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Land Title Trends

TAX-DEFERRED REAL PROPERTY EXCHANGES: DO CO-OPS QUALIFY?

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TAX-DEFERRED EXCHANGES have long been a popular means of shielding real estate investors from capital gains tax. A properly structured tax-deferred exchange under § 1031 of the Internal Revenue Code of 1986, as amended (IRC), allows an owner of real property, the "Exchanger," to defer the recognition of capital gains tax normally recognized upon the sale of real property.

While exchanges have been possible since 1921, it was not until the now famous decision in Starker v. U.S., 602 F.2d 1341 (9th Cir. 1979), which provided for exchanges on a delayed, rather than simultaneous basis, that exchanges really came into vogue. Starker appears, however, to have been greeted with a great deal of scepticism on the East Coast, while real estate investors on the West Coast fully embraced this new method of exchanging property. Consequently, the volume of case law, revenue rulings, etc., regarding exchanges of New York real property is small compared to the volume of law amassed on the West Coast.

When attempting to resolve issues regarding an exchange of New York property, it is sometimes useful, and oft times necessary, to consider this larger body of West Coast law as persuasive authority. Although exchanges of personal property are permitted as well, the principle focus of this article will be on exchanges of real property.

At the heart of the exchange transaction is the requirement that properties must be of "like-kind" in order to qualify for exchange treatment. Like-kind property is defined as property held for productive use in a trade or business, or for investment purposes, that is exchanged for property which is also held for productive use in a trade or business, or for investment purposes. IRC § 1031 (a)(1). Like-kind refers to the nature or character of the property, and "[t]he 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." Treas. Reg. § 1.1031 (a) 1(b). Any property conforming to this definition will be considered like-kind.

For example, vacant land which is held for investment purposes can be exchanged for industrial property held for business purposes. There is no requirement that properties be similar in type or class. However, real property must be exchanged for real property. This rule leads to the basis of this article: Are cooperative apartments considered real property for purposes of an IRC § 1031 tax-deferred exchange?

The determination as to what is considered real property, and what is considered personal property, is generally determined by state law. Reg. § 1.1031(a)-1(b), (c); Aquilino v. U.S., 363 U.S. 509 (1960); Coupe v. Commissioner of Internal Revenue, 52 TC 394 (Tax Ct., 1969), acq. in result, 1970-1 C.B., acq. in result, 1970-2 C.B.

In addition, the Internal Revenue Service opined, in Rev. Rul. 55-749, that state law controls the characterization of property interests for the purposes of IRC § 1031. Although there has not been a ruling by the IRS directly on the question of the exchangability of New York cooperative apartments, there is a body of Revenue Rulings and Private Letter Rulings, coupled with a body of New York and federal case and statutory law governing the existence of cooperative apartments, that helps

provide a framework to the analysis.

Where state law is not clear on the characterization of a property interest, such as is the case for an interest in a New York cooperative apartment, federal law can be referenced to see how similar property has been treated under IRC § 1031. Private Letter Rulings 8443054 and 8810034 (PLRs) state that an interest in a California cooperative apartment is a unique combination of a stock interest coupled with a leasehold interest, which should not merely be regarded as a stockholder s interest in realty.

The stockholder s interest is important to consider because IRC § 1031(a)(2)-(b) provides that nonrecognition of a gain or loss shall not apply to any exchange of, among other things, stocks, bonds or notes. However, the PLRs remove this important hurdle by stating that a "tenant-stockholder s" interest in a cooperative apartment should not fall "within the parenthetical language of section 1031(a) excluding stocks from favorable treatment under that provision." Inasmuch as the statutory schemes of both California and New York cooperative apartment interests are similar, these PLRs appear to persuasive.

Applicable Law

Although a lessor s interest is defined as a chattel real under New York law, Ehrsam v. City of Utica, 37 A.D. 272 (4th Dep t 1899), and thus considered a personal property interest, § 1.1031(a)-1(c) of the tax regulations provides that no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges a leasehold of a fee with 30 years or more to run for real estate, including options to renew. Both PLRs state that the "tenant- stockholder s" leasehold interest, and the term remaining in the lease, are factors in considering whether a cooperative apartment is an interest in real property.

While a leasehold interest is considered real property in California, In re Pitts Estate, 218 Cal. 184 (1933), the PLRs seem to imply that a cooperative apartment lease having a term of less than 30 years may prove fatal to an exchange transaction, regardless of the underlying state law. For purposes of a tax-deferred exchange, an interest in a New York leasehold with 30 years or more left to run, including renewal options, is exchangeable for a leasehold of 30 years or more, or a fee interest in real property.

Accordingly, proper planning could alleviate a potentially fatal problem if the owner of the cooperative apartment were to secure a new lease or option to renew for at least 30 years, in advance of the exchange transaction. However, securing a new lease or option within one year of the intended exchange runs the risk of the IRS disallowing nonrecognition treatment of the capital gains tax because the property was not held for business or investment purposes, but rather for resale. IRC § 1031(a)(2)-(A)

The IRS presumably sought to add authority to its reasoning in the PLRs by citing Cal.Civ.Code § 783 and Rev. Rul. 77-423, which treat a California condominium interest as an ownership interest in real property. However, the language recited in PLR 8810034 seems to be brought forth verbatim from PLR 8443054, which was written before the enactment, in 1985, of Cal.Civ.Code § 783.1, which states that "both the separate interest and the correlative interest in the stock cooperation, however designated, are interests in real property."

Unfortunately, in what could be described as the dicta of the PLR, the IRS contrasted the PLR to Rev. Rul. 66-40, in which an interest in a New York cooperative apartment was not considered real property for the purposes of § 2515 of the IRC of 1954. IRC § 2515 provided for an exemption from federal gift tax when creating a tenancy by the entirety between spouses after 1954. The effect of this ruling, which was decided in 1966, was that when one spouse used his or her own funds to purchase an interest in a cooperative apartment, and in connection with this purchase, added the name of the spouse to the stock certificate as a tenant by

the entirety or joint tenant, a taxable gift was made.

Although New York courts have always recognized a tenancy by the entirety in real property, In re Klatzl s Estate, 216 N.Y. 83 (1915), reargument denied, 218 N.Y. 734 (1916), and Real Prop. L. § 339-i(3) was later enacted in 1964 to allow the same for New York condominiums, it was not until 1996 that EPTL § 6-2.1(a)(4) was enacted, providing the owners of cooperative apartments with the same status. Clearly, this statutory change shows the New York Legislature s continuing drive to increase the real property characteristics of cooperative apartments.

Additionally, Rev. Rul. 66-40, citing In re Miller s Estate, 205 Misc. 770 (N.Y. Sur. 1954), states that an interest in a cooperative apartment did not pass by devise of "all real estate owned by me." At the time of this Revenue Ruling, the disposition of an interest in a coop by a devise of "all real estate owned by me" was at odds with a bequest of "all stock owned by me."

Problems arose when a decedent, prior to death, sold his or her interest in a house, or some other form of generally recognized real property interest, and purchased an interest in a cooperative apartment. The intent to devise a dwelling to a beneficiary under the will was often disallowed because the coop interest was considered personalty for the purposes of the estate distribution.

Fortunately, New York Courts have decided to make the disposition of an interest in a cooperative apartment more certain. The Court of Appeals asserted, in Matter of Estate of Carmer, 71 N.Y.2d 781 (1988) that

> indisputably, for many commerical purposes the law treats a shareholder's interest in a cooperatiave apartment primarily as an interest in a corporation. Here, however, the intent of the decedent controls, not the technical definitions found in commerical law. The will mainfests decedent's intent to leave the interest in her home to her relatives, and to this intent the court must give effect.DPA1In reaching this decision, the Court of Appeals was clearly acknowledging the obious fact that the decedent's interest in a cooperative apartment should be treated as an interest in real property, because to do otherwise would be to ignore its true nature, namely, that of a dwelling.

Further, Rev. Rul. 66-40 states that a long line of New York decisions has consistently held that an interest of a tenant of realty under a real estate lease is not realty, but a chattel real. State Tax Commission v. Shor, 43 N.Y.2d 151 (1977); Ehrsam v. City of Utica, 37 A.D. 272 (4th Dep t 1899). However, an interest in a cooperative apartment is much more than its individual components of stock ownership and leasehold interest. It is the marriage of these interests that creates the unique entity. To state that the only aspect of a coop which borders on real property is the leasehold interest is to ignore the overall scope of the ownership interest. Consequently, many practitioners, upon reading Shor, come away with the misleading impression that an interest in a New York cooperative apartment is purely personal.

The Shor Ruling

In Shor, the Court of Appeals ruled that for the purposes of securing a judgment lien interest on a cooperative apartment, docketing the judgment in the County Clerk s office was not sufficient. In order to secure a judgment creditor s interest in a cooperative apartment, a creditor must have delivered an execution on the judgment to the Sheriff.

In reaching this conclusion, the Court was merely looking to the current state of banking law, which treats the stock certificate and proprietary lease as personal property. However, the reasons for doing so have less to do with the actual classification of the interest with the protection of a lender s interest.

At the time Shor was decided, a lender would take possession of the stock

certificate and proprietary lease as security for the loan in connection with the closing, instead of recording a mortgage as in a typical purchase of a real property interest. Were an interest in a cooperative apartment treated as real property for security purposes, mere possession of the stock certificates, without recording, would subordinate the lender s security interest to the claims of other creditors. Shor, 43 N.Y.2d at 158.

This method of securing the lender s interest was problematic when an owner of a cooperative apartment sought secondary financing. Secondary lenders were reluctant to lend money if they were not in possession of the stock certificate and proprietary lease. Accordingly, New York Uniform Commercial Code § 9-304 was amended, effective Oct. 1, 1988, to provide for the filing of a UCC-1 financing statement in the Register s or County Clerk s office to perfect a security interest in the cooperative apartment. This method of securing a lender s interest in a coop closely resembles the recording of a mortgage to secure a lender s interest in a traditional real property interest.

Although the Court in Shor was unwilling to change the manner in which judgment liens and security interests in cooperative apartments were determined, because to do so would drag the public "into a rigidly fenced corral, kicking," the Court did not pronounce an owner s interest in a coop to be personal property. Quite to the contrary, an interest in a cooperative apartment was labelled sui generis, of its own kind or class, acknowledging that the interest defied any one exclusive classification.

Further, the Court explained that "[f]or some special purposes, the real property aspect may predominate. Grenader v. Spitz, 537 F.2d 612, 617-620, cert den, 429 U.S. 1009; cf. United Housing Foundation v. Forman, 421 U.S. 837, esp 854-860, reh den, 423 U.S. 884." Shor, 43 N.Y.2d at 154. The issue presented in Grenader and United Housing Foundation was whether the shares of stock in a coop were to be considered securities for the purposes of New York and federal securities law.

The panel in Grenader most clearly articulated the view that "the continuing obligation to pay a monthly rental fee to maintain the tenancy of the lessee strongly supports the conclusion that this was basically a real estate transaction and not an investment in a security." Although the Court of Appeals was reluctant to change the statutory scheme protecting lenders, it is apparent that for most other purposes, an interest in a cooperative apartment is treated like an interest in real property.

Further Support

In support of the premise that an interest in a cooperative apartment is evolving toward real property, one need only look to the following statutes which protect cooperative apartment owners:

CPLR § 5206 provides for a homestead exemption from creditors;

Public Authorities Law § 2402(5) provides that a "mortgage" includes a loan by a bank to a borrower to finance the purchase of stock in a cooperative corporation;

Real Property Law § 254-b limits late charges on loans secured by cooperative apartments;

Real Property Law § 279(5) permits the issuance of graduated mortgage loans for the purposes of financing the cooperative ownership of real estate;

Article 36B of the General Business Law creates a statutorily implied warranty in new home sales, including cooperatives.

Although by no means an exhaustive list, these statutes clearly show the New York Legislature s continuing attempt to give cooperative apartment owners the same

benefits that owners of traditional interests in real property enjoy.

The last persuasive argument that the IRS sought to make in Rev. Rul. 66-40 was that "nowhere in the Tax Law has the [New York] legislature characterized a leasehold as taxable real property." Once again the treatment of an interest in a cooperative apartment as two separate interests, that of a stockholder and lessee, leads to an inconsistent result. Although owners of coops do not pay real estate taxes directly, a portion of their maintenance charges is directly attributable to the payment of real estate taxes by the cooperative corporation.

The IRS recognizes this unique situation by allowing an owner of a cooperative apartment to take a tax deduction for his or her proportionate share of the real estate taxes allowed as a deduction to the corporation, and the interest allowable as a deduction to the corporation for the indebtedness incurred in connection with the acquisition, construction, alteration, rehabilitation or maintenance of the land and apartment building. IRC § 216. The U.S. Supreme Court in United Housing Foundation, id. at 855, stated that these tax benefits enjoyed by the coop owners are "nothing more than that which is available to any homeowner who pays interest on his mortgage."

In conclusion, although most of the precedents relied on in Rev. Rul. 66-40 have been rejected by the evolution of case and statutory law, the IRS has continued to cite the ruling for purposes of classifying an interest in a New York cooperative apartment as a personal property interest. Inasmuch as the definition of real property is governed by state law, it would appear that the true nature of the coop, namely, that of a dwelling or business space, should predominate based on the current state of New York law. Accordingly, there appears to be overwhelming legal authority to support the conclusion that a cooperative apartment contains a sufficient real property identity to be considered real property for the purposes of an IRC § 1031 tax-deferred exchange.

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