# 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 will look 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). The following are examples of *other interests* in real property that are considered to be of like kind to a fee interest in real property:

- Mineral rights, water (riparian) rights, scenic easements, agricultural conservation easements, and possibly air rights, development rights and zoning rights (which must be considered real estate under state or local law to be an interest in real property);
- A remainder interest in realty; and
- Cooperative apartments provided they are considered equivalent to real estate under state law, such as in California.

**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. 301. The Internal Revenue Service 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 excluded from exchange treatment.

**Mixed uses:** 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 gains tax exclusion (subject to specific limitations) under IRC §121, while simultaneously pursuing an exchange of the ranch portion of the property under IRC §1031. The Exchanger's replacement property could be a single replacement property consisting of both another personal residence and ranch or two separate replacement properties consisting of a separate home and an apartment complex.



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