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Exchanging Leaseholds Involving Real Property in a Like-Kind Exchange

-by Neil E. Harl*

Almost 57 years ago, the Department of the Treasury issued final regulations¹ making it clear that certain leaseholds in real estate (those with 30-years or more remaining) were eligible for like-kind exchange treatment.² Nonetheless, the United States Tax Court decided a case in 2013 in which the parties argued, unsuccessfully, that the rules applicable to leasehold interests were merely a “safe harbor.”³ The outcome was quite costly to the taxpayers with \$2,215,986 of additional gain recognized on the transaction with \$832,347 additional federal income tax owed.⁴

The governing authority

The like-kind exchange statute does not provide guidance on exchanging leasehold interests in a like-kind exchange⁵ but the regulations issued in 1956 deal explicitly with the issue.⁶ Under the regulations, “. . . no gain or loss is recognized . . . [if] a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold with 30-years or more to run for real estate, or exchanges improved real estate for unimproved real estate. . . .”⁷

VIP's Industries, Inc. & Subs. v. Commissioner

In the 2013 Tax Court case, *VIP's Industries*,⁸ VIP operated several wholly-owned and majority-owned entities engaged in owning and operating hotels, motels, restaurants and hospitality ventures and also invested in real estate.⁹ The lease in question was originally a 33-year lease on real properties, commencing August 1, 1994. The property was sold to investors using a qualified intermediary. At the time of the assignment of the lease, the lease had 21 years and four months remaining.¹⁰ As noted above, the regulations specify that a lease with 30 years or more to run is eligible for an exchange for real property owned in fee simple.¹¹ The taxpayer argued that the “30- year” requirement for leaseholds was only a “safe harbor” and did not preclude shorter terms as of the time of the exchange.

The Tax Court, citing to numerous cases decided over the years, held that the exchange failed the tests established for like-kind exchanges involving interests in real property because the leasehold interest with 21 years and four months to run was simply not eligible for like-kind exchange treatment for real property interests under the regulations.¹² The court also pointedly noted that it was not appropriate to look to state law for guidance.¹³

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The Tax Court cited, in support of the decision, *May Department Stores Co. v. Commissioner*,¹⁴ which held that a 20-year leasehold was not equivalent to a fee simple interest and *Standard Envelope Mfg. Co. v. Commissioner*,¹⁵ in which a leasehold of one-year and an option to renew for 24 years was not equivalent to a fee interest. The court pointed out that options to renew are included in determining whether a leasehold is equivalent to a fee simple interest.¹⁶

The taxpayer also argued that the improvements to the property (which were estimated by the taxpayer to total 85 percent of the value—which the court doubted) should be eligible but the Tax Court held that the improvements were also short-term property interests.¹⁷

Other authority on leasehold exchanges involving real property

An exchange of a leasehold interest in a producing oil lease, extending until exhaustion of the deposit, for a fee simple interest in ranch land was considered as a like-kind exchange in a 1968 ruling.¹⁸ A sale followed by a leaseback involving terms of 30-years or more constituted a like-kind exchange involving real property interests.¹⁹ In a 2001 private letter ruling, an exchange of a leasehold interest (with more than 30-years to run) in a cooperative for a condominium interest was like-kind.²⁰ Similarly, in a 2008 private letter ruling a taxpayer's leasehold interest could be like-kind to a replacement leasehold.²¹

ENDNOTES

¹ T.D. 6210, 1956-2 C.B. 508, adopted November 6, 1956.

² I.R.C. § 1031. See generally 4 Harl, *Agricultural Law* § 27.04[4][b][i][A] (2013); Harl, *Agricultural Law Manual* § 4.02[16][b][i] (2013); 1 Harl, *Farm Income Tax Manual* § 2.07[2][a][i] (2013 ed.). See also Harl, "What is 'Like-Kind' for Real Estate?" 17 *Agric. L. Dig.* 177 (2006); Harl, "Like-Kind Exchanges: A Popular Option for Property Transfers," 11 *Drake J. Agric. L.* 25 (2006).

³ *VIP's Industries, Inc. & Subs. v. Comm'r*, T.C. Memo. 2013-157 (leasehold with 21 years and four months remaining was not "like-kind" to fee simple interest).

⁴ *Id.*

⁵ I.R.C. § 1031. See also I.R.C. § 1001.

⁶ Treas. Reg. § 1.1031(a)-1(c).

⁷ Treas. Reg. § 1.1031(a)-1(c).

⁸ *VIP's Industries, Inc. & Subs. v. Comm'r*, T.C. Memo. 2013-157.

⁹ *Id.*

¹⁰ *Id.*

¹¹ Treas. Reg. § 1.1031(a)-1(c).

¹² *VIP's Industries, Inc. & Subs. v. Comm'r*, T.C. Memo. 2013-157.

¹³ *Id.*, footnote 7.

¹⁴ 16 T.C. 547, 556 (1951).

¹⁵ 15 T.C. 41, 48 (1950).

¹⁶ See *Peabody Natural Resources Co. v. Comm'r*, 126 T.C. 261 (2006) (coal supply contracts in mining property like-kind to gold; were real property under state law).

¹⁷ *VIP's Industries, Inc. & Subs. v. Comm'r*, T.C. Memo. 2013-157.

¹⁸ Rev. Rul. 68-331, 1968-1 C.B. 352.

¹⁹ Rev. Rul. 60-43, 1960-1 C.B. 687.

²⁰ Ltr. Rul. 200137032, June 15, 2001.

²¹ Ltr. Rul. 200842019, July 15, 2008.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ANIMALS

HORSES. The plaintiff was injured while horseback riding at the defendant's horse farm. The defendant raised the defense of assumption of risk and the trial court granted summary judgment to the defendant on that issue. The appellate court looked at three aspects of the defense of assumption of risk. First the court found that the doctrine includes the inherent risks of horseback riding. Second, the risks do not include intentional conduct or unreasonably increased risks. Third the doctrine requires that the plaintiff be aware of the risks. On the first two issues, the court held that the accident occurred within the inherent and reasonable

risks of horseback riding. On the third issue, the plaintiff alleged that the plaintiff had reduced mental capacity to appreciate the risks of horseback riding. The court noted that the evidence showed that the plaintiff was a skilled and experienced horse rider and there was no evidence of the extent of the mental incapacity or to show that the plaintiff was not aware of the risks. The court upheld the trial court grant of summary judgment. **Fenty v. Seven Meadow Farms, Inc.**, 2013 N.Y. App. Div. LEXIS 5102 (Sup. Ct. N.Y. 2013).