1031 LIKE-KIND EXCHANGES AFTER THE 2017 TAX CUTS AND JOBS ACT

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Publications

"Recent Developments in Transferee Liability for Intermediary Transactions," published in Checkpoint's *Federal Taxes Weekly Alert Newsletter*.

"Estate and Gift Tax Updates and Opportunities in the Current Economy," published in *Investments & Wealth Monitor* and the tax newsletter of the *Illinois Bar Journal.*

I. OVERVIEW

A. General.

1. Code Section 1031 as Amended by the Act. Section 1031 of the Internal Revenue Code ("**IRC**" or "**Code**") was amended by the 2017 Tax Cuts and Jobs Act (the "**Act**") whereby only real property is now eligible for nonrecognition treatment under Code Section 1031. Prior to the Act, taxpayers could avoid gain recognition upon exchanges of personal property of a "like kind" held for productive use in a trade or business or for investment.

2. Amended Text of Code Section 1031.

§ 1031. Exchange of **real** property held for productive use or investment

(a) Nonrecognition of gain or loss from exchanges solely in kind.--

(1) In general.--No gain or loss shall be recognized on the exchange of **real** property held for productive use in a trade or business or for investment if such **real** property is exchanged solely for **real** property of like kind which is to be held either for productive use in a trade or business or for investment.

(2) Exception for real property held for sale.--This subsection shall not apply to any exchange of~~--~~

~~**(A)** stock in trade or other~~ **real** property held primarily for sale~~,~~

~~**(B)** stocks, bonds, or notes,~~

~~**(C)** other securities or evidences of indebtedness or interest,~~

~~**(D)** interests in a partnership,~~

~~**(E)** certificates of trust or beneficial interests, or~~

~~**(F)** choses in action.~~

~~For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership~~.

(3) Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property.--For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if--

(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(B) such property is received after the earlier of--

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

(b) Gain from exchanges not solely in kind.--If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) Loss from exchanges not solely in kind.--If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) Basis.--If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange~~-~~**.** If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange~~-~~**.** For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.

~~**(e) Exchanges of livestock of different sexes.**--For purposes of this section, livestock of different sexes are not property of a like kind.~~

(e) Application to certain partnerships.--For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

(f) Special rules for exchanges between related persons.--

(1) In general.--If--

(A) a taxpayer exchanges property with a related person,

(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

(C) before the date 2 years after the date of the last transfer which was part of such exchange--

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer, there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

(2) Certain dispositions not taken into account.--For purposes of paragraph (1)(C), there shall not be taken into account any disposition--

(A) after the earlier of the death of the taxpayer or the death of the related person,

(B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or

(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

(3) Related person.--For purposes of this subsection, the term “related person” means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).

(4) Treatment of certain transactions.--This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

(g) Special rule where substantial diminution of risk.--

(1) In general.--If paragraph (2) applies to any property for any period, the running of the period set forth in subsection (f)(1)(C) with respect to such property shall be suspended during such period.

(2) Property to which subsection applies.--This paragraph shall apply to any property for any period during which the holder's risk of loss with respect to the property is substantially diminished by--

(A) the holding of a put with respect to such property,

(B) the holding by another person of a right to acquire such property, or

(C) a short sale or any other transaction.

(h) Special rules for foreign real ~~and personal property.~~ ~~--For purposes of this section--~~

~~**(1) Real**~~ **property.**--Real property located in the United States and real property located outside the United States are not property of a like kind.

~~**(2) Personal property.**--~~

~~**(A) In general.**--Personal property used predominantly within the United States and personal property used predominantly outside the United States are not property of a like kind.~~

~~**(B) Predominant use.**--Except as provided in subparagraphs (C) and (D), the predominant use of any property shall be determined based on--~~

~~**(i)** in the case of the property relinquished in the exchange, the 2-year period ending on the date of such relinquishment, and~~

~~**(ii)** in the case of the property acquired in the exchange, the 2-year period beginning on the date of such acquisition.~~

~~**(C) Property held for less than 2 years.** Except in the case of an exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection--~~

~~**(i)** only the periods the property was held by the person relinquishing the property (or any related person) shall be taken into account under subparagraph (B)(i), and~~

~~**(ii)** only the periods the property was held by the person acquiring the property (or any related person) shall be taken into account under subparagraph (B)(ii).~~

~~**(D) Special rule for certain property.** Property described in any subparagraph of section 168(g)(4) shall be treated as used predominantly in the United States.~~

~~**(i) Special rules for mutual ditch, reservoir, or irrigation company stock** For purposes of subsection (a)(2)(B), the term "stocks" shall not include shares in a mutual ditch, reservoir, or irrigation company if at the time of the exchange--~~

~~**(1)** the mutual ditch, reservoir, or irrigation company is an organization described in section 501(c)(12)(A) (determined without regard to the percentage of its income that is collected from its members for the purpose of meeting losses and expenses), and~~

~~**(2)** the shares in such company have been recognized by the highest court of the State in which such company was organized or by applicable State statute as constituting or representing real property or an interest in real property.~~

II. Peripheral Implications of the Act.

A. Mixed Property Exchanges. Prior to the Act, many practitioners associated Code Section 1031 exchanges with real property. However, real property exchanges often include ancillary personal property interests that are transferred simultaneously. After 12/31/2017, any personal property transferred as part of a real property like kind exchange would be considered "other property" (i.e. taxable boot). Since personal property is no longer eligible for tax deferred treatment under Code Section 1031, much closer consideration and analysis are required in real property exchanges when ancillary personal property interests are also transferred.

1. Example. Acme and OilCo each own 100% of the working interests in oil and gas leases held by production (the "**Leases**") having a fair market value of $20M. In connection with their ownership of the Leases, each of Acme and OilCo also own tank batteries and other salvageable surface equipment that could be removed from the underlying property (i.e. not considered "real property" for federal income tax purposes[1]) (the "**Equipment**") with a fair market value of $2.5M and an adjusted tax basis of $0.00.

[1] "Federal income tax law rather than state law controls whether exchanged properties are of like kind for purposes of § 1031. Under the Income Tax Regulations of § 1031, properties are generally of like kind if they are of the same nature and character. State law property classifications, while relevant for determining if property is *real or personal* property, are not determinative of whether properties are of the same nature and character. Rather, all facts and circumstances should be considered in determining whether properties are of the same nature and character and thus are of like kind. . . ." CCA 201238027 (emphasis added).

Chief Counsel Advisory 201238027 analyzed (among others) the following facts: "Case 2: A steam turbine *attached as a fixture* in a State A land improvement (a building) as a component of a system for the commercial production of electricity *that is treated as real property in State A* is exchanged for a steam turbine attached as a fixture in a State B land improvement as a

Each of Acme and OilCo also own similar seismic and engineering reports and title opinions (the "**Reports**"). Acme's and OilCo's respective Reports each have a fair market value of $1.2M, and the preparation and other costs for such Reports have been fully expensed or amortized whereby each party's adjusted tax basis therein is now $0.00. Acme and OilCo enter into a standard Exchange Agreement that collectively defines the Leases, Equipment and Reports as "**Assets**" and further provides that each party agrees to exchange with the other all of its right, title and interest in and to its respective Assets. The Exchange Agreement did not require the parties to allocate the consideration among the Assets pursuant to Code Section 1060.

a. Tax Results Prior to the Act (i.e. prior to 01/01/18). The exchange of the Leases would qualify for nonrecognition treatment under Code Section 1031. Assuming that the exchanged Equipment was in the same general asset class, the exchanges of the Equipment would also qualify under Code Section 1031. Likewise, assuming the Reports satisfied the "like kind" test for intangible personal property,[2] the exchange of the Reports would not trigger gain recognition.

b. Tax Results After the Act (i.e. after 12/31/17). The exchange of the Leases would qualify for nonrecognition treatment under Code Section 1031. The exchanged Equipment would constitute an exchange of "other property" (i.e. taxable as boot) and each of Acme and OilCo would likely recognize ordinary income of $2.5M for depreciation recapture under Code Section 1245. However, the gain

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component of a system for the commercial production of electricity that is treated as personal property in State B (The land and buildings associated with the steam turbines in both State A and State B are also exchanged.) . . . ." CCA 201238027 (emphasis added).

CCA 201238027 concluded that "(i)n Case 2, the steam turbines in both State A and State B are of the same nature and character and, therefore, of like kind. The steam turbines, as machinery used in the commercial production of electricity, and not as structural components, *are personal property*. Therefore, the steam turbines in State A and State B are of like kind, *but should not be a treated as part of the real property* . . . ." CCA 201238027 (emphasis added). Due to the Act, whether the steam turbines are of a like kind is immaterial, and their classification as personal property for federal income tax purposes automatically disqualifies the exchange thereof for nonrecognition under Code Section 1031.

In contrast, CCA 201238027 held that "natural gas pipelines should be treated as real property because they are inherently permanent structures that are affixed to real property that will ordinarily remain for an indefinite period of time, and they are transferred as part of the land to which they are affixed. Thus, the pipelines are of the same nature and character as land and improvements or other real property. Therefore, in applying § 1.1031(j)-1, relating to exchanges of multiple properties, the natural gas pipelines in this case should be treated as real property and included in the real property exchange. . . ." CCA 201238027.

[2] Prior to the Act, the following rules and examples applied to determine if intangible property was of a like kind: "In the case of exchanges of intangible property. . . a two-pronged analysis is required under § 1.1031(a)-2(c)(1), which requires a matching of both (i) the nature or character of the rights involved and (ii) the nature or character of the underlying property to which the intangible personal property relates.

In view of the commonality of legal protections afforded to unregistered intangible property generally, it is apparent that the proprietary information exchanged by Taxpayer (designs and drawings, trade secrets and secret know-how, and software) satisfy the first prong of the test set forth in § 1.1031(a)-2(c)(1) for determining if intangible properties exchanged are of like kind. . . .

There is no basis in law for adopting broad categories for purposes of satisfying the like-kind test under § 1.1031(a)-2(c), and . . . the matching of very different kinds of property interests beyond the scope and intendment of § 1031. . . . For example, the drawing or unpatented design for a coated gas welding rod is not similar to the drawing or unpatented design for a wind turbine. The underlying property for the former is a coated gas welding rod, and of the latter, a wind turbine." TAM 200602034, 01/13/2006.

recognized on the exchanged Equipment should be considered "qualified property" eligible for 100% accelerated depreciation under Code Section 168(k) if such exchange occurs prior to 01/01/2023.[3] Similarly, the exchange of the Reports would trigger additional gain recognition to each party of $1.2M.

c. How the Exchange Agreement Could Have Been Altered. The Exchange Agreement could have separately addressed the Records and not included such in the definition of "Assets." Further, instead of providing that each party exchanged all of its right, title and interest in the Records, the Exchange Agreement could have stated that each party retained complete ownership of its Records and permitted the other party a non-exclusive temporary right to make copies of the Records.[4] Regarding the Equipment, the Exchange Agreement could have required the parties to agree upon, specify and report on IRS Form 8594 a lower but defensible fair market value for the Equipment.[5]

d**. How the Transaction Could Have Been Restructured.** Although fundamentally changing the transaction, if Acme and OilCo farmed out and let the other party carry and earn an undivided 90% of the working interests in the Leases, with 100% of the revenue until complete payout, then the transaction could potentially qualify for tax free treatment under the pool of capital doctrine.[6]

2. No Exception to Exclude Incidental Personal Property as Taxable Boot. Treasury Regulation 1.1031(k)-1(c)(5) provides that *solely* for purposes of accurately *identifying* replacement property, incidental personal property "is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if— (A) In standard commercial transactions, the property is typically transferred together with the larger item of property, and (B) The aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property."[7] However, even prior to the Act this provision did not prevent incidental personal property from being taxable boot.[8] After the Act, all personal property transferred is now taxable boot regardless of whether it is incidental or of a like kind.

III. Unaffected Real Property Exchange Issues.

A. Continuing Uncertain Legal Issues. The more that changes, the more that stays the same. There are still a plethora of issues and gray areas that remain even when exchanges consist of exclusively real property interests.

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[3] Commencing in 2023 until 2027, the percentage of accelerated depreciation that a taxpayer may deduct under Code Section 168(k) generally begins to "phase out" by being reduced in 20% increments per year (e.g. "qualified property" acquired in 2023 is eligible for depreciation at a rate of 80% of its adjusted tax basis).

[4] The Internal Revenue Service (the "**IRS**" or the "**Service**") could assert the substance over form doctrine and attempt to recast the purported "record sharing arrangement" as a taxable disposition under Code Section 1001 or alternatively, as a taxable licensing arrangement. However, the retention of title to the Records should provide a defensible position that a taxable disposition did not occur.

[5] The IRS would not be bound by the allocation of value agreed upon by OilCo and Acme for the Equipment.

[6] Again, the IRS could assert the substance over form doctrine to recast the purported "simultaneous carry to earn arrangement" as taxable sales, especially if the terms of such arrangement are not market.

[7] Treas. Reg. 1.1031(k)-1(c)(5)(i).

[8] PLR 8434015 ("Rev. Rul. 72-151, 1972-1 C.B. 225, held that when an exchange under Section 1031 of the Code involves multiple assets, the fact that the assets in the aggregate comprise a business or an integrated economic investment does not result in treating the exchange as a disposition of a single piece of property. Rather, an analysis is required of the underlying property involved in the exchange. The effect of the ruling is that a transfer of "multiple assets" must be fragmented in applying section 1031(a) even if the assets constitute a going business or an integrated economic investment.")

1. Exclusion of Property Primarily Held for Sale. Both before and after the Act, Code Section 1031 excluded any property held primarily for sale. In the oil and gas industry questions often arise regarding whether a taxpayer acquired particular oil and gas interests primarily for sale or for investment. The former being ineligible for like kind exchange treatment and the latter being eligible for nonrecognition under Code Section 1031.

a. Primarily Held Standard for Code Section 1031. "The exclusion of 'property held primarily for sale' from nonrecognition treatment in section 1031(a)(1) is broader than the exception to capital gain treatment in section 1221"[9] (which excludes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[10] Accordingly, a taxpayer *without* customers could arguably hold real property (not used in his trade or business[11]) primarily for sale and be eligible for long term capital gain treatment but ineligible for like kind exchange treatment.

i. "In Chief Counsel Advice 201025049, the IRS held that a corporation held equipment primarily for sale. Although the corporation rented out some of its equipment, the IRS found that 91% of the corporation's income was generated from sales, while only 9% was generated from its rental operation."[12]

ii. If a substantial majority of a taxpayer's income is generated from sales of oil and gas properties rather than from production or royalty income, then the analysis in CCA 201025049 could be applied to hold that the taxpayer's properties are held primarily for sale and ineligible for Code Section 1031 like kind exchange treatment.

b. Sample Letter to a Client.

Dear Client:

Newco Petroleum, LLC ("Newco") will be acquiring *new* oil and gas leases (the "Leases"), and depending upon market conditions, Newco may subsequently sell some of the Leases to third parties whereby the sales proceeds would be held by a Qualified Intermediary (the "QI") and subsequently used to purchase replacement property (the "Replacement Property") through the QI (the "Transactions"). The Transactions may involve multiple sales of the Leases.

This letter is being written to inform you that while it is theoretically possible for the Transactions to qualify for tax deferred treatment under Code Section 1031, there exists a significant risk that the IRS in an examination may take a contrary position and recast the Transactions as taxable sales. The scope of this letter will not cover the basic requirements of Code Section 1031 such as the time-frames for identifying and closing on replacement property and the properties being of a "like kind." Rather, this letter will address the risks associated with the properties involved in the Transactions being treated as "held primarily for sale" (a factor that disqualifies property from Code Section 1031 treatment). If you have additional questions regarding the requirements for a Code Section 1031 exchange, please discuss them with us prior to undertaking the Transactions.

The facts as I understand them are as follows:

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[9] *Neal T. Baker Enterprises Inc.*, TC Memo 1998-302.
[10] IRC 1221(a)(1).
[11] *See* IRC 1231(b)(1)(B) and IRC 1231(a)(2) which exclude real property used in a trade or business.
[12] 110 Requirements for Nonrecognition Treatment Under IRC § 1031. 505 Like-Kind Exchanges / Catalyst Checkpoint.

All of the members of Newco have previously engaged in the investment and development of oil and gas properties for productive business use and have also engaged to some degree in the selling of undeveloped leases. The Leases being sold pursuant to the Transactions were not acquired pursuant to any binding contract for resale and at the time of acquisition Newco will not unequivocally know whether the Leases will be held for development into producing properties (whether developed by Newco or in conjunction with a third party) or for resale at a profit. At this juncture, Newco has not decided exactly what Replacement Property it will seek to acquire with the sales proceeds from the Transactions

Position Newco Would Need to Establish

To prevail against an IRS challenge that the Transactions qualify for Code Section 1031 treatment (in addition to following the standard rules for a 1031 exchange), Newco would need to establish that the Leases and the Replacement Property were not acquired with the principal purpose and intent of being sold.

Law

A general rule for Code Section 1031 is that both the property sold and the property acquired (the "Replacement Property") must be held for productive use in a trade or business or for investment.[13] Code Section 1031 specifically excludes property that is "held primarily for sale"[14] as such property is not considered to be held for investment or for the productive use in a trade or business.

Neither the Code nor the Regulations define "held for investment." The regulations provide that "(u)nproductive real estate held by one ***other than a dealer*** for future use or future realization of the increment in value is held for investment and not primarily for sale."[15] In *Bolker v. Commissioner* the court stated that "a taxpayer may satisfy the 'holding' requirement by owning the property, and the 'for productive use in trade or business or for investment' requirement by lack of intent either to liquidate the investment or to use it for personal pursuits."[16] "Whether property was 'held primarily for sale' is entirely a factual question that requires consideration of the facts surrounding the exchange, the principal or primary purpose for which the property acquired in the exchange was to be held, the use of the property during its holding period, and the principal or primary purpose for which the property acquired was held at the time of its sale."[17]

"Where the taxpayer seeking nonrecognition treatment is a dealer in that property, gain or loss is ordinarily recognized to the taxpayer because he doesn't hold the property for the required purpose. He ordinarily holds it 'primarily for sale' rather than for productive use in a trade or business or for investment."[18] In *Horsting v Commissioner*, an individual taxpayer was denied like kind exchange treatment where during the tax years under examination he "traveled extensively in connection with the transactions resulting in the many purchases and sales[19]. . . (and) had no income during these years other than that derived from

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[13] I.R.C. 1031(a)(1)
[14] I.R.C. 1031(a)(2)
[15] Treas. Reg. 1.1031(a)-1(b) (emphasis added).
[16] *Bolker v. Commissioner*, 760 F.2d 1039, 1045 (9th Cir. 1985), affg 81 T.C. 782 (1983).
[17] Federal Tax Coordinator (RIA); *Bernard, George M.*, (1967) TC Memo 1967-176.
[18] Federal Tax Coordinator (RIA).
[19] "He traveled extensively during these years in purchasing and selling oil properties or undivided interests therein. He made 34 separate sales in 1940 and 15 in 1941. Held, petitioner and his wife were in business of buying and selling oil properties. Held, further, the properties held by petitioner and his wife were held primarily for sale to customers in the ordinary course of business and were not capital assets." *Horsting v Commissioner*, 5 T.C.M. (CCH) 421 (1946).

the sales made." The Tax Court ruled that "considering the frequency, regularity and continuity of the many transactions here involved we think it is clear that petitioner. . . . during the taxable years, engaged in the business of buying oil properties and selling undivided interests therein and we have so found as an ultimate fact."[20]

Analysis

To be eligible for Code Section 1031 treatment, the Leases and the Replacement Property cannot be property "held primarily for sale."[21] If the IRS were to determine that Newco is a dealer in oil and gas leases as opposed to an investor, then there is a much higher likelihood that the Transactions would be re-characterized as taxable sales. In an examination the IRS would consider the following factors as relevant: 1) the number and frequency of the acquisitions and sales; 2) the duration of time during which the Leases were held; 3) any evidence (or lack thereof) indicating that the Leases were going to be developed by Newco; and 4) the subsequent use and holding period of the Replacement Property. For example, if shortly after acquiring the Leases Newco contacts a broker to look for potential buyers, then such would be substantial evidence that the Leases were acquired for the primary purpose of reselling the same. Also, if Newco sells the Replacement Property to another party shortly after its acquisition, such circumstances would strongly indicate that the Replacement Property was acquired with the intent to resell the same and thus be ineligible for Code Section 1031 treatment.[22] In contrast, if the Leases and the Replacement Property have active production from which Newco derives income, then such would tend to show that the Leases and the Replacement Property were acquired for investment purposes.

In examining the legislative history of Code Section 1031 and the "holding" requirements of the statute, one commentator notes that "(a)lthough clearly reflecting a pro-investment congressional posture, section 1031 provides relief under limited circumstances (and) . . . . only where there is a continuing investment."[23] As cited above in *Bolker v. Commissioner* the court stated that "a taxpayer may satisfy the 'holding' requirement by owning the property, and the 'for productive use in trade or business or for investment' requirement by lack of intent . . . to liquidate the investment. . . . (intent to sell disqualifies exchange)."[24]

If Newco were to retain an interest in the Leases whereby its disposition is still considered a "sale" for federal income tax purposes (e.g. retaining a royalty causes for the transaction to be taxable as a “lease” rather than a "sale"), then an argument could be made that there was not a complete liquidation of the property and continuity of investment was preserved. For example, if Newco were to dispose of 7/8 of its

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[20] *Horsting v Commissioner*, 5 T.C.M. (CCH) 421 (1946). "We have also found as an ultimate fact that the oil properties in question were held primarily for sale to customers in the ordinary course of business rather than primarily as an investment."

[21] The Supreme Court in *Malat* concluded that "primarily" means "of first importance" or "principally."

[22] In *Regals Realty Co v. Corn*. (1942, CA2) 29 AFTR 444, the court held that property sold soon after its acquisition did not satisfy the use requirement. The corporation acquired property intended to be replacement property. Less than two weeks after the corporation acquired the deed to the intended replacement property, the corporation's board of directors adopted resolutions to liquidate the corporation by distributing its cash to the shareholders and selling the newly acquired property. The corporation's immediate disposal was evidence that the corporation acquired the property for resale, not to hold for productive use in a trade or business or for investment." Tax Advisors Planning System (RIA)

[23] Burke, J. Martin and Friel, Michael K., TO HOLD OR NOT TO HOLD: MAGNESON, BOLKER, AND CONTINUITY OF INVESTMENT UNDER I.R.C. SECTION 103, 20 USFLR 177 (Winter 1986) ("Although clearly reflecting a pro-investment congressional posture, section 1031 provides relief under limited circumstances. Only property which the taxpayer 'held' for investment or for productive use in the trade or business (the 'holding' requirement) is subject to the nonrecognition rule of section 1031 and then only if that property is exchanged for 'like-kind' property (the 'like-kind' requirement) 'to be held' by the taxpayer for investment or for productive use in the taxpayer's trade or business (the 'to be held' requirement).... (T)hey represent Congress' effort to assure that nonrecognition is accorded only where there is a continuing investment").

[24] *Bolker v. Commissioner*, 760 F.2d 1039, 1045 (9th Cir. 1985), affg 81 T.C. 782 (1983).

8/8 interest in the lease and retained a carried working interest, then the transaction would be taxable as a sale and there would not be a complete liquidation of the investment.

Assuming Newco moves ahead with the Transactions as Code Section 1031 Exchanges and reports them as such on Newco's 201X income tax return, there exists a possibility the IRS could later challenge the Transactions as being taxable sub-leases on audit. If the IRS were to prevail in such a challenge, Newco and its Members would be liable for taxes that would have been incurred in a fully taxable sale of the Leases, interest accrued on the amount of underpayment and potential penalties for under reporting tax liability.

Sincerely,

John Smith, Esq.

B. Retention of ORRIs and Perpetual Non-Cost Bearing Interests Taxable as Sales.

1. Applicable Law. To be eligible for a like-kind exchange, the underlying transaction must be taxable as a sale rather than a lease. In General Counsel Memorandum 22730 the opinion noted that "a sale of capital assets is not involved in a lease agreement in which the lessor, in consideration of a bonus or lump sum cash payment made at the time the lease was executed … and stipulated royalties measured either by a percentage of production under the lease or by a stated sum per unit extracted and sold … which are payable over the entire lease life, grants a lessee the right to enter upon and use the land for purposes of exploitation, ..."[25]

A taxpayer that transfers a leasehold estate and retains any non-operating interest (i.e. non-cost bearing interest) that lasts for the duration of the leasehold is taxable as a lease rather than a sale.[26] The consideration received in a leasing transaction is considered a lease bonus (taxable as ordinary income) without any offset for adjusted tax basis. The lease bonus may be recouped through depletion deductions.[27]

However, if a taxpayer owns both a leasehold interest and a fee mineral interest that remain unmerged, the taxpayer's sale of the leasehold interest without retaining any non-operating interest therein is a taxable sale rather than a lease (i.e. the retention of a fee mineral interest acquired in a previous and separate transaction does not cause a sale of an existing leasehold interest that burdens such minerals to be taxable as a lease).[28]

[25] G.C.M. 22730, 1941-1 C.B. 214 citing *Bankers Pocahontas Coal Co. v. Burnet*, 287 U.S. 308 (1933), and *Burnet v. Harmel*, 287 U.S. 103 (1932). *See* CCA 201520004 ("an oil and gas leasing transaction occurs when the taxpayer, as owner of the operating rights, assigns all or part of such rights to another person for no immediate consideration, or for cash or its equivalent, and retains a continuing non-operating interest in production.").
[26] See *Crooks v. Comr.*, 92 T.C. 816 (1989).
[27] "(T)he Supreme Court in *Palmer v. Bender*, 287 U.S. 551 (1933). . . . refused to distinguish between lessors and sub-lessors or assignors of leasehold interests who, by stipulation for royalty payments, reserved an interest in production coextensive with the leasehold life. The Court held that the bonus payment, oil payments, and royalty payments involved in the case were all ordinary income to the sub-lessor or assignor subject to the depletion allowance, rather than proceeds from the sale of capital assets." CCA 201520004.
[28] *Badger Oil Co. v. Comr.*, 118 F.2d 791 (CA5 1941) ("This taxpayer, after selling outright for money its lease interest, still had an interest in the oil reserve as the successor in title of the lessor, but that is not the same thing as retaining a royalty in the transfer. His two interests stood unmerged. He sold his lease interest without any reservation. What he got for it was purchase money. The interest he kept was that which the lessors had reserved fourteen years before. None of that royalty was paid in

2. Strategies. If a taxpayer acquires a leasehold interest that has a net revenue interest in excess of what is marketable (e.g. in excess of a 75% NRI), then the taxpayer should carve off the excess NRI and assign such to an affiliated but separate taxpayer. If the taxpayer is a taxable as a partnership, then an assignment in-kind of an overriding royalty interest (an "**ORRI**") to its partners should be a tax free distribution. For a corporate taxpayer, gain would be recognized on an assignment of an ORRI to its shareholders if the ORRI constitutes appreciated property.

If the assignment of an ORRI is not done on the eve of a sale, then asset protection should be a sufficient business purpose for the ORRI assignment as holding working interests and royalty interests in separate entities is prudent planning apart from tax considerations. However, even if the assignment of an ORRI is done on the eve of a sale, the IRS may respect the overall transaction as a sale.[29]

C. Depletion and IDC Recapture in Exchanges of Natural Resource Property. It is well established that an interest in an oil and gas lease held by production is "like kind" with a fee interest improved real estate. Although such an exchange qualifies under Code Section 1031, the taxpayer is generally required to recognize (as ordinary income) all of the previously taken intangible drilling costs and depletion deductions unless and to the extent the replacement property is "natural resource recapture property." This effectively limits the gain deferral available under Code Section 1031 to what otherwise would have been long term capital gain.

1. Applicable Law. "If natural resource recapture property is disposed of and gain (determined without regard to section 1254) is not recognized in whole or in part under section 1031. . . the amount of gain taken into account by the transferor under section 1254(a)(1) may not exceed the sum of—(i) The amount of gain recognized on the disposition (determined without regard to section 1254); plus (ii) The fair market value of property acquired **that is *not* natural resource recapture property**. . . (that is, qualifying property under section 1031 . . . .that is not natural resource recapture property)."[30]

"The term *natural resource recapture property* means section 1254 property *or* oil, gas, or geothermal property as those terms are defined in this section."[31] "The term section 1254 property means any property. . . that is placed in service by *the taxpayer* after December 31, 1986 . . . if any expenditures. . . relating to costs. . . under section 263[32], 616, or 617[33]. . . *are properly chargeable* to such property, ***or*** if the adjusted basis of such property includes adjustments for deductions for depletion under section

advance by International in this purchase. It all remained yet to be paid. There is no room to say that the money in this transaction was paid as advance royalty and hence is depletable income arising from the operation of the oil wells.").

[29] *See* FSA 1999-819 ("The individual acquired oil and gas leases and would sell the leases but retain overriding royalty interests. The individual would transfer the overriding royalty interests to a trust set up for his children at about the same time as he sold the other interests in the leases. . . . Stepping these transactions together, the purchase and assignment of the lease interests and ORRs constitute sales of assets.").

[30] Treas. Reg. 1.1254-2(d)(1)(i)-(ii).

[31] Treas. Reg. 1.1254-1(b)(2)(i).

[32] "In the case of oil and gas wells, a taxpayer has an option to treat intangible drilling and development costs as either capital expenditures, under IRC 263(a), or as expenses as provided in IRC 263(c)". I.R.M. 4.41.1.2.4.

[33] "Under § 617(a), taxpayers may elect to deduct mining exploration expenditures paid or incurred before the mine's development stage, instead of capitalizing them. Section 616(a) similarly allows an expensing of expenditures for the development of mines and other natural deposits paid or incurred after the existence of minerals in commercially marketable quantities has been established. Neither provision applies to oil or gas wells or to expenditures for the acquisition or improvement of depreciable property." Mining Exploration and Development Expenditures, Bittker & Lokken: Federal Taxation of Income, Estates, and Gifts (WG&L).

611[34]. . . .[35] "The term oil, gas, or geothermal property means any property. . . that was placed in service by the taxpayer before January 1, 1987, if any . . . (Section 1254 costs). . . are properly chargeable to such property."[36]

Treasury Regulation 1.1254-1(b)(2)(iv)(A) defines property to which Section 1254 costs are properly chargeable as follows: "An expenditure is properly chargeable to property if:

(1) The property is an operating mineral interest with respect which the expenditure *has been deducted*;

(2) The property is a nonoperating mineral interest (e.g., a net profits interest or an overriding royalty interest) burdening an operating mineral interest if the nonoperating mineral interest is carved out of an operating mineral interest described in paragraph (b)(2)(iv)(A)(1) of this section;

(3) The property is a nonoperating mineral interest retained by a lessor or sublessor if such lessor or sublessor held, prior to the lease or sublease, an operating mineral interest described in paragraph (b)(2)(iv)(A)(1) of this section; . . . .[37]

In more specifically defining natural resource recapture property the Treasury Regulation provides that: "Property held by a transferor of natural resource recapture property is natural resource recapture property if the transferor's basis in the property received is determined with reference to the transferor's basis in the property transferred by the transferor (e.g., a like kind exchange). For purposes of this paragraph (b)(2), property described in this paragraph (b)(2)(vii) is treated as *placed in service at the time the property transferred by the transferor was placed in service by the transferor*."[38]

2. Do New Leases or Mineral Interests on which IDCs or Depletion Deductions Have not Previously been Taken Qualify as Natural Resource Recapture Property? The argument could be made that the past tense "has been deducted" disqualifies new leases on which exploration or depletion deductions have not previously been taken from qualifying as "natural resource recapture" replacement property that defers ordinary income recapture. However, the stronger argument is that new leases do qualify since the "taxpayer" (i.e. the exchanging party or transferor) has a carryover basis in the new leases (from its basis in the relinquished property) and is deemed to have placed the new leases in service when the relinquished property was placed in service.

3. Alternative Natural Resource Investments to O&G Properties. Natural resource recapture property includes not only oil and gas properties but also interests in mines of other natural deposits such as gold and copper. In the case of *Peabody Natural Resources Company*, the Tax Court held that an exchange of a gold mine for a coal mine subject to coal supply contracts qualified as a like-kind exchange for purposes of Section 1031.[39]

IV. Planning Opportunities After the Act.

A. Modifications to Code Section 1031. The Act deleted from Code Section 1031 the statutory language that expressly excluded from non-recognition treatment "partnership interests," "certificates of

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[34] IRC 611(a) provides, "(i)n the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion...."

[35] Treas. Reg. 1.1254-1(b)(2)(i). (emphasis added)

[36] Treas. Reg. 1.1254-1(b)(2)(iii). (emphasis added)

[37] Treas. Reg. 1.1254-1(b)(2)(iv)(A)(1)-(3). (emphasis added)

[38] Treas. Reg. 1.1254-1(b)(2)(vii).

[39] *Peabody Natural Resources Company, et al. v. Comm.*, 126 TC 261 (2006).

trust or beneficial interests" and "other securities". Prior to the Act, the express exclusions of securities, stocks, partnership interests and other excluded types of assets were necessary as such assets are "property" under both the laymen's and federal tax law definitions of the word. These express exclusions were no longer needed after the Act as the only eligible property under the new Code Section 1031 is real property.

1. Publicly Traded Grantor Trusts. In Rev. Rul. 2004-86 the IRS held that certain grantor trusts organized to hold passive real property investments (with limited trustee powers) are properly characterized as "trusts" for tax purposes rather the "business entities" (taxable as corporations or partnerships) whereby the "grantors"[40] thereof are treated as owning undivided interests in the trust asset. Grantors of such trust may effectuate like-kind exchanges with their trust interests. Although the trust interests analyzed in Rev. Rul. 2004-86 were freely transferable, such interests were not publicly traded securities.[41] There has been and probably still is a divergence of opinions among some of the most prominent tax practitioners in the country as to whether interests in publicly traded grantor trusts (such as the Permian Basin Royalty Trust) are eligible for non-recognition treatment under Code Section 1031.

a. Why Publicly Traded Grantor Trusts May Qualify. Practitioners who believe publicly traded grantor trust ("**PTGT**") interests are eligible for like-kind exchange treatment reason that since the grantors thereof are treated as owning undivided interests in the underlying assets for all other income tax purposes, the grantors should likewise be treated as owning the assets directly for purposes of Code Section 1031. Accordingly, if a grantor trust owns real property, then becoming a grantor of such trust through the acquisition of an interest therein should be treated as an acquisition of an undivided real property interest regardless of whether the trust interest is publicly traded. Even before the Act, courts acknowledged that a "real property interest" may constitute a "security" under applicable securities law but not tax law. See *Plow Realty Co. of Texas*, 4 T.C. 600 (1945).

b. Why Publicly Traded Grantor Trusts May Not Qualify. Practitioners who believe to the contrary previously cited the exclusionary language of "certificates of trust" and "securities" as primary support for the position that Code Section 1031 was not intended to apply to publicly traded grantor trust interests. The IRS has previously considered whether instruments that entitle the holder thereof to the underlying property or its income should be considered ownership of the underlying property itself or a security. [42]

c. PTGT as Like-Kind Exchange Real Property After the Act. Prior to the Act, the IRS could have challenged a PTGT interest as being ineligible "like kind" property by establishing that PTGT interests fell within the definitions of "certificates of trust" or "securities" as such terms were intended to be defined for purposes of Code Section 1031. If the IRS now desires to challenge a like-kind exchange

[40] "Under § 1.671-2(e)(3), the term "grantor" includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in § 301.7701-4(c). . . .

A person that is treated as the owner of an undivided fractional interest of a trust under subpart E of part I, subchapter J of the Code (§§ 671 and following), is considered to own the trust assets attributable to that undivided fractional interest of the trust for federal income tax purposes." Rev. Rul. 2004-86.

[41] "The trust agreement provides that interests in DST are freely transferable. However, DST interests are not publicly traded on an established securities market." Rev. Rul. 2004-86.

[42] In General Counsel Memorandum 32771 the issue addressed was "whether or not warehouse receipts for whiskey constitute "securities" within the meaning of that portion of section 1031(a)" when two taxpayer had exchanged whiskey warehouse receipts and sought like-kind exchange treatment. GCM 32771 01/20/1964. GCM 32771 concluded that an exchange of such warehouse receipts would qualify under Code Section 1031.

involving a PTGT, it would need to establish that the PTGT interests do not constitute an interest in real property. Citing to the prior version of the statute, the IRS could make a legislative intent argument that Congress did not intend for *indirect* interests in real property (such as those owned through PTGT) to qualify for like-kind exchange treatment. Relying on the plain language of the statute in making a legal argument is always superior than relying on legislative intent. Accordingly, the IRS may now be slightly more reluctant to challenge a PTGT interest as not constituting an interest in real property.

d. How To Identify PTGT Interests as Replacement Property. A taxpayers nomination of a PTGT as replacement property can be done either by specifying the (i) the dollar figure of monies that will be used to acquire the PTGT interest or (ii) the number of units of PTGT interests the taxpayer intends to acquire.

i. For example, the identifications could be made as either: (i) $1,000,000 worth of units of beneficial interest of the Permian Basin Royalty Trust (NYSE: PBT) or (ii) 100,000 units of beneficial interest of the Permian Basin Royalty Trust (NYSE: PBT). If on the date of the identification the PBT units are trading at $10.00, then this is essentially an identification of the same amount of replacement property. However, the legal support for a PTGT interest being eligible like-kind exchange property is that the property being acquired is an undivided interest in the PTGT's assets. A taxpayer would not typically identify $1,000,000 of minerals in Section 47 of __________ County, Texas. Rather, a taxpayer would identify 30 net mineral acres in Section 47 of __________ County, Texas.

The Treasury Regulations provide that the replacement property acquired must be “substantially the same” as the property identified. The term “substantially the same” is not defined. However, the Treasury Regulations have examples that indicate acquiring replacement property which is 75% of the fair market value of the identified property, as of the date of receipt, is considered to be receipt of substantially the same property.[43] The same example in the Treasury Regulations provides that acquiring 1.5 acres when a 2 acre larger tract was identified (that contained the 1.5 acquired acres) is substantially the same (being 75% of the acres identified).[44] The same logic should apply if the fair market value were to increase by 25% (and less PTGT interests were acquired), or if the fair market value were to decrease (and more PTGT interests were acquired). If the price per PTGT unit was the exact same on the property identification date and the replacement property acquisition date, then the taxpayer should be able to acquire either 75,000 units or 125,000 units (both within the 25% permissible variance). If a taxpayer stays within the permissible 25% variance in both the number of units and the fair market value thereof, then a valid identification and a subsequent acquisition of "substantially the same" property should be satisfied.

2. "Swap and Drop" and "Drop and Swap" Like Kind Exchanges. Taxpayers often desire to effectuate like kind exchanges whereby 1) shortly after the exchange the "replacement property" is contributed to a partnership or corporation (a "**Swap and Drop**") or 2) prior to the exchange the "relinquished property" is conveyed in-kind from a partnership (or another taxpayer) to its partners (or owners) and shortly thereafter the partners (or owners) exchange undivided interests in the relinquished property for the "replacement property" (a "**Drop and Swap**"). The risk and concern with both a Swap and Drop and a Drop and Swap is that the exchanging taxpayer did not "hold" the replacement property

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[43] Treas. Reg. 1.1031(k)-1(d)(2) Ex. 4.

[44] Id.

or the relinquished property, as applicable, for investment or use in a business for any meaningful period of time. In a Swap and Drop, the transferee entity receiving the property is the taxpayer that will hold the "replacement property" for the requisite purpose. Similarly, with a Drop and Swap, the exchanging taxpayer may have only owned the "relinquished property" for a matter of days before it exchanged the same.

a. **Bolker and Magneson.** The Ninth Circuit Court of Appeals affirmed two Tax Court decisions that respectively upheld like kind exchanges that utilized a Drop and Swap and a Swap and Drop.

> "In . . . in *Magneson*, . . . 753 F2d 1490S (CA-9, 1985), aff'g 81 TC 767 (1983), a taxpayer exchanged investment property for other like-kind property, and immediately thereafter contributed the replacement property to a partnership in exchange for a 10% general partnership interest. The court concluded that holding the property for contribution to the partnership was holding it for investment, and that the ownership of property as a general partner was not substantially different than direct ownership of the property.
>
> The problem with *Magneson* is that these authorities are not completely on point, particularly because only rarely will the partners (or, more commonly now, the members of an LLC) be general partners in a partnership. Furthermore, *Magneson* was decided when a tax-free exchange of partnership interests was permissible under Section 1031; Section 1031(a)(2)(D) altered that rule. . . .
>
> In *Bolker*, both the Tax Court and the Ninth Circuit rejected the Service's position, as set forth in Rev. Rul. 77-337, that property acquired prior to a like-kind exchange through the liquidation of a taxpayer's wholly owned corporation did not satisfy the "held for" requirement under Section 1031(a)(1). . . .
>
> Pursuant to an exchange agreement, the taxpayer ultimately exchanged his newly acquired property for other real property. Although the taxpayer caused the liquidation of his corporation under former Section 333 and entered into an exchange agreement on essentially the same date, the exchange was not effectuated—and the taxpayer did not give up ownership of the relinquished property—until more than three months later.
>
> The Tax Court concluded that the taxpayer's ownership of the relinquished property satisfied the "held for" requirement because (1) the taxpayer acquired the relinquished property in a tax-free transfer under old Section 333 and (2) the taxpayer held an economic interest in the relinquished property prior to such liquidation, and this interest was maintained after the liquidation and subsequent exchange of the property."[45]

b. IRS's Position Before and After the Act. The IRS has never acquiesced in the *Bolker* and *Magneson* decisions and has subsequently challenged other taxpayers in similar cases. The Act's deletion of the words "partnership interest" will likely have little or no impact on the Service's position since a "partnership interest" has never been considered an interest in real property. If properly documented and effectuated prior to a binding agreement being executed to sell the

[45] The 'State of the Art' in Like-Kind Exchanges, 2012, Journal of Taxation, May 2012, Journal of Taxation (WG&L).

replacement property or buy the relinquished property, taxpayers may continue to rely on *Bolker* and *Magneson* as legal authority to effectuate Swap and Drop and Drop and Swap transactions.

i. For Swap and Drop transactions, the taxpayer should avoid entering into any binding agreements to contribute the replacement property to an entity whereby the taxpayer has unfettered ownership of the replacement property. The longer the replacement property is held by the taxpayer (ideally spanning into January 1st of the following tax year), the better chance the taxpayer has to avoid IRS scrutiny or challenges.

ii. For Drop and Swaps, careful documentation means that recorded deeds for "relinquished property" are filed of record before a binding commitment to sell is executed. Also, if more than one taxpayer will own an interest in the dropped/relinquished property, then simultaneously with the "Drop" the taxpayers should enter into a Tenants in Common Agreement that affirmatively elects out of Subchapter K such as follows:

> **"Nature of Relationship Between Co-Tenants.** The Tenants in Common shall each hold their respective Interests as tenants-in-common. The Tenants in Common do not intend by this Agreement to create a partnership or a joint venture, but merely to set forth the terms and conditions upon which each of them shall hold their respective Interests. Each Tenant in Common hereby elects to be excluded from the provisions of Subchapter K of Chapter 1 of the Code with respect to the joint ownership of the Property. The exclusion elected by the Tenants in Common hereunder shall commence with the execution of this Agreement and shall be equally applicable to all assignees of a Tenant in Common upon such assignment. Each Tenant in Common hereby covenants and agrees that such Tenant in Common shall report on such Tenant in Common's federal income tax returns (if any) such Tenant in Common's share of items of income, gain, loss, deduction and credits that result from holding the Property in a manner consistent with (i) the treatment of the co-tenancy as a co-ownership of real property (and not a partnership) for Federal and state income tax purposes and (ii) the exclusion of the Tenants in Common from Subchapter K of Chapter 1 of the Code, commencing with the first taxable year of such Tenant in Common that includes the Effective Date or, for assignees of a Tenant in Common, the date of such assignment. No Tenant in Common shall notify the Commissioner of Internal Revenue that such Tenant in Common desires that Subchapter K of the Code apply to the Tenants in Common and each Tenant in Common hereby agrees to indemnify, protect, defend and hold the other Tenants in Common free and harmless from all costs, liabilities, tax consequences and expenses, including, without limitation, reasonable attorneys' fees, which may result from any Tenant in Common so notifying the Commissioner in violation of this Agreement or otherwise taking a contrary position on any tax return. The Tenants in Common shall not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the Tenants in Common as partners, shareholders, or members of a business entity, or otherwise hold themselves out as a partnership or other form of business entity. Except as expressly provided herein, no Tenant in Common is authorized to act as agent for, to act on behalf of, or to do any act that will bind any other Tenant in Common or to incur any obligations with respect to the Property."