

Section 1031 Exchanges: Pitfalls and Policy Implications*

—by Neil E. Harl**

I. General rule

- A. The like-kind exchange concept has been in federal tax law since 1918. Few concepts go back farther than the predecessors to Section 1031.
- B. Neither gain nor loss is recognized when property held for productive use in a trade or business or for investment is exchanged for like-kind property which is to be held for productive use in a trade or business or held for investment.
 - 1. The income tax basis of the property acquired in the exchange is, with modifications, the same as the basis of the property transferred in the exchange.
 - 2. The unrecognized gain is transferred to the new property.
 - 3. Gain is recognized to the extent that recapture of depreciation (and other deductions and credits) is required and to the extent nonqualified property is received in exchange.
 - 4. Losses are generally not recognized on the acquisition of like-kind property.
 - 5. A like-kind exchange failed where there was an immediate exchange after corporate liquidation.
 - 6. In a letter ruling, IRS took the position that property acquired for the purpose of exchanging for other property is not received with an investment motive although the courts have not been supportive of that position.
 - 7. Where there was an intent to use the exchanged property for use as a personal residence after the exchange, gain is recognized.
- C. Like-kind exchanges must be reported to IRS whether or not there is any gain or loss recognized on the exchange. Taxpayers are required to file Form 8824, *Like-Kind Exchanges*, with either Schedule D or Form 4797, Sales of Business Property. The form is filed in the year in which the property given up was transferred. For exchanges with related parties, the form must be filed for the two years following the year of the exchange.

II. Requirements for an exchange

- A. To be eligible for tax-free exchange treatment, a reciprocal transfer of like-kind property is required.
 - 1. A sale of property and reinvestment in similar property is not a like-kind exchange.
 - 2. Even a simultaneous sale of property and acquisition of other like-kind property is treated as a sale and reinvestment if the two transactions are independent.

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3. If a taxpayer receives control over cash in a transaction, like-kind exchange treatment is not available even though the taxpayer ultimately ends up with like-kind property. But deposit of funds in a trust in exchange for real estate with trust using part of the funds to purchase replacement property deeded directly to the taxpayer has been held to be an integrated plan involving the exchange of like-kind real property.
 4. The simultaneous transfer of like-kind properties of approximately equal value through a qualified intermediary is treated as an exchange.
 5. Transfer of property by a partnership with the replacement property deeded to the partners in liquidation of their partnership interest is not a like-kind exchange.
 6. The business purpose test and the step-transaction doctrine have been applied to a like-kind exchange of personal property.
- B. Simultaneous transfer is not required for like-kind exchange treatment but an exchange does not qualify as like-kind exchange property unless the property to be acquired is identified and the exchange is completed within specified time periods. The requirements were imposed statutorily after the Ninth Circuit Court of Appeals held that a like-kind exchange required neither a simultaneous exchange of like-kind properties nor an identification of these properties within any time limits.
1. A taxpayer must identify the property to be received on or before 45 days after the date of transfer of the property given up in the exchange.
 - a. The identification period begins on the date the taxpayer transfers the relinquished property and ends 45 days thereafter.
 - b. If several properties are transferred, the identification period is determined by reference to the earliest date on which any of the properties is transferred.
 - c. Identification of property is adequate only if it is designated as replacement property in a written document signed by the taxpayer and delivered, mailed or otherwise sent before the end of the identification period to either the person obligated to transfer the replacement property to the taxpayer or to any other person involved in the exchange other than the taxpayer or a disqualified person.
 - (1) A “disqualified person” for this purpose is—
 - (a) A person who is an agent of the taxpayer at the time of the transaction,
 - (b) Any person or entity specified in the disallowance of loss rules and the rules disallowing losses between a partner and a controlled partnership, substituting 10 percent for 50 percent, or
 - (c) Any person or entity having a relationship in (b) above with the taxpayer’s agent.
 - (2) A person is an agent of the taxpayer if acting as an agent at the time of the transaction or has acted as the taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first of the relinquished properties.
 - d. Like-kind exchange deadlines can be extended because of war (members of armed forces) or Presidentially-declared disasters.

2. Replacement property is identified only if it is unambiguously described in a written document or agreement by legal description, street address or distinguishable name.
 - a. Personal property is unambiguously described if it is described by a specific description of the particular type of property (such as make, model and year for equipment or vehicles).
 - b. Property that is incidental to a larger item of property (such as equipment in a building) is unambiguously described if the property to which it is incidental is unambiguously described.
3. More than one property may be identified as replacement property but the maximum number of replacement properties that may be identified is—
 - a. Three properties, without regard to their fair market value (determined without regard to liabilities), or
 - b. Any number of properties so long as their fair market value in the aggregate at the end of the identification period does not exceed 200 percent of the aggregate fair market value of all relinquished properties as of the date the properties given up were transferred.
 - (1) If a taxpayer identifies more properties than is permitted, then no properties are treated as identified.
 - (2) This rule does not apply, however, and the identification requirements are considered satisfied for—
 - (a) Any replacement property received before the end of the identification period, and
 - (b) Any replacement property identified before the end of the identification period and received before the end of the replacement period if the taxpayer receives replacement property constituting at least 95 percent of the aggregate fair market value of all identified replacement properties before the end of the exchange period.
4. Property that is “incidental” to a larger item of property is not treated as separate property for this purpose if—
 - a. The items are typically transferred together in standard commercial transactions, and
 - b. The incidental property does not exceed 15 percent of the value of the larger item.
5. Exchange period—
 - a. The property received in exchange must be identified within 45 days, as noted above, and must also be received by *the earlier of*—
 - (1) 180 days after the date of transfer of the taxpayer’s property, or
 - (2) The due date, including extensions, of the transferor’s tax return for the tax year in which the transfer occurred.
 - b. The exchange period begins on the date the taxpayer transfers the relinquished property and ends on the earlier of 180 days thereafter or the due date (with extensions) for the taxpayer’s tax return for the tax year in which the relinquished property is transferred.
 - (1) If several properties are transferred, the exchange period is determined by reference to the earliest date on which any of the properties is transferred.

- (2) Note that the exchange period cannot extend beyond 180 days *even with an extension request filed*.
 - (3) The provision (I.R.C. § 7503) which extends the time for filing a tax return and doing some acts when the date falls on a Sunday or holiday, does not apply to I.R.C. § 1031 deadlines.
 - c. The identified replacement property is considered received before the end of the exchange period if—
 - (1) The replacement property is received before the end of the exchange period, and
 - (2) The replacement property received is substantially the same property as identified.
 - d. A transfer of property may qualify for nonrecognition of gain even though the replacement property is not in existence or is being produced at the time the property is identified as replacement property.
 - (1) Replacement property to be produced (built, constructed, installed, manufactured, developed or improved) must be identified in the same manner as other types of replacement property.
 - (2) For purposes of the 200 percent rule and the 95 percent rule, the fair market value of replacement property to be produced is its estimated fair market value as of the date the property is expected to be received by the taxpayer.
 - e. A taxpayer transferring relinquished property in a deferred exchange may have gain to recognize with the transaction treated as a sale if money or other property is actually or constructively received in the full amount of the consideration for the relinquished property before like-kind replacement property is received.
 - f. For a discussion of eligibility of tobacco quota payments for like-kind exchange treatment and transfers to a qualified intermediary to defer gain on payments to tobacco quota holders, see *Notice 2005-57, I.R.B. 2005-32*. IRS has granted a period of relief for recipients of tobacco quota payments to take advantage of like-kind exchange treatment. To qualify for transitional relief (available to an owner who applied by June 17, 2005), the payment must be remitted to a qualified intermediary within five business days after the later of the date the exchange agreement was entered into or the date the payment was received by the owner. The date the owner transfers the quota was deemed to be September 16, 2005.
 - g. Failure to find replacement property in a like-kind exchange results in recognition of income tax liability on the transaction.
 - h. If a taxpayer receives property before relinquishing the property given up, the tax result is known as a “reverse Starker exchange.”
- 6. Safe-harbor transactions
 - a. A taxpayer is not considered in actual or constructive receipt of money or other property—
 - (1) Merely because the obligation of the other party to the transaction is or may be secured by a mortgage or other security interest in property, a standby letter of credit that does not allow the letter of credit to be drawn upon except upon default of the transferee’s obligation to transfer replacement property or a guarantee of a third party. The safe harbor ceases to apply if the taxpayer has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guarantee arrangement.

- (2) Before replacement property is received merely because the obligation of the other party to the transaction is or may be secured by cash or a cash equivalent held in a qualified escrow account or in a qualified trust.
 - (a) A qualified escrow account is an escrow account in which—
 - [1] The escrow holder is not the taxpayer or a disqualified person, and
 - [2] The escrow agreement limits the taxpayer's rights to obtain the benefits of the escrow account.
 - (b) A qualified trust is a trust in which—
 - [1] The trustee is not the taxpayer or a disqualified person, and
 - [2] The taxpayer's rights to obtain the benefits of the trust are limited.
 - (c) These rules allow taxpayers to carry out deferred like-kind exchanges without risk that the presence of cash or cash equivalents held in a qualified escrow account or qualified trust might require the recognition of gain under the installment sale rules.
 - (3) Merely because the taxpayer transfers the relinquished property to a qualified intermediary or money or other property is received by a qualified intermediary.
 - (a) The determination of whether the taxpayer is in actual or constructive receipt of money or other property before like-kind replacement property is received in exchange is made as if the qualified intermediary was not the agent of the taxpayer.
 - (b) A qualified intermediary is someone who—
 - [1] Is not the taxpayer or a disqualified person.
 - [2] Enters into a written agreement limiting the taxpayer's rights to obtain the benefits of the money or other property held by the qualified intermediary, and
 - [3] Acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property and transfers the replacement property to the taxpayer as required by the written agreement.
 - [4] A disqualified person is someone who is an agent of the taxpayer at the time of the transaction. A party's regular attorney can be a disqualified person.
 - (4) Merely because the taxpayer may be entitled to receive any interest or growth factor with regard to the deferred exchange provided the taxpayer's rights are limited.
7. The deferred exchange rules have not been specifically applicable to transactions in which the taxpayer receives the replacement property before transferring the relinquished property. However, IRS has issued guidelines for reverse like-kind exchanges that involve "parking" the replacement property with an accommodation party until the relinquished property is transferred to the ultimate transferee.
- a. IRS will not challenge the transaction if the property is held in a "qualified exchange accommodation arrangement" (QEAA). Property is held in a QEAA if all of the following requirements are met—

- (1) Qualified indicia of ownership of the property is held by a person (the “exchange accommodation title holder” or EAT) who is not the taxpayer or a disqualified person and either the EAT is subject to income tax or, if the EAT is a partnership or S corporation for tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to income tax.
 - (2) At the time the qualified indicia of ownership of the property is transferred to the EAT, it is the taxpayer’s bona fide intent that the property represent either replacement property or relinquished property in an exchange that is intended to qualify for non-recognition treatment.
 - (3) No later than five business days after the transfer of qualified indicia of ownership of the property to the EAT, the taxpayer and the EAT enter into a QEAA providing that the EAT is holding the property for the benefit of the taxpayer in order to facilitate a like-kind exchange and the taxpayer and the EAT agree to report the acquisition, holding and disposition of the property as provided in *Rev. Proc. 2000-37*.
 - (4) No later than 45 days after the transfer of the replacement property to the EAT, the relinquished property is properly identified.
 - (5) No later than 180 days after the transfer, the property is transferred to the taxpayer as replacement property or is transferred to a person who is not the taxpayer or a disqualified person as relinquished property. Note that *Rev. Proc. 2000-37* does not add the provision from I.R.C. § 1031(a)(3)(B) specifying that the property must be received not later than the earlier of 180 days after the date of property transfer or the due date, including extensions, for the tax return.
 - (6) The combined time period that the relinquished and replacement properties are held in a QEAA does not exceed 180 days.
- b. Property will not fail to be treated as held in a QEAA as a result of legal or contractual arrangements enumerated in *Rev. Proc. 2000-37*. Also, property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory or state, local or foreign tax treatment of the arrangement between the taxpayer and the EAT is different from the treatment in *Rev. Proc. 2000-37*, § 4.02(3).
 - c. The procedure is effective for QEAA entered into on or after September 15, 2000. No inference is intended for those entered into prior to that time.
 - d. In 2004, IRS modified the safe harbor rules to provide that the safe harbor will not apply to replacement property held in a QEAA if the property was owned by the taxpayer within the 180-day period ending on the date that qualified indicia of ownership of the property are transferred to an exchange accommodation title holder.

C. Exchanges involving related parties

1. If, within two years of a like-kind exchange of property with a related person, the related person disposes of the property, or the taxpayer disposes of the property, the gain is recognized on the exchange.
 - a. Like-kind exchange treatment is denied for exchanges structured to avoid the related party rules.
 - b. A primary objective in enactment of the related party rules was to deny non-recognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of sale of the low basis property. The related parties have, in effect,

“cashed out” of the investment and the original exchange is not accorded non-recognition treatment.

2. That provision does not apply to—
 - a. Dispositions involving the death of the taxpayer or the related person.
 - b. In a later compulsory or involuntary conversion.
 - c. Where IRS is satisfied that avoidance of federal income tax is not a principal purpose of the transaction. This exception includes—
 - (1) Transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of the properties;
 - (2) Dispositions of property in non-recognition transactions; and
 - (3) Transactions that do not involve the shifting of basis between properties. IRS has ruled that exchange of an undivided interest for a whole interest is not a “disposition” of property subject to the waiting period for related-party transactions.
 3. For this purpose, “related person” is as defined in I.R.C. §§ 267(b), 707(b)(1).
 4. Routing the exchange through an unrelated party to avoid the related party rules does not avoid the denial of like-kind exchange treatment.
 5. A transferor transferring like-kind property to a qualified intermediary in exchange for property owned by a related party must recognize gain if the related party receives cash or non like-kind property which is not part of an exchange of like-kind property.
 6. This provision poses a substantial risk for exchanges involving related parties. No party to the exchange can “cash out” within the two-year period after the exchange.
- D. Whether a partition is an “exchange”
1. The regulations state that gain or loss is realized and recognized from the conversion of property into cash or from the exchange of property for other property different materially either in kind or extent.
 2. Rulings issued indicate that gain or loss in a partition is not recognized unless a debt security (such as a promissory note) is received or property is received that differs “materially...in kind or extent” from the partitioned property.

III. Like-kind property

- A. Like-kind property is property of the same nature, character or class rather than same grade or quality.
 1. Real property qualifies as like-kind to other real property regardless of dissimilarities.
 - a. Improved real estate qualifies as like-kind to unimproved real estate.
 - b. Urban real estate may be exchanged for a ranch or farm.
 - c. Real property may be exchanged for a leasehold with 30 years or more to run.

- (1) The unexpired term of the lease includes renewal option periods.
 - (2) The lessee of real property with a total unexpired lease term of at least 30 years may exchange the leasehold interest for a fee simple interest in real property.
 - (3) The owner of a fee interest in realty may exchange the property interest for a leasehold of at least 30 years.
 - (4) Real estate not encumbered by a long-term lease may be exchanged for a fee title in other real estate encumbered by a long-term lease.
 - (5) Both the lessee of property subject to a long-term lease and the lessor of the property are allowed to exchange their respective interests for a fee simple interest in unencumbered property.
- d. An exchange of land containing sand deposits has been considered like-kind even though the taxpayers had mined sand from the tract.
- e. Fractional interests may be exchanged for an entire interest in another property.
- (1) IRS was to study whether undivided interests in realty are considered separate entities for purposes of the like-kind exchange rules. *Rev. Proc. 2000-46, 2000-2 C.B. 438*. IRS announced that advance rulings or determination letters would not be issued on the matter.
 - (2) However, IRS in 2002 announced conditions under which a request for a ruling would be considered involving undivided interests in rental real property for an *I.R.C. § 1031* exchange, as discussed below.
- f. A conservation easement in perpetuity may be exchanged for a fee simple interest in different farmland.
- g. A remainder interest in farmland may be exchanged for a remainder interest in other farmland.
- (1) A remainder interest may be exchanged for a fee simple interest in real property held for investment or used in a trade or business.
 - (2) A life estate in real property with a life expectancy of less than 30 years, for a remainder interest in real property, is not considered like-kind.
- h. A sale followed by a leaseback involving terms of 30 years or more constitutes a like-kind exchange.
- (1) Some courts have held that losses in such transactions cannot be recognized.
 - (2) But other courts recognize such transactions as sales if the rent payable is less than the fair market rental value of the property.
- i. Undivided interests in farmland under a crop share lease may be exchanged for specific tracts owned separately.
- j. Exchange of real property for other real property with the owner of the other real property required to build a building to the transferor's specifications qualifies as a tax-free exchange. However, an exchanger cannot build the replacement property on land the exchanger already owns.
- k. An exchange of utility easements between corporations has qualified as a like-kind exchange.

1. An exchange of water rights in perpetuity (considered real property under state law) for a fee simple interest in land is like-kind.
 - (1) However, the exchange may not be like-kind if the water rights are limited in quantity, duration and priority.
 - (2) IRS has approved an exchange of water rights for a fee simple interest in land where the water rights were limited in quantity to a specified amount per year rather than limited in quantity to a specific percentage of the overall supply of agricultural water.
- m. An exchange of a leasehold interest in a producing oil lease, extending until exhaustion of the deposit, for a fee interest in improved ranch land is like-kind.
- n. An easement and right-of-way granted to an electric power company is like-kind with real property with nominal improvements and real property improved with an apartment building.
- o. Fruit trees have been considered “other tangible property” for purposes of investment tax credit and thus are eligible for expense method depreciation but are considered part of the land. Expense method depreciation is available for “...tangible property (to which section 168 applies) which is section 1245 property...”
- p. A purchaser’s rights under an installment contract are apparently considered equivalent to a fee simple interest.
- q. An exchange of outdoor advertising signs is like-kind.
- r. An exchange of fee simple partnership-owned real property for real property owned in tenancy in common was like-kind and not an exchange involving partnership interests.
- s. Real property outside the United States *is not like-kind*.
- t. IRS has ruled that where a trust terminates after an involuntary conversion with distribution of property to an in-kind beneficiary, replacement of the property under I.R.C. § 1033 is not precluded.
- u. IRS has ruled that the exchange of shares of stock (equivalent to interests in real property under state law) were like-kind exchanges of real property).
2. Exchanges of an interest in natural resources such as coal, oil or gas for another such interest or for a fee simple interest in land are eligible for like-kind exchange treatment if the interests exchanged are both either realty or personalty under state law and of the same character as defined by federal tax law.
3. Unharvested crops are part of the land on which they are growing and may be exchanged with the land for other qualified property.
 - a. Timberland may be exchanged without regard to the quantity or quality of the timber.
 - b. Timberland qualifies for like-kind exchange treatment for land without a crop.
 - c. An exchange of timberland for timberland is like-kind.
4. Depreciable tangible personal property
 - a. Depreciable tangible property held for productive use in a trade or business or for investment may be exchanged for property of a like-kind or of like class.

(1) But underlying business assets consisting of intangible personal property are not allowed to be aggregated as a single asset for the purpose of determining whether an exchange of two businesses qualifies as a like-kind exchange.

(2) The regulations do not define “depreciable tangible personal property.”

(a) Moreover, it is not clear to what extent state law governs in the meaning of the term.

(b) The term “personal property” is defined for purposes of I.R.C. § 1245 as “(1) tangible personal property (as defined in paragraph (c) of § 1.48-1, relating to the definition of ‘section 38 property’ for purposes of the investment credit), and (2) intangible personal property.”

(c) The term “personal property” as used in I.R.C. § 1031 does not appear to embrace all of the “other property” branch of I.R.C. § 1245.

(d) The term “tangible personal property” as defined for purposes of “section 38 property” has acquired meaning through regulations and cases—

[1] The regulations specify that “local law shall not be controlling for purposes of determining whether property is or is not ‘tangible’ or ‘personal.’ Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property.” The investment tax credit regulations have been applied to situations involving the classification of property for depreciation purposes.

[2] The regulations define “tangible personal property” to mean—

“...any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.” *Treas. Reg. § 1.48-1(c)*.

[3] The term “tangible personal property” has been held to include—

[a] Air conditioning.

[b] Propane storage tanks.

[c] Photo labs (but not concrete foundations).

[d] Bulk tanks and storage tanks used in bulk petroleum distribution and retail operations.

[e] Fire extinguishers.

- [f] Fixed or floating docks (but not pilings).
 - [g] Construction site trailers.
 - [h] Billboards, signs, lighting fixtures and detachable poles at retail stations (but not concrete foundations).
 - [i] Bank vault doors, record vault doors, night depository facilities and walk-up and drive-up teller's windows (but a drive-up teller's booth is a building).
- b. Property is of a like class to other depreciable tangible personal property if the properties exchanged are within the same *general asset class* or the same *product class*.
- (1) Property cannot be classified within more than one general asset class or more than one product class.
 - (2) Property classified a general asset class may not be classified within a product class.
- c. Depreciable tangible personal property is classified into 13 general asset classes.
- (1) The classes are listed in the IRS publication for determining classification for depreciation purposes as asset classes 00.11 through 00.28 and 00.4.
 - (2) The general asset classes are—
 - (a) Office furniture, fixtures and equipment;
 - (b) Information systems;
 - (c) Data handling equipment;
 - (d) Airplanes (other than commercial airliners or freight carriers);
 - (e) Automobiles and taxis;
 - (f) Buses;
 - (g) Light general purpose trucks;
 - (h) Heavy general purpose trucks;
 - (i) Railroad cars and locomotives, except those owned by railroad transportation companies;
 - (j) Tractor units for use over-the-road;
 - (k) Trailers and trailer-mounted containers;
 - (l) Vessels, barges, tugs, and similar water transportation equipment, except those used in marine construction; and
 - (m) Industrial steam and electric generation and/or distribution systems.
- d. Depreciable tangible personal property that is not classified with any general asset class is classified into four or six digit product classes. See the *Standard Industrial Classification Systems*

Manual (SIC Manual), Office of Management and Budget (1987). The Manual has been replaced by the *North American Industry Classification Manual* (2002).

(1) IRS released the guidance for using the NAICS Manual for federal income tax purposes on August 12, 2004.

(a) The regulations *adopted Sectors 31 through 33 of NAICS for defining product classes*.

(b) The 2004 regulations, published in T.D. 9151, apply to transfers on or after August 12, 2004, although taxpayers may apply the provisions to transfers of property on or after January 1, 1997, in taxable years for which the period of limitation has not expired. The four-digit product class system could continue to be used until the regulations became final. The regulations became final on May 19, 2005.

(2) Properties within the same product class generally are of a like class.

(3) Much of the personal property used in a farm business is included in product class 3523, Farm Machinery and Equipment, under the SIC system. Under the NAICS system, farm machinery and equipment are under product class 333111.

(a) Under the NAICS system, product class 333111 specifically lists combines, cotton gin machinery, feed processing equipment, fertilizer equipment, planters, plows, farm tractors, haying machinery, milking machines and poultry feeding and watering equipment.

(b) An exchange of farm machinery for farm machinery is like-kind.

(4) Sports utility vehicles and passenger automobiles are considered like-kind.

e. Livestock

(1) Livestock of different sexes is not property of a like-kind.

(2) Half-blood heifers (which were artificially inseminated) and three quarter blood heifers (which were the offspring of the artificially inseminated heifers) have been held to qualify as like-kind.

(3) A trade of steer calves (which the court found were not held for sale in the ordinary course of business) for registered Aberdeen-Angus cattle has been held not to be a taxable exchange.

(4) An exchange of cows with calves at side was considered like-kind but only 103 of 425 mixed yearlings were considered held for breeding purposes rather than for sale and thus were considered like-kind.

(5) It is believed that exchange of a grade beef cow for a purebred registered beef cow would be like-kind.

(a) An exchange of a dairy cow for a beef cow apparently is not like-kind.

(b) SIC and NAICS classifications—

	<u>SIC</u>	<u>NAICS</u>
Beef cattle	0212	112111
Hogs	0213	112210
Dairy cattle	0241	112120

Sheep and goats	0214	112410
Horses	0272	112920
Rabbits and other fur-bearing animals	0271	112930
Chickens (egg production)	--	112310
Broilers	--	112320
Turkeys	--	112330
Other poultry	--	112390
Animal aquaculture	--	112511

- f. IRS has provided a safe harbor involving ongoing exchanges of tangible personal property using a single intermediary involving multiple exchanges of 100 or more properties. Although programs may differ, a safe harbor program must have all of the following characteristics—
- (1) The taxpayer regularly and routinely enters into agreements to sell tangible personal property as well as agreements to buy tangible personal property;
 - (2) The taxpayer uses a single, unrelated intermediary to accomplish the exchanges in the LKE Program;
 - (3) The taxpayer and the intermediary enter into a written agreement (“master exchange agreement”);
 - (4) The master exchange agreement expressly limits the taxpayer’s rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the intermediary as provided in Treas. Reg. § 1.1031(k)-1(g)(6);
 - (5) In the master exchange agreement, the taxpayer assigns to the intermediary the taxpayer’s rights, but not necessarily its obligations, in some or all of its existing and future agreements to sell relinquished property and/or to purchase replacement property;
 - (6) The taxpayer provides written notice of the assignment to the other party to each existing and future agreement to sell relinquished property and/or to purchase replacement property;
 - (7) The taxpayer (a) implements a process that identifies potential replacement property or properties before the end of the identification period for the relinquished property or group of relinquished properties of which it is disposing in each exchange, (b) complies with the identification requirement by receiving replacement property or properties before the end of the 45-day identification period, or (c) satisfies the identification requirements by a combination of the approaches in (a) and (b);
 - (8) The taxpayer implements a process for collecting, holding and disbursing funds (which may include the use of joint taxpayer and intermediary bank accounts, or accounts in the name of a third party for the benefit of both the taxpayer and the intermediary) that ensures that the intermediary controls the receipt, holding and disbursement of all funds to which the intermediary is entitled (i.e., proceeds from the sale of relinquished properties);
 - (9) Relinquished property or properties that are transferred are matched with replacement property or properties that are received in order to determine the gain, if any, recognized on the disposition of the relinquished property and to determine the basis of the replacement property; and
 - (10) The taxpayer recognizes gain or loss on the disposition of relinquished properties that are not matched with replacement properties, and the taxpayer takes a cost basis in replacement properties that are received but not matched with relinquished properties.

5. Section 1245 property and Section 1250 property

- a. If Section 1245 property is disposed of in a like-kind exchange, Section 1245 recapture must be recognized *to the extent of the fair market value of property acquired that is not Section 1245 property*.
- b. For Section 1250 property, recapture must be recognized to the extent of the larger of (1) the excess, if any, of the gain reported as ordinary income because of additional depreciation had the property been sold over the fair market value of the Section 1250 property acquired or (2) any gain on the exchange. The recapture of depreciation for Section 1250 property is partially or fully deferred until there is a disposition of the acquired property.
- c. The instructions for Form 8824, line 21, restate these rules and provide a location on the form for calculating the Section 1245 and 1250 recapture (“ordinary income” under recapture rules) to the extent non-Section 1245 and non-Section 1250 properties are received in exchange to the extent of additional depreciation.

6. Other personal property

- a. An exchange of nondepreciable personal property or intangible personal property qualifies for like-kind exchange treatment if the exchanged properties are of a like-kind.
 - (1) Generally, tax-free exchange treatment is limited to identical types of property.
 - (2) Whether intangible personal property is of a like-kind to other intangible personal property generally depends upon the nature or character of the rights involved and on the nature and character of the underlying property to which the intangible personal property relates.
 - (3) Goodwill and going concern value are not of a like-kind.

B. Interests in a partnership and co-ownership of assets

1. Interests in a partnership are not considered like-kind.

- a. The problem is that IRS has ruled, in some instances, that fractional interests in property may be deemed a partnership.
- b. Under *Treas. Reg. § 1.761-1(a)* and *Treas. Reg. §§ 301.7701-1* through *301.7701-3*, a partnership for federal tax purposes does not include mere co-ownership of property where the owners’ activities are limited to keeping the property maintained, in repair and leased.

2. Efforts to resolve the problem—

- a. In 2002, IRS issued a revenue procedure addressing the circumstances under which advance rulings will be issued in situations involving co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common. The revenue procedure specifies conditions that must be met for an advance ruling—
 - (1) Title held in tenancy-in-common (rather than by an entity).
 - (2) The number of co-owners 35 or fewer.
 - (3) The co-owners must not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying the co-owners as partners, shareholders or

other members of a business entity or otherwise hold itself out as a partnership or other form of business entity.

- (4) The co-owners may enter into a “limited co-ownership agreement” that may run with the land (e.g., an agreement specifying that a co-owner must first offer the co-ownership interest to the other co-owners).
 - (5) The co-owners must retain the right to approve the hiring of any manager, sale or other disposition, leases or the creation of a blanket lien.
 - (6) Each co-owner must have the rights of transfer, encumbrance and partition without the approval of others.
 - (7) If the property is sold, any debt must be satisfied before distribution of the proceeds to the co-owners.
 - (8) Each co-owner must share in all revenues generated by the property and all costs in proportion to the co-owner’s interest.
 - (9) The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.
 - (10) A co-owner may issue an option to purchase the co-owner’s undivided interest (a “call” option) if the price for the call option reflects fair market value of the property as of the time of exercise of the option.
 - (11) The co-owners’ activities must be limited to those “customarily performed” in connection with maintenance and repair of the property.
 - (12) The co-owners may enter into management or brokerage agreements.
 - (13) All leasing agreements must be bona fide leases for federal tax purposes and reflect the fair market value for the use of the property.
 - (14) The lender, if any, with respect to the debt encumbering the property or debt incurred to acquire the co-ownership interest, must not be a related person.
 - (15) Payments, if any, to a “sponsor” for the acquisition of the co-ownership interest and the fees paid must reflect fair market values and may not depend on income or profits derived from the property.
- b. If the conditions of *Rev. Proc. 2002-22, 2002-1 C.B. 733*, are satisfied, it is believed that the transaction should not be treated as involving partnership interests.
 - c. Authority is contained in the statute for a co-tenancy arrangement to be excluded from partnership treatment and not to be deemed a partnership. That election, however, is limited to fact situations where the arrangement is for investment purposes and not for the active conduct of a trade or business.
- C. If a single member LLC is disregarded in a like-kind exchange, the exchange may be treated as a direct receipt of the assets involved.
 - D. A Delaware statutory trust has been deemed eligible to be a participant in a like-kind exchange.

IV. Policy implications

A. Impact of like-kind exchanges on land values

1. Just about every survey of farmland values in recent months has shown an increase—some in the hefty eight to nine percent range. Some are asking how can that be when commodity prices have been at relatively low levels?
2. There are several explanations, and which one applies varies from area to area. Basically, farmland values depend upon three factors—(1) potential purchasers' expectations as to crop profitability over the next several years (but with the nearby years given greater weight); (2) potential purchasers' expectations as to government payments again discounted to present value with nearby years carrying a greater weight; and (3) purchasers' expectations as to non-farm development influence on land values.
3. Assuming there's little chance of development activity in the foreseeable future, it comes down to two factors—expected crop profits and expected levels of government payments.
4. Although there is little research on the effect of like-kind exchanges on land values, there is a public perception that such exchanges add to the buoyancy of land values.
 - a. The like-kind exchange rules contribute pressure to reinvest the proceeds from a land transaction (the 45-day and 180-day rules).
 - b. It is arguable that some like-kind exchange decisions may be irrational, particularly as the end of the identification period approaches.
5. Repeal of I.R.C. § 1031 is unlikely to happen, as some have urged.
6. However, if it is desired to lessen the impact of like-kind exchanges on farmland values, one possibility would be to subject real property exchanges to the types of limitations imposed on exchanges of personal property with farmland exchangeable for farmland but non-farmland could only be exchanged for non-farmland.