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The Whole Truth About Using Partial Real Estate Interests in Section 1031 Exchanges

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The Whole Truth About Using Partial Real Estate Interests in Section 1031 Exchanges
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Speaking in general terms, all real estate is like kind for Section 1031 purposes and state law determines whether certain property is real estate for this purpose. Recently, however, a district court in *Wiechens* (a decision your author questions) held that a water right, even though real estate under Arizona law, is not like kind to a fee interest in raw land. That decision, while perhaps inconsistent with other rulings on the like-kind requirement, is a clear reminder that general statements about the definition of like-kind real estate do not always hold true.

Reg. 1.1031(a)-1(b) provides:

>[T]he words “like kind” have reference to the nature or character of the property and not to its grade or quality. . . . 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. . . . [Furthermore, no] gain or loss is recognized if . . . 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 . . .

*Wiechens* warns us that courts may place boundaries on this seemingly boundless definition of like-kind real estate.

Water rights are only one type of partial real estate interest that requires careful scrutiny when involved in a transaction intended to qualify for Section 1031 nonrecognition treatment. Other partial real estate interests — such as leases, remainder and reversionary interests, life interests, mineral interests, timber rights, and easements — also require close examination to ensure they are like kind to a fee in real estate,

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1. 228 F. Supp. 2d 1080 (DC Ariz., 2002).
2. For purposes of analysis in this article, partial real estate interests are compared to a fee interest in other real estate. Because there appears to be no authority to the contrary, this article assumes that if two partial real estate interests are like kind to a fee in other real estate, the two partial interests are like kind to each other. Thus, if Partial Interest A is like kind to Fee Interest B, which is like kind to Partial Interest B, then Partial Interest A is like kind to Partial Interest B.
involved in a transaction intended to qualify for Section 1031 nonrecognition treatment.\(^3\)

Exchanges involving partial real estate interests are further complicated by cases such as *Pembroke*\(^4\) and *Crooks*,\(^5\) in which the courts found that regardless of the nature or character of the property involved, certain transactions did not qualify for Section 1031 nonrecognition treatment because they were leases. As such, the transactions did not qualify as transfers and failed to satisfy the Section 1031 exchange requirement. *Pembroke* and *Crooks* show us that when dealing with partial real estate interests, planning and analysis are not complete if the exchange requirement has not received adequate attention. These and other cases admonish that the treatment of a transaction under state law does not dictate its treatment for federal income tax purposes.

The complexity created by using partial real estate interests in Section 1031 exchanges also creates planning opportunities. In tax planning, because complexity is a double-edged sword, tax advisors have opportunities to use partial real estate interests\(^6\) creatively to reduce current tax liabilities. In Ltr. Rul. 200251008,\(^7\) for example, the Service granted Section 1031 nonrecognition treatment to a taxpayer who acquired a 32-year sub-sublease and improvements constructed on the subject land in exchange for other real property. That ruling is important because the service recognized that a leasing structure under Rev. Proc. 2000-37\(^8\) provides a means of structuring a build-to-suit exchange involving property owned by a party related to the taxpayer without violating the Section 1031(f) related party rules. This ruling was followed by Ltr. Rul. 200329021 which also involved the creative use of a lease in a build-to-suit exchange on property owned by a related party. The creative use of the lease in Ltr. Rul. 200251008 and Ltr. Rul. 200329021 demonstrates that planning opportunities are available when partial real estate interests are properly implemented in an exchange.

II. THE LIKE-KIND PROPERTY REQUIREMENT

Section 1031(a)(1) requires that the property transferred and the property received in an exchange be like kind. The regulations and case law identify partial interests in real estate that are like kind to a fee in real

\(^3\) This article does not explore the use of concurrent ownership interests (e.g., joint tenancy, tenancy in common, cotenancy, and tenancy by the entirety) in the Section 1031 context. Such interests are for discussions elsewhere. See, e.g., Borden, “Exchanges Involving Tenancy-in-Common Interests Can Be Tax-Free.” 70 Practical Tax Strategies 4 (January 2003).

\(^4\) 23 BTA 1176 (1931).

\(^5\) 92 TC 816 (1989).

\(^6\) Reg. 1.1031(a)-1(b).


\(^8\) 2000-2 CB 308.
estate under Section 1031. According to Rev. Rul. 55-749,9 “the fact that two varieties of properties . . . may be legally classified as real property does not of itself signify that the two are property of a like nature or character within the meaning of [Reg. § 1.1031(a)-1(b)].”

In making this comparison [of partial real estate interests and a fee interest in real estate], consideration must be given to the respective interests in physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality. Significantly, as the standard for comparison, Section 1031(a) refers to property of a like (not an identical) kind. The comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his or her property to acquire a new kind of asset or has merely exchanged it for an asset of like nature or character.10

As the following discussion demonstrates, “if there be substantial difference in the rights created in and to the respective properties, then the properties are not of like kind.”11 State law is not always controlling, and at times the cases are difficult to reconcile.

A. Leases

The terms of a lease, the manner in which a lease is created, and the parties to the lease all affect the viability of using a lease in a Section 1031 exchange.

1. Leases of 30 Years or More

The Section 1031 regulations provide that “a leasehold of a fee with 30 years or more to run in real estate” is considered like kind to other real estate.12 Optional renewal periods are counted in determining whether a leasehold has 30 years or more to run.13 For example, in Century Electric Co., the Eighth Circuit held that a lease “for a term of not less than 25 years and not more than 95 years” was like kind to a fee in real property.

12. Reg. 1.1031(a)-1(c)(2).
In *R&J Furniture Co.*, the lease had an initial term of five years and gave the lessee the right to ten successive renewals of five years each. The Tax Court stated that the lease gave the lessee “the right to possess, occupy, and use such real estate for a period of 55 years,” and “[l]easeholds for such an extended period of time have been administratively classified in [the Section 1031 regulations] as property of a like kind with and the equivalent of a fee in real estate within the purview of Section 1031.” Unfortunately, there appears to be no basis for the 30-year rule other than the Service’s decision to so declare. Thus, the significance of the 30-year term may be lost.

Likewise, in Rev. Rul. 78-72, the Service ruled that a lease with an initial period of 25 years plus three optional 10-year renewal periods under the same rental terms was like kind to unimproved real property. In so ruling, the Service concluded that the “optional renewal periods should be added to the initial term of the lease for the purpose of determining whether the leasehold interest qualifies as ‘like kind’ property . . . .” In Ltr.Rul. 9126007, the Service ignored the stated term of a lease to privately rule that a Section 1031 exchange had occurred. The lease in question charged rent at approximately 1% of fair market rental value for a 10 year term and was readily renewable. This being the case, the lessee would suffer economic hardship if it failed to renew the lease on such favorable terms. Accordingly, the Service ruled that the so-called ten-year lease should be treated as longer than a 30-year lease for tax purposes.

The taxpayer’s acquisition of a lease in land that the taxpayer owns does not appear to affect the analysis. In Rev. Rul. 68-394, the taxpayer used a portion of the proceeds received from the involuntary transfer of land to purchase, in an arm’s-length transaction, the outstanding leasehold on property owned. At the time the taxpayer acquired the leasehold it had 45 years to run. The Service ruled that the condemned land and the leasehold satisfied the like-kind property requirement under Section 1033(g) (see below), stating that “[i]t is not material that the taxpayer acquired the leasehold on property already owned by him so long as he acquired it in an arm’s-length transaction.” The Service also noted that, “purchasing the outstanding leasehold the taxpayer acquired the right to enjoy the possession of this land prior to the time he would have come into its possession under the terms of the lease.” This ruling clarifies the Service’s position that the acquisition of a leasehold by the landlord is treated the same as the acquisition of other property for purposes of the like-kind property requirement.

By implication, the Service has acknowledged that, like a leasehold of a fee within 30 years or more to run for real estate, a sub-sublease of a fee with 30 years or more to run for real estate is like kind to a fee in real estate. In Ltr. Rul. 200252009, the taxpayer transferred a fee in improved

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real estate in exchange for a 32-year sub-sublease of improved real estate. The Service ruled privately that the exchange qualified for Section 1031 treatment.\(^{15}\)

2. \textit{Leases of Fewer than 30 Years}

Although not expressly stated in the regulations, it appears leases of fewer than 30 years for real estate are not like kind to a fee in real estate. Section 1033 rulings are often referred to when analyzing the Section 1031 like-kind property requirement. Section 1033(g)(1) provides that “if real property . . . held for productive use in a trade or business or for investment is (as a result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in a trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.” Reg. 1.1033(g)-1(a) further provides that the principles set out in Reg. 1.1031(a)-1(b) shall be used in determining whether replacement property is property of like kind under Section 1033(g). In the Section 1033 context, the Service takes the position that Reg. 1.1031(a)-1(c)(2) provides that a leasehold of a fee with fewer than 30 years to run is not like kind to other real property.

Rev. Rul. 83-70, above, involved a Section 1033 involuntary conversion in which property the taxpayer was leasing was condemned. At the time of the condemnation, the lease had 15 years to run. The taxpayer used the proceeds from the condemnation to acquire a fee in other real property. The Service ruled that the 15-year leasehold was “similar or related in service or use” to a fee interest and does qualify for Section 1033(a) treatment. The Service stated, however, that the leasehold should not be treated as like kind to a fee interest in real property under Section 1033(g). In Rev. Rul. 83-70, the Service stated that to be of the same nature as a fee in real property, the leasehold must have a remaining term of at least 30 years. The Service thus ruled that because the leasehold was less than 30 years, the taxpayer could not rely on the “like kind” provisions of Section 1033(g) to defer gain recognition.

In the sale-leaseback context, the Tax Court has ruled that a real estate lease of fewer than 30 years was not equivalent to a fee in the same real estate.\(^{16}\) In \textit{Standard Envelope Manufacturing}, the Court did not consider whether the transaction qualified for nonrecognition treatment under the like-kind exchange rules, but held that since a lease of 25 years is not the equivalent of a fee, the taxpayer’s economic position changed as part of a sale-leaseback. The court cited the predecessor of Reg. 1.1031(a)-


\(^{16}\) \textit{Standard Envelope Manufacturing}, 15 TC 41 (1950); May Department Stores 16 TC 547 (1951); and Capri, 65 TC 162 (1975).
1(c)(2) in holding that a lease of fewer than 30 years is not equivalent to a fee. In *May Department Store*, the Tax Court held that a lease of 20 years with no renewal rights vested economic interests in the lessee different from the economic interests of a fee in the same real estate. Finally, in *Capri*, the Service challenged the loss under a tax-free exchange theory. The Tax Court held, however, that the transaction was not a tax-free exchange under Section 1031 because a lease of 10 years is not like-kind to the transferred fee (see also the exchange requirement discussion, below).

Although leases in real estate with terms of fewer than 30 years are not like kind to a fee in other real estate, such interests may be like kind to leases with similar terms. In Rev. Rul. 76-301, the Service ruled that two leaseholds of fewer than 30 years were like kind. The taxpayer in that ruling held the leasehold of an entire building that would expire on June 30, 2000. On January 2, 1973, the taxpayer transferred its interest in the entire leasehold to an unrelated party in exchange for cash and an identical lease for a portion of the building. The Service ruled that even though the leases were for a term of fewer than 30 years, they were of like kind and Section 1031 applied. Note that the taxpayer in Rev. Rul. 76-301 desired to recognize a loss on the transaction, which the ruling disallowed.

In Ltr. Rul. 8319011 the Service privately ruled that a leasehold in a motel and golf course with fewer than 30 years remaining “will be considered 'like kind' property to a 23-year leasehold on the condemned [hotel].” That ruling involved a Section 1033 involuntary conversion, but the ruling that the leaseholds are like kind was based on the principles in the Section 1031 regulations under Section 1033(g). Thus, it appears the Service will treat two leaseholds in real property of fewer than 30 years as like-kind property, at least so long as the lease terms are similar.

In determining whether a property interest is a lease, the Tax Court has stated, “the relevant consideration in this regard is whether the useful life of the property extends beyond the term of the lease so as to give the purchaser a meaningful possessory right to the property.” Under this analysis, if the useful life of property is less than the term of the lease, perhaps a lease for real estate of fewer than 30 years would be like kind to a fee in real estate. In such situations, it would be useful to know the mind of the Treasury at the time it adopted the 30-year rule. There are situations in which a transaction that is labeled as a lease is treated as a sale for federal tax purposes. Thus, in theory at least, there may be situations in which a lease for real estate of fewer than 30 years is like kind to a fee in real estate. Brave is the person who would plan a transaction based on such a theory, especially if other alternatives are available.

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19. Grodt & McKay, Inc., 77 TC 1221 (1981); ILM 200234039; see discussion below about “surreal” estate interests.
3. **Leases That are Personalty Under State Law**

Although a lease of more than 30 years is generally like kind to other property, the Service has made at least one exception to this rule. In Ltr. Rul. 8327003, the Service privately ruled that a leasehold that was not real estate under local laws was not like kind to a fee in other real estate. The lease involved in that ruling was a State of New Mexico institutional lease for grazing and agricultural purposes. Apparently, New Mexico law provides that a state lease of public land is a chattel, not realty. This ruling indicates that a partial real estate interest must be real estate under local law to be like kind to a fee interest in other real estate.

**B. Remainder and Reversionary Interests**

Remainder interests in real estate generally may be exchanged for a fee in other real estate under Section 1031. In Rev. Rul. 78-4, the Service ruled that the exchange of a remainder interest for a remainder interest in another property qualified for Section 1031 nonrecognition treatment. The ruling involved a surviving spouse who had a one-half undivided fractional interest in two properties (A and B) and a life estate in the other one-half undivided fractional interest in the properties. The children of the surviving spouse had a remainder interest in a one-half undivided fractional interest of both A and B. The children exchanged their remainder interests in the undivided fractional interest in A for the surviving spouse’s remainder interest in the undivided fractional interest in B. Thus, after the exchange, the surviving spouse held a fee simple interest in A and the children held a remainder interest in B. The Service ruled that the remainder interests were like kind and that the exchange qualified for Section 1031 nonrecognition treatment.

In *Koch*, the taxpayer transferred a fee in improved and unimproved land in exchange for “parcels of real estate which were subject to 99-year condominium leases.” The sole issue before the court was whether the fee interests transferred were like kind to the property received subject to the 99-year condominium leases. The Service made two arguments for its position that the properties were not like kind: (1) the asset the taxpayer received that had value was “the right to an ‘income stream’ represented by the rent under the 99-year lease,” and (2) because the lessees’ interests are like kind to a fee in real property, a lessor’s interest in the same property cannot be like kind to a fee.

Regarding the first argument, the Tax Court held that “the fee simple interests which petitioners acquired cannot be segmented into two separate sets of rights. The right to the rent is merely an incident of the ownership of the fee simple interest. It automatically follows the

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20. 1978-1 CB 256.
reversionary interest and vests with the owner of the fee.” Thus, the court did not consider the right to rental income as an asset separate from the fee.

Regarding the second argument, the court noted that of the bundle of rights held by a fee owner, multiple interests may be transferred, each of which may qualify as like kind to a fee in real estate. As an example the Court referred to Crichton,21 Rev. Rul. 68-331,22 and Rev. Rul. 55-73923 (all discussed further below), stating:

[T]he law is settled that a fee owner can convey mineral interests or perpetual water rights in a like kind exchange while retaining the surface interests in the land. . . . Thereafter, the fee simple interest in the surface could undoubtedly be exchanged for other land under Section 1031(a). The owner of the mineral interests or perpetual water rights could also make qualifying Section 1031(a) exchanges for other land. Similarly, in the instant case, both the lessor-petitioner and the lessee have interests in the same real estate, and both are eligible for Section 1031(a) treatment.

Thus, the court held that the interest in the property subject to the long-term condominium lease was like kind to a fee in other real estate. By implication, this ruling also appears to acknowledge that two partial interests in the same property may be like-kind property.

Similarly, in Ltr. Rul 9224008, the Service privately ruled that a reversionary interest in property subject to a lease was like kind to a fee in other real estate, and that the transfer of the reversionary interest in exchange for a fee in other real estate qualified for nonrecognition treatment under Section 1031. In that ruling, the taxpayer, as lessor, entered into a long-term lease with a third party and later transferred the reversionary interest in the property in exchange for a fee in other real estate, obtaining Section 1031 nonrecognition treatment.

C. Life Interests

A life interest in real estate should qualify as like kind to a fee in other real estate if it is not estimated to be for fewer than 30 years. In Rev. Rul. 72-601,24 a father owned a fee interest in Property A and his son

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21. 122 F.2d 181, 27 AFTR 824 (CA-5, 1941), aff’d 42 BTA 490 (1940).
22. 1968-1 CB 352.
owned a fee interest in Property B. The father transferred a remainder interest in Property A to his son for a life interest in Property B.25

Regarding the like-kind property requirement, the Service held that the life interest the father received did not qualify for Section 1031 nonrecognition treatment because the father, at age 70, had a life expectancy of fewer than 30 years.26 Thus, a life estate in real estate with an estimated life of fewer than 30 years probably was not like kind to a fee in real estate. Since the basis for the Service’s decision in that ruling was the estimated term of the life interest, by negative inference, a life interest with an estimated term of more than 30 years should be like kind to other real estate under Reg. 1.1031(a) 1(c)(2).

D. Easements

In Rev. Rul. 72-549,27 the Service ruled that a perpetual easement and right-of-way granted to an unrelated party were properties of like kind to real estate with nominal improvements and real estate improved with an apartment building. The Service has also privately ruled in Ltr. Rul. 200201007 that the exchange of a perpetual “conservation easement in real [estate], under [Section] 1031, for a fee interest in other real estate that is also subject to a conservation easement will qualify as a tax deferred exchange of like-kind property. . . .” It is worth noting that the laws of the state in which the conservation easement was granted provided that the perpetual conservation easement is an interest in real estate.

Because these rulings address only perpetual easements, they leave unanswered whether an easement in real estate for a term of at least 30 years may be like kind to other real estate. The Service’s extension of the 30-year rule to life interests may be an indication that the 30-year rule also applies to non-perpetual easements. The decision in Koch also leads one to believe that property subject to an easement, regardless of duration, is like kind to a fee in other real estate.

E. Rights in Natural Resources

Rights in natural resources (e.g., water rights, mineral interests, timber rights, crops) may or may not be like kind to a fee in other real estate, regardless of the state law classification of such interests. Because the rulings addressing these issues are often fact-specific, each of the

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25. Under the current related-party rules in Chapter 14 of the Code, this transaction would not accomplish the transfer tax benefits the father sought; Property A would be included in the father’s estate.
26. The Service treated the son’s retention of a remainder interest as a lease and also disallowed Section 1031 treatment to the son. As discussed below, a lessor’s entering into a lease is not capable of satisfying the exchange requirement.
27. 1972-2 CB 472.
various general types of interests deserves separate consideration.

1. **Timber Rights**

The use of timber rights in Section 1031 exchanges has been the subject of several rulings. These rulings answer some questions, but leave others unanswered.

**Timber Rights for Fee Interests in Other Real Estate.** *Oregon Lumber Co.*[^28] is the leading case addressing whether timber rights are like kind to a fee in other real estate. In *Oregon Lumber Co.*, the Tax Court found that in each of three transactions the taxpayer exchanged land for the right to cut and remove standing timber from government property within a reasonable period of time. (The court apparently did not consider relevant the fact that in two of the exchanges, land transferred by the taxpayer included standing timber.) The court’s discussion about why the right to cut standing timber is not like kind to a fee in real estate is informative and deserves close attention.

First, the court considered whether the right to cut and remove standing timber is realty or personalty. The court described three treatments of timber rights by the various states. The most widely accepted view, it said, was that “growing trees constitute a part of the land and as such are real property.” Thus an agreement for the sale of growing trees is a contract for the sale of an interest in land. A second rule, the “immediate severance rule,” is “to the effect that when standing timber is sold with the understanding that it is to be removed immediately, or in a reasonably continuous manner, the sale is considered being one for the sale of chattels.” Third, “a few jurisdictions without qualification or limitation of any sort subscribe to the view that contracts for the sale of growing timber contemplate” the conveyance of personal property.

The court looked specifically to Oregon law to determine whether the right to cut and remove timber in the instant case was personal property. Oregon subscribes to the view “that a contract for the sale of trees, if the vendee is to have the right to the soil for a time for the purpose of further growth and profit, is a contract for an interest in land…”[^29] On the other hand, “where the trees are sold in the prospect of separation from the soil immediately or within a reasonable time, without any stipulation for the beneficial use of the soil, but with license to enter and take away, it is regarded as a sale of goods only…”[^30] The Tax Court also recognized that the Oregon Supreme Court found that “standing timber is deemed to be goods when and only when it is agreed to be severed before sale or under

[^28]: 20 TC 192 (1953).
[^30]: Id.
Based on these rulings, the court concluded that the taxpayer’s right to cut and remove the Oregon standing timber within a definite period was personal property. An exchange of realty for personalty is not an exchange of like kind property, so the transaction did not qualify for Section 1031 nonrecognition treatment.

While under Oregon law the right to cut and remove the timber is personal property, the court stated that it would not be improper to conclude that petitioner’s real property was exchanged for a license to cut and remove standing timber. Nonetheless, the court noted that an exchange of real property for a license would not satisfy the like-kind property requirement.

Second, the court considered what the outcome would have been had it, contrary to fact, found that the right to cut and remove the timber was real property under Oregon law. Citing Midfield Oil Co.32 and Kay Kimbell33 (both discussed below), the court recognized that not all property treated as real estate under state law is like kind to other real estate. An oil payment right, for example, is not like kind to a royalty interest, even though both are real property. An oil payment right is a limited interest — once paid, the liability is removed — but a royalty interest is in the nature of a fee because it continues as long as gas and oil are produced. By analogy, the taxpayer in Oregon Lumber Co. exchanged a fee in real estate for a limited right to cut and remove standing timber. The right to cut and remove standing timber is transient and depends on the affirmative action of the holder of that right. The fee is permanent and depends only upon the original grant. The right to cut and remove timber is more in the nature of utilization of land; the fee is ownership of the land itself. Thus, even if it had found that the timber right was realty, it appears that the Tax Court would have ruled that the timber right was not like kind to a fee in other real estate.

In TAM 9525002, the National Office advised that standing timber is not like kind to raw land. The relinquished property in the TAM was “all hardwood and pine timber now standing or lying on the . . . land which are cut and removed from said land . . . within two (2) years from the date of the deed . . . and all trees and timber not cut and removed from said land on or before said date shall be the property of the taxpayer.”

The Service did not consider whether the standing timber conveyed by the taxpayer was real property under state law. Instead, it compared the standing timber to the oil payment at issue in W.M. Fleming.34 From a bird’s-eye-view, the Service concluded that “[a]fter the transaction, Taxpayers ended up with (1) [their] original land less the trees that were

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32. 39 BTA 1154 (1939), discussed below.
33. 41 BTA 940 (1940).
34. 24 TC 818 (1955).
growing thereon, and (2) three additional tracts of timberland.” The timber deed transferee ended up with the trees situated on the taxpayers’ property. The lack of continuity in the nature of investments contemplated by Section 1031(a) dictated that the taxpayers should recognize gain.

In Smalley, the Tax Court considered whether the taxpayer intended to enter into an exchange to determine the timing of gain recognition. The exchange involved the taxpayer transferring to another party the exclusive rights to cut and remove standing timber over a two-year period on land owned by the taxpayer. The taxpayer used the exchange proceeds to acquire three other parcels of land with standing timber. Because the court decided the case on the question of whether the taxpayer intended to enter into an exchange of like-kind property on the date the right to standing timber was transferred, it is unclear whether the transaction would qualify for nonrecognition treatment.

All the property involved was located in Georgia. The court agreed that, under Georgia state law, the prevailing view appears to have been that a conveyance of standing timber, to be severed by the buyer, generally constituted a transfer of real property. The court noted that not every exchange of real property interests met the Section 1031 like-kind property requirement. Nonetheless, the taxpayer’s reliance on existing authority and the possibility that under Georgia law the timber-cutting rights are real property were sufficient to establish that the taxpayer had a bona fide intent to exchange realty for realty.

Based on Oregon Lumber Co., it is apparent that a timber right treated as personal property under state law is not like kind to a fee in other real estate. The dicta in Oregon Lumber Co. and the Service’s position in TAM 9525002, indicate that a timber right of limited duration, even if treated as real estate under local law, is not like-kind to a fee in other property. The discussion in Smalley about timber rights most likely is not sufficient to overcome the other discussions on this point. Thus, the only type of timber right that may be like kind to a fee in other real estate appears to be the right to cut and remove timber for an extended period of time (perhaps 30 years or more) that is treated as real property under state law.

Timber Rights for Timber Rights. In a memorandum opinion, the Tax Court in Everett held that the transfer of timber rights for other timber rights qualifies for Section 1031 nonrecognition treatment. The timber rights transferred permitted the taxpayer to remove timber for periods between 36 months and six years. The opinion does not discuss the terms of the timber rights acquired, nor does the opinion discuss the attributes that make the two timber rights like kind. Nonetheless, the case

36. 37 TCM 1978-53
demonstrates that the right to cut timber on one piece of property may be like kind to the right to cut timber on another piece of property.

Timberland for Timberland or Raw Land. Two revenue rulings established the Service’s position that timberland is like kind to other timberland and that timberland is like kind to raw land. In Rev. Rul. 72-515, the Service ruled that timber growing on the land is part of the land. “Such things as the quantity, quality, age and species of the timber growing on the land may influence the grade or quality of the timberland involved in the exchange, but do not influence the kind or class of the property exchanged, that is, land.” Thus, the taxpayer’s timberland with some virgin timber and substantial stands of second growth timber were like kind to timberland that supported substantial amounts of virgin timber. Similarly, in Rev. Rul. 78-163, the Service ruled that timberland is like kind to raw land. Therefore, it appears that as long as timber rights are transferred with the underlying land, they are like kind to a fee in real estate.

2. Unharvested Crops

Much like the authority addressing timber rights, the cases and rulings addressing the applicability of the like-kind property rule to unharvested crops answer some questions, but leave others unanswered. Rev. Rul. 59-229 involved an exchange of two farm properties consisting of farm lands, farm buildings, residences, and unharvested crops. The central issue was whether the unharvested crops fell within the provision that excluded stock in trade or other property held primarily for sale from Section 1031 nonrecognition treatment (the focus was not on the like-kind property requirement).

The Service turned to Section 1231(b)(4), which provides that unharvested crops sold or exchanged with land are considered used in a trade or business, and held that the exclusion for stock in trade, did not apply to the transaction. Because it did not apply, the Service ruled that the unharvested crops transferred and received satisfied the business use requirement. The Service did not state whether the unharvested crops alone were like kind to a fee in other real property, merely like kind to the unharvested crops received in the exchange, or, together with the land, like kind to other real estate.

Asjes nibbled on the edges of the like-kind property issue, but also left those questions unanswered. It involved the involuntary taking of a nursery and all of its “nursery stock” (i.e., its various trees, shrubs, and

37. 1972-2 CB 466.
39. 1978-1 CB 257.
40. 1959-2 CB 180.
41. 74 TC 1005 (1980).
plants). The bulk of the nursery stock was grown by the nursery from seeds, grafts, and cuttings. As the Tax Court pointed out:

This operation involves a long process of planting, transplanting, and moving nursery stock through various technologically equipped greenhouses located on the property until it is capable of survival in the fields. There, protection from sun and strong southwesterly winds was afforded young nursery stock, until stable, by large trees and plants, called windbreaks, which are essential to their survival.

The taxpayer used the condemnation proceeds to acquire other property on which it could build necessary buildings and operate its nursery. The replacement property had significant natural windbreaks and salable vegetation. To rule that the involuntary transfer of the taxpayer’s property and the acquisition of the replacement property qualified for nonrecognition treatment, the court recognized that “[t]he standard which replacement property must meet [under Section 1033(g)] to qualify for nonrecognition treatment is that it be of a ‘like kind’ to the property condemned.” The court found that the taxpayer “gave up land with vegetation, buildings, and improvements, and that is what it repurchased.” Thus, although the two properties were not identical, the court held that they “are the same kind of assets, having the same nature and character, [and found] that the like kind test of [S]ection 1033(g) has been met.”

In both Rev. Rul. 59-229, and Asjes, the property transferred and the property received bore unharvested crops. Because of the limited authority addressing exchanges involving unharvested crops and the limited facts in those cases, three questions remain unanswered: (1) whether unharvested crops by themselves are like kind to other unharvested crops by themselves, (2) whether unharvested crops by themselves are like kind to a fee in other real estate, and (3) whether land with unharvested crops is like kind to other real estate without unharvested crops. The timber right cases provide the best analogies for answering these questions. Everett provides that a timber right (i.e., the right to harvest timber) is like kind to other timber rights. Therefore, by analogy, the right to harvest and take crops would appear to be like kind to another right to harvest and take crops. Does this analogy, however, amount to comparing apples to oranges? Could the Service take the position that wood is wood while crops can vary from lettuce to citrus, to potatoes, to sugar beets, to peanuts, so that one must look closely at the underlying crop to determine whether the rights to the crops are like kind? While the Service could take such a position, one could argue that the nature and character of most crops is that they are consumable, perishable goods, and thus the rights to harvest them would be like kind.
Based on *Oregon Lumber Co.*, it appears that if a taxpayer transfers only the right to harvest the crops in exchange for a fee in other real estate, the like-kind property requirement most likely will not be met. The right to unharvested crops is similar to a right to cut timber in that it lasts for a limited period and pertains to a specific quantity of goods.

Finally, by analogy, Rev. Rul. 72-515 and Rev. Rul. 78-173 indicate that land with unharvested crops is like kind to land without crops. In all of this, however, a person exchanging only crops may have difficulty surmounting the requirement that they be held for productive use in a trade or business or for investment.

**PROPERTY INTERESTS IN MINERALS**

Before considering cases and rulings on Section 1031 exchanges, it is appropriate to review several general types of mineral interest that may be involved.

*Mineral Estate.* A mineral estate is an interest in all the minerals in the land. It can be transferred with or without the land and gives the owner the right to take the minerals or to receive a royalty if someone else takes the minerals. A mineral estate has a perpetual existence.

*Mineral Lease.* The mineral lease gives the lessee the right to use the land to explore and then, if mineral is discovered, to take the mineral either for a definite term or so long as it can be produced. The holder of the mineral lease will likely make royalty payments to the owner of the royalties, who may or may not be the owner of the land.

*Working Interest.* A working interest is “[t]he right to the mineral interest granted by an oil-and-gas lease. The term is so called because the lessee acquires the right to work on the lease property to search, develop and produce oil and gas, and the obligation to pay all costs.” Remember, Section 761(a)(2) allows a partnership that owns and operates a working interest to elect out of a Subchapter K. In such a case a partner’s interest in the working interest would probably include an interest in personal property, so care must be taken when such an interest is involved in an exchange.

*Mineral Royalty.* Stated more specifically, a mineral royalty is a right to receive a specified percentage of all minerals produced, which right will last for the entire life of the property interest assigned.

*Oil Payment.* An oil payment (a.k.a., production payment) is a right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as, and when produced.

*Intangible Drilling Costs.* While perhaps not a right in minerals, intangible drilling costs are an important aspect of mineral interests. Intangible drilling costs are “[c]onstruction expenses incurred in drilling, testing, and completing an oil or gas well.”

Property owners can become quite creative in further dividing these general types of interests.
4. Mineral Interests

Because of their variety and prevalence, mineral interests (see sidebar above) are often involved in Section 1031 exchanges. Several cases and rulings consider whether mineral interests are like kind to other real estate.

Exchanges Involving Mineral Estates. The leading case involving a mineral estate is *Crichton*. There, the taxpayer received an undivided interest in a city lot in exchange for an undivided three-twelfths interest in “oil, gas and other minerals, in, on and under, and that may be produced from” country land. Based on the definition in the sidebar, this right to minerals appears to be a mineral estate. In a very short opinion, the Fifth Circuit ruled that the exchange qualified for nonrecognition treatment under the like-kind exchange rules.

First, the court acknowledged that “under Louisiana law, mineral rights are interests not in personal but in real property, and that the rights exchanged were real rights.” The court forbade the Service from “marshal[ling] or parad[ing] the supposed dissimilarities in grade or quality, the unlikeness, in attributes, appearance and capacities, between undivided real interests in a respectively small town hotel, and mineral properties.” Furthermore, it said no gain or loss is recognized “from an exchange of real estate for other real estate, and … the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property.” The law was not intended “to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use.” This ruling appears to establish a broad definition of like-kind real estate, apparently adopting the view that all real property is like kind. Unfortunately, as discussed below, not all courts agree.

Exchanges Involving Mineral Leases. In Rev. Rul. 68-331, the Service considered whether an oil lease is like kind to a ranch. In Rev. Rul. 68-331 the taxpayer, a lessee in a producing lease of an oil deposit in place extending until the exhaustion of the deposit, transferred the oil lease for a fee interest in an improved ranch. The Service ruled that the oil lease and fee in the improved ranch were like kind.

Exchanges Involving Mineral Royalties. In the Section 1033(g) context the Service has ruled that an overriding oil and gas royalty is like

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42. The exchange was between the taxpayer and her children, but this case was decided before Congress became concerned about related-party exchanges and enacted Section 1031(f) in 1989. See Borden, “Recent Developments in Build-to-Suit Exchanges,” 44 Tax Management, Inc. 19 (January 27, 2003), for an in-depth discussion of related-party exchanges.

43. 1968-1 CB 352.

44. An interest in real property for federal income tax purposes, under the ruling in Rev. Rul. 68-226, 1968-1 CB 362.
kind to unimproved real estate. Because this ruling applied the Section 1031 like-kind property standard, one should be comfortable adopting the ruling in the Section 1031 context.

Exchanges Involving Oil Payments. In Midfield Oil Co. the taxpayer assigned an oil and gas payment in exchange for an overriding oil and gas royalty. The oil and gas payment provided that the owner would receive four-eighths of the entire production of oil and gas from a certain piece of property up to $28,500. The oil and gas royalty was five thirtyseconds of seventh-eighths of the oil and gas until the oil and gas payment had been paid, and then it became one-fourth of seven eighths of the overriding oil and gas royalty.

The Board of Tax Appeals listed two reasons for ruling that the interests were not like kind. First, the oil and gas payment is limited in amount – that is, the right of the holder terminated after the holder received a specified amount of proceeds derived from oil and gas produced on the lease. On the other hand, the overriding oil and gas royalty continued for so long as oil or gas might be produced from the leased property. Second, the fractions to be applied were different. The Court found the difference to be so substantial that it held the properties were not like kind. Notice that it did not consider whether the properties were real property under applicable state law – apparently the Board did not deem that fact relevant.

Kay Kimbell also involved an oil payment. In that case, the Board considered two separate exchanges, holding that the like-kind property requirement went unmet in both situations. In the first exchange, the taxpayer received two oil and gas payments in exchange for transferring an undivided one-fourth interest in and to a specified oil and gas lease, together with all the leasehold equipment and personal property located thereon, (i.e., a working interest). The Board held that the exchange did not satisfy the like-kind property requirement based upon the authority of Midfield Oil Co.

The second exchange involved the transfer of a contingent oil payment in consideration for a three-fourths working interest and a one-sixteenth royalty interest in eight acres of an oil and gas lease, together with leasehold equipment and personal property. The Board held that since there was nothing contingent about the working interest, it was unlike the contingent oil payments. Furthermore, the Board abided by the Midfield Oil Co. decision to find the properties were not like kind.

In P.G. Lake, the Supreme Court considered four separate Tax Court decisions and one district court decision involving oil payments. All of the cases involved the assignment of an oil payment, but only one, W.M. Fleming, involved the question of whether a like-kind exchange had

46. See also Crooks, supra note 5 (the Tax Court stated in dicta that the subsequent transfer of the royalty interest for other real estate could qualify for Section 1031 non-recognition treatment).
47. Note 11, supra.
occurred. In each of the non-exchange cases, the Supreme Court, applying
the fruit-of-the-tree doctrine,\textsuperscript{48} found that the payment received for the
assignment was ordinary income, as it was a substitute for the payment that
would have been received if the oil payment had been retained. The Court
stated that the taxpayers were merely converting future income into current
income. Thus, the transaction did not qualify for Section 1031
nonrecognition treatment.

\textit{Exchanges Involving Intangible Drilling Costs.} The Service, in
GCM 39572,\textsuperscript{49} advised that proceeds from condemned mineral leases could
be reinvested in capitalized intangible drilling costs to develop other oil and
gas interests. The basis for the Service’s position was that, under the
Section 1033(g) like-kind property standard, the condemned oil interests
and the new developed interests were like-kind. This causes one to
speculate that taxpayers should be able to use the proceeds from the sale of
real property to develop oil and gas property as part of a build-to-suit
exchange.\textsuperscript{50}

These rulings lead to the following conclusions: First, a mineral
estate is like kind to a fee in other real estate. Second, an oil lease is like-
kind to a fee in other real estate. Third, a mineral royalty is like-kind to a
fee in other real estate. Fourth, an oil payment is not like kind to a fee in
other real estate. Fifth, intangible drilling costs, if capitalized, may be like
kind to a fee in other real estate. It is important to note that, with the
possible exception of oil payments, the decisions did consider whether the
interests were real estate. This is important in the following discussion
about water rights.

\textit{Water Rights.} Because of \textit{Wiechens}, one of the most troubling
like-kind property questions is whether water rights are like kind to a fee in
other real estate. This is unfortunate because transactions involving water
rights can be significant. As an example, in February 2002, San Antonio
Water System agreed to pay the Lower Colorado River Authority $1 billion
for the right to billions of gallons of water over as many as 80 years.\textsuperscript{51}
While this transaction did not need to and may not otherwise qualify for
Section 1031 treatment, it demonstrates the potential magnitude of water
right transactions. For taxpayers who wish to exchange such rights under
Section 1031, definite guidance in this area would be appreciated. The
authority addressing water rights in the Section 1031 context is limited,
with some questionable results.

The Service has ruled that a perpetual water right is like kind to a
fee in other real estate for Section 1031 purposes. In Rev. Rul. 55-749,\textsuperscript{52} A

\begin{footnotesize}
\begin{enumerate}
\item[48.] See Horst, 311 U.S. 112, 24 AFTR 1058 (1940).
\item[49.] 12/1/86
\item[50.] See Borden, supra note 42.
\item[51.] Richter, “SAWS Signs LCRA Water Pact,” San Antonio Express-News, February 28,
February 2002.
\item[52.] 1955-2 CB 295.
\end{enumerate}
\end{footnotesize}
Bradley T. Borden

was the owner in fee of 20 acres of arid land, but he was not entitled to receive water from the irrigation district that included his land. B had a contract with the irrigation district whereby he had the right to “petition into” a specified number of acres of arid land for perpetual irrigation purposes. B agreed to petition A’s 20 acres of land into the irrigation district for water facilities in perpetuity in exchange for one half of the land owned by A. Under the applicable laws of the state in which the property is located, water rights are real estate.

The Service reasoned, “that from the applicable regulations the implication is clear that the rights vested in the respective grantees in and to the properties exchanged must be of the same general character or of substantial equality and, if they are not, then the properties exchanged are not of like kind . . . .” Based on this reasoning the Service ruled that:

Under the circumstances in the instant case, where the water right, whatever its size, is in perpetuity, as distinguished from a right to a specific total amount of water or to a specific amount of water for a limited period, the water rights and land involved are regarded as sufficiently similar to constitute property of like kind within the meaning of Section 1031(a).

More recently, the district court in Wiechens held that certain nonperpetual water rights were not sufficiently similar to be like kind to a fee in land, even though the rights are real estate under state law. The taxpayer, Wiechens, obtained the right to receive Colorado River water on an annual basis to irrigate its land, which was located within the boundaries of Harquahala Valley Irrigation District (HVID). After the HVID and the U.S. Department of the Interior entered into a contract allowing HVID landowners to sell their water rights back to the government without an accompanying sale of the land, the taxpayer opted to retain its land but to exchange its water rights for a fee interest in other farm land. The only issue before the court was whether the water rights were like kind to the farm land. The court and the Service agreed with the taxpayer that the water rights were an interest in real property under Arizona state law.

Before answering whether the water rights and farm qualify as like-kind real property, the court examined the nature of the water rights and found that they are limited in (1) quantity, (2) priority, and (3) time. HVID was limited to 7.67% of the total supply of agricultural water available for delivery from the Central Arizona Project. During water shortages, municipal, industrial, and Indian uses of the water have priority over non-Indian irrigation uses, including the taxpayer’s transferred right. The subcontract under which the taxpayer’s right was derived was limited to a 50-year period. The court held that these characteristics distinguish the
Wiechens water rights from the water rights in Rev. Rul. 55-749 and cause the rights to not be like kind to the farm land.

Your author questions the ruling in Wiechens and asserts that the water rights in question are like kind to a fee in other real estate. Before considering why this is so, recognize that the court incorrectly paraphrased Rev. Rul. 55-749, stating, “Revenue Ruling 55-749 clearly advises that water rights of a limited amount or duration are not sufficiently similar under [Section] 1031 to a fee simple interest in land.” (Emphasis added.) In this reference, the court focuses on a limited amount and a limited duration. This inaccurate summary ignores the facts of Rev. Rul. 55-749 and it overlooks the Service’s exact language.

Rev. Rul. 55-749 dealt with a perpetual water right. The Service did not rule on whether a non-perpetual water right could qualify for Section 1031 treatment. Therefore, any discussion by the Service about a non-perpetual water right is a form of dicta and should not be relied upon by the court. The court states that the ruling advises that water rights of a limited duration are not sufficiently similar under Section 1031 to a fee in land. This is not a correct summary of the ruling. The court similarly states that the ruling advises that a water right of limited amount is not sufficiently similar to a fee in land. This, too, is not correct. The exact language of the ruling provides that “the water right, whatever its size” (emphasis added) is like kind to a fee in other real estate. The Service’s disregard for size indicates the Service’s contemplation that a water right of limited amount (as opposed to a specific amount) could be like kind to a fee in other real estate.

The Service distinguished a perpetual water right from “a specific total amount of water or a specific amount of water for a limited period.” A specific amount of water, regardless of the period over which it is available, arguably is different from a limited amount of water. For example, a specific amount of water is 1,000 acre feet of water. A specific amount of water for a limited period could be 1,000 acre feet of water per year for ten years. Indeed, the only case cited by the Service in Rev. Rul. 55-749 is W.M. Flemming, in which an oil payment of a fixed dollar amount was held to not be like kind to other real estate. As discussed below, the difference between a right to a specific quantity of water and a limited percentage of available water is sufficient to disregard the Service’s comment in Rev. Rul. 55-749.

Other factors indicate that the Wiechens water right is like kind to a fee in land. First, the interest was real property under Arizona law. Although the state law treatment of a property interest is not dispositive, it is, as provided in Crichton and Oregon Lumber Co., an indication that the interest is like kind to real property.

Second, the 7.67% of available water that the taxpayer was entitled to in Wiechens was not a right to a specific amount of water or a specific amount of water for a limited period, as referred to in Rev. Rul. 55-749.
The interest involved in *Wiechens* is limited only by total available water. Thus, if total available water in a year is 100,000 acre feet, the owner of the Wiechens right would be entitled to 7,670 acre-feet. As total available water fluctuates, the holder of the interest would have varying rights to water. A limit imposed by available water applies to all water rights because a severe drought could prevent water from being drawn against even the most favorable water right. In fact, the interest is similar to an oil and gas lease that, by its nature, is limited to a percentage of production and is limited by the quantity of available oil and gas. In the case of a water right, however, there is perhaps greater hope the water supplies will be replenished. As stated in *Koch*:

> The main distinction between the two transactions [an exchange of an oil payment versus an exchange of a royalty interest] is the duration of the interests - an overriding royalty interest continues until the mineral deposit is exhausted whereas a carved-out oil payment right terminates usually when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received.

The water right in *Wiechens* is more similar to a royalty interest in that it entitles the holder to a percentage of available water and the right exists until the water is depleted. Thereafter, if the water is replenished, the right exists in the additional water.

Third, the *Wiechens* court identifies the holder’s order of priority as a factor indicating that the interest is not like kind to a fee in land. This factor does not appear to have been important in other situations. For example, a reversionary interest gives the holder inferior priority to the person holding the current right to possession. Nonetheless, as discussed above, courts have held that such interests are like kind to land. Thus, the court should not allow the inferior priority to influence its decision.

Finally, the court appears to give the most weight to the limited duration of the Wiechens interest. It has long been the position of the Service that a lease of real estate of 30 years or more is equivalent, and therefore like kind to a fee in other real estate. While it is difficult to determine the significance of 30 years, the long-standing rule makes clear that a right to use property for at least 30 years is the equivalent of the right to use the property indefinitely. It also establishes that, for purposes of the Section 1031 like-kind property requirement, the distinction between the right to use property for a limited period and the right to use property in perpetuity disappears if the limited period equals or exceeds 30 years.

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53. See, e.g., Century Electric, *supra* note 13 (the 30-year rule “has survived successive re-enactment of the internal revenue acts and has thus acquired the force of law.”).
Since the right to water in Wiechens exceeds 30 years, it should be the equivalent of a perpetual right for purposes of applying the Section 1031 like-kind property rule.

The court, however, ruled that “equating the [taxpayer’s] water rights to a leasehold of a fee for 30 years or more is inappropriate.” After citing Koch to the effect that the like kind determination requires an examination of “the respective interests in physical properties, the nature of the title conveyed, the rights of the parties, [and] the duration [of the interest],” the court found that the taxpayer’s “water rights were narrowly restricted, unlike a fee simple interest in land.” As discussed already, the water rights do not appear to be narrowly restricted, at least not more than other real estate interests discussed above.

Additionally, the court failed to compare the 50-year period of the water right to the 30-year period of a leasehold in real estate. Instead of examining the significance of the 30-year lease, the court made a conclusory statement about the water right and a fee interest in land. Because this issue is so critical to the ruling, the court should have undertaken additional analysis and should have given the issue greater attention before ruling. The court would have benefitted by examining other cases that have considered similar interests. In this context, in addition to the 30-year rule in the regulations, the court could have looked at cases and rulings addressing mineral royalties. A royalty interest, by granting the holder a right to minerals until depleted contemplates the interest terminating at some future date. While the duration of the interest could be estimated, there is no indication that this has ever been attempted in determining whether the Section 1031 like-kind property requirement has been satisfied. Arguably, the Wiechens water rights, extending more than 30 years, are “perpetual in nature, and they meet the duration-of-the rights test” as stated by the court in Koch. While not identical, the Wiechens water rights and the ranch appear to be like kind.

F. Real Estate Improvements

Perhaps nowhere is the like-kind property rule more clouded than in situations in which one exchanged property is nothing more than real estate improvements and the other is land or land and improvements. The overcast nature of this issue seems unwarranted based on a reading of the regulations. Reg. 1.1031(a)-1(b) states: “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.” Reg. 1.1031(a)-1(c) provides “exchanges of improved real estate for unimproved real estate” as an example of exchanges of like-kind property. It seems clear from these provisions the real estate improvements are like kind to raw land or improved land. The Service, however, by ruling contrary to this in the Section 1033 context has obfuscated the issue.
In Rev. Rul. 67-255, the Service ruled that none of the buildings, storm drains, water systems, or roads constructed on land already owned by the taxpayer qualified as like-kind replacement property to land involuntarily converted. The Service, citing no precedent, ruled that:

[Although the term ‘real estate’ is often used to embrace land and improvements thereon, land and improvements are by nature not alike merely because one term is used to describe both. Land is not of the same nature or character as a building, or a storm drain, or a water system or a road.

The Service used this same language in Rev. Rul. 76-391 to rule that a commercial building constructed on land owned by the taxpayer does not qualify as a like-kind replacement of farmland under Section 1033(g).

The Service’s conclusion in both of these rulings is surprising. As stated above, the definition of like-kind property in Reg. 1.1031(a)-1 applies to Section 1033(g). By stating in Rev. Rul. 67-255 and Rev. Rul. 76-391 that land is not of the same nature or character as improvements, the Service contradicts its language in the regulations. As cited above, the regulations provide that improvements to real estate relate only to the grade or quality of the property and not to its kind or class. If, as the regulations provide, an exchange of improved property for unimproved property qualifies as a like-kind exchange, the improvements must be like kind to the land. Thus, the inconsistent application of this rule in two revenue rulings appears to be incorrect.

A district court noticed the Service’s inconstant application of the definition of like-kind property in Davis. In that case, the taxpayers used the proceeds from involuntarily converted land to construct a storm drainage and water system, grade the land, and excavate a roadway. The court ruled “that the improvements made by the taxpayers represent a substantial continuation of their prior commitment of capital and that these improvements qualify for non-recognition of gain as real property of ‘like kind’ to the property condemned as required by Section 1033(g).”

To reach this conclusion, the court acknowledged the Service’s ruling in Rev. Rul. 67255, and compared it to the ruling in Rev. Rul. 73-120. In Rev. Rul. 73-120, the Service ruled that a water plant — together with appurtenant pipelines, mains, manholes, and accessory installations, and an apartment complex are like-kind property. The district court

54. 1967-2 CB 270.
56. The Service followed this position in Ltr. Rul. 9031015.
57. 411 F.Supp. 964, 37 AFTR2d 76-1447 (DC Hawai, 1976), aff’d. 589 F.2d 446, 43 AFTR2d 79-584 (CA-9, 1979) (holding that the transaction came within Section 1033(a) without considering the applicability of Section 1033(g).
58. 1973-1 CB 369.
recognized that whether the interest in the apartment complex included the land or not:

[T]he Service has either approved an “improvements for improvements” replacement or “land and improvements for improvements” replacement. If the former, then it is plain that it is consistent in holding that improvements cannot be equated to land as “real property.” If the latter, which appears more likely, then it has taken an inconsistent position.

Because the court found Rev. Rul. 67-255 to be inconsistent with other rulings, the court disregarded it.

The court did not look to whether the label of real estate attached to any of the interests in question. Instead, it looked “to the purpose of the statute and whether or not the improvements made by taxpayers re-establishes [their] prior commitment of capital.”\(^59\) Thus, it ruled without considering the legal character of the property.

Additional analysis also leads one to conclude that real estate improvement are like kind to land or land with improvements. It is well established that if a taxpayer transfers raw land in exchange for a ranch consisting of land and machinery, the machinery, as personal property, will not be like kind to the transferred land.\(^60\) It is clear that non-like-kind property is separated from the like-kind property in such a transaction to determine the applicability of Section 1031. This principle would apply to an exchange of unimproved property for improved property if the improvements were not like kind to the unimproved property transferred. The improvements would be boot, which could trigger gain. Based on the regulations, such a result appears to be unreasonable.

A private letter ruling in the Section 1031 context casts further doubt about whether Rev. Rul. 67-255 and Rev. Rul. 76-391 reach the correct result. In Ltr. Rul. 8008113, the taxpayer transferred improvements and leased the underlying property to an unrelated party for 35 years the underlying property. In exchange, the taxpayer received a fee interest in other property. The Service ruled that the “improvements that are affixed to the land are real property under the applicable state law. Therefore, the improvements of the shopping center which are exchanged for a fee simple interest in the Exchange Properties satisfy the ‘like-kind’ requirements of Section 1031.” Thus, although Rev. Rul. 67-255 and Rev. Rul. 76-391 create some confusion about this issue, it appears — based on the Davis decision, the regulations, and Service’s position in other rulings — that real

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estate improvements are of the same nature and character as unimproved real estate.

The proliferation of build-to-suit exchanges has caused this issue to gain renewed attention. In Ltr. Rul. 200251008 and Ltr. Rul. 200329021, the Service ruled that the transfer of a fee interest in real estate in exchange for a leasehold of greater than 30 years of land with improvements qualifies for Section 1031 nonrecognition treatment. In the context of the like-kind property rule, this is the logical extension of the provisions in the regulations stating that a leasehold in real estate is like kind to a fee in real estate and that unimproved real estate is like kind to unimproved real estate. The like-kind property requirement would also appear to be satisfied if the taxpayer (1) leased raw land to an exchange accommodation titleholder at an arms-length rate under a Rev. Proc. 2000-37 arrangement, (2) financed construction of improvements on the leased property, and (3) used the proceeds from the sale of other real estate to acquire the leasehold and improvements from the exchange accommodation titleholder.

III. THE EXCHANGE REQUIREMENT

Section 1031(a) requires an exchange — a transfer to and from the taxpayer — to obtain nonrecognition treatment. “[T]o constitute an exchange, the transaction must be a reciprocal transfer of property . . . .”61 Neglecting the exchange requirement and focusing solely on the like kind property requirement when dealing with partial real estate interests may be disastrous. As stated by the Chief Counsel’s Office: “The parallel treatment that is accorded transferors of leaseholds and life interests in real property, for purposes of characterizing the nature of the transaction, reinforces our belief that such interests should likewise receive parallel treatment under [S]ection 1031(a).”62 Thus, to have an exchange, there must be a transfer. Certain transactions involving partial real estate interests do not constitute transfer, however, and therefore cannot satisfy the exchange requirement.

A. Land Leases

Although the regulations provide that a leasehold interest of 30 years or more in real estate is like kind to a fee interest in real estate, entering into a lease as a lessor, regardless of its length, does not satisfy the Section 1031 exchange requirement. In considering cases that have addressed whether an exchange has occurred, remember that an exchange requires a reciprocal transfer. “Central to this issue is whether the granting

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61. Reg. 1.1002-1(d).
62. GCM 34450, 3/8/71
of the lease in consideration for the real property received is a ‘sale or exchange of property’ for purposes of [Section] 1031.”

I. Entering Into a Lease as Lessor

Butler, while not a like-kind exchange case, establishes that executing a lease as lessor is different for federal income tax purposes from transferring a fee in real estate. In that case, the taxpayer was an Ohio resident who owned real estate in Ohio. The taxpayer executed a lease of the property granting the lessee a 99-year lease, renewable forever for terms of 99 years. The lease called for regular lease payments and provided the lessee, or his heirs or assigns, the option of purchasing the land at any time during the original term of the lease or any of the renewal periods for an agreed amount that would not increase after the lease had been in effect for ten years.

The Board of Tax Appeals recognized that in Ohio, a lease with such terms is treated, in many respects, as a conveyance of a fee. Nonetheless, citing the Supreme Court’s decision in Weiss v. Weiner, held that irrespective of the laws of Ohio, “the instrument in question is no more than a lease and that the question as to whether amounts paid by the lessee under its terms and in consideration of its execution constitute income to the lessor is governed by the law applicable to other leases.” Therefore, the execution of the lease was not treated as a transfer of the property, irrespective of the state law treatment of the transaction.

Pembroke applied the principles in Butler to an intended like-kind exchange. In Pembroke, the taxpayer owned improved real estate (82-90 North Front Street). The taxpayer entered into a 99-year lease that property providing that the lessee would transfer other real estate (514-30 West Rich Street) and make annual rental payments to the taxpayer. The Board of Tax Appeals held that this transaction was not an exchange of properties within the purview of the predecessor of Section 1031. Instead, the Board held that 514-30 West Rich Street was received “in the nature of a bonus for making the 99 year lease on the Front Street property. The bonus payment constituted income to the petitioner when received in 1925, to the extent of its fair market value.” The Board did not provide a significant discussion of the basis for its holding, but since the execution of a lease is not a transfer, the transaction could not qualify as an exchange.
The taxpayer in Rev. Rul. 66-209, the taxpayer, Y Corporation, owned two pieces of real estate, Lot A and Lot C. Y Corporation entered into an agreement with unrelated X Corporation, under which X Corporation agreed to acquire Lot B and convey it to Y Corporation in exchange for Y Corporation leasing Lot A, Lot B, and Lot C to X Corporation. The term of the lease extended beyond 30 years. Improvements on the lots would become the property of Y Corporation, but X Corporation would have the right to use the improvements during the term of the lease. The Service ruled, based on Pembroke, that the receipt of Lot B for entering into the lease was an advanced rental received in consideration for executing the lease. Thus, entering into the lease as lessor and receiving Lot B from the lessee did not qualify as an exchange under Section 1031.

2. Entering Into a Lease as Lessee

Interestingly, in Rev. Rul. 66-209, the Service stated that while the transferee-lessee did not exchange like-kind properties, “the transfer of real property in consideration of the execution of a leasehold interest in the same or other property may be an exchange of properties of like-kind for purposes of Section 1031 of the Code to the transferor-lessee. . . .” The Service’s reference to the execution of a leasehold interest in the same property appears to refer to a sale-leaseback, which, as discussed below, may qualify for Section 1031 nonrecognition. The Service’s reference to a lease in other property begs the question of whether a lessee’s entering into a lease of greater than 30 years, outside the sale-leaseback context, can qualify as part of a Section 1031 exchange.

Because entering into a lease as lessee is different from entering into a lease as lessor, it appears a lessee should be able to enter a lease as part of an exchange. A person who holds a fee interest in land only grants to the lessee a right to use the property for a period of time when she enters into a lease. At the termination of the lease, the lessor once again becomes the owner of the fee simple interest in the property. Thus, the lessor carves out an interest in existing property, granting the lessee the right to use the property, but retains a reversionary interest in it. The retention of an interest and the carve-out appear to be what distinguishes a lessor’s entering into a lease from a transfer of property.  

The lessee, on the other hand, acquires the right to use property when it enters into a long-term lease. If the lessee pays a premium to acquire a lease with capital value, arguably it has acquired property, i.e., the right to use the property for below-market rent. Transferring property

66. 1966-2 CB 299.  
67. See Rev. Rul. 72-601, supra note 24, and the discussion below regarding Crooks, supra note 5, for situations in which carve-outs do not qualify for Section 1031 treatment.
in exchange for an existing leasehold satisfies the exchange requirement. Such a transaction from the standpoint of the party acquiring the leasehold interest is no different from a lessee entering into a lease with capital value in exchange for other property. In both situations, the party transfers existing property and acquires the right to use other property. Therefore, your author submits that entering into a lease as a lessee by paying a premium for a lease with capital value should qualify as part of a Section 1031 exchange. Indeed, as discussed below, this is the result in the sale-leaseback context.

To conclude, a landowner cannot enter into a lease of his or her property as a party of a Section 1031 exchange. Furthermore, the receipt of any property in such a transaction will be advance rental payments, which must be included in income in the year received, unless the payment qualifies for amortization under Section 467. If the property owner’s object is, however, to retain a reversionary interest in the underlying land, but grant to the lessee the right to use any improvements for their useful life, a land-building split may allow the property owner to accomplish a Section 1031 exchange without significantly altering the economic arrangement.

B. Land-Building Split

A land-building split is a transaction in which the owner of improved real estate either transfers the improvements and leases the land, retaining a reversionary interest in the land, or transfers the land and retains ownership of the improvements. The land-building split not only creates opportunities for the land owner, but also should allow the seller/lessor to use the property as part of an exchange. An examination of the case law addressing land-building splits reveals that they must be carefully structured to accomplish the intended purpose.

1. Failed Attempts

The several cases and rulings that have considered land-building splits show attributes that must be present to ensure that the building is sold, not merely leased. First, there are a number of cases that demonstrate an ineffective split, resulting in a lease. For example, in

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68. See e.g., Rev. Rul. 68-394, supra note 14; Ltr. Rul. 200251008; Ltr. Rul. 200329021.
69. The asymmetrical treatment of a lessor and lessee in this manner should not matter, as Section 1031 often produces such a result. For example, exchange proceeds may be used to acquire replacement property that completes a tax-free exchange for the exchanger, but results in a taxable sale for the transferor.
70. Reg. 1.61-8(b).
71. The definitive article on land-building splits is Kaster, “Separating a Building for Tax Purposes From the Land on Which it Rests.” 80 J. Tax’n 90 (Feb. 1994).
Gates, the taxpayer conveyed a building to an unrelated party by warranty deed. The deed was subject to a 99-year lease of the ground on which the building stood. The ground lease allowed the lessee to demolish, repair, and rebuild the building and add additional stories thereto, but the lessee could do nothing to the building to weaken the support of any building, diminish the value thereof, or make it structurally dependent on another building. The lessee was required to furnish a bond before demolishing, altering, or making additions to the premises.

If the existing building was remodeled or a new building was built, the lease required that new building have a fair value at least as great as the value of the original building, but in no event could it be less than an agreed-upon minimum value. The lessee was required to keep the premises in good repair but was allowed to sell or assign the lease or sublease the property. Additionally, the lease provided that in case of forfeiture or termination of the lease, any building on the premises should reattach to the realty and be taken as liquidated damages, becoming the property of the lessor. The Eighth Circuit, based on these findings, held that the deed of the building and the lease of the land constituted a single transaction and are, by their terms, inseparable.

Other authorities that likewise found no split of the land and building yield the following list of factors that evidence no split:

1. The lessee is required to restore the buildings that are destroyed or removed.
2. The lessee’s right to remove the existing buildings and construct new ones is conditioned upon the lessee giving bond equal to the demolition cost plus the cost of erecting a new building of equal value.
3. The lessee is required to insure the buildings.
4. Any recovery from the loss of the buildings is to be paid to the lessor to the extent necessary to restore the buildings.
5. The lessee is required to maintain the buildings in good condition.
6. When the lease terminates, title to all of the buildings reverts back to the lessor.
7. The lessee is not permitted to sever or remove the buildings.

In Minneapolis Syndicate, the Board of Tax Appeals found that such restrictions reserved to the lessor a reversionary interest in the building. Thus, ignoring the instruments used and “the delicate questions

72. 69 F.2d 277, 13 AFTRA 684(CA-8, 1934).
73. Lindley’s Trust No. 1, 120 F.2d 998, 27 AFTRA 557 (CA-8, 1941); Minneapolis Syndicate 13 BTA 1303 (1928); Estate of Budd Frankenfield, 17 TC 1304 (1952); Crile, 55 F.2d 804, 10 AFTRA 1183 (CA-6, 1932); and Ltr. Rul. 8519009.
of conveyancing and the technical estates created in law by the particular method used[,] the Board found that the lessor, “in fact, only surrendered the use and occupancy of its property for a term of 130 years, at the end of which time it will stand possessed of it again.” This language demonstrates that courts ignore the state law treatment of a transaction and apply a facts-and-circumstances test in determining whether buildings have been split from the land for federal income tax purposes.

2. **Successful Splits**

Other cases reveal how this type of transaction may be structured to ensure that the seller/lessor is indeed treated as transferring the building and leasing the land, or vice versa. In *R.A. Waldrep*, the question was whether a taxpayer sold buildings along with the land. The Tax Court held that since the taxpayer retained control over the buildings and subsequently removed them, the taxpayer sold only the land, not the land and buildings.

Rev. Rul. 70-607 involved condominiums. The taxpayer owned land on which it had constructed the building, selling apartments to individuals and at the same time entering into leases with the purchasers for the use of the land on which the apartments were situated. The ground lease was for an undivided interest of the land for a period of 75 years as tenants in common with the other lessees. The lease provided for the payment by the lessee of a rental based upon the fair market value of the land exclusive of improvements, and payment of property taxes and insurance.

At the end of the ground lease, the lessee, with the approval of and together with all the other owners, had the right to remove and dispose of the buildings. If the buildings were not removed or disposed of, the lessor agreed to acquire them for a specified amount to be divided among the ground lessees. The lease provided that in the case of condemnation, the leasehold interests would terminate and all compensation and damages for, or on account of, any buildings or improvements on the land would be payable to and be the sole property of the lessees as the owners of the building and improvements. Relying on the general principles in Rev. Rul. 55 542, the Service ruled that “it was the intent of the parties to consummate a sale as to the condominium apartments and a rental agreement as to an undivided interest in the land. The facts disclose sufficient evidence of ownership in the purchase of the condominium apartments to justify a holding that an equity interest in the apartments is in the purchasers of the apartments.”

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74. 52 TC 640 (1969).
76. 1955-2 CB 59.
A district court in *Bratton v. Roundtree*\(^77\) found that land had been transferred, but the transferor retained the building on the land. The court relied on the following factors in its decision:

1. The warranty deed stated expressly that the taxpayer/grantor retained title to all improvements on the tract.
2. The title to the land was being conveyed subject to all existing leases, allowing the taxpayer to continue to receive rent from the tenants of the building.
3. The taxpayer/grantor had the right to remove the buildings during the term of the lease.\(^78\)
4. The taxpayer/grantor received the insurance proceeds when one of the buildings burned.

In Ltr. Rul. 8433003, the Service listed the following factors in ruling that a building sale and a land lease had occurred:

1. Legal ownership of the building vested completely in the buyer/lessee, which was free to sell or mortgage its interest.
2. The buyer/lessee had the right to remove, demolish, or abandon the building at any time during the term of the ground lease and at its expiration or earlier termination.
3. The proceeds of any condemnation award allocable to the building belonged to the buyer/lessee.
4. The basic rent approximately equaled the fair rental value of the land exclusive of the value of the building.
5. In the event of a casualty affecting the building, insurance proceeds would be the property of the buyer/lessee.
6. If the building is damaged or destroyed, the buyer/lessee could elect to restore or replace the building at its own cost or to demolish the structure.

In *Sanderson*,\(^79\) J.C. Penney Company, Inc. constructed a building for its retail operations, sold it to an unrelated party, and leased it back. At the same time, it leased the underlying land to the buyer and sub-leased it back. In ruling that the building had been sold and the land leased, the Tax Court considered whether the transaction satisfied the business purpose test. The court found that the buyer/lessee was a sophisticated real estate investor who entered into the transaction with a reasonable expectation to

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77. 37 AFTR.2d 76-762, 37 AFTR2d 76-762 (DC Tenn., 1976).
78. The lease referred to is that under which the taxpayer/grantor leased back the land.
79. TCM 1985-477.
make a profit. Thus, it respected the form of the transaction. It did not, however, focus on the list of factors considered in the other cases. Perhaps this was so because the transaction at issue was a sale-leaseback.

Finally, in Ltr. Rul. 9026033, the Service relied heavily on Rev. Rul. 55-540\(^{80}\) to rule that a sale of condominiums occurred even though the transferor retained an interest in the land as lessor and the transfer document was labeled a lease by the parties. The Service found that the lease with renewal options had a 1,089-year term, with unlimited renewal options thereafter: the useful life of the building was significantly shorter than the lease term; the amount paid for a unit approximated what the unit would sell for as a condominium; and the amount paid for a unit materially exceeded all the then-current fair rental value of the unit. The Service ruled that these factors demonstrate that the buyer became the equitable owner of the unit, so the transaction clearly constituted a sale.

These cases and rulings demonstrate that a properly structured land-building split is a viable method to help ensure that an exchange occurs for Section 1031 purposes in certain situations. It can accomplish this purpose as long as any property received at the time of the sale and lease is equal in value to the property sold. To the extent the value of any property received is an advance rental payment, the transaction will not qualify for Section 1031 purposes.

C. Sale Leasebacks

A sale-leaseback may be treated as a Section 1031 exchange if certain requirements are met. After struggling with these transactions in several cases, it now appears the courts have found direction with respect to application of Section 1031.

The first issue to consider when dealing with a sale-leaseback in the Section 1031 context is whether a transfer has occurred or whether the transaction is a financing arrangement. If the transaction is a financing arrangement, it will not qualify as a transfer for purposes of the Section 1031 exchange requirement because the taxpayer will be treated as borrowing money instead of transferring property for consideration. The leading case on whether a sale-leaseback is a financing arrangement is Frank Lyon Co.,\(^{81}\) in which the Supreme Court respected the sale leaseback (i.e., did not treat it as a financing arrangement). Other cases have found such transactions constitute financing arrangements.\(^{82}\) This issue has been addressed extensively in other articles,\(^{83}\) and need not be explored further.

82. See, e.g., Lazarus & Co., 308 U.S. 252, 22 AFTR 585 (1939); Sun Oil Co., 262 F.2d 258, 40 AFTR2d 77-5737 (CA-3, 1977).
here. If a sale-leaseback is respected, the focus then turns to whether the transaction is a Section 1031 exchange.

In *Century Electric Co.*, the taxpayer transferred property to a college in exchange for a lease to run on the transferred property from 25 to 95 years. The taxpayer attempted to recognize the loss realized on the transaction, but the court disallowed the loss, holding that the sale leaseback qualified for Section 1031 nonrecognition treatment.

The Second Circuit, in *Jordan Marsh*, held that a sale-leaseback was not an exchange and allowed the taxpayer to recognize a loss on the transaction. The focus there was on whether the cash the taxpayer received in consideration for the transfer of the fee was a fair market amount and whether the lease required fair market rental payments. The court drew upon the legislative history of the predecessor of Section 1031 to establish the significance of receiving cash consideration equal to the fair market value of the property transferred in sale-leaseback transactions. The legislative history provides that, “if the taxpayer’s money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss . . . .” The court also quoted the First Circuit’s statement that the exchange rules apply “where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really ‘cashed in’ on the theoretical gain, or closed out a losing venture.” Based on these statements, the court held thus:

> By its unconditional conveyances to a stranger, [the taxpayer] had done more than make a change in the form of ownership: it was a change as to the quantum of ownership whereby, in the words just quoted, it had "closed out a losing venture." By the transaction its capital invested in the real estate involved had been completely liquidated for cash to an amount fully equal to the value of the fee. This we hold was a sale - not an exchange within the purview of [Section 1031]. (Emphasis in original.)

The Second Circuit distinguished *Jordan Marsh* from *Century Electric Co.* on the basis that there was no finding in *Century Electric* that the fee was sold for fair market value. The Second Circuit also noted that the lease in *Century Electric* “may well have had a premium value.” Absent evidence to the contrary, the court distinguished the two cases and

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64. Note 13, *supra*.
65. 269 F.2d 453 (CA-2, 1959).
66. H. Rep’t No. 73-104, 73d Cong., 2d Sess. 1939-1 CB (Part 2) 554, 564 (1939).
allowed the loss. The Service noted its disappointment in the ruling by publishing a nonacquiescence.\textsuperscript{88} Not surprisingly, \textit{Jordan Marsh} was not the last case to consider the issue.

The Service’s next attempt to require loss recognition on a sale-leaseback transaction met with disappointment in the Tax Court. In \textit{City Investing},\textsuperscript{89} the taxpayer sold the legal title to land on which a commercial building sat and leased the land back at the time of the transfer. The taxpayer reported a loss on the transaction, which the Service challenged, claiming the transaction was an exchange. The Tax Court ruled that the transaction was a sale and not an exchange, because the taxpayer received fair market value for the land and agreed to pay fair market value for the lease. Therefore, citing \textit{P.G. Lake}, the court said that the taxpayer’s rights as lessee in the property “were in no sense a ‘continuation of the old investment [in the land] still unliquidated.’” By yielding substantial economic and property rights, the taxpayer “succeeded for purposes of this transaction in liquidating its invested capital in the land.” Thus, the Service fell behind in the win-loss category with this type of case.

The Service was momentarily redeemed in \textit{Mo. Pacific RR. Co.},\textsuperscript{90} in which a sale-leaseback was held to be an exchange and a loss was disallowed. In that case, the Court of Claims developed a list of factors to use in determining whether a sale-leaseback falls under Section 1031. Although the factors do not appear to have been adopted by any other court or the Service, they are worthy of note. According to the Court of Claims, if a sale-leaseback does not satisfy all of the following elements, it is an exchange for purposes of Section 1031:

1. The seller has relinquished effective control of the property.
2. The lease is for a total term of no more than 30 years, inclusive of optional renewal periods.
3. The consideration, apart from the lease, for the transfer is fairly equivalent to the market value of the property transferred.
4. The rental payments under the lease are reasonable compensation for use and occupancy of the desired premises.

The court found that because the taxpayer failed to meet the first two requirements (i.e., did not transfer control and the lease was for more than 30 years), the transaction was a Section 1031 exchange. A close look at this transaction reveals even though it may not have been a Section 1031 exchange, loss disallowance seems appropriate.

The court said little regarding the 30-year lease requirement, finding simply that the lease was for at least 30 years and, thus, like kind to the fee.

\textsuperscript{88} Rev. Rul. 60-43, 1960-1 CB 687.
\textsuperscript{89} 38 TC 1 (1962).
\textsuperscript{90} 32 AFTR2d 73-5816 (1973).
On the issue of giving up control, the court found that since the taxpayer “retained the right to reacquire the subject property in the near future and at a reasonable price, such a defeasible surrender of legal title could only have been deemed to mark the suspension of a losing venture, not the closing out of it.” Thus, the case was distinguished from Jordan Marsh and loss was disallowed under Section 1031. While loss disallowance may be appropriate, the taxpayer’s retention of control is evidence that the property was never transferred. If that were the case, this transaction would be a financing arrangement, in which case no loss would be allowed as no transfer occurred. Furthermore, the transaction would not be a Section 1031 exchange.

Cases that followed Mo. Pacific R.R. Co. did not list the four factors, but focused instead on whether the cash received from the sale equaled the fair market value of the property transferred and whether the lease required fair market rent payments. Those two elements of a sale-leaseback are so closely intertwined that the existence of one will result in the other being present, assuming no other consideration is involved. The interrelationship is that if the transferor-lessee does not receive cash equal to the fair market value of the property, the consideration for the property sold includes a premium value in the lease. Likewise, if the lease calls for less-than-fair-market rent, the taxpayer is receiving a lease with a capital value (i.e., premium value), and such capital lease is in part consideration for the property transferred. Thus, it appears that if a taxpayer is asked to show that property has been transferred for fair market value cash consideration and leased back at fair market value, the taxpayer should escape Section 1031 nonrecognition. In other words, if the taxpayer can show that the property is transferred and the only consideration received for the property is cash, the transaction will not be an exchange. Therefore, loss on the transaction will be allowed, as was the case in Leslie Co. and Crowley, Milner & Co.91

Each of the remaining cases examines sale-leaseback transactions from the seller/lessee’s perspective. We should not, however, forget the purchaser/lessor. If the acquisition and lease are both at fair market value terms, the purchaser/lessor will take a basis in the property equal to the amount paid and recognize ordinary income when rent is received. If the purchaser/lessor pays less than fair market value for the property and gives no other consideration, it will also charge less than fair market value for the lease. This is because the consideration for the property would include (1) the lower-than-market cash consideration paid and (2) the lease to the seller/lessee for lower-than-market rent. Thus, the purchaser/lessor receives a portion of the property as an advance rent payment. Since this

91. Leslie Co., 64 TC 247, aff’d 539 F.2d 943, 38 AFTR2d 76-5458 (1975); Crowley, Milner & Co., 76 TC 1030 (1981), but see Rev. Rul. 76-301, 1976-2 CB 241 (the Service, with no significant analysis, disallowed loss on a sale-leaseback it treated as an exchange).
cannot qualify as an exchange (i.e., a lessor cannot enter into a lease as part of an exchange), the purchaser/lessor could recognize ordinary income on the transaction.

D. Transactions Involving Mineral Interests

Complicated issues are often involved in determining whether transactions involving mineral interests satisfy the Section 1031 exchange requirement. As with land leases, the analysis involves determining whether a transfer has occurred.

*Crooks*[^92] is the seminal Section 1031 mineral interest case addressing the exchange requirement. In *Crooks*, the taxpayers owned a farm in Brown County, Illinois, under which oil was discovered. The taxpayers conveyed all of the mineral interests in the land to an energy company in consideration for four other farms located in Adams County, Illinois, new farm equipment, and a one-fourth royalty interest in any oil or gas produced from the Brown County property. The taxpayers treated the receipt of the Adams County property as an exchange for the Brown County mineral interest that qualified for Section 1031 treatment. The Tax Court disallowed nonrecognition treatment, holding that because the taxpayers retained an “economic interest” in the Brown County property (i.e., a one-fourth interest in oil and gas to be produced), for federal income tax purposes the taxpayers had not conveyed the mineral estate but instead “leased their interest in the minerals underlying the [land] and retained a one-fourth royalty of any and all production of oil and gas.” Relying on the ruling in *Pembroke*, the court concluded that, “having decided that the transaction constituted a lease, it follows that the farms received from the lessee . . . are a lease bonus and that there has been no sale or exchange within the meaning of Section 1031.” Because the transaction was a lease (i.e., there was no required transfer), the court had to rule that the transaction did not qualify for Section 1031 nonrecognition treatment.[^93]

A full understanding of the significance and relevance of *Crooks*, requires careful consideration of the definition of “transfer” in the mineral interest context. Fortunately, there is no dearth of authority on this issue. In fact, the cases addressing the definition of transfer in the mineral interest context are extensive enough to allow prediction of the types of mineral interest transactions that will and will not satisfy the Section 1031 exchange requirement.

In determining whether a mineral interest has been transferred, the general rule appears to be that if “a transferor retains an ‘economic interest’ in mineral rights, as a matter of federal tax law he has not made a sale of

[^92]: Note 5, *supra*.
[^93]: The court’s decision demonstrates that the Service’s ruling in Ltr. Rul. 7906061, in which Section 1031 nonrecognition was granted even though the taxpayer retained production royalties and minimum royalties in a coal lease that was transferred as part of an exchange, is (probably incorrect).
those rights regardless of how the transaction is classified under state law.”

The term “economic interest” is a term of art. Reg. 1.611-1(b)(1) provides that an “economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital.” The owner of an economic interest in minerals or standing timber is eligible for the depletion deduction. Thus, many of the cases that examine whether a mineral interest has been transferred determine who is eligible for the depletion deduction related to the interest. Rulings on whether the following specific transactions transfer “economic interest” help show which types of mineral transactions can satisfy the exchange requirement. If the courts find that a specific transaction is a transfer, it should qualify to be part of a Section 1031 exchange. If a transaction is not a transfer, one can conclude that it cannot be part of a Section 1031 exchange.

1. Assignment of Mineral Estate

Case law establishes that the assignment of a mineral estate, even if the transferor retains the remaining interests in the property (i.e., the land and improvements), is considered a transfer for federal income tax purposes. Thus, it should be possible to structure a transaction involving the assignment of a mineral estate in a manner that satisfies the Section 1031(a) exchange requirement.

2. Execution of a Mineral Lease

Courts have consistently held that a fee owner’s executing a mineral lease does not qualify as a transfer for federal income tax purposes. Furthermore, the courts disregard state law treatment of the transaction in determining whether a transfer has occurred for federal income tax purposes. Because a lessor’s executing a mineral lease is not treated as a transfer for federal income tax purposes, it cannot satisfy the Section 1031 exchange requirement. A lessee’s entering into a mineral lease may, however, be an acquisition that could be part of an exchange.

95. Crichton, supra note 21; Glenn, 39 TC 427 (1962).
96. Burnet v. Harmel, 287 U.S. 103, 11 AFTR 1085 (1932) (state law disregarded in holding that bonus lease payments are rental income, not return of capital); Wood, 377 F.2d 300, 19 AFTR2d 857 (CA-5, 1967) (lessor’s retention of royalty interest in sand and gravel lease caused transaction to not qualify as a transfer); Hogan, 141 F.2d 92, 32 AFTR 246 (CA-5, 1944) (state law treatment of lease as sale is disregarded and execution of a universal lease is treated as lease, not transfer for federal tax purposes).
97. See discussion above regarding a lessee’s entering into a land lease.
3. Assignment of an Oil Payment

Courts rely on the fruit-of-tree doctrine in holding that the assignment of an oil payment creates ordinary income, not capital gains. The transaction is treated as assigning the right to receive future income.\(^{98}\) Thus, consideration, in whatever form received, in exchange for an oil payment is treated as ordinary income, and, consequently, does not qualify for Section 1031 nonrecognition treatment.\(^{99}\)

4. Assignment of Mineral Estate, Retention of Royalty

As in Crooks, a transaction in which a mineral estate is assigned but a royalty is retained is treated as a lease.\(^{100}\) Therefore, such an assignment cannot satisfy the Section 1031 exchange requirement.

5. Assignment of a Royalty Interest

While a lessor’s executing a mineral lease, which entitles the lessor to royalty, is not a transfer for federal income tax purposes, the assignment of an existing royalty interest is deemed a transfer for federal income tax purposes.\(^{101}\) Thus, an assignment of an existing royalty interest for a fee in other real estate should satisfy the Section 1031 exchange requirement.

6. Assignment of Lessee’s Interest

The Service has ruled that the assignment of a lessee’s interest in a mineral lease is treated as a transfer for federal income tax purposes.\(^{102}\) Thus, such assignment may be part of a transaction that could satisfy the Section 1031 exchange requirement.

7. Assignment of Lease, Retention of a Royalty Interest or an Oil Payment

Even though the assignment of a lessee’s interest in a mineral lease is generally treated as a transfer for federal income tax purposes, such treatment will be lost if the lessee retains a royalty interest or an oil payment.

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\(^{98}\) Foster, 324 F.2d 702, 12 AFTR2d 5945 (CA-5, 1963); Christie, 436 F.2d 1216, 27 AFTR2d 71-635 (CA-5, 1971).

\(^{99}\) P.G. Lake, supra note 11 (the transaction was treated as a financing arrangement).

\(^{100}\) See also Burnet v. Harmel, supra note 96.

\(^{101}\) Crooks, supra note 5 (“If [the taxpayer], subsequent to the transaction involved here, exchanged the interest it acquired for a fee interest in real estate, the Commissioner has held that such exchange would be non-taxable under section 1031.”); Fleming, 82 F.2d 324, 17 AFTR 628 (CA-5, 1936); Hammonds, 106 F.2d 420, 23 AFTR 379 (CA-10, 1939).

payment right. Thus, a transaction involving such assignment cannot satisfy the Section 1031 exchange requirement.

8. Odds and Ends

Other transactions have also been considered. For example, the Service ruled that the assignment of a water right where the assignor retained a small reserve should be treated as a transfer for federal income tax purposes. The Tax Court has held that the assignment of all of a water right for 25 years with a 20-year renewal option is a transfer for federal income tax purposes. If these types of interests satisfy the like-kind property requirements, they should qualify to be exchanged for other qualifying real estate interests under Section 1031.

IV. Exchanges Involving ‘Surreal Estate’ Interests

As discussed above, courts and the Service may disregard state law treatment of certain arrangements involving partial real estate interests. Because state law is often disregarded, the question arises of whether the like-kind property requirement and exchange requirement make reference to federal income tax interests in real estate or state law interests in real estate. Based on the discussion above, the conclusion would appear to be that Section 1031 concerns itself with the treatment of a transaction for federal income tax purposes, not state law purposes.

On several occasions, the courts and the Service have found a transfer to occur for federal income tax purposes, even though the transaction was structured as a lease under state law. This bifurcated treatment seems to create a “surreal estate” interest. There are several types of arrangements that may fall into this category, providing planning opportunities and creating the proverbial tax planning pitfalls.

A. Synthetic Leases

The synthetic lease may prove to be the most complex real estate interest to exchange. If the taxpayer is able to get over the hurdles involved in obtaining approval from the financing entity/lessor, the next problem is the intellectual exercise of creating an exchangeable real estate interest. Stated generally, a synthetic lease is a financing structure under which the taxpayer enters into several agreements with an unrelated party (the financing entity/lessor). Under those agreements, for federal income tax purposes, the taxpayer is deemed to borrow money from the financing

103. Standard Oil Company (Indiana), supra note 94; Palmer, 287 U.S. 551, 11 AFTR 1106 (1933); Kirby, 326 U.S. 599, 34 AFTR 526 (1946); and Fleming, supra note 101.
entity/lessor to acquire, and often construct, property. For financial accounting purposes, however, the taxpayer is deemed to enter into an operating lease with the financing entity/lessor. Thus, for financial accounting purposes, the arrangement is a lease; for federal income tax purposes, the arrangement is a debt-financed acquisition. ¹⁰⁶

Assuming the property that is subject to the synthetic lease is real property, the taxpayer may find itself in a situation where it wants to transfer its interests in the synthetically leased property, use any improvements being constructed under the synthetic lease arrangement as part of a build-to-suit exchange, or acquire property that is the subject of a synthetic lease and continue the arrangement as part of a Section 1031 exchange. Each of these transactions involves significant legal and tax issues.

Generally, to obtain the objectives of a synthetic lease (i.e., an acquisition for federal income tax purposes and a lease for financial accounting purposes), the governing documents provide that the taxpayer/lessee will lease the property for a short period of time. The period generally will be less than ten years, including renewal options. Nonetheless, because of other provisions in the lease documents, such as purchase options and rights of termination, the taxpayer is treated as owning the property for federal income tax purposes. Thus, although the governing documents provide that the taxpayer is leasing the property for a relatively short period the taxpayer acquires and owns a fee interest for federal income tax purposes.

The mental exercise involved when a synthetic lease is part of a Section 1031 exchange requires answering several questions. First, for federal income tax purposes, is the taxpayer/lessee treated as assigning a fee simple interest in the underlying property if it assigns all of its rights under the governing documents? If the answer to this question is no, the taxpayer may not assign its rights in the synthetic lease in exchange for other real property because the lease, with a term of fewer than 30 years, will not be like-kind to other real property. If the answer is yes, the taxpayer assigning all of its interests under the synthetic lease should be treated as transferring a fee interest in the property for federal income tax purposes.

Second, if the taxpayer/lessee subleases its right to use the property to an exchange accommodation titleholder as part of a build-to-suit exchange under the model in Ltr. Rul. 200251008, can the sublease have a term of greater than 30 years for federal income tax purposes? Answering yes to this question requires overlooking the fact that the documents provide that the lease is for a period of less than 30 years. Because the lease term in the documents does not dictate the federal income tax

treatment, it would appear that a lease for federal income tax purposes and a sublease for financial accounting purposes are possible.

Third, does the taxpayer acquire a fee interest in the underlying property for Section 1031 purposes when it enters into a synthetic lease, or does it enter into a short-term lease? This answer would appear to be yes because the taxpayer is treated for federal income tax purposes as acquiring a fee interest when entering into the lease arrangement. That treatment should not vary for Section 1031 purposes.

The answer to each of these questions is very important because if the taxpayer/lessee is deemed to acquire a fee simple interest in the underlying property when it enters into a synthetic lease, the 30-year rule in Reg. 1.1031(a)-1(c) will not apply. On the other hand, if the transaction is treated as a lease for Section 1031 purposes, it will arguably have a term of fewer than 30 years and will have diminished utility under Section 1031.

Your author believes that the synthetic lease scenario helps establish that the reference in Reg. 1.1031(a)-1(c) to leases refers only to arrangements that are treated as leases for federal income tax purposes. It does not refer to arrangements that transfer a fee interest to the taxpayer for federal income tax purposes, even though labeled a lease and treated as a lease for state law or financial accounting purposes. In the case of a synthetic lease, the taxpayer/lessee is treated as acquiring a fee interest in the underlying property for federal income tax purposes. Thus, a transfer occurs and the exchange requirement should be satisfied if a synthetic lease is involved in a transaction. Also, because the taxpayer acquires a fee interest in the property for federal income tax purposes, the 30-year lease requirement should not affect the like-kind property requirement.

Finally, in the build-to-suit context, because the taxpayer is deemed to own the fee interest in the property for federal income tax purposes, the taxpayers should be able to assign some of its rights in the governing documents for a period not to exceed 32 years to an exchange accommodation titleholder and accomplish a Ltr. Rul. 200251008 build-to-suit transaction. Even though the governing documents provide that the taxpayer’s right to use the property is less than 32 years, because the taxpayer is the fee owner of the property for federal income tax purposes, the taxpayer should be able to lease the property for 30 years or more by assigning a portion of its rights under the governing documents. The legal challenges involved in this exercise are likely to widen the chasm that already existed between the tax planner and other attorneys involved in the transaction.

B. Other ‘Surreal Estate” Transactions

Other transactions also provide planning opportunities. The following examples demonstrate how state law and federal income tax treatment diverge in various arrangements and reveal what courts consider
in determining whether a transfer has occurred for federal income tax purposes.

1. **Lease Term and Useful Life**

   Courts consider whether a lease agreement allows the lessee to use substantially all of the leased property’s value during the lease. Thus, if at the time the lease is entered into, the property is expected to have little or no value or have no remaining useful life at the termination of the lease, the lease agreement looks more like a sale than a lease.\(^{107}\)

2. **Fixed-Price Option**

   A fixed-price purchase option standing alone may cause an agreement to lose its lease status, if the exercise price is substantially below the property’s expected fair market value.\(^{108}\) If, however, the exercise price is based on the property’s expected fair market value, the agreement may be treated as a lease.\(^{109}\) Thus, any call option that is granted should be based on the property’s expected fair market value at the time of exercise and should not be so far below the expected fair market value that it is deemed to be a bargain purchase option, if the transaction is intended to be a lease. Along these lines, if the rental payments are credited against the purchase price, the agreement may look more like a transfer.

3. **Lessor’s Investment**

   Another factor to consider is whether the lessor has an investment in the rental property. If the lessor has invested none of its own cash in the rental property, an agreement looks more like a sale and less like a lease.\(^{110}\) This issue usually arises in situations in which the lessor has borrowed most of, if not all, the funds needed to finance the acquisition of rental property.

4. **Simultaneous Put and Call Options**

   If any of the above factors are strong enough to indicate that the lease agreement is actually a sale for federal income tax purposes, the use of put and call options will be irrelevant. If, on the other hand, the arrangement may be treated as a lease after considering all the factors other than put and call options, the use of puts and calls should not prevent the

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\(^{107}\) Rice’s Toyota World, Inc., 81 TC 184 (1983); Estate of Starr, 274 F.2d 294, 5 AFTR2d 572 (CA-9, 1959).

\(^{108}\) Oesterreich, 226 F.2d 798, 48 AFTR 335 (CA-9, 1955).

\(^{109}\) Lockhart Leasing Co., 54 TC 301 (1970).

\(^{110}\) Estate of Franklin, 64 TC 752 (1975).
agreement from being treated as a lease so long as the put and call options do not shift the benefits and burdens of ownership to the lessee. The Service and courts apply a facts-and-circumstances test to determine whether puts and calls transfer the benefits and burdens of ownership.

A ruling and a case set forth facts under which put and call options cause a transfer. In the first, the Service ruled that put and call options exercisable at the same time for the same price cause an agreement to look like a sale, not a lease. In that ruling, the lessee originally attempted to acquire property but was unable to obtain the necessary financing. Thus, the lessor acquired the property and leased it to the lessee. Under the lease agreement, the lessee was obligated to repay the total acquisition and reconstruction costs of the leased property in the form of basic rentals. The lessee was also obligated to pay the normal costs of operating the vessel and to keep the vessel insured in a manner consistent with the insurance carried on similar property. The call allowed the lessee to purchase the property at the end of the lease term for an amount equal to the unamortized principal amount of the loan the lessor incurred to acquire the equipment.

In a memorandum opinion, the Tax Court ruled that put and call options accompanying a lease agreement were factors showing the agreement was a sale, not a lease. There were other factors that the court also considered. For example, the property was permanently affixed to the lessee's property. The lessor had no knowledge about the property and acquired it to lease it to the lessee. The call was exercisable at any time within one year from the last day the put could be exercised. The put was exercisable during the period beginning the last month of the lease term and running for fourteen months thereafter. The lessors cost of the property was $363,940. The put allowed the lessor to sell the property for $238,910. The call allowed the lessee to acquire the property for $159,452. Thus, the put protected the lessor from downside risk while the call gave the lessee the upside potential of the property.

At least one Tax Court opinion establishes facts under which the presence of put and call options do not cause a transfer. In Penn-Dixie Steel Corp., the court held that a sale did not occur when put and call options were obtained by the parties to a transaction. That case, however, did not involve a lease and the taxpayer was arguing that even though the transaction was not structured as a sale, the Service should treat the transaction as a sale effective at the time the put and call were acquired. In Penn-Dixie Corp., the taxpayer and another party each contributed assets to a newly formed corporation in exchange for a 50% ownership interest in the corporation. The taxpayer also obtained a call option and the other

113. 69 TC 837 (1978).
party obtained a put option at the time the corporation was formed. The options had identical exercise prices. The put was exercisable between August 1, 1970, and July 31, 1971, while the call was exercisable between August 1, 1971, and July 31, 1972. The corporation was formed by the parties and the options entered into on July 31, 1968.

The court in *Penn-Dixie Corp.* stated that there was more than a remote possibility that market fluctuations could cause neither party to exercise the options. For example, if the corporation prospered during the period the put was exercisable, the other party would not have exercised the put option. If, during the following year, the company were to experience economic hardships, the taxpayer would not exercise the call option. The court disregarded the existence of the options because the taxpayer failed to persuade it that it should ignore the form chosen by the taxpayers.

These examples demonstrate that a ‘surreal estate’ interest may be created and may find utility in a Section 1031 exchange. As the court in *Penn-Dixie Corp.* pointed out, however, taxpayers may have a difficult time convincing the Service and courts that the form of a transaction should be ignored. If this hurdle is overcome, however, as with synthetic leases, the federal income tax treatment of a transaction should dictate how a surreal estate interest will be treated for Section 1031 purposes. If, under state law, a transaction is a transfer of a fee, but a lease for federal income tax purposes, the Section 1031 lease rules should apply. On the other hand, if a fee is transferred for federal income tax purposes, the state law treatment of the transaction should be disregarded for federal income tax purposes.

V. CONCLUSION

If nothing else, this extensive discussion reminds tax practitioners that Section 1031 real estate exchanges may raise fundamental questions about whether the property involved is like kind and in whether the transaction will satisfy the exchange requirement. What may seem apparent based on the regulations and general concepts may not hold true with certain interests in certain venues. This was so with water rights in *Wiechens* and with improvements in Rev. Rul. 67-225 and Rev. Rul. 76-391. We also saw that the exchange requirement may create unexpected results unless the parties carefully consider whether a particular real estate transaction is a transfer for federal income tax purposes. If not, it is impossible to satisfy the exchange requirement. This issue is especially relevant when a transaction is a lease under federal income tax laws. Finally, the synthetic lease and other ‘surreal estate’ show that the title of a set of documents does not dictate the federal income tax treatment of the subject transaction for Section 1031 purposes. Thus, when federal tax treatment diverges from state law treatment, seemingly impossible results
may obtain in the Section 1031 context, creating fertile ground, if not parched, (thanks to Wiechens), for the exchange junkie.