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Like-Kind Property?
(IRS Ruling Blesses 1031 Exchange of Co-op Apartments)

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At the risk of sounding like a commercial, a good thing may have just gotten better. A recent private letter ruling issue by the Internal Revenue Service may give hope to those seeking to execute like-kind exchanges involving New York co-op apartments (held for investment or used in a trade or business, but not used as personal residences).

Section 1031 of the Internal Revenue Code provides for the non-recognition of gain or loss in an exchange of properties that are held for productive use in a trade or business or for investment, if such properties are exchanged solely for like-kind properties that are held for such purposes. The definition of "like-kind" in the case of real estate is particularly broad. However, one corner of the real estate landscape has remained murky: the status of co-ops. Are co-ops real property? In form, co-op ownership consists of shares of stock and a proprietary lease, but in most other respects it looks and smells like real estate. Given the number of co-ops in New York City, this like-kind exchange issue is ubiquitous.

In Private Letter Ruling 200631012, two taxpayers owned shares of stock relating to various co-operative apartments located in New York State. The taxpayers rented these apartments to tenants. All of the apartments were owned by co-operative housing corporations organized under New York State law. The taxpayers proposed to transfer their interests in these assets and replace them with improved and unimproved real property to be received in transactions intended to qualify as like-kind exchanges under Code section 1031.

The ruling considers whether the taxpayers' interests in co-operative apartments in New York State are considered like kind to the real property interests that the taxpayers would acquire in the exchange.

Regulations under Code section 1031 define "like kind" for purposes of section 1031 and explain that the term "like kind" refers to the nature or character of the property and not to its grade or quality. Properties to be exchanged tax free under section 1031 must be of the same "kind or class." With respect to real estate, the regulations state that whether the real estate is improved or unimproved is not material, because that relates only to the grade or quality of the property and not to its kind or class. Examples of properties that will be considered like kind are set forth in the regulations. The most relevant examples pertain to real estate and provide that a taxpayer who is not a dealer in real estate may exchange city real estate for a ranch or farm, real estate for a leasehold with 30 years or more to run, or improved real estate for unimproved real estate.

State law is usually determinative as to whether an interest in property constitutes real or personal property and, therefore, whether the property interest in question is amenable to a like-kind exchange for other real property. For example, in Revenue Ruling 55-749, the IRS held that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land may qualify under section 1031 of the Code.

Therefore, whether stock in a cooperative apartment located in New York State constitutes real or personal property under Code section 1031 is determined under New York law.

In Private Letter Ruling 200137032, the IRS was asked whether the conversion of a New York City co-op unit into a condominium unit was a qualifying like-kind exchange. After establishing that state law governed the classification of a co-op as real or personal property, the ruling reasoned as follows:

The legal status of stock ownership in a cooperative in the State of New York as real property or personal property is unclear. See e.g., *State Tax Commission v. Shor*, 43 N.Y. 2d 151, 154 (1988); and *AHL Properties Ten v. 306-100th St. Owners Corp.*, 86 N.Y. 2d 643 (1995). However, under various New York statues, stock ownership in a co-operative is often treated and equated as

an interest in real property. Moreover, the condominium deed will constitute a fee interest to the same underlying real property, to the same common areas and particularly to Apartment, (the same apartment). The only difference will be that Taxpayer will hold title to Apartment directly by condominium deed rather than indirectly as a shareholder in a cooperative corporation and proprietary lessee.

Although the ruling blessed the exchange in question, many practitioners were unsure whether the IRS had concluded that a New York City co-op was real property. The ruling's characterization of New York law was far from reassuring; moreover, the ruling seemed to rely on the fact that the taxpayer merely changed its form of ownership of the same apartment.

The new ruling (PLR 200631012), in contrast, covers a situation where a taxpayer is exchanging a co-op unit for entirely different replacement property. The only way to conclude that the exchange described in the ruling qualifies is to conclude that a co-op is real property. Using nearly the same language as the 2001 ruling, PLR 200631012 provides:

> Although New York case law might suggest that there are conflicts concerning whether a co-operative interest in real property is real property *(State Tax Comm'n v. Shor*, 43 N.Y.2d 151, 371 N.E.2d 523, 400 N.Y.S.2d 805 (1977), questioned in *In re Pandeff*, 201, B.R. 865 (Bankr. S.D.N.Y. 1996)), various New York statutes treat an interest in a co-operative as equivalent to an interest in real property. N.Y. Civ. Prac. L.& R. section 5206(a) (McKinney 1997) (homestead exemption); N.Y. Real Prop. Law section 279(5) (McKinney 1989) and N.Y. Pub. Auth. Law section 2402(5) (McKinney Supp. 2006) (mortgage for cooperative interest); N.Y. Real Prop. Tax Law section 467(3-a) (McKinney Supp. 2006) (real property tax for senior citizens); N.Y. Tax Law section 1402-a(a) (McKinney 2004) ("mansion tax"); and N.Y . Real Prop. *Law section 254-b(1)* (McKinney 1989) (limit on mortgage late charges).

Based on this authority, the IRS ruled that the interests in co-operative apartments in New York owned by the taxpayers are considered like kind, for purposes of Code section 1031, to the improved and unimproved real property that the taxpayers intended to acquire as replacement properties.

Although the ruling cites the same New York law cited in a footnote to the 2001 ruling, this time it is not the legal status of stock ownership in a co-op in New York that the ruling describes as "unclear," rather, only the New York case law is deemed unclear. The ruling seems to find a clear pattern in the New York statutes of treating co-ops as real property.

True, private letter rulings are not precedential, but they usually are a good barometer of current IRS thinking. This ruling goes a long way to clarify a confused area and may solve a practical problem for investors in New York co-ops.