area Ratio (FAR) rights that can be transferred between the owners of contiguous properties that have been consolidated into a single zoning lot, and there are transferable development rights (TDRs) that the owners of certain landmark and historical district properties are eligible to sell to certain nearby receiving properties.

A recent IRS Private Letter Ruling (LTR 200805012, October 30, 2007, released February 1, 2008) should raise confidence concerning like-kind exchanges that involve TDRs. At the same time, it should raise at least minor concerns about careless transactions involving development rights among owners of a consolidated zoning lot.

Consolidated Zoning Lots

The standard unit for development rights in New York City is the floor area ratio (FAR). The Zoning Resolution defines the floor area ratio as:

"... the total floor area on a zoning lot, divided by the lot area of that zoning lot. (For example, a building containing 20,000 s/f of floor area on a zoning lot of 10,000 s/f has a floor area ratio of 2.0.)1"

Densities for various land uses are described by the Zoning Resolution in terms of the FAR for that use in that zone.

By filing a Declaration of Restrictions with the Building Department, two or more contiguous lots within the same block, although they are owned by different parties, can be combined into a single zoning lot.2 The total FAR allowance for the consolidated zoning lot then can be allocated among the various parcels that comprise the zoning lot. Therefore, with the cooperation of several neighbors, a developer can build (by right) an apartment house, for example, on a lot that could not otherwise legally support such an extensive structure, based upon the unused FAR rights of the surrounding lots.

This regime has the purpose of encouraging development of neighborhoods up to target density, while discouraging the demolition of the best structures within those neighborhood, since those structures can be economically preserved through the sale of the properties' unused development rights.

Transferrable Development Rights

The other sort of development rights that are commonly sold in New York are transferrable development rights (or TDRs). TDRs are used in New York primarily to help preserve landmark sites and historic districts, although they have been relied on with less success in order to preserve open spaces. Owners of these sites are restricted from most types of future development in

exchange for which they receive TDRs that are meant to compensate them for their lost development rights and may also be intended as a source of funds to support landmark preservation. These TDRs can be sold to the owners of real estate within a designated receiving area. Typically, the receiving area is close to the restricted area so that aggregate development within the two areas approximates the density of use that would have occurred without the TDRs.
TDR regimes can be either compulsory or voluntary. Voluntary regimes are far easier to justify legally, but they may not be sufficiently effective to achieve critical planning goals.
NYC has been at the forefront of the development of TDRs. Grand Central Station was saved from substantial damage and possible destruction due principally to the timely development of NYC's first-in-the-nation transferrable development rights program. That ordinance was drafted in response to the demolition of New York's Penn Station. TDRs have been used to preserve and to restore the South Street Seaport district as well as for many other purposes around the city.
1 Zoning Resolution Â§12-10, "Floor Area Ratio."
2 Zoning Resolution Â§12-10, "Zoning lot" subsection (d).
To be continued in the April 8 ODM edition of The New York Real Estate Journal.

IRS Approves an Exchange Involving a TDR
In the recent IRS Letter Ruling 20080512, the Service considered a TDR plan similar in many ways to the several TDR plans in New York. The City in question (anonymous in the published version of the letter ruling) had an unused railroad line through town. In order to preserve light and air, as well as the City's art district, the City wanted to encourage limited development in the immediate vicinity of the railroad line, while encouraging more extensive development a little further away. Therefore, in exchange for development limits near the railroad line, the owners of those properties were given TDRs that could be transferred to the more outlying district. Similar to New York's plans, these TDRs permitted the receiving property to increase its "base floor ratio" beyond what otherwise would be permitted under the local zoning ordinance.
In the typical format of an IRC Â§1031 forward exchange, the taxpayer in this case proposed to sell relinquished property through a qualified intermediary (QI). The QI would use the proceeds to acquire transferable development rights as replacement property for the benefit of the taxpayer. The taxpayer would use those development rights to increase the extent of development on property that the taxpayer already owned within the receiving district of the City. Therefore, the essential question raised was whether these development rights were like-kind to the fee interest that the taxpayer proposed to sell.
The IRS noted with approval many of the features of the City's TDR ordinance as well as features of the State's real property law. Documents recording the transfer would be recorded in a manner similar to a deed. The rights were granted as of right and in perpetuity. The interest conveyed appeared to be within the state's definition of real estate for state tax purposes.
Based upon these factors, the Service concluded that the TDRs in question were, in fact, like-kind to a fee interest in real property.
Comparison to New York's Consolidated Zoning Lot Air Rights
Because the New York City TDR programs are in essence very similar to the TDR program examined by the IRS, it appears most likely that the IRS would accept New York's TDRs as being like-kind to a fee interest in real estate for Â§1031 purposes. A more interesting question arises when a taxpayer seeks to use FAR rights from another property within a consolidated zoning lot in a

like-kind exchange.

On the positive side are these factors: The Zoning Resolution specifies that the contiguous parcels are consolidated into a single zoning lot by filing a Declaration of Restrictions, a document that is very similar to a deed. This Declaration is recorded with the City Registrar in the same manner as a deed, and it is subject to real estate transfer tax.

There are, however, a few considerations on the negative side. The Zoning Resolution permits the filing of a waiver of the right to file a Declaration of Restrictions in lieu of filing a Declaration, itself. That is something like a tenant in common filing a waiver of his or her right to sign a deed when the property is sold. On its face, this provision of the law is very much unlike any ordinary conveyance of an estate in land. On the other hand, looked at in another way, this waiver appears to be intended to function something like a power of attorney, permitting one tenant in common in the property to execute a Declaration of Restrictions on behalf of himself and others who filed waivers. Even so, this waiver option appears to lack some of the formality of a conveyance, although the waiver is required to be recorded.

The Zoning Resolution requires the complete consolidation of the grantor's parcel with the developer's parcel into a single zoning lot. Then the Resolution contemplates (but does not require) that the grantor will convey to the developer FAR development rights associated with sufficient square feet of the grantor's property as may be needed to satisfy the developer's FAR shortfall. Conveyance of these rights is typically accomplished in a manner very much like the conveyance of an easement in perpetuity. Nevertheless, it is possible under the ordinance to transfer development rights with very little formality. For example, two property owners might file a Declaration that simply pools all of the development rights in their contiguous parcels. Thereafter either of them should be able to use those rights on a first-come-first-served basis or in some other fashion inconsistent with the conveyance of an estate in land.

It is the opinion of this writer that these distinctions should not be considered significant when the usual formalities are observed. However, it is worth keeping in mind that, for these reasons, the grantor of excess FAR rights who intends to perform a like-kind exchange should have an interest as great as the grantee/developer in assuring that the documents conveying development rights are in proper order.

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