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What Is "Like-Kind" for Real Estate?

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What Is “Like-Kind” for Real Estate?

-by Neil E. Harl*

Since the earliest days of like-kind exchanges,¹ the line between real property and depreciable tangible personal property has been indistinct, at best.² Interestingly, the dichotomy between real and personal property is a creature of the Treasury regulations,³ not of the statute. The statute merely refers to “property”⁴ other than for separate provisions for real property and personal property indicating that foreign property is not “like-kind” to property located in the United States.⁵ Actually, the relevant authority has identified three classes of property eligible for like-kind exchange treatment – (1) real property,⁶ (2) depreciable tangible personal property⁷ and (3) other personal property including intangible personal property.⁸

The rules governing depreciable personal property embrace an elaborate system of classification as to what is like-kind.⁹ Real property has never been subjected to such a classification scheme. A recent Tax Court case¹⁰ has focused attention on the need for a more finite classification system for real property in the context of like-kind exchanges.¹¹

The scope of “like-kind” exchanges of real property

The regulations, in defining what is “like-kind,” starts off by stating that the words “like kind” have reference to “. . . the nature or character of the property and not its grade or quality.”¹² The regulations go on to state that whether real estate is improved or unimproved is immaterial.¹³ The regulations proceed to draw some lines in stating that an exchange of a leasehold with 30 years or more to run for a fee interest in real estate can be like-kind.¹⁴ Rulings have contributed additional guidance in reciting, as examples, that a remainder interest may be exchanged for a remainder interest in other farmland,¹⁵ a life estate in real property with a life expectancy of less than 30 years exchanged for a remainder interest in real property is not considered like-kind,¹⁶ a sale followed by a leaseback involving terms of 30 years or more constitutes a like-kind exchange,¹⁷ and unharvested crops are considered part of the land on which they are growing and may be exchanged with the land for other qualified property.¹⁸ Litigation has also contributed guidance with a purchaser’s rights under an installment contract apparently considered equivalent to a fee simple interest.¹⁹

But that process has been slow and incremental with the authorities emerging over more than a half century and leaving interstices in the guidance.

Peabody Natural Resources Co.

A Tax Court decision on May 8, 2006, *Peabody Natural Resources Co. v. Comm’r*,²⁰ addressed yet another dimension of the problem with a significant enlargement in what

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property is eligible for like-kind exchange treatment. In that case, operating gold mines, including real estate, were exchanged with operating coal mines in New Mexico which were subject to coal supply contracts that obligated the mine owner to provide electric utilities with coal.²¹ The owners of the mines treated the exchange as like-kind, including the coal supply contracts, as interests in real property.²² The Internal Revenue Service disagreed, arguing that the coal supply contracts were not real property.²³

The Tax Court conceded that minerals that are severed and removed from the land become personal property under the Uniform Commercial Code²⁴ as contracts for the sale of goods. However, the court was enamored with the taxpayers' argument that the coal supply contracts created servitudes under state law which can be interests in real property.²⁵ Under New Mexico law, there are three requirements for an equitable servitude – (1) the covenant must “touch and concern” the land; (2) the parties must intend that the covenant run with the land; and (3) any successor against whom enforcement is sought must have “actual, constructive, or inquiry notice” of the covenant.²⁶ The Tax Court found that the three requirements were met, the coal supply contracts created servitudes and the servitudes were real property interests under state law.

The Tax Court then proceeded to examine whether, given that the interests were real property, the interests were eligible for like-kind exchange treatment. The court agreed with IRS that just because an asset is an interest in real property does not mean that it is automatically eligible for like-kind exchange treatment.²⁷ The court then examined whether the nature and character of the transferred rights in the properties were “substantially alike.”²⁸ The Tax Court concluded that the supply contracts could not be separated from the ownership of the coal reserves and the supply contracts were ancillary to the ownership of the coal reserves, holding that the supply contracts were like-kind to the gold mining property.²⁹

Role of state law

The dominant role of state law in characterizing the contracts as real property means that what is considered real property, eligible for like-kind exchange treatment, could necessarily vary from state to state. That concern was addressed in a 2003 private letter ruling³⁰ which cited to *Morgan v. Commissioner*³¹ for the proposition that “[i]n the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayers had in the property or income sought to be reached by the statute.”³²

The *Peabody* case³³ provides encouragement to broaden the scope of what is eligible for real property like-kind exchanges.

Footnotes

¹ See Reg. 45, 1920 Ed., Act 1563 (regulations issued under the 1918 Act provided that no gain or loss from the acquisition and subsequent disposition of property would be recognized unless there was a change of substance and not merely in form. The statutory nonrecognition of gain or loss in the case of property held for productive use or for investment has remained largely

unchanged since 1924). See Harl, “Like-Kind Exchanges: A Popular Option for Property Transfers,” 11 *Drake J. of Agric. L.* 25, n. 2 (2006).

² Treas. Reg. § 1.1031(a)-2. See generally 4 Harl, *Agricultural Law* § 27.04 (2006); Harl, *Agricultural Law Manual* § 4.02[16] (2006).

³ See Treas. Reg. § 1.1031(a)-2.

⁴ I.R.C. § 1031(a)(1).

⁵ I.R.C. § 1031(h)(1), (2).

⁶ Treas. Reg. § 1.1031(a)-1(b).

⁷ Treas. Reg. § 1.1031(a)-2(b).

⁸ Treas. Reg. § 1.1031(a)-2(c).

⁹ Treas. Reg. § 1.1031-2(b)(2), (3); Temp. Treas. Reg. § 1.1031(a)-2T(d) (four and six-digit classification system). See Harl, “New Rules on Like-Kind Exchanges with Personal Property,” 15 *Agric. L. Dig.* 129 (2004).

¹⁰ *Peabody Natural Resources Co. v. Comm’r*, 126 T.C. 261 (2006).

¹¹ I.R.C. §§ 1031, 1033(g)(1).

¹² Treas. Reg. § 1.1031(a)-1(b).

¹³ Treas. Reg. § 1.1031(a)-1(b), (c).

¹⁴ Treas. Reg. § 1.1031(a)-1(c).

¹⁵ Rev. Rul. 78-4, 1978-1 C.B. 256.

¹⁶ Rev. Rul. 72-601, 1972-2 C.B. 467.

¹⁷ Rev. Rul. 60-43, 1960-1 C.B. 687.

¹⁸ Rev. Rul. 66-209, 1966-2 C.B. 299.

¹⁹ *Starker v. Comm’r*, 602 F.2d 1341 (9th Cir. 1979).

²⁰ 126 T.C. 261 (2006).

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ N.M. Stat. Ann. § 55-2-107.

²⁵ *Peabody Natural Resources Co. v. Comm’r*, 126 T.C. 261 (2006).

²⁶ *Lex Pro Corp. v. Snyder Enterprises, Inc.*, 671 P.2d 637 (N.M. 1983).

²⁷ *Peabody Natural Resources Co. v. Comm’r*, 126 T.C. 261 (2006).

²⁸ *Id.*

²⁹ *Id.*

³⁰ Ltr. Rul. 200424001, Dec. 8, 2003.

³¹ 309 U.S. 78 (1940).

³² *Id.* at 82.

³³ *Peabody Natural Resources Co. v. Comm’r*, 126 T.C. 261 (2006).