Section 1031 Alchemy: Transforming Personal Tangible and Intangible Property Into Real Property

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SECTION 1031 ALCHEMY: TRANSFORMING PERSONAL TANGIBLE AND INTANGIBLE PROPERTY INTO REAL PROPERTY
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Long have we studied the Internal Revenue Code in search of the secrets of tax alchemy. Many nights and weekends have we spent cloistered in our library in pursuit of this esoteric knowledge. The object of our most ardent investigation has been Section 1031, the philosopher's stone of the Internal Revenue Code.¹ We discovered that it could transform a taxable sale followed by a purchase into a tax-deferred exchange, merely by following a formula, reciting a magical incantation, and adding an exchange accommodator – the qualified intermediary.² Even more amazing, we found that Section 1031 could confer the tax equivalent of immortality: gain, like death, could be postponed indefinitely by continuing to dispose of exchange properties in subsequent like-kind exchanges and then passing the exchange properties to one’s progeny at one’s death with a stepped-up basis.

With the passage of time, a distinct branch of Section 1031 science emerged – Section 1031 real property alchemy. This branch of study seeks to transform certain types of personal property, both tangible and intangible, into real property. Over time, this branch has abandoned its secret formulae and magical incantations and has gained respectability as its hypotheses have been tested and have produced practical operating rules for Section 1031 real property alchemy.

The Section 1031 real property alchemist follows a basic methodology. First, he (or she) develops a hypothesis. To develop a hypothesis that will predict the outcome of tax transactions, the alchemist relies upon existing principles of Section 1031. Second, the alchemist tests his (or her) hypothesis through experimentation. In the legal laboratory,

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¹ The philosopher’s stone is a legendary substance that for centuries has been believed to have the ability to turn lesser metals into gold. It is also believed to be capable of curing illness, extending life, and perfecting the human soul. As mere tax alchemists we cannot comment on the validity of any of these claims.

² See generally Treas. Reg. §1.1031(k)-1.
this necessitates that the alchemist structure a transaction, which depends upon the validity of the hypothesis for its success, and then wait for the Internal Revenue Service to challenge the tax treatment of the transaction during an audit of the exchanger. Alternatively, the alchemist may respectfully request a ruling from the IRS in order to obtain their approval of the hypothesis, at least as applied to a specific exchanger. Finally, court opinions and IRS rulings and regulations formally present the findings of these experiments. Through repetition and refinement of this process over the course of many years, certain fundamental rules of Section 1031 real property alchemy have been identified.

The findings in a recent Tax Court case, *Peabody Natural Resources Co. v. Commissioner*, prompted us to analyze and organize this body of knowledge for presentation in a single place. This article presents, for the benefit of the masses, a short discussion of the *Peabody* case, the findings of various Section 1031 alchemy experiments, and the rules that have been developed therefrom. The article also discusses an emerging hypothesis and predicts what future experiments might reveal about that hypothesis.

**The Latest Experiment in Section 1031 Real Property Alchemy**

In *Peabody*, the taxpayer exchanged operating gold mines, including real property, for operating coal mines in a Section 1031 like-kind exchange. The coal mines were subject to two coal supply contracts that obligated the mine owner to provide the electric utilities, which were parties to the contracts, with coal; the gold mines were not subject to any supply contracts. The sole issue for decision was whether the coal supply contracts were like kind to real property. The court used a two step analysis. It first looked to the status of the coal supply contracts under New Mexico state law and concluded that the contracts were covenants running with and appurtenant to the real property. The court determined, however, that the status of the coal supply contracts as real property under New Mexico law did not automatically give the contracts the status as real property for purposes of Section 1031. The court then compared the exchanged properties to determine whether the nature and character of the transferred rights in and to the respective properties were alike. The court concluded that they were, based upon the broad tests established in the Section 1031 regulations and in *Koch v. Commissioner*.

The recent experiment in the *Peabody* case confirmed that Section 1031 can be used to turn gold into coal. Yet, notwithstanding the joy with

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4. 71 T.C. 54 (1978), *acq.*, 1979-2 C.B. 2 (holding that fee interests in real estate are like-kind to fee interests in real property subject to 99-year condominium leases).
which *Peabody* has been received by the community of tax practitioners, for the Section 1031 alchemist, turning gold into coal is rudimentary science.\(^5\) More important to the like-kind exchange alchemist is the finding in *Peabody* that Section 1031 can turn intangible property into real property.

**The Rules of Section 1031 Real Property Alchemy**

To aid in our quest for greater knowledge we have developed an analytical framework for Section 1031 real property alchemy. We have identified four specific rules and an area of uncertainty, which we call the “emerging hypothesis.”

**Rule #1: Transforming Personal Property into Real Property Through Attachment**

The improvements exchange (also known as the build-to-suit exchange) is an age-old technique for transforming personal property into real property.\(^6\) Once a tightly guarded secret among Section 1031 initiates, it has long passed into the public domain. A properly executed improvements exchange will transform bricks, lumber, steel, cement, and other personal property into real property, eligible for an exchange with other real property.\(^7\) One of the key elements to this technique is the addition of the construction-services catalyst. The like-kind exchange alchemist understands the subtlety that the transformation of personal property into real property must occur while a party other than the exchanger (who is not an agent of the exchanger) owns the improvements being constructed. Otherwise, if the exchanger acquires personal property piece by piece and adds the catalyst himself, the transformation occurs too

\(^5\) Previous experimentation has revealed that raw land can be converted to oil and gas interests, see *Comm’r v. Crichton*, 122 F.2d 181 (5th Cir. 1941), and that farmland can be converted to city property, see Treas. Reg. §1.1031(a)-1(b).

\(^6\) For an in-depth discussion of improvements exchanges, see Bradley T. Borden, *Recent Developments in Build-to-Suit Exchanges*, 44 TAX MGT. MEMO. 19 (January 27, 2003).

\(^7\) See, e.g., *Coastal Terminals v. U. S.*, 320 F.2d 333 (4th Cir. 1963) (holding that a replacement oil and gas terminal constructed according to the exchanger’s specifications could be exchanged for the exchanger’s existing terminals because a party unrelated to the exchanger owned the land on which the new terminals were constructed and all of the improvements being constructed). Exchangers may also use leasehold improvements exchanges to transform personal property to real property. See PLR 200251008 (September 11, 2002) (ruling privately that improvements built on property leased from a party related to the exchanger to a Rev. Proc. 2000-37 exchange accommodation titleholder were like kind to other real property transferred by the exchanger). *See also* Kelly E. Alton, Bradley T. Borden, and Alan S. Lederman, *Rev. Proc. 2004-51: The IRS Strikes Back*, 83 Taxes 17 (February 2005) (discussing limits on the availability of Rev. Proc. 2000-37 for certain leasehold improvements exchanges); Bradley T. Borden, Alan S. Lederman, and Glenn Spear, *Build-to-Suit Ruling Breaks New Ground for Taxpayers Seeking Swap Treatment*, 98 J. Tax’n 22 (January 2003) (discussing related party leasehold improvements exchanges).
late and the resulting improvement is not eligible for a like-kind exchange with real property.\footnote{See Bloomington Coca-Cola Bottling Co. v. Comm’r, 189 F.2d 14 (7th Cir. 1951) (holding that improvements constructed on property owned by the exchanger did not qualify for like-kind exchange treatment with other real property); DeCleene v. Comm’r, 115 T.C. 457 (2000) (holding that construction on property deemed owned by the exchanger did not qualify for Section 1031 nonrecognition).}

A variant of this technique is the attachment of personal property to the exchanger’s real property such that it becomes permanently attached to the real property and is considered to be a fixture under state law. If this transformation occurs before the exchanger transfers the real property to which the fixture is attached, then the affixed property can be exchanged as part of the same exchange for like-kind real property.\footnote{For a discussion of the fixtures issue in the Section 1031 context, see Kelly E. Alton and Louis S. Weller, Does State Law Really Determine Whether Property is Real Estate for Section 1031 Purposes?, 32 REAL ESTATE TAX’N 30 (4th Quarter 2004).}

Transforming personal property to real property and real property to personal property is so common that Hollywood found a specific occasion to depict it. A scene in a recent spoof of corporate looting shows the unfortunate employee-victims of such an occurrence losing their lawn to creditors.\footnote{Fun With Dick and Jane (Columbia Pictures 2005) (motion picture).} One of the characters observed, “Our lawn was repossessed today. I didn’t even know they could do that.”\footnote{To the extent that the creditor had a security interest in the sod perfected under the state’s commercial code, perhaps state law treated the sod as personal property in some respects. If so, then there could be a conflict among the laws of that state regarding the status of the sod as real or personal property. For a discussion of some of the issues raised by state law characterizations, see Alton & Weller, Does State Law Really Determine Whether Property is Real Estate for Section 1031 Purposes?, supra.}

This scene provides a vivid visual demonstration of Section 1031 real property reverse alchemy. The removal of the sod transformed it from real property to personal property. If the residence had been sold while the sod was in place, it should have been treated as part of the real property for Section 1031 purposes.\footnote{See Rev. Rul. 59-229, 1959-1 C.B. 180 (ruling that a transfer of real property with unharvested crops in exchange for other real property with unharvested crops qualified for Section 1031 nonrecognition and relying on Section 1231(b)(4) for characterization as used in the trade or business); Asjes v. Comm’r, 74 T.C. 1005 (1980), acq. in result, 1982-2 C.B. 1 (holding that the sale of condemned real property with nursery stock and purchase of real property with saleable vegetation qualified for Section 1033 nonrecognition by meeting the Section 1031 like-kind test).} Once removed from the land, however, it became personal property.

Thus, the first rule of Section 1031 real property alchemy is: personal property is transformed into real property when it is physically attached to land or other real property before the exchanger acquires it as replacement property or before the exchanger transfers it as relinquished property. Expressed formulaically: real property + services + personal property = real property.
Rule #2: Transforming Personal Property to Real Property Through Border Crossing\textsuperscript{13} and Stripping

Another way to transform personal property into real property is to stretch it across the border of two states with different definitions of real property. A simple example of the type of personal property that lends itself to this transformative exercise is a pipeline that crosses state boundaries: on one side of the border the pipeline is real property, yet on the other side of the border it is personal property, although both segments of the pipeline are virtually identical. The issue appears to be simple, but the IRS has yet to issue guidance on this fact pattern.\textsuperscript{14}

The only real difference between the exchanged segments is that they are located in two separate legal jurisdictions. While this difference in location does not affect the function of the two segments, it may, nevertheless, have consequences. Although the two segments of the pipeline are identical for all functional purposes, if State A confers the rights and obligations associated with real property on the portion of the pipeline within its borders and State B confers the rights and obligations associated with personal property on the portion of the pipeline within its borders, from the perspective of Section 1001 and the Cottage Savings case,\textsuperscript{15} the exchange of those segments would be a realization event for tax purposes. If Section 1031 does not deem the two segments like kind, the exchange would not qualify for Section 1031 nonrecognition.

Section 1031 typically looks first to state law to determine if the property to be exchanged is considered to be real or personal property, but state law is not determinative of the like-kind issue.\textsuperscript{16} The Tax Court in Fleming v. Commissioner determined that in making the like kind determination a court must consider both the nature and character of the physical corporeal properties as well as the nature and character of the title conveyed or the rights of the parties therein.\textsuperscript{17} The court concluded that the legal rights created in the property determine its character.\textsuperscript{18} In that case, the legal rights in oil payments rights, which were real property under state law, were not sufficiently similar to other real property interests to make

\textsuperscript{13} This should not to be confused with illegal international border crossing, a current topic of much debate, but ultimately having nothing to do with tax alchemy. The discussion herein refers exclusively to intranational border crossing property. International border crossing property would be governed by Section 1031(h), which treats U.S. property and non-U.S. property as non-like-kind property.

\textsuperscript{14} At the May 2006 courtesy meeting held at the IRS National Office between members of the Sales, Exchanges and Basis committee of the American Bar Association Section on Taxation and Office of Chief Counsel personnel charged with the administration of Section 1031, the government officials present seemed to be amenable to the idea of publishing favorable guidance on this issue.


\textsuperscript{16} See generally Alton & Weller, Does State Law Really Determine Whether Property is Real Estate for Section 1031 Purposes?, supra.

\textsuperscript{17} 241 F.2d 78 (5th Cir. 1957) (holding that oil payment rights are not like kind to real property for Section 1031 purposes, even though the rights were real property under state law).

\textsuperscript{18} 24 T.C. at 823-824. See also Koch, supra.
the property like kind to other real property. Furthermore, the physical character of the oil payment rights differed from the physical character of other tangible real property. In its more recent decision in *Peabody*, the Tax Court again acknowledged that state law concerns are not controlling of the issue of like kind status for Section 1031 purposes but held that intangible property bundled with other real property was like kind to real property. Through bundling, the intangible property became a part of the tangible property and possessed both its physical and legal rights.

Because of the potential confusion and administrative difficulty that may arise by treating virtually identical property as not like kind, the authors propose a “stripping” approach for cross-border exchanges. Under the stripping approach, the properties, if otherwise physically identical (i.e., identical in physical nature and character), must be stripped of their legal rights and obligations and compared on a purely physical basis to determine whether they are like kind for Section 1031 purposes.

Thus, the second rule of Section 1031 real property alchemy is: differences in state law characterization of identical property do not affect the like-kind characterization of that property. Expressed formulaically: state law “real” property = state law “personal” property, if physical corporeal property $\approx$ physical corporeal property.

**Rule #3: Transforming Intangible Property into Real Property Through Bundling**

*Peabody* and *Koch* provide the formula for turning intangible property into real property. In both cases, the IRS unsuccessfully argued that intangible property could not be like kind to real property. In *Koch*, the taxpayer acquired title to real property subject to a 99-year lease. The IRS argued that the property subject to a 99-year lease was not like kind to other real property because it was merely a right to receive rental payments. The Tax Court held that the acquired interest was like kind to real property because the right to rental payments was part of the bundle of rights the taxpayer acquired. The right to rental payments cannot be separated from that bundle for purposes of applying the Section 1031 like-kind property rule. In *Peabody*, the taxpayer acquired a coal mine, a lease of other coal mine land, and accompanying supply contracts in exchange for a gold mine; the gold mine received by the other party to the exchange was not burdened by gold supply contracts. The court held that the coal supply contracts were like kind to the gold mine because the coal mine land and leases and the supply contracts were acquired together and could not be separated.19

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19. The court also found that the supply contracts were real property under state law, but held that that characterization was not determinative of the like-kind property issue. 126 T.C. No. 14 at p. 20.
The lease in *Koch* and the supply contracts in *Peabody* standing alone would be intangible property, and in both cases, a significant part of the value received in the exchange was attributable to the intangible property. Further, these intangibles were transferable: the landowner in *Koch* could assign the rights to receive lease payments and the owner of the coal mine in *Peabody* could assign the right to receive payments under the supply contracts. Thus, although not all aspects of the *Koch* lease and the *Peabody* supply contracts could be separated from the underlying property interests, a portion of each could be. Moreover, it is clear that an assignment of the rights under either the *Koch* lease or the *Peabody* supply contracts would not qualify for Section 1031 treatment, nor would the rights be like kind to real property.\(^{20}\) Such rights must be bundled with other real property interests to be transformed into real property.

Thus, the third rule of Section 1031 real property alchemy is: intangible property is transformed into real property by bundling it with another real property interest. Expressed formulaically: real property + bundled intangible = real property.

**Rule #4: The Underlying Property Interest is Crucial to Make Bundling Work**

*Peabody* and *Koch* provide an interesting study of the definition of like-kind real property. The underlying real property interest in *Koch* was a fee simple interest in the property and an underlying real property interests in *Peabody* were both a fee simple interest in land and coal leases to other land. This demonstrates that intangible property does not have to be bundled with a fee simple interest in real property to be like kind to other real property. The implication is, however, that the underlying property interest with which the intangible is bundled must be real property or property that is like kind to real property (i.e., the court in *Peabody* recognized that the coal mine lease was like kind to real property).

Several types of real property interests are considered like kind to real property.\(^{21}\) For example, leases with 30 years or more to run are like kind to real property.\(^{22}\) Similarly, perpetual easements and water rights are like kind to real property.\(^{23}\) Certain mineral interests and timber rights also may be like kind to real property.\(^{24}\) An intangible bundled with any of

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\(^{20}\) See Fleming v. Comm’r, supra; Comm’r v. P.G. Lake, Inc., 356 U.S. 260 (1958) (holding that oil payment rights are an assignment of income and cannot be part of a Section 1031 exchange).

\(^{21}\) For an in-depth discussion of partial real estate interests that are like kind to real property see Bradley T. Borden, *The Whole Truth About Using Partial Real Estate Interests in Section 1031 Exchanges*, 31 Real Estate Tax’n 19 (4th Quarter 2003).

\(^{22}\) See Treas. Reg. §1.1031(a)-1(b).


these rights, which is inseparable from the right, should also be considered like kind to real property.

Thus, the fourth rule of Section 1031 real property alchemy is: intangible property is like kind to real property only if it is bundled with underlying property that is like kind to real property. Expressed formulaically: property like kind to real property + bundled intangible = real property.

**An Untested, Emerging Hypothesis**

The results of this experimentation leaves one obvious Section 1031 real property alchemy question unanswered: what intangibles standing alone are like kind to real property? Some intangibles such as a lease with 30 years or more to run are like kind to real property. The Section 1031 real property alchemist might describe these intangibles as “independent” intangibles. Other intangibles, such as oil payment rights, are not like kind to real property, regardless of their state law characterization as real property. In order to convert the latter intangibles to real property, the exchanger must bundle them with an underlying property interest that is like kind to real property. In contrast, the Section 1031 real property alchemist might describe these intangibles as “dependent” intangibles.

Recently, some optimistic Section 1031 real property alchemists have hypothesized that other intangible property could be transformed into real property without being bundled with an underlying interest that is like kind to real property. For example, some have theorized that an intangible such as an option to acquire or sell real property may be transformed into Section 1031 real property. It has been suggested that Rev. Rul. 84-121 provides support for this position. Although this ruling involves an option, the exchange itself does not involve an option. Thus, prior experimentation has not proven that such intangible property standing alone can be transformed into real property. An option, bundled with an underlying interest that is like kind to real property, however, could be transformed into real property. For example, an option to sell real property that is acquired with the underlying property to which the option applies should be like kind to real property.

Section 1031 real property alchemy suggests that options that are not bundled with the underlying real property interests cannot be like kind to real property. Prior experimentation shows that the only intangible property that is like to real property without bundling grants the owner a possessory interest in the property (i.e., leases) or a right to extract from the property (i.e., mineral interests, water rights, etc.). An option grants neither

26. 1984-2 C.B. 168 (ruling that Section 1031 applied to B’s exercise of an option resulting in B’s acquisition of A’s property and A’s acquisition of B’s newly acquired property used as payment for the exercise of the option).
type of right. Therefore, it is unlikely that it is like kind to real property, without its being bundled with another property interest that is like kind to real property.

Another type of intangible that some Section 1031 alchemists have posited may be like kind to real property is a contract to acquire real property. One theory advanced in support of this position is that a contract to acquire real property creates equitable ownership of that property under state law; another theory for this position is that the favorable holding regarding a land sale contract in the *Starker* case supports real property classification of the intangible property. Other more cautious Section 1031 real property alchemists may be hesitant to rely upon this untested hypothesis, believing that the *Starker* decision dealt with a somewhat unusual Oregon law that is not the norm in other states. 28

### Section 1031 Real Property Alchemy Rules Misapplied

Some Section 1031 alchemists would argue that even the IRS at times fails in its understanding of Section 1031 real property alchemy. For example, in Rev. Rul. 67-255, the IRS ruled that a building without the underlying land is not like kind to other real property. 29 The IRS, in that ruling, appears to have confused the Section 1031 real property alchemy rules applicable to personal property with the Section 1031 real property alchemy rules applicable to intangible property. The intangible rules require bundling; the personal property rules require attachment. In Rev. Rul. 67-255, the property interest was not intangible property, so bundling would not be required. Instead, attachment would be required. The building and its component parts appear to have been attached and to have become real property. Therefore, the IRS should have ruled that the building, being real property, is like kind to real property. 30

### Conclusion: Continued Viability of Section 1031 Real Property Alchemy

27. 602 F.2d 1341 (9th Cir. 1979). Proponents of this theory find little support in *Starker*. With regard to the first basis, the Ninth Circuit Court of Appeals allowed the taxpayer to exchange real property for a contractual right to receive kind real property in the future but held that the transaction was a deferred exchange of real properties. With regard to the second basis, the court concluded that the taxpayer’s acquisition of a third party contract right to purchase the Booth property was the equivalent of a fee interest even though the taxpayer had not acquired the legal title to that property.

28. It is the authors’ understanding that land sale contracts are treated as mortgages under Oregon law such that the vendee is deemed to own the subject property.

29. 1967-2 C.B. 270 (ruling that under Section 1033(g) the construction of a building on land already owned by the taxpayer did not qualify as like kind to the converted land).

Unlike other types of exchanges involving intangibles, such as exchanges involving only unbundled intangibles, exchanges utilizing Section 1031 real property alchemy are flourishing under the protection of favorable case law and rulings. Much, though, still remains to be formulated and tested, so back to our library and our research we must go in order to probe further the deeper secrets of our chosen discipline.

31. See TAM 200602034 (dealing with attempted like-kind exchanges of patents, trademarks and trade names, designs and drawings, software and trade secrets); see also Kelly E. Alton and Louis S. Weller, New IRS Ruling Unveils Restrictive Approach to Like-Kind Exchanges of Intangibles, 104 J. Tax’n 208 (April 2006).