

LIKE KIND EXCHANGES OF PROPERTY LEASED TO CELLULAR TOWER OPERATORS

Situation: Taxpayer owns land or a building, and is approached to grant a lease to a cell tower/antenna operator, or alternatively, to sell his existing lease. Can the taxpayer do a like kind exchange?

The answer to this question depends entirely on the nature of the agreement. The agreement must be carefully reviewed by legal counsel and the taxpayer's tax advisors to understand the nature of the interest being conveyed, and its eligibility for a like-kind exchange.¹

If the agreement creates a leasehold interest, then the taxpayer is not eligible to do an exchange. A lease has a fixed and determinable duration. Payments received for the creation of a leasehold interest are not income from the sale or exchange of a capital asset, but ordinary (rental) income. If the owner creates a leasehold interest in favor of a third party, and then later sells his rights under the lease, the payments will still be treated as prepaid rental income.² This is an application of the "assignment of income doctrine." Sale of the lease should be distinguished from the sale of the property. A lease consists of both the right to receive a stream of income payments for occupancy, or other rights in the property, plus a reversionary interest at the expiration of the lessee's rights. Retaining an economic interest causes the payments to be taxed as advance rental payments. In Crooks v. Commissioner, a transfer of a ranch with a reservation of a ¼ royalty interest in minerals from the property constituted a retained economic interest that prevented the taxpayer from completing a "sale or exchange" of the property.³ The Crooks argument could be raised in any conveyance that does not fully sever the grantor's interest in the property.⁴ Contrast this to a lessee that sells its leasehold interest or surrenders its leasehold interest to the landlord in exchange for a payment from the landlord. Such payments are considered amounts received from the sale or exchange of a leasehold interest.⁵ The lessee's complete termination of interest would be eligible for an exchange into like-kind property.

Part of the confusion about exchanges of leasehold interests stems from the Income Tax Regulation's statement that a "leasehold of a fee with 30 years or more to run" is like-kind to a fee interest in land.⁶ The Regulations' statement only addresses the like-kind nature of two interests in real estate. It should not be viewed as a statement that a landlord can sell its rights under a lease and exchange them for other real estate.

One strategy we see used is to transfer an easement, rather than assigning the cell tower lease. The easement interest will convey a perpetual interest in a certain area of the property where the tower or antenna is located, together with an assignment of the existing lease. Conveying an easement is possible for both existing free-standing towers or existing rooftop antennae. The documentation should particularly define and describe the interest conveyed, to avoid creating title problems affecting marketability of the property. Also, lenders may be reluctant to subordinate to or release an interest in the property being conveyed.

If the agreement creates an easement, then like-kind exchange treatment is possible. Most easements are like-kind to, and therefore may be exchanged for fee interests in real estate.

An easement can be exchanged for a fee interest in land only if it is a perpetual interest in real estate. There is, nevertheless, a risk that the IRS would view the transaction as, in substance, an assignment of the lease under the substance over form argument. If the easement grants no significant rights other than those contained in the pre-existing lease agreement, then the easement is susceptible to attack under this argument. Therefore, proper drafting of the easement is critical.

Another consideration is how to make payments for the granting of an easement part of a like-kind exchange. Owners must be sure to enter into an exchange agreement with a qualified intermediary and assign rights in the agreement BEFORE the transfer of an interest occurs. Otherwise, it would be like attempting an exchange after the closing on relinquished property.

¹ Another alternative to doing a like-kind exchange would be for owners of leases to contribute their tower leasehold interests to a partnership in exchange for an interest in a partnership under IRC §721, similar to the formation of a REIT umbrella partnership.

² See: Helvering v. Horst, 311 U.S. 112 (1940). Commissioner v. P.G. Lake, Inc. et al., 356 U.S. 260 (1958).

³ Crooks v. Commissioner, 92 T.C. 816 (1989).

⁴ However, a sale for an installment note, or the sale of property or a mineral interest with reservation of a production payment not determined with reference to the property or mineral interest thereon, would be treated as a complete severance, and constitute a sale or exchange.

⁵ See Internal Revenue Code §1241 which supplies the "sale or exchange" element for a termination of a lease or distributorship agreement. This section does not address status as a capital asset, which would be determined under IRC §1231.

⁶ Reg. §1.1031(a)-1(c).

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