SELECTED ISSUES ASSOCIATED WITH LIKE-KIND EXCHANGES[1]

Presented at K-State Research and Extension
Cowley County
January 6, 2021
Arkansas City, Kansas

Roger A. McEowen
Professor of Agricultural Law and Taxation
Washburn University School of Law

roger.mceowen@washburn.edu
www.washburnlaw.edu/waltr
@WashburnWaltr (Twitter)
@RogerMceowen (Parler)

OVERVIEW

The TCJA eliminated tax-deferred like-kind exchanges of personal property under IRC §1031 for exchanges completed after 2017. However, exchanges of real estate can still qualify for tax-deferred treatment if the exchange involves real estate that is "like-kind."[2]

The tax deferral of a §1031 exchange is only achieved if all the requirements of §1031 are satisfied. If the requirements are not satisfied, the exchange is taxable as a sale or exchange under the general rules of IRC §1001.[3]

There are four basic requirements to achieving tax-deferred treatment under §1031.[4]

1. There is an exchange of property rather than a sale.
2. The property exchanged and the property received must be like-kind real estate.
3. The property exchanged and the property received must both be held for productive use in a trade or business or for investment.

[1] This article is an updated version of a portion of the "Agricultural Issues and Rural Investments Chapter contained in the 2020 University of Illinois Tax Workbook. It is used with permission of the University of Illinois Board of Trustees.
[2] Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [https://lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html]. Used with permission from Law Professor Blogs Network.
[3] Ibid.
[4] IRC §1031(a)(1).

4. The exchange of properties must be simultaneous, or the replacement property must be identified within 45 days of the exchange and the identified property must be received within 180 days of the identification or the due date of the transferor's return (including extensions), if earlier.[5]

DEFINITION OF LIKE-KIND PROPERTY

Under the former rules governing trades of personal property, such as farm machinery, Treasury Regulations determined if property was like-kind by reference to property within the same product class.[6] In addition, property was of a like-kind to property that was of the same nature or character.[7] However, like-kind personal property did not necessarily have to be of the same grade or quality. Thus, a like-kind exchange could involve a bull for a bull, a combine for a combine, but not a combine for a sports car or a farm or ranch for publicly traded stock. In addition, for intangible assets, the determination of like-kind (like classes are not allowed) had to be made on an asset-by-asset basis.[8]

With respect to real estate, a much broader definition of "like-kind" applies. Virtually any real estate used for business or investment can be exchanged for any other real estate if the exchanger continues to use the replacement property for business or investment. The regulations define "like-kind" in terms of reference to the nature or character of the replacement property rather than its grade or quality.[9]

Proposed Regulations

On June 11, 2020, the Treasury Department issued proposed regulations defining "real property" for like-kind exchanges completed after 2017.[10] Prop. Treas. Reg. §1.1031(a)-3 defines **real property** as one of the following.

- Land
- Improvements to land
- Unsevered natural products of land
- Water and airspace adjacent to land

The definition includes interests in real property such as the following.

- Fee ownership
- Co-ownership

[5] IRC §§1031(a)(3)(A)-(B)((ii). Generally, up to three properties can be exchanged. Treas. Reg. §1.1031(k)-1(c)(4)(i)(A). As an alternative, the taxpayer can identify any number of properties if their aggregate fair market value (as of the end of the identification period) does not exceed 200% of the fair market value of the relinquished property. Treas. Reg. §1.1031(k)-1(c)(4)(i)(B).
[6] See Treas. Reg. §1.1031(a)-2(b)(2).
[7] See Treas. Reg. §1.1031(a)-2.
[8] Treas. Reg. §1.1031(a)-2(c).
[9] Treas. Reg. §1.1031(a)-1(b); see also CCA 201238027 (Apr. 17, 2012).
[10] REG-117589-18, 85 FR 35835.

- A leasehold
- An option to acquire real property
- An easement
- A similar interest

> **Note.** The proposed regulation states that local law definitions are **not** controlling for purposes of determining the meaning of the term **real property.** The regulation also makes clear that these definitions are **solely** for the purposes of §1031 and do not apply to other provisions in the Code.[11]

The proposed regulation also addresses the concept of a "distinct asset" and that a:

> *[D]istinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure. Buildings and other inherently permanent structures are distinct assets. Assets and systems listed as a structural component in paragraph (a)(2)(iii)(B) of this section are treated as distinct assets.*[12]

The proposed regulation provides a test to determine if an item is a distinct asset for the purposes of the proposed regulations. Under the proposed regulation, the determination of whether a particular separately identifiable item of property is a distinct asset is based on all the facts and circumstances. In particular, the following factors must be taken into account.[13]

- Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset
- Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset
- Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part
- Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset

Improvements to land include inherently permanent structures and structural components of inherently permanent structures.[14] The proposed regulation defines a "building" as "… any structure or edifice

[11] Prop. Treas. Reg. §1.1031(a)-3(a)(1).
[12] Prop. Treas. Reg. §1.1031(a)-3(a)(4)(i).
[13] Prop. Treas. Reg. §1.1031(a)-3(a)(4)(ii).
[14] Prop. Treas. Reg. §1.1031(a)-3(a)(2)(i).

enclosing a space within its walls, and covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space.[15]

The regulations provide that buildings include the following distinct assets if permanently affixed.[16]

- Houses
- Apartments
- Hotels and motels
- Enclosed stadiums and arenas
- Enclosed shopping malls
- Factories and office buildings
- Warehouses
- Barns
- Enclosed garages
- Enclosed transportation stations and terminals
- Stores

Other inherently permanent structures include the following items if permanently affixed. [17]

- In-ground swimming pools
- Roads
- Bridges
- Tunnels
- Paved parking areas, parking facilities, and other pavements
- Special foundations
- Stationary wharves and docks
- Fences

[15] Prop. Treas. Reg. §1.1031(a)-3(a)(2)(ii)(B).
[16] Ibid.
[17] Prop. Treas. Reg. §1.1031(a)-3(a)(2)(ii)(C).

- Inherently permanent advertising displays for which an election under IRC §1033(g)(3) is in effect
- Inherently permanent outdoor lighting facilities
- Railroad tracks and signals
- Telephone poles
- Power generation and transmission facilities
- Permanently installed telecommunication cables
- Microwave transmission
- Cell towers, broadcasting towers, and electric transmission towers
- Oil and gas pipelines
- Offshore drilling platforms, derricks, oil and gas storage tanks
- Grain storage bins and silos
- Enclosed transportation stations and terminals

The proposed regulation provides guidance to determine if an asset is permanently affixed.[18]

- The manner in which the distinct asset is affixed to real property
- Whether the distinct asset is designed to be removed or to remain in place
- The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed
- Any circumstances that suggest the expected period of affixation is not indefinite
- The time and expense required to move the distinct asset

Machinery is generally **not considered** part of real property because it is usually not an inherently permanent structure unless it is a structural component of a building that serves the inherently permanent structure and does not produce or contribute to the production of income other than for the use or occupancy of space.[19]

The proposed regulation defines a "structural component" as a distinct asset "that is a constituent part of, and integrated into, an inherently permanent structure."[20] The regulation notes that "[i]f interconnected

[18] Ibid.
[19] Prop. Treas. Reg. §1.1031(a)-3(a)(2)(ii)(D).
[20] Prop. Treas. Reg. §1.1031(a)-3(a)(2)(iii)(A).

assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component."[21] Additional detailed rules concerning a structural component are provided.[22]

Real property can also include "unsevered natural products of land," which includes the following. [23]

- Growing crops, plants, and timber
- Mines
- Wells
- Other natural deposits

Once such products have been severed, extracted or removed from the land, they cease to be real property.[24]

The proposed regulations also create a safe harbor for incidental amounts of personal property that are received in an exchange. Under the safe harbor, personal property is deemed to be incidental to real property acquired in an exchange if in standard commercial transactions, the personal property is typically transferred together with the real property and the aggregate fair market value (FMV) of the incidental personal property transferred with the real property does not exceed 15% of the aggregate FMV of the replacement real property.[25]

Final Regulations

Final regulations were approved on Nov. 18, 2020 and published in the Dec. 2, 2020 Federal Register. The final regulations are effective for exchanges beginning after December 2, 2020. Under the final regulations, property is classified as real property for purposes of I.R.C. §1031 if the property is specifically listed as real property in the final regulations; classified as real property under the state and local law test included in the final regulations; or considered real property based on all the facts and circumstances under the various factors provided in the final regulations.

The final regulations establish a state and local law test that differs from the approach of the proposed regulations. Under the proposed regulations, the classification of property under state or local law was not taken into account in classifying a property for purposes of I.R.C. §1031, with one limited exception for mutual ditch, reservoir, or irrigation companies. Under the final regulations, property is real property for purposes of I.R.C. §1031 if, on the date it is transferred in an exchange, the property is classified as real property under the law of the state or local jurisdiction in which the property is located. Thus, property that might otherwise have failed to be real property under the proposed regulations may be classified as real property under the final regulations.[26]

The final regulations clarify that some property is still not real property for like-kind exchange purposes regardless of state law. This property includes stock (other than stock in a cooperative housing corporation

[21] Ibid.
[22] Prop. Treas. Reg. §§1.1031(a)-3(a)(2)(iii)(A) and (B).
[23] Prop. Treas. Reg. §1.1031(a)-3(a)(3).
[24] Ibid.
[25] Prop. Treas. Reg. §1.1031(k)-1(g)(7)(iii).
[26] The Treasury was clear that the final regulations do not allow property that was ineligible for I.R.C. §1031 under pre-TCJA law to now become eligible simply because the property is classified as real property under state or local law. In addition, the final regulations are clear that property that was ineligible for LKE treatment under pre-TCJA law remains ineligible for LKE treatment after the enactment of the TCJA, even if the property is classified as real property under the relevant state or local law.

or shares in certain mutual ditch, reservoir, or irrigation companies); bonds, and notes; other securities or evidences of indebtedness or interest; partnership interests (other than an interest in a partnership that has in effect a valid election under section 761(a)); and certificates of trust or beneficial interests; and choses in action. As for machinery, it may be real property for purposes of I.R.C. §1031 if it comprises an inherently permanent structure, a structural component or is real property under the state or local law test regardless of its purpose or use or whether it contributes to the production of income.[27]

In determining whether the agreement between the taxpayer and the qualified intermediary, qualified trustee, or qualified escrow agent expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property as required by Treas. Reg. §1.1031(k)-1(g)(6), the taxpayer's receipt of, or right to receive, personal property that is incidental to real property acquired in the exchange is disregarded.

For purposes of this exception, personal property is incidental to real property acquired in an exchange if: 1) in standard commercial transactions, the personal property is typically transferred together with the real property; and 2) the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15% of the aggregate fair market value of the replacement real property or properties received in the exchange.

REAL ESTATE HELD IN TRUST[28]

Overview

A significant amount of farm and ranch land is held in a trust. Trusts are a popular part of many farm and ranch (and other) estate plans. An important question is whether farmland or ranchland that is contained in a trust, remains eligible to be exchanged for other real property and have the gain (or loss) on the transaction deferred under I.R.C. §1031. If so, that means that placing land in a trust for estate planning (or other) reasons doesn't eliminate the favorable tax consequences of I.R.C. §1031.

Trusts and I.R.C. §1031 – The Basics

There is no absolute bar against a trust being part of an I.R.C. §1031 transaction. A trust can qualify if it otherwise satisfies the requirements of I.R.C. §1031. However, the taxpayer that owns the relinquished property must be the same taxpayer that takes ownership of the replacement property. This means that the taxpayer's identity must not change between the time of the relinquishment of the real estate and the time the replacement real estate is received.

With respect to a trust, the key determinations to be made are who (or what) is the taxpayer and whether the taxpayer's identity is preserved during the exchange process. A taxpayer's identity is not necessarily the same concept than the manner in which property is titled. Instead, the question is whether the entity holding title to the real estate (such as a trust) that is involved in an exchange preserves the taxpayer's identity. If the taxpayer's identity changes between the time the taxpayer relinquishes the property and the time the replacement property is received, the same taxpayer will not have disposed of and received property.

---

[27] In making this determination, the focus is on the degree to which the property should be considered permanently affixed, not on whether the property contributes to the production of income.

[28] This section is adapted from *Is Real Estate Held in Trust Eligible For I.R.C. §1031 Exchange Treatment?* McEowen, Roger. November 30, 2020. Law Professor Blogs Network. [https://lawprofessors.typepad.com/agriculturallaw/2020/11/is-real-estate-held-in-trust-eligible-for-irc-1031-exchange-treatment.html]. Used with permission from Law Professor Blogs Network.

Grantor trusts. If the trust is a grantor trust, such as a revocable trust, *generally* the grantor, trustee and beneficiary are same person. Such a trust is a "tax disregarded" entity and all items of income, loss, deduction and credit and are taxed to the grantor. The trust does not file a return in addition to that of the grantor. Thus, the grantor can meet the same taxpayer requirement of an I.R.C. §1031 exchange. The taxpayer's identity is preserved. This all means that a revocable living trust can be utilized as an ownership vehicle in a 1031 exchange - the grantor or trustee are considered the taxpayer. But, if the beneficiary is a different individual than the grantor, the beneficiary is not considered to be the taxpayer and cannot directly benefit from an I.R.C. §1031 exchange.

Non-grantor trusts. Conversely, if the trust is a non-grantor trust (such as an irrevocable trust where the grantor has not retained other powers), the trust is the taxpayer that is engaged in the like-kind exchange transaction. Unlike a revocable trust, an irrevocable trust has its own tax identification number and is not, for tax purposes, treated interchangeably with the grantor/settlor. But, an irrevocable trust can be a grantor trust if the grantor retains, for example, the "power to control beneficial enjoyment."[29]

"Illinois" Land Trust

An Illinois land trust is comparable to a revocable living trust that is used to hold real estate. It can be revoked or amended during the grantor's life. The trust's grantor/beneficiary retains all rights and responsibilities of owning the real estate. A land trust can only hold real estate interests, and the trustee is a professional trustee. A land trust is recognized in a minority of states - Florida, Georgia, Hawaii, Illinois, Indiana, Montana, South Dakota and Virginia.

For land held in a land trust, title to the real estate is held by the trustee as the owner of the trust, and the trust owner holds the beneficial interest in the trust that holds the title to the property. That created some uncertainty as to whether a land trust can be involved in an I.R.C. §1031 exchange because I.R.C. §1031 restricts the exchange of a beneficial interest in an asset. However, the IRS issued a Revenue Ruling in 1992 taking the position that an interest in an Illinois Land Trust is an interest in real property that can be exchanged for like-kind real estate.[30] While a beneficiary's interest in a land trust was deemed to be personal property under state (IL) law, that characterization didn't control the outcome. The IRS looked at the facts of the particular situation and noted that the trustee was only acting at the discretion of the taxpayer (beneficiary). The trustee merely held title and could only potentially transfer that title. Thus, the trust was an agency relationship between the trustee and beneficiary involving the holding and transferring of the title to the real estate contained in the trust. The taxpayer/beneficiary retained the right to manage and control the trustee, and remained the direct owner of the property for tax purposes. It was the beneficiary that remained obligated to pay the taxes and other liabilities associated with the trust property, and it was the beneficiary that had the exclusive right to the trust property's earnings and profits. Based on those facts, the IRS determined that the beneficiary's interest in the trust was an interest in real property that could be exchanged for other real property and qualify for deferral of gain (or loss) via I.R.C. §1031.

The trust and the relationship of the parties in the 1992 ruling was not determined to be a partnership. If the IRS had determined that a partnership was involved, that would have meant that the beneficiary's interest in the real estate in the trust would not have qualified for like-kind exchange treatment – partnership interests are not eligible. Important to that point, only one beneficiary was involved under the facts of the ruling. With multiple beneficiaries, it may be easier for the IRS to asset that a partnership exists and deny I.R.C. §1031eligibility.

---

[29] I.R.C. §674.

[30] Rev. Rul. 92-105, 1992-2 C.B. 204.

Based on Rev. Rul. 92-105, if a trust (or similar arrangement created under state law) is merely an investment vehicle, it can qualify as like-kind to real property under I.R.C. §1031. That's certainly the case for a trust if the trustee has title to the real property in the trust; the beneficiary has the exclusive right to direct or control the trustee in dealing with title to the property; and the beneficiary has the exclusive control of the property's management as well as the obligation to pay any taxes and other liabilities that relate to the property. When those factors are present, an exchange transaction actually involves the exchange of the underlying trust property rather than an exchange of a certificate of trust beneficial interest, and the gain or loss on the transaction can be eligible for deferral under I.R.C. §1031.

Delaware Statutory Trust

Twelve years after Rev. Rul. 92-105, the IRS issued another revenue ruling on the issue. Rev. Rul. 2004-86, 2004-2 C.B. 191 involved a Delaware Statutory Trust (DST) that was formed to hold real property subject to a lease. A DST is a form of business trust where the owner of a DST share is regarded as owning a beneficial interest in the trust. Under the facts of the Rev. Rul., the trustee's powers were limited to only collecting and distributing income. As such, the DST was merely an investment trust and its interests could be exchanged for real property in an I.R.C. §1031 transaction. Specifically, Rev. Rul. 2004-86, stands for the proposition that a DST can be utilized for the purchase of replacement property in an I.R.C. §1031 exchange. However, with more retained powers in the trustee, the IRS said that the trust would be a business trust rather than an investment trust and would not qualify for like-kind treatment. Consequently, Rev. Rul. 2004-86 is quite limited. But, if all of the interests in the trust are of a single class that represent undivided beneficial interests of the trust and the trustee cannot vary the trust's investments, the trust will be an investment trust and its assets can be exchanged for real property with any gain qualifying for deferral under I.R.C. §1031. On the other hand, if the trustee has greater discretion with respect to the trust property, those additional powers could cause disqualification from I.R.C. §1031 treatment. Those additional powers could include, for instance, the power to dispose of the real property in the trust and acquire new property, the power to renegotiate leases on the trust property, or approve more than minor modifications or improvements to the property. If those powers are present, the IRS could take the position that the trust constitutes a business entity not eligible for I.R.C. §1031 treatment.

Perhaps the most important aspect of Rev. Rul. 2004-86 is that the IRS at least impliedly classified the DST as a grantor trust. Thus, real estate contained in a grantor trust could be exchanged for interests in a grantor trust containing real property and the transaction would qualify for deferral treatment under I.R.C. §1031. That has important estate planning implications.

Safe Harbor for Trusts Holding Rental Real Estate

An arrangement with a single class of ownership interests, representing undivided beneficial interest in the trust assets, is classified as a trust if there is no power under the trust agreement to vary the investment of the beneficiaries ("power to vary").[31] As noted above, in Rev Rul. 2004-86 the IRS took the position that a DST formed to hold real property subject to a lease was an arrangement classified as a trust for Federal tax purposes under Treas. Reg §301.7701-4(c). However, the trust would be a business entity and not a trust if the trustee had a power to, among other things, renegotiate the lease with the tenant, to enter into leases with other tenants, or to renegotiate or refinance the mortgage loan whose proceeds were used to purchase the real estate.

After the issuance of Rev. Rul. 2004-86, the IRS provided safe harbors for determining the Federal income tax status of certain securitization vehicles that hold mortgage loans. Under the safe harbors, certain modifications of mortgage loans in connection with forbearance programs described in that guidance are not treated as manifesting a power to vary. When those safe harbors were issued, the IRS received comments addressing arrangements organized as trusts under Treas. Reg. §301.7701-4(c), and Rev. Rul.

[31] Treas. Reg. §301.7701-4(c).

2004-86 that hold rental real property. As a result, the IRS in 2020 provided additional guidance detailing actions that will not constitute a power to vary for purposes of determining whether the arrangement is treated as a trust under Treas. Reg. §301-7701-4(c) and Rev. Proc. 2020-34, Sec. 7. *Rev. Proc. 2020-26, I.R.B. 753.* Section 6 of the safe harbor allows these arrangements to make certain modifications to their mortgage loans and their lease agreements and to accept additional cash contributions without jeopardizing their tax status as trusts.

Specifically, under Rev. Proc. 2020-26, the following do *not* constitute a power to vary in violation of the regulation: 1) modification of one or more mortgage loans that secure the trust's real property in a CARES Act forbearance or a forbearance that the trust requested, or agreed to, between March 27, 2020, and December 31, 2020, and that were granted as a result of the trust experiencing a financial hardship due to the actions of state governments in reaction to the virus; 2) modification of one or more real property leases entered into by the trust on or before March 13, 2020, where the modifications were requested and agreed to on or after March 27, 2020 and on or before December 31, 2020, and the reason for the lease modification is to coordinate the lease cash flows with the cash flows that result from one or more transactions described in the Notice or to defer or waive one or more tenants' rental payments for any period between March 27, 2020 and December 31, 2020 because the tenants are experiencing a financial hardship due to the COVID-19 emergency; and 3) the acceptance of cash contributions that were made between March 27, 2020, and December 31, 2020, as a result of the trust experiencing financial hardship due to state government conduct in reaction to the virus. However, the contribution must be needed to increase permitted trust reserves, to maintain trust property, to fulfill obligations under mortgage loans, or to fulfill obligations under real property leases. A cash contribution from one or more new trust interest holders to acquire a trust interest or a non-pro rata cash contribution from one or more current trust interest holders must be treated as a purchase and sale under I.R.C. §1001 of a portion of each non-contributing (or lesser contributing) trust interest holder's proportionate interest in the trust's assets.

IRC §§1245 AND §1250 TAX TRAP

It does not matter whether the real estate involved in a tax-deferred exchange is improved or unimproved.[32] Thus, agricultural real estate may be traded for residential real estate. However, if bare farmland is traded for farmland with depreciable structures on it, tax issues can arise. Many farm depreciable buildings and structures are IRC §1245 property. For example, commodity storage facilities and single-purpose agricultural structures are §1245 property, as are irrigation systems, drainage tile, and other improvements to farm real estate.

If property with a §1245 depreciation recapture attribute is disposed of in a like-kind exchange, the §1245 depreciation recapture must be recognized to the extent that the replacement property has insufficient §1245 property. If replacement property has like and similar improvements equal or exceeding that of the property disposed of, recapture may be avoided. If improved property is exchanged for unimproved property, recapture may result regardless of the fact that an exchange occurred.

> **Example 1.** Bob traded his real estate containing §1245 property with an adjusted basis of $200,000, for a like-kind property with an FMV of $180,000 and unlike-kind property with an FMV of $70,000.
>
> Upon the exchange, $50,000 (($180,000 + $70,000) – $200,000) of gain is recognized because the property worth $70,000 is not §1245 (i.e., unlike-kind) property. The basis of the properties received in the exchange is $250,000 ($200,000 + $50,000). Of that amount, $70,000 is allocated to the property worth $70,000, and the $180,000 balance is allocated to the other property.

[32] Treas. Reg. §§1.1031(a)-1(b) and (c).

Observation. The result in this example is the same as a disposition by sale. There was no like-kind exchange tax-deferred benefit.

In some cases, IRC §1250 depreciable real property (e.g., machine shed, barn, shop, etc.) is transferred in an exchange. The amount of gain taken into account as recapture income is the larger of:

- The gain recognized on the exchange, regardless of the recapture provision; **or**

- The excess, if any, of the gain reported as ordinary income because of additional depreciation if the property had been sold **less** the FMV of the § 1250 property acquired in the transaction.[33]

Example 2.[34] On September 1, 2020, Chris P. Bacon exchanged his fee interest in a 45-acre farm with improvements (FMV of $400,000) for a fee interest in an 80-acre tract of bare farm real estate (FMV of $400,000). Chris intended the transaction to be a like-kind exchange. All property meets the definition of real estate. However, Chris is required to report the $170,000 gain recognized as §1245 depreciation recapture as taxable income. This is likely a surprising result, especially because no cash exchanged hands.

Like-Kind Property	**FMV**	**Basis**	**Gain Realized**
Land (40 Acres)	$185,000	$32,000	$153,000
Tile (40 acres)	15,000	0	15,000
Land/acreage (5 acres)	10,000	2,500	7,500
Machine shed (2002)	20,000	16,955	3,045
TOTAL	$230,000	$51,455	$178,545

Unlike-Kind Property IRC §1245 Recapture	FMV	Basis	Gain Realized
Well/water system	$ 3,500	$ 0	$ 3,500
Machine shed (1985) accel. depr. (not SL)	6,500	0	6,500
Hog confinement bldg.	125,000	0	125,000
Grain bins/drying system	35,000	0	35,000
TOTAL	$170,000	$ 0	$170,000

Fair market value		$400,000
Basis	(51,455)	
Gain realized		$348,545
Gain recognized (§1245 recapture)	(170,000)	
Gain deferred		$178,545

The basis of the property received is the basis of the exchanged §1250 property:

- **Decreased** by the amount of any money received that was not spent acquiring similar property;

[33] IRC §1250(d)(4).

[34] The following example is authored by David A. Brown, JD for inclusion in the Iowa Bar Tax Manual. The author of this chapter is also the editor of the Manual.

- **Increased** by the amount of gain recognized; and

- **Decreased** by the amount of loss recognized. If more than one item of property of each type is received, the total basis is allocated to the individual items of property.

> **Note.** The instructions for Form 8824, *Like-Kind Exchanges*, set forth the above rules and provide a location on the form for calculating the recapture amounts under both §§1245 and 1250.

The recapture for §1250 property is deferred until a disposition of the acquired property occurs. For real property, gain is recognized as recapture income in the exchange of like-kind assets to the extent that the amount of recapturable income exceeds the FMV of the acquired depreciable real property. If gain is recognized on the exchange, recapture income is recognized to the extent of the greater of the gain recognized under the like-kind rules, or the amount of recapture income less the FMV of the acquired depreciable real property.

The "Structured" Installment Sale - Interaction of IRC §§1031 and §453

If an exchange satisfies the requirements of §1031, but property is received that is not like-kind (such as money or other nonlike-kind property, the recipient of such property recognizes gain to the extent of the sum of the money and the FMV of the nonlike-kind property received.[35] Thus, tax deferral is not achieved with respect to the nonlike-kind property (or "boot") received in the exchange.[36]

However, a taxpayer may elect to recognize the gain on the boot under the installment method.[37] To be eligible to do so, the exchange must qualify under **both** §1031 and §453. In that event, the taxpayer can achieve tax deferral on the entirety of the exchange. Similarly, a taxpayer that fails to satisfy the requirements of §1031 may be able to defer gain on the transaction under §453 by properly structuring the sale.[38]

> **Note.** IRC §453 (i.e., the installment method) is automatically triggered when a taxpayer disposes of property in a taxable transaction and at least one payment is to be received in a tax year after the year in which the transaction occurred. As a result, any payment received is to be reported in the year of receipt.[39]

Rev. Rul. 65-155[40] involved a taxpayer who sold investment real estate. Gain was triggered on the sale, and the transaction qualified under §1031. The cash received along with the value of the similar property received in the year of the exchange did not exceed 30% of the entire amount received under the contract. The balance of the indebtedness was evidenced by a 5% interest-bearing note that was to be received in annual installments over seven years. The IRS determined that the taxpayer could recognize the gain under the installment method as long as the requirements of §453 were satisfied.[41]

---

[35] IRC §1031(b).
[36] Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [https://lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Used with permission from Law Professor Blogs Network.
[37] IRC §453.
[38] The seminal academic article on this topic was authored by Robert W. Wood and published in Tax Analysts in 2004. The article is title, *Structured Sales: Breathing Life Into Installment Sales.* The following commentary is based largely on Mr. Wood's work and expands upon it in key places. See also, the author's blog article at https://taxprof.typepad.com/taxprof_blog/files/2005-12400-1.pdf.
[39] IRC §453(b)(1).
[40] Rev. Rul. 65-155, 1965-1 CB 356.
[41] See also Ltr. Rul. 8836006 (Jun. 6 1988).

Treasury Regulation Example[42]

Treas. Reg. §1.1031(k)-(1)(j)(2)(vi), Example 4 indicates that a buyer's installment note issued to a seller qualifies for the installment treatment under §453. In the example, the buyer offered to buy the seller's real property but did not want to have the transaction structured as an like-kind exchange. As a result, the seller entered into an exchange agreement with a qualified intermediary to facilitate the exchange. Under the agreement, the seller transferred the real property to the qualified intermediary, who then transferred the property to the buyer. The buyer paid $80,000 cash and issued a 10-year installment note for $20,000.

The example specifies that the seller has a bona fide intent to enter into a deferred exchange, and the exchange agreement specifies that the seller cannot receive, pledge, borrow, or otherwise obtain the benefits of the money or other property that the qualified intermediary held until the earlier of the date the replacement property is delivered to the seller or the end of the exchange period. The example also states that the buyer's obligation bears adequate stated interest and is not payable on demand or readily tradable. The qualified intermediary acquires replacement property having an FMV of $80,000 and delivers it, along with the $20,000 installment obligation, to the seller.

Practitioner Planning Tip. The key phrase "not payable on demand or readily tradable" allows the use of a promissory note from the seller to retain installment sale treatment.

While the $20,000 of the seller's gain does not qualify for deferral under §1031(a), the seller's receipt of the buyer's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of installment reporting of gain under §453. Thus, the example concludes that the seller may report the $20,000 gain on the installment method upon receiving payments from the buyer on the obligation.

Note. When §§1031 and 453 overlap with respect to a transaction, §1031 generally controls.[43] The regulations under §1031 have specific rules for the determining gain or loss when both §§1031 and 453 apply. The §453 regulations generally defer to the §1031 regulations.[44] In an installment sale situation, the term "payment" generally does not include the receipt of an evidence of indebtedness from the person acquiring the property.[45]

Constructive Receipt

A cash-basis taxpayer takes income into account when it is actually received, as well as when it is **constructively** received.[46] Constructive receipt complicates cash accounting for many farmers and ranchers. Income is considered to be constructively received when it is credited to the taxpayer's account, set apart for the taxpayer, made available so the taxpayer can draw on it, or made available so the taxpayer can draw on it if notice of intent to withdraw is given.[47] However, income is not constructively received if the taxpayer's control of receipt is subject to substantial limitations or restrictions.[48]

[42] Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [https://lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Used with permission from Law Professor Blogs Network.
[43] Treas. Reg. §1.1031(k)-1(j)(1).
[44] Treas. Reg. §15a.453-1(b)(3)(i).
[45] Ibid.
[46] See, e.g., *Romine v. Comm'r,* 25 TC 859 (1956) (check for hogs made available to taxpayer in 1946 but not received until 1947; income constructively received in 1946).
[47] Treas. Reg. § 1.451-2(a).
[48] Ibid. If the only limitation on the taxpayer's right to receive income during the tax year is a self-imposed limitation, that is insufficient to be effective for deferral purposes. See, e.g., *Scherbart v. Comm'r,* 453 F.3d 987 (8th Cir. 2000), *aff'g* TC Memo 2004-143 (co-op value-added payments not eligible for deferral; only limitation on receipt self-imposed and co-op held to be agent of taxpayer); *Walter v. U.S.,* 148 F.3d 1027 (8th Cir. 1998).

Safe Harbor.[49] A safe harbor exists that provides protection against an IRS assertion that a taxpayer is in actual or constructive receipt of money or other property held in a qualified escrow account, qualified trust, or by a qualified intermediary.[50] With respect to a qualified intermediary, the determination of whether a taxpayer has received payment for purposes of §453 is made as if the qualified intermediary is **not** the taxpayer's agent.[51] Thus, when a taxpayer transfers property under such an arrangement and receives like-kind property in return, the transaction is an exchange rather than a sale, and the qualified intermediary is **not** deemed to be the taxpayer's agent.[52]

Similarly, when a buyer places money in an escrow account or with the qualified intermediary, the seller is **not** in constructive receipt of the funds if the seller's right to receive the funds is subject to substantial restrictions.[53] The regulations state that any agency relationship between the seller and the qualified intermediary is disregarded for purposes of §453 and Treas. Reg. §15a.453-1(b)(3)(i) in determining whether the seller has constructively received payment.[54]

> **Observation.** Constructive receipt rules do not prevent a taxpayer that receives payment in a future year in a deferred exchange from recognizing gain under §453 and reporting the gain on the installment method if the safe harbor requirements are satisfied.

Bona Fide Intent. A taxpayer must have a bona fide intent to enter into a deferred exchange at the beginning of the exchange period.[55] Intent is determined based on the facts and circumstances.[56] The fact that an exchange has been completed may be sufficient to establish intent at the time the exchange was entered into.[57]

The following example illustrates how an installment sale can be utilized in an exchange transaction that fails the requirements of §1031.

> **Example 3.** Molly Cule owns a tract of farmland that she uses in her farming business and would like to exchange it for other farmland in a like-kind exchange transaction. Bill Bored and Molly enter into a purchase contract, which provides that Bill will buy Molly's farmland. The purchase contract clearly states that Bill must accommodate Molly's desire to complete a like-kind exchange and states that Molly desires to enter into a like-kind exchange.
>
> Molly and a qualified intermediary then enter into an exchange agreement specifying that the qualified intermediary agrees to acquire Molly's farmland and transfer it to Bill. The agreement also states that the qualified intermediary will acquire like-kind farmland and transfer it to Molly. Molly assigns her rights in and to the farmland she gave up to the qualified intermediary. She also assigns her rights to the qualified intermediary in all contracts she enters into with the owner who holds title to the replacement farmland.

---

[49] Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [https://lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Used with permission from Law Professor Blogs Network.
[50] Treas. Reg. §§1.1031(k)-1(g)(3)–(4); TD 8535 (Jan. 1994).
[51] Treas. Reg. §§1.1031(k)-1(j)(2)(ii) and (g)(4).
[52] See Ltr. Rul. 200327039 (Mar. 27, 2003)
[53] See, e.g., *Stiles v. Comm'r,* 69 TC 558 (1978).
[54] Treas. Reg. §1.1031(k)-1(j)(2)(vi), Example 2.
[55] Treas. Reg. §1.1031(k)-1(j)(2)(iv).
[56] Ibid. See e.g., *Smalley v. Comm'r,* 116 TC 450 (2001).
[57] *Magneson v. Comm'r,* 753 F.2d 1490 (9th Cir. 1985).

The exchange agreement requires Molly to identify replacement farmland within 45 days of the initial exchange and to notify the qualified intermediary of the identified parcel within that 45-day period. The exchange agreement allows Molly 180 days from the date of the first exchange to receive the identified replacement property.

The exchange agreement specifies that the qualified intermediary will sell Molly's farmland and hold the sales proceeds until the qualified intermediary buys replacement farmland. When the replacement farmland is purchased, it will then be transferred to Molly.

Note. If the sum of the aggregate cash consideration that the qualified intermediary pays for the purchase of the replacement farmland exceeds the cash proceeds from the sale of the relinquished property, Molly must provide the excess amount required to complete the purchase of the replacement property to the qualified intermediary. The qualified intermediary will hold the funds and, to deflect a potential IRS argument that she is in constructive receipt of the proceeds, Molly cannot have the ability to obtain any benefits from the property the qualified intermediary holds.

Structured sale aspect. The exchange agreement says that if the transaction qualifies under §1031, but Molly receives "boot," the qualified intermediary and Molly must engage in a structured sale for the boot. This is to bar Molly from having any right to receive cash from the exchange. Similarly, the exchange agreement contains additional language stating that if the transaction fails to qualify for §1031 treatment for any reason, the qualified intermediary and Molly must engage in a structured sale.

The structured sale involves the qualified intermediary making specified periodic payments to Molly pursuant to an installment sale agreement (based on the consideration the qualified intermediary holds), coupled with a note for a set number of years. Thus, the exchange agreement is drafted to specify that if an installment sale results, Molly will report each payment received in income in the year she receives it.

The assignment agreement. If the installment sale language is triggered, the exchange agreement specifies that the qualified intermediary assigns its obligations to make the periodic payments under the installment note to an assignment company pursuant to a separate assignment agreement between the qualified intermediary and the assignment company. Molly is not a party to this agreement.

The assignment agreement requires the qualified intermediary to transfer a lump sum to the assignment company. The lump sum amount equals the discounted present value of the stream of payments that the qualified intermediary must make under the installment note and exchange agreement. In return, the assignment company assumes the qualified intermediary's obligation to pay Molly. Thus, the assignment company becomes an obligor under the installment note.

Note. An assignment company often buys an annuity contract from an insurance company that names the assignment company as the buyer. The seller of the real property (Molly, in the example) is designated as the beneficiary.

As discussed earlier, Example 4 of Treas. Reg. §1.1031(k)-1(j)(vi) involves an installment note that the buyer issues to the seller of the property. That note qualifies for installment treatment under §453. In Example 3, it is the qualified intermediary that issues the note. While the regulations provide that the qualified intermediary is not the agent of Molly for purposes of §453, that is only the case until the earlier of the identification (or replacement) period, or the time that Molly has the unrestricted right to receive, pledge, borrow, or otherwise benefit from the money or other property that the qualified intermediary holds.[58]

Thus, if the qualified intermediary distributes the installment note **after** the exchange period expires, an agency relationship could be found to exist and the IRS could claim that Molly obtained the benefit of the cash that the qualified intermediary holds. Such an assertion would be based on the notion that the qualified intermediary can only issue a note because it is the buyer's cash that the qualified intermediary is holding.

> **Note.** The risk of the IRS asserting that Molly is in constructive receipt of the buyer's funds is eliminated if, under the terms of the exchange agreement, Molly agrees to receive periodic payments attributable to any boot triggered on the exchange or to the extent the exchange fails the §1031 requirements. Under the regulation's safe harbor, at the time Molly enters into the exchange agreement she becomes contractually bound by it and the qualified intermediary is not Molly's agent. Molly is contractually barred from having access to the cash involved in the exchange or deriving any benefit from it.

The occurrence of a structured installment sale upon the contingency and to the extent of a failed §1031 exchange does not negate Molly's intent to enter into a tax-deferred exchange.[59] This is especially true if the exchange agreement is drafted to evidence Molly's intent as such when the exchange is entered into.[60] This contractual language also does not trigger the cash equivalency doctrine.[61] Similarly, because Molly is not a party to the transaction between the assignment company and the buyer, the economic benefit doctrine should not apply.[62]

Alternative Approach. There is an alternative to the approach taken in **Example 3** involving Molly.

Example 4.[63] Millie is engaged in a similar transaction to that engaged in by Molly. Millie used installment reporting but received all of the cash up front via a loan.

Millie sells an asset to Howard's Exchange Service (HSE) and HSE resells the asset to Andy. Millie receives a loan from Usurious Bank, an independent lender, shortly after selling the asset to HSE for an amount equal to the selling price to HSE. The repayment of the loan is funded by installment payments over 30 years that HSE makes to Usurious Bank.

Three escrow accounts are established with an escrow company affiliated with Usurious Bank. The escrow company, on a monthly basis, takes funds from HSE and moves it into Escrow Account No. 1 as an interest payment on the loan; then to Escrow Account No. 2 (which is designated as Millie's account); and then to Escrow Account No. 3 to pay interest on the loan. The transactions are conducted as automatic debit/credit transactions that occur on a monthly basis over the length of the installment period.

> **Note.** From an economic standpoint, Millie receives cash upfront in the form of a loan and has a "wash" (or nearly so) on the interest income and interest expense on the monthly escrow transactions. Millie pays capital gain tax in the last year of the installment period,

---

[58] Treas. Reg. §1.1031(k)-1(j)(2)(ii).
[59] See, e.g., *Smalley v. Comm'r,* 116 TC 450 (2001).
[60] Ibid.
[61] See, e.g., *Reed v. Comm'r,* 723 F.2d 138 (1st Cir. 1983).
[62] See, e.g., *Sproull v. Comm'r,* 16 TC 244 (1951).
[63] Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [https://lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Accessed on Jul. 8, 2020. Used with permission from Law Professor Blogs Network.

with the loan proceeds received in the year of sale used as the source of the funds to pay the tax.

Analysis. For the seller to receive installment treatment on the proceeds of the sale, §453 requires that the initial debt obligation be that of the buyer of the property. If the obligor is someone other than the buyer, the debt is treated as payment on the sale.[64] Thus, for installment sale treatment to result, HSE must be both the buyer of the asset and the obligor on the installment note rather than only being the obligor. To achieve installment sale status, the transaction must be structured such that the obligation is due to Millie from Andy, followed by a substitution of the obligor via an independent transaction in which Andy assigns the obligation.[65]

Note. In Rev. Rul. 82-122,[66] the substitution of a new obligor on the note and an increase in the interest rate, together with an increase in the amount paid monthly to reflect the higher interest rate, was not considered to be a satisfaction or disposition of an installment obligation within the meaning of §453B(a).

For escrow accounts, generally an installment note of the buyer cannot be used as security or pledged to support any other debt that benefits the seller. If that happens, the net proceeds of the debt are treated as a payment received on the installment sale.[67] However, there is an exception to this "pledge rule" that triggers gain recognition if the seller uses an installment obligation to secure a loan. Property that is used or produced in the trade or business of farming is not subject to the rule.[68] Thus, a taxpayer who sells farmland (or other farm property) in an installment sale may use that installment receivable as security, or in a pledged manner, to borrow funds from a third party. The third party should collateralize the payments and file a Uniform Commercial Code-1 form to formally pledge the installment payments.[69]

Note. Apparently, the exception is based on the recognition that farmers routinely use the installment method of reporting income when selling grain and other products produced in the business of farming. Therefore, they should be able to utilize that same method of reporting income when borrowing from third-party lenders.

[64] Treas. Reg. §15a.453-1(b)(3)(i).
[65] See, e.g., Rev. Rul. 82-122, 1982-1 CB 80, amplifying Rev. Rul. 75-457, 1975-2 CB 196.
[66] Ibid.
[67] IRC §453A(d)(1); Treas. Reg. §15A.453-1(b)(3)(i); Rev. Rul. 79-91, 1979-1 CB 179; Rev. Rul. 77-294, 1977-2 CB 173; Rev. Rul. 73-451, 1973-2 CB 158.
[68] IRC §453A(b)(3)(B).
[69] Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [https://lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Used with permission from Law Professor Blogs Network.