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Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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What is Eligible for a Like-Kind Exchange?

-by Neil E. Harl*

It has been just short of 100 years since like-kind exchanges first appeared on the tax scene. The concept was first developed by the Department of the Treasury in 1918 and implemented in regulations. Three years later, in 1921, like-kind exchanges were introduced into the Internal Revenue Code.¹ Although there have been moves to eliminate the idea from the Internal Revenue Code, the popularity of the concept assures that any effort to repeal like-kind exchanges has been (and will be) met with opposition.

The basic features of like-kind exchanges

The statute itself,² states succinctly the basic requirements for a like-kind exchange to be successful – neither gain nor loss is recognized when property *held*³ for productive use in a trade or business or for investment is exchanged for like-kind property which is *to be held* for productive use in a trade or business or held for investment.⁴ The income tax basis of the property acquired in the exchange is, with modifications, the same as the basis of the property given up in the exchange.⁵ Any unrecognized gain on the property given up is simply transferred to the newly acquired property. Gain may be recognized to the extent that recapture of depreciation (and other deductions and credits) is required and to the extent nonqualified property is received in the exchange.

Following a Tax Court decision denying a like-kind exchange for vacation property,⁶ the Internal Revenue Service developed a “safe-harbor” for dwelling units designed to be rented to others with no more than incidental use by family members.⁷

What property is eligible?

Over the years, different rules have been developed for like-kind exchanges involving real property and like-kind exchanges involving personal property. In this article, the focus is just on eligible real property. Those rules have changed relatively little over the years. The rules governing the eligibility of personal property for like-kind exchanges have undergone dramatic change in recent years with classification schemes implemented.

The general rule. Basically, real property qualifies as like-kind to other real property regardless of dissimilarities in productivity, location or level of improvements. Improved real estate qualifies as like-kind to unimproved real estate (but watch for depreciation recapture in such instances).⁸ Urban real estate can be exchanged for farm or ranch real

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

property.

Leasehold property. Real property may be exchanged for a leasehold with 30 years or more to run. The like-kind statute does not provide guidance on exchanging leasehold interests.⁹ However, the regulations issued in 1956 dealt explicitly with the issue.¹⁰ Under those 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.”

In a 2013 Tax Court decision, *VIP's Industries, Inc. & Subs. v. Commissioner*,¹¹ 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. The lease in question, which figured into a like-kind exchange, was originally a 33-year lease on real properties but, at the time of the exchange, the lease had 21 years and four months remaining. The taxpayer argued that the “30-year” requirement was only a “safe harbor” and did not preclude shorter terms for leases of real property under the regulations. The Tax Court, however, disagreed and denied like-kind exchange treatment, stating that it was settled law, not a mere “safe harbor.”

A sale followed by a leaseback involving terms of 30 years or more constitutes a like-kind exchange.¹²

A conservation easement or development rights to maintain property in an undeveloped state around major cities have been held to be eligible for a like-kind exchange with a fee simple interest in real estate.¹³ An exchange of land containing sand deposits has been held to be like-kind with other real estate even though the taxpayers owning the land had mined sand from the property.¹⁴

A purchaser's rights under an installment land contract were considered equivalent to a fee simple interest.¹⁵

The exchange of real property for other real property with the owner of the other real property required to construct a building to the transferor's specifications has qualified as a tax-free, like-kind exchange.¹⁶ However, only the portion completed prior to the closing qualifies as like-kind.¹⁷ In an earlier litigated case, the

exchanger could not have the replacement property built on land already owned by the exchanger.¹⁸

ENDNOTES

¹ See Harl, “Like-Kind Exchanges: A Popular Option for Property Transfer,” 11 *Drake J. of Agric. Law* 25 (2006).

² I.R.C. § 1031(a)(1).

³ A like-kind exchange has failed where there was an immediate retransfer of the property. See Rev. Rul. 77-337, 1977-2 C.B. 305. See also *Regals Realty v. Comm'r*, 43 B.T.A. 194 (1940), *aff'd*, 127 F.2d 931 (2d Cir. 1942); Ltr. Rul. 200440002, June 14, 2004.

⁴ See generally 4 Harl, *Agricultural Law* § 27.04 (2016); 1 Harl, *Farm Income Tax Manual* § 2.07 (2016). See also Harl, note 1 *supra*.

⁵ See *Bundren v. Comm'r*, T.C. Memo. 2001-2, *aff'd*, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,331 (10th Cir. 2002).

⁶ *Moore v. Comm'r*, T.C. Memo. 2007-134 (taxpayer argument that vacation property was expected to increase in value and, therefore, was “held for investment” failed).

⁷ See Rev. Proc. 2008-16, 2008-1 C.B. 547. See also I.R.C. §§ 280A(d)(2), 280A(d)(3), 280A(d)(4).

⁸ Treas. Reg. § 1.1031(a)-1(c).

⁹ I.R.C. § 1031. See I.R.C. § 1001.

¹⁰ Treas. Reg. § 1.1031(a)-1(c).

¹¹ T.C. Memo. 2013-157.

¹² Rev. Rul. 60-43, 1960-1 C.B. 687.

¹³ See e.g., Ltr. Rul. 200201007, Oct. 2, 2001 (exchange of conservation easement for ranchland).

¹⁴ *Beeler v. Comm'r*, T.C. Memo. 1997-73.

¹⁵ *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979).

¹⁶ Ltr. Rul. 9413006, Dec. 20, 1993.

¹⁷ *Id.*

¹⁸ *Bloomington Coca-Cola Bottling Co. v. Comm'r*, 189 F.2d 14 (7th Cir. 1951).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ANIMALS

CATTLE. The plaintiff incurred damage to the plaintiff's truck when it struck several cattle which were owned by the defendant and which had escaped from their pasture. The evidence indicated that the cattle had broken through a chained gate. The plaintiff sued for damages, alleging either that the defendant was negligent in maintaining the gate or that the defendant was statutorily liable

for violating Wis. Stat. § 172.015 which prohibits allowing cattle to run at large on public highways. The defendant testified as to the efforts taken to secure the cattle and maintain the fence and gates. Because the plaintiff did not present any contradicting evidence, the court held that the defendant was not negligent. The court noted that Wis. Stat. § 172.015 provides that “No livestock shall run at large on a highway at any time except to go from one farm parcel to another. If the owner or keeper of livestock knowingly permits livestock to run at large on a highway, except when going from one farm parcel to another, and after notice by