Internal Revenue Service

Number: **200651025**
Release Date: 12/22/2006
Index Number: 1031.02-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B04
PLR-151724-05
Date:
September 12, 2006

TY:

LEGEND:

Shareholder =

Corporation =
Subsidiary =
S =
T =
$V =
W =
X =
County Y =
State Z =
Year 1 =
Year 2 =
Year 3 =
Date 1 =

Dear

This responds to your request for a private letter ruling, dated October 7, 2005, as later amended. Specifically, you have asked us to rule that a transaction involving the grant of an easement for land use credits using a qualified intermediary, and the subsequent acquisition by the qualified intermediary of replacement property using proceeds from the sale of the credits may qualify as an exchange of like-kind property under § 1031 of the Internal Revenue Code.

FACTS:

A. Background

In recent years, State Z has enacted laws designed to control and regulate its growth. Its legislature recognized a need for innovative planning and development strategies to

address the anticipated demands of continued urbanization of State Z's coastal and other environmentally sensitive areas. The goal of the legislature was to accommodate less populated regions of the state which seek economic growth and which have suitable land and water resources to accommodate growth in an environmentally acceptable manner. The legislature further recognized the substantial advantages of innovative approaches to development which may better protect environmentally sensitive areas, maintain the economic viability of agricultural and other predominantly rural land uses, and provide for the cost-efficient delivery of public facilities and services.

One such innovative approach adopted was a program for encouraging the designation by local governments of agricultural lands as rural land stewardship areas. A rural land stewardship area includes both a “stewardship sending area” (SSA) and a “stewardship receiving area” (SRA) between which “transferable rural land use credits” (also known as “stewardship credits” or “credits”) are “sent” and “received.”

Under this rural land stewardship area program, a local government, in conjunction with a regional planning council, a stakeholder organization of private land owners, or another local government, must notify State Z in writing of its intent to designate a rural land stewardship area. The written notification must describe the basis for the designation, including the extent to which the rural land stewardship area enhances rural land values, controls urban sprawl, provides necessary open space for agriculture and protection of the natural environment, promotes rural economic activity, and maintains the rural character and economic viability of local agriculture.

Under the statute, counties designate rural land stewardship areas as overlays on a future land use map. A rural land stewardship area cannot be less than 10,000 acres, must be located outside of municipalities and established urban growth boundaries, and must be designated by “plan amendment” (hereinafter referred to as a “plan”). A plan designating a rural land stewardship area is subject to review by the Department of Community Affairs and must provide, *inter alia*, criteria for the designation of receiving areas within rural land stewardship areas in which innovative planning and development strategies may be applied. The criteria provide, at a minimum, for the following: (a) the adequacy of suitable land to accommodate development to avoid conflict with environmentally sensitive areas, resources, and habitats; (b) compatibility between and transition from higher density uses to lower intensity rural uses; (c) the establishment of receiving area service boundaries which provide for a separation between receiving areas and other land uses within the rural land stewardship area through limitations on the extension of services; and (d) connection of receiving areas with the rest of the rural land stewardship area using rural design and rural road corridors.

A receiving area must be designated by the adoption of a land development regulation. Prior to the designation of a receiving area, the local government must provide the Department of Community Affairs a period of 30 days in which to review a proposed

receiving area for consistency with the rural land stewardship area plan and to provide comments to the local government.

At the time of designation of a stewardship receiving area, a listed species survey must be performed. If listed species are present on the receiving area site, the developer must coordinate with each appropriate local, state, or federal agency to determine if adequate provisions have been made to protect those species in accordance with applicable regulations. In determining the adequacy of provisions for the protection of listed species and their habitats, the rural land stewardship area is considered as a whole. The impact on areas to be developed as receiving areas must be considered together with the environmental benefits of areas protected as sending areas in fulfilling this criterion.

Upon the adoption of a plan creating a rural land stewardship area, the local government must, by ordinance, establish the methodology for the creation, conveyance, and use of stewardship credits, the application of which shall not constitute a right to develop land, nor increase density of use of the land, except as provided. The total amount of stewardship credits within the rural land stewardship area must enable the realization of the long-term vision and goals respecting land use and community development of the local governments, within statutory parameters. Stewardship credits are also subject to certain limitations, including the following:

1. Stewardship credits may only exist within a rural land stewardship area.

2. Stewardship credits may only be used on lands designated as receiving areas and then solely for the purpose of implementing innovative planning and development strategies and creative land use planning techniques adopted by the local government.

3. An increase in the density of use on a parcel of land located within a designated receiving area may occur only through the assignment or use of stewardship credits.

4. A change in the density of land use on parcels located within receiving areas must be specified in a development order which reflects the total number of stewardship credits assigned to the parcel of land and the infrastructure and support services necessary to provide for a functional mix of land uses corresponding to the plan of development.

5. Stewardship credits may be assigned at different ratios of credits per acre according to the natural resource or other beneficial use characteristics of the land and according to the remaining land use following the transfer of credits. The highest numbers of credits per acre are assigned to the most environmentally valuable land or to locations where the retention of open space and agricultural land is a priority.

6. The use or conveyance of stewardship credits must be recorded in the public records of the county in which the property is located as a covenant or restrictive (stewardship)

easement running with the land in favor of the county and either the Department of Environmental Protection, the Department of Agriculture and Consumer Services, a water management district, or a recognized statewide land trust.

B. The Transaction

Corporation owns approximately X acres of ranch property located in County Y, State Z. Since Year 1, Corporation has engaged in the cattle ranching business on that land. Shareholder is Corporation's largest shareholder. Shareholder separately owns about S acres of ranch property located in County Y, State Z, which he acquired in Year 2. Subsidiary, a wholly owned subsidiary of Corporation, separately owns T acres of real property located in County Y, State Z and has engaged in the business of growing and producing fruit on that property since Year 3.

Corporation, Shareholder, and Subsidiary are not in a partnership or joint venture with each other. They have never filed a partnership income tax return with respect to the ownership of the land that is the subject of this letter. Although Corporation and Subsidiary are consolidated taxpayers, they operate separate businesses, retaining different employees. Although Corporation uses Shareholder's separate property in its cattle business, it pays regular fees for the right to do so. The parties do not carry on any joint business activity. Hereafter, Corporation, Shareholder and Subsidiary are together referred to as "Taxpayer" and the lands at issue, which they separately own, are collectively referred to as the "Ranch."

On Date 1, Taxpayer entered into a "Contract for Sale and Purchase of Stewardship Credits and Agreement to Create Rural Land Stewardship Regarding [the Ranch]" (the Contract), with Buyer, an unrelated individual in the land development business. Pursuant to the Contract, the parties agreed to create a rural land stewardship overlay on the Ranch in accordance with statutes of State Z. This action would include the elimination by Taxpayer of certain land use layers from about W acres of the Ranch pursuant to a separate SSA Credit Agreement (Credit Agreement) and granting a perpetual restrictive stewardship easement to County Y pursuant to a separate Stewardship Easement Agreement (Easement Agreement).[1] These actions, which will impair the value of the Ranch, will amount to a legal inducement of County Y to grant stewardship credits (credits) that reflect the value of the property rights that Taxpayer permanently relinquishes. Buyer will purchase the credits pursuant to the Contract for the expected sum of $V (depending on the number of credits generated) from Taxpayer through a qualified intermediary (QI).[2]

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[1] The Credit Agreement is the document by which County Y will agree to issue the credits in exchange for the grant of the perpetual stewardship easement.

[2] For purposes of this ruling letter, this office presumes that normal allocations apply, *i.e.,* that the portion of the relinquished property (the easement/credits) allocated to each party constituting "Taxpayer" will reflect each party's pro-rata share of such amount. In other words, if x percent of the credits corresponds

Taxpayer will structure this transaction as a like-kind exchange using a QI as defined by § 1.1031(k)-1(g)(4)(iii) of the Income Tax Regulations. Taxpayer will comply in all other respects with the requirements of the QI safe harbor as outlined in § 1.1031(k)-1(g)(4).[3] Among other things, that regulation requires that a taxpayer seeking exchange treatment to enter into an exchange agreement with a QI. Pursuant to that agreement, the QI "acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer." *See* § 1.1031(k)-1(g)(4)(iii)(B). The regulation also requires that the QI enter into an agreement with a person other than the taxpayer for the transfer of the relinquished property. The regulation specifically provides that this requirement may be satisfied if the rights of a party to the agreement (in this context, Taxpayer's rights in the Contract, the Credit Agreement and the Easement Agreement) are assigned to the QI and all parties to these agreements are notified in writing of the assignments, on or before the date of the relevant transfer of property. *See* § 1.1031(k)-1(g)(4)(v).

More particularly, Taxpayer will assign its rights under the Contract to a QI before Taxpayer and County Y enter into the Credit Agreement and before Taxpayer, County Y and State Z's Department of Agriculture and Consumer Services enter into the Easement Agreement. Subsequent to that assignment, but prior to the closing, the Credit Agreement and the Easement Agreement will also be assigned to the QI. Each of these assignments will be made in the manner consistent with § 1.1031(k)-1(g)(4)(v). By assigning its rights to the credits to the QI prior to the awarding of such credits, Taxpayer will not have actual or constructive receipt of the credits or the relinquished property proceeds.

Upon closing, Buyer will pay the relinquished property proceeds directly to the QI pursuant to these assignments and receive, in exchange therefor, the stewardship credits. These credits will entitle Buyer to develop real property it owns in a manner not permitted in the absence of the credits. Once Buyer pays the QI for the credits, the QI will use the money thus derived to acquire other real estate identified by Taxpayer as its replacement property.

Taxpayer and the QI will act in such manner as to insure full and timely compliance with the identification period and replacement period requirements set forth in § 1031(a)(3)(A) and (B) (as well as Rev. Proc. 2000-37, 2000-2 C.B. 308, as applicable). Taxpayer held the relinquished property and will hold the replacement property for "productive use in a trade or business or for investment" as required by

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to land owned by one of the parties, then that party will be allocated x percent of the proceeds for the relinquished property.

[3] Corporation, Shareholder and Subsidiary will each engage a QI separately and undertake its own like-kind exchange transaction in conjunction with the others, just as each has submitted its own private letter ruling request.

§ 1031(a)(1). As noted previously, § 1.1031(k)-1(g)(4)(iii)(B) requires that the QI acquire and transfer the replacement property to Taxpayer. For this purpose, the QI will be treated as having acquired and transferred the replacement property if the QI enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to Taxpayer. Section 1.1031(k)-1(g)(4)(v) provides that a QI will be treated as having entered into an agreement (for the acquisition of replacement property) if the rights of a party to the agreement are assigned to the QI and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the replacement property. In this case, Taxpayer will identify one or more replacement properties, enter into agreements with the owners of such properties for their acquisition and, prior to the closings of such acquisition(s), assign its rights as purchaser under such agreements to the QI. Upon the closing of such acquisition(s), the QI will pay the seller(s) of the replacement property out of proceeds from the sale of the relinquished property and such sellers will convey title to the replacement property (or properties) directly to Taxpayer.

LAW AND ANALYSIS:

Section 1031(a)(1) 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) provides, in part, that the words like kind refer 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.

As examples of exchanges of property of like kind, § 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; or (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.

A number of revenue rulings, three of which are summarized below, address the issue of the character of easements as real property. 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 for purposes of § 1031(a).

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 of 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, provides 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.[4]

With respect to Taxpayer's ruling request, the stewardship easement will be in perpetuity and arises out of Taxpayer's interest in the underlying land. Such easements are also interests in real property under the laws of State Z. In effect, Taxpayer will exchange a perpetual stewardship easement for a fee simple interest in like-kind property in a deferred exchange, using the safe harbor provided under § 1.1031(k)-1(g)(4). The steps in the transaction, to the extent outlined above, conform to the rules of that safe harbor. Therefore, we rule as follows:

1. A perpetual stewardship easement of the type described in the facts presented is of like kind to a fee interest in other real property; and

2. The use of the proceeds from the relinquished perpetual stewardship easement (i.e., the cash proceeds derived from the credits which are issued to Buyer through the QI by assignments in connection with Taxpayer's grant of such easement) to purchase one or more fee interests in real property to be held by Taxpayer for productive use in a trade or business or for investment will not disqualify the transaction from tax deferred exchange treatment under § 1031.

CAVEAT(S):

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[4] 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 long-term 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 principle owed on an installment obligation for real estate with interest).

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. Specifically, we express no opinion whether the proposed transaction qualifies in all other respects for tax deferral under § 1031 beyond what is expressly stated in the above ruling. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under § 6110.

Sincerely,

Michael J. Montemurro
Chief, Branch 4
(Income Tax & Accounting