The "State of the Art" in Like-Kind Exchanges - 2023

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A review of recent legislation, IRS guidance, and court decisions provides insights on the current use of and restrictions on like-kind exchanges.

Complications, variations, nuances, idiosyncrasies, and significant new changes resulting from the recent "real property" final regulations abound in the rules that govern Section 1031 exchanges. Different types of property may no longer be exchangeable (personal and intangible). On the bright side, however, the machinery exclusion has been abandoned and options now are explicitly listed as real property for Section 1031 exchange purposes. And the DST world continues to thrive and innovate with new Section 1031 exchange techniques and REIT-related structures emerging. Different types of real property, different ownership structures, and different forms of exchanges (deferred, reverse) still may affect the bottom line, which is whether the taxpayer can defer recognizing gain.

In 1999, the first article on the "state of the art" in like-kind exchanges appeared in The Journal. It was followed in 2003 by an updated discussion of the techniques available to defer gain on exchanges of real property and other assets, a third installment in 2006, a fourth in 2009, a fifth in 2012, a sixth in 2015 and the most recent in 2019.[1]

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It is time for the next installment addressing recent developments in this area.

Background

The statutory revisions to Section 1031 as part of tax reform, the latest guidance from the IRS, and the recent court decisions in this area are examined below. The matters discussed include:

- The final regulations under Section 1031 defining "real property" in reaction to the changes made by the Tax Cuts and Jobs Act (TCJA).
- Recent developments in the "like kind" analysis.
- Issues concerning the treatment of recapture in a Section 1031 exchange.
- Cautionary tales involving failed exchanges and related-party exchanges.
- Update on Delaware Statutory Trust (DST) structures, planning, and guidance.

Requirements for a Tax-Free Exchange

Under Section 1031(a), no gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment. Prior to the enactment of the TCJA, Section 1031(a) applied to the like kind exchange of any type of property, other than certain excluded categories of property. In a major change to the like kind exchange rules, Section 1031(a) now applies only to exchanges of real property. Taking this change into account, there are four requirements for a tax-free exchange: (1) there must be an "exchange" of relinquished property for replacement property; (2) each "property" must be real property that is not held primarily for sale; (3) the replacement property must be "of like kind" to the relinquished property; and (4) both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment.

The General Rule and Boot

The general rule in Section 1031(a) requires that qualifying property must be exchanged solely for other qualifying property. Section 1031(b) provides, however, that if an exchange otherwise would be eligible for tax-free treatment under Section 1031(a) but for the receipt of cash or non-qualifying property (boot), any gain realized on the exchange is recognized to the extent of the boot received.

Liabilities

Taxable boot includes relief from liabilities, but the regulations expressly permit a taxpayer to use a "netting" concept to determine whether liabilities have been relieved. That is, the taxpayer's liabilities that are assumed or taken "subject to" by the other party to the exchange may be offset against liabilities encumbering the replacement property or taken subject to by the taxpayer. Liabilities of the taxpayer encumbering relinquished property also may be offset by cash given by the taxpayer to the other party. It is a common misconception that a taxpayer must "equalize" the debt in an exchange. In fact, boot will be avoided if the taxpayer satisfies two tests in the exchange: (1) the purchase price of the replacement property equals or exceeds the sale price of the relinquished property, and (2) the amount of equity used to acquire the replacement property equals or exceeds the equity received on the sale of the relinquished property. This two-part test does not directly refer to debt, although any debt that encumbers the relinquished property will reduce the taxpayer's equity in that property.

Basis

Like-kind exchanges result in tax deferral, not tax elimination. To preserve the deferred gain, Section 1031(d) provides that the basis of the replacement property received in a Section 1031 exchange equals the basis of the property transferred, reduced by any cash received and any loss recognized, and increased by any gain recognized. The basis of property received by a taxpayer in a like-kind exchange also may be increased by any cash paid by the taxpayer. The taxpayer's holding period for the replacement property will include the period during which the taxpayer held the relinquished property (i.e., the holding periods are tacked).

Related Parties

Section 1031(f) provides special limitations for exchanges between certain related parties. The impetus for these related-party restrictions was basis swapping by taxpayers pursuant to the basis rules of Section 1031(d) (property acquired in a like-kind exchange generally takes the basis of the property relinquished). Taxpayers were exchanging low-basis property intended to be cashed-out for high-basis property owned by an affiliate, and then having the affiliate sell the property (now with a much higher basis) in order to reduce gain or increase loss on the property to be cashed-out. Under current law, if a taxpayer exchanges property with a related person, nonrecognition treatment otherwise would apply to such exchange, and within two years of the date of the last transfer either the taxpayer or the related person disposes of the property received in the exchange, then generally there is recognition of the deferred gain or loss as of the date of the disposition of the property received in the initial exchange.

Multiparty and Deferred Exchanges

In a multiparty exchange, the taxpayer transfers property to a party who desires to own the taxpayer's property (a buyer) or to a party who holds property that the taxpayer wants (a seller). If the transfer is to a buyer, the buyer, in turn, acquires the replacement property desired by the taxpayer from a seller and transfers it to the taxpayer. If the transfer is to a seller, the seller conveys the replacement property to the taxpayer and sells the taxpayer's former property to the buyer. These are referred to as "buyer-cooperating" and "seller-cooperating" exchanges. A significant advance in procedures used in multiparty exchanges arose from the Regulations

allowing deferred exchanges—often referred to as *Starker* transactions after the Ninth Circuit decision that first sanctioned such arrangements.[2] The Regulations set forth detailed, and generally taxpayer-friendly, guidance concerning how a taxpayer can comply with the deferred-exchange requirements in Section 1031(a)(3), which allows the transferor of relinquished property up to 45 days to identify replacement property and 180 days to close on the acquisition. The Regulations importantly contain safe harbors that taxpayers now use to avoid constructive receipt of the proceeds from relinquished property.

Reverse Exchanges

In a reverse exchange, the replacement property is acquired before the sale of the taxpayer's relinquished property to a third-party buyer. The IRS has provided an important safe harbor for qualifying a reverse exchange. Subsequent guidance, however, limits the application of the safe harbor, providing that the safe harbor does not apply if the taxpayer previously owned the intended replacement property within 180 days prior to the exchange. Nevertheless, if the replacement property was previously owned by a related party, there appears to be a manner sanctioned by the IRS under which such property may be used in a reverse exchange within the safe harbor.

What Is Like Kind?

The TCJA limited like-kind exchanges to "real property" and removed the other exceptions previously found in Section 1031(a)(2).[3] After the enactment of the TCJA, it was unclear to what extent the requirement of properties being "of like kind" may or may not apply. As a general matter, an ownership interest in real property is treated as like kind to any other ownership interest in real property, except that real property located in the United States is not like kind with respect to property located outside of the United States. The changes to Section 1031 under the TCJA failed to define what constitutes real property for purposes of a Section 1031 exchange. Final regulations released in 2020 now provide this guidance (the "Final Regulations").

The Final Real Property Regulations[4]

On June 13, 2020, the IRS issued proposed regulations ("Proposed Regulations") addressing the definition of "real property" for purposes of Section 1031. On November 20, 2020, the Final Regulations were released. As discussed below, the definition of "real property" included in the Final Regulations diverges from the approach taken in the Proposed Regulations and hews closer to the administrative and judicial rules existing prior to the TCJA. Notably, the Final Regulations merely define real property for purposes of Section 1031, but do not address whether exchanged properties are of like kind to one another (which remains an additional hurdle).

The need to understand what constitutes real property for Section 1031 purposes gained greater importance following the TCJA. The long-standing regulations concerning the application of Section 1031 were silent on what is "real property," dealing only (in somewhat truncated fashion) with determining when something considered real property is like kind to something else that is real property, coupled with the unstated assumption that real property was not like kind to personal property. Since adoption, these regulations had provided that the like kind test (which is applicable when comparing relinquished and replacement real property) involves a comparison of the "nature or character" not the "grade or quality" of exchanged properties.[5] Whether real estate is improved or unimproved has not been and is not material, nor is the character of the property as productive or unproductive, except where held by a dealer, since real property used in a trade or business can be like kind to real property held for investment and vice-versa.

There is a significant body of law, in the form of both judicial opinions and Internal Revenue Service ruling determinations, addressing the question of what constitutes like-kind real property. Suffice it to say that, on this threshold definitional question, all authority prior

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1 *See* Lipton, "The 'State of the Art' in Like-Kind Exchanges," 91 JTAX 78 (August 1999); Lipton, "The 'State of the Art' in Like-Kind Exchanges, Revisited," 98 JTAX 334 (June 2003); Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2006," 104 JTAX 138 (March 2006); Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2009," 110 JTAX 27 (January 2009); Lipton and Gruen, "The 'State of the Art' in Like-Kind Exchanges, 2012," 116 JTAX 246 (May 2012); Lipton, Grilli, and Pollack, "The 'State of the Art' in Like-Kind Exchanges, 2015," 124 JTAX 5 (January 2016); and Lipton, Gruen, Grilli, and Pollack, "The 'State of the Art' in Like-Kind Exchanges, 2019," 130 JTAX 7 (Feb. 2019).

2 *Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979).

3 Section 13303 of P.L. 115-97 (131 Stat. 2054).

4 Significant portions of the discussion of the Final Regulations were excerpted from the following article co-written by Richard Lipton: Weller, Lipton, Christianson and Carlson, "Final Regs Defining 'Real Property' for Section 1031: IRS Gets It Right With 'State Law Plus,'" 134 J. of Tax'n, No. 02 (Feb. 2021).

5 Treas. Reg. § 1.1031(a)-1(b).

6 Treas. Reg. § 1.1031(k)-1(g)(8)(vi).

7 Treas. Reg. § 1.1031(a)-3(a)(1).

8 IRC § 48.

9 Treas. Reg. § § 1.263(a)-3(b) and 1.263A-8(c).

10 Treas. Reg. § 1.856-10.

11 Treas. Reg. § 1.897-1(b).

12 CCA 201238027.

13 *See* Weller, "IRS Muddies the Like-Kind Waters in Guidance Considering State Law Classification," 118 JTAX 13 (January 2013).

14 Treas. Reg. § 1.1031(a)-3(a)(6).

15 *Compare* Prop. Treas. Reg. § 1.1031(a)-3(a)(2)(ii)(B) with final Treas. Reg. § 1.1031(a)-3(a)(2)(ii)(B).

16 Dropped from this list between the Proposed and Final Regulations were "enclosed transportation stations and terminals," presumably because this is the topic of analysis in Example 4, discussed below.

17 Treas. Reg. § 1.1031(a)-3(b)(3).

18 The Final Regulations consciously reject any functional test for OIPS of the sort that appears in REIT regulations, treating as real property assets eligible for REIT ownership OIPS that serve a "passive function" and "do not serve an active function." *See* Treas. Reg. § 1.856-10(d)(2)(iii)(A).

19 Treas. Reg. § 1.1031(a)-3(a)(2)(iii).

20 Treas. Reg. § 1.1031(a)-3(a)(2)(iii)(A).

21 Treas. Reg. § 1.1031(a)-3(a)(2)(iii)(B) provides that "[s]tructural components include the following items, provided the item is a constituent part of, and integrated into, an inherently permanent structure: walls; partitions; doors; wiring; plumbing systems; central air conditioning and heating systems; pipes and ducts; elevators and escalators; floors; ceilings; permanent coverings of walls, floors, and ceilings; insulation; chimneys; fire suppression systems, including sprinkler systems and fire

to 2012 agreed: taxpayers were directed to look to state law definitions in the state where property was located to determine whether a specific interest was or was not classified as real property. Where taxpayers transferred outright permanent ownership of an asset classified as real property under applicable state law, and acquired outright permanent ownership of an asset classified as real property under applicable state law, all authority prior to 2012 concluded that such assets would be like-kind for Section 1031 purposes. While the Proposed Regulations deviated from this starting point, the Final Regulations endorse it.

Also historically, if an asset was treated as real property under state law, then its purpose or use was not a factor in determining whether or not the asset should be treated as real property for purposes of Section 1031. While the Proposed Regulations deviated from this starting point, the Final Regulations endorse it.

Both the Proposed and Final Regulations also include a fix for a newly discovered theoretical constructive receipt problem with deferred exchanges where relinquished property sale proceeds will be used to purchase replacement assets that include personal property, such as a hotel with significant moveable furniture and non-real estate equipment. The clarifying rule, also discussed below, protects a taxpayer from completely losing the benefit of Section 1031 due to application of constructive receipt principles that are effectively ignored when utilizing the qualified intermediary safe harbor. However, the limited scope of this new protective rule was initially confusing to some and might lead to unfortunate consequences if misunderstood.[6]

The Construct of the Final Regulations

The Final Regulations contain the same "basic" definition used in the Proposed Regulations, which is that "real property" consists of land and improvements to land, and improvements to land include certain specified types of property as well as structural components of improvements to land. Examples of improvements to land and structural components are provided, as well as certain facts-and-circumstances tests that can be applied when an asset is not specifically described in the Final Regulations. We will discuss these tests below.

We think four major aspects of the Final Regulations should be highlighted:

1. First, real property under Treas. Reg. § 1.1031(a)-3 now is defined using a three-part test set forth in the Preamble to the Final Regulations:
   i. Is the asset treated as real property under state law?
   ii. If an asset is not treated as real property under state law, is the asset specifically described in the Final Regulations as an improvement to land or a structural component of an improvement to land?
   iii. If an asset is not real property under state law and also is not specifically described in the Final Regulations, is the asset treated as an improvement to land or a structural component of an improvement to land under the facts-and-circumstances test set forth in the Final Regulations?

   If the answer to any of the above three questions is positive, then the asset is real property for purposes of Section 1031. Thus, state law definitions are the starting point, and if property is clearly real property for state or local law purposes, it is real property for Section 1031 purposes.[7] But there will also be types of property not characterized as real property under state law, but which nonetheless will be treated as real property for purposes of Section 1031 to the extent specified in the Final Regulations, or which satisfy the facts-and-circumstances test of the Final Regulations. This definitional framework, which is used to determine the treatment of improvements to land and related structural components, occupies a significant part of the Final Regulations.
2. Second, a variety of intangible interests in real property, that may or may not be real property for state law purposes, are included in the definition.
3. Third, the Regulations' definition of real property is expressly limited to Section 1031. It creates no inference of application to the tax credit,[8] cost recovery, cost capitalization,[9] real estate investment trust,[10] foreign investment withholding,[11] or any other regime that looks to distinctions between real and personal property.
4. Finally, the Final Regulations are clearly limited to defining real property that comes within the ambit of Section 1031 and do not address the separate question of determining whether relinquished and replacement real property are like-kind.

"State Law Plus"

In a somewhat obscure Chief Counsel Advice issued in 2012,[12] the IRS decided that two identical assets located in different states (in-ground oil and gas pipelines) must be like-kind under Section 1031, even though one state classified the asset as real property and the other state classified the asset as personal property. To reach that result, the Chief Counsel asserted that federal law essentially preempted state law. Unfortunately, the CCA did not stop there. In reviewing another set of examples dealing with assets that were conceded to be real property for applicable state law purposes, it applied an additional test looking at the function served by the assets, not the duration or character of a taxpayer's ownership, to determine whether they were like-kind.

This novel approach attracted some criticism when it was made public,[13] but had not really been put under a microscope by the tax community because many thought it had limited application. Unfortunately, as we will discuss below, in undertaking the project to write post-TCJA regulations, the IRS decided it was appropriate to look to that CCA as a touchstone. This provoked a significant amount of commentary from the public that ultimately led Treasury and the IRS to rethink the approach and return (with some salutary clarifications) to alignment with prior law—with a "Plus." By Plus, we refer to several new lists of assets included in the Final Regulations which are automatically regarded as real property despite uncertain or contrary characterization under state law. The lists further include a new category of "Intangible Interests," as well as method-

ologies to reach real property classification for assets not on the lists.

Applicable "state law" for purposes of the Regulations is both state and local law applicable to the location of the property in question.[14] While not explicitly explained, we assume the reference to local law is included to cover circumstances where law of a county or local jurisdiction applies to an asset, but the law of the state where the asset is located is silent on its classification.

The Final Regulations presume, however, that a state's law will not always be clear on whether an "improvement" is classified as real property, and that there will be situations where state law will differ for the same asset (as with oil pipelines in the 2012 CCA). The Final Regulations address this in two ways: by specifically listing items to be classified as real property regardless of state law classification, and by creating analytic tests to be applied to assets that are not included in the specific lists. In both cases this is additive to state law classification.

With respect to identical assets classified differently by different state law regimes, the Final Regulations reject the CCA conclusion that identical assets must qualify as like-kind regardless of state law because they have the same nature or character, but solve the problem through the "Plus" approach of listing assets and creating rules that will overlay a federal classification system that overcomes state law differences. The solution is found in the list of "inherently permanent structures" which are defined as real property regardless of their state or local law classification.

The Final Regulations start with the proposition that buildings and "other inherently permanent structures" (referred to below as "OIPS") are real property. The term "building" is broadly defined to include "any structure or edifice enclosing a space within its walls and covered by a roof," going on to provide "[b]uildings include the following distinct assets if permanently affixed: houses, apartments, hotels, motels, enclosed stadiums and arenas, enclosed shopping malls, factories and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores." Gone in the Final Regulations is any reference to the specific purpose served by a building as relevant to its classification as real property.[15]

In order to deal with state law uncertainty and potential inconsistency, the OIPS definition goes on to describe numerous kinds of man-made additions to land that are included in the definition of real property if they are "inherently permanent" or "permanently installed." Specifically listed additions which meet these requirements are: "In-ground swimming pools; roads; bridges; tunnels; paved parking areas, parking facilities, and other pavements; special foundations; stationary wharves and docks; fences; inherently permanent advertising displays for which an election under section 1033(g)(3) is in effect; inherently permanent outdoor lighting facilities; railroad tracks and signals; telephone poles; power generation and transmission facilities; permanently installed telecommunications cables; microwave transmission, cell, broadcasting, and electric transmission towers; oil and gas pipelines; offshore platforms, derricks, oil and gas storage tanks; and grain storage bins and silos."[16] An improvement may be regarded as permanently installed or affixed by reason of weight alone.

Of particular note is the attention paid by Treasury and IRS, both in the Final Regulations and in the Supplementary Information released with them, to petroleum industry assets, including offshore platforms and pipelines. In general, these assets receive real property classification as inherently permanent structures.

Where a specific type of OIPS is not listed but might arguably fit within the general criteria for OIPS, the Final Regulations provide a five-factor test to establish qualification. Treas. Reg. §

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alarms; fire escapes; security systems; humidity control systems; and other similar property."

[22] The American Society of Cost Segregation Professionals ("ASCSP") has defined cost segregation as "the process of identifying personal property assets that are grouped with real property assets and separating out personal assets for cost recovery reporting purposes." *See* ASCSP Comments for Proposed Regulations 1.1031(a)-3 (8/6/2020), available at https://ascsp.org/wp-content/uploads/2020/08/ASCSP-Comments-for-Proposed-Regulations-1.1031a-3-REG-117589-18-1-1-1.pdf.

[23] Prop. Treas. Reg. § 1.1031(a)-3(b)(5).

[24] Prop. Treas. Reg. § 1.1031(a)-3(b)(6).

[25] Treas. Reg. § 1.1031(a)-3(b)(5).

[26] *Compare* Prop. Treas. Reg. § 1.1031(a)-3(b)(8) with Treas. Reg. § 1.1031(a)-3(b)(7).

[27] Treas. Reg. § 1.1031(a)-3(b)(4).

[28] Treas. Reg. § 1.1031(a)-3(b)(6).

[29] Treas. Reg. § 1.1031(a)-3(a)(4)(i).

[30] Prop. Treas. Reg. § 1.1031(a)-3(a)(4)(ii).

[31] Treas. Reg. § 1.1031(a)-3(a)(3).

[32] The Proposed Regulations and the Final Regulations faithfully follow the direction of Congress not to take away real property classification from mutual ditch, reservoir, or irrigation company stock for entities described in Section 501(c)(12)(A) where "the shares have been recognized by the highest court of the State in which the company was organized or by a State statue as constituting or representing real property or an interest in real property."

[33] The Final Regulations do not expressly address whether contractual rights under a typical real estate purchase and sale agreement may be the subject of a Section 1031 exchange, but presumably these rights would be treated similar to an option to acquire real property.

[34] *See Peabody Natural Resource Co. v. Comm'r*, 126 T.C. 261 (2006); CCA 201238027.

[35] *Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979).

[36] May 30, 1995.

[37] The FSA cites *Koch v. Comm'r*, 71 T.C. 54 (1978), which examined whether the exchanger's money was "still tied up in real property of the same class or character as they owned before the exchange." 71 T.C. at 66.

[38] Notably, the 1031 exchange under examination in the FSA failed for other reasons.

[39] Treas. Reg. § 1.1031(a)-3(a)(5).

[40] Prop. Treas. Reg. § 1.1031(a)-3(a)(5)(ii).

[41] Treas. Reg. § 1.1031(a)-3(b)(11).

[42] Treas. Reg. § 1.1031(a)-3(b)(12).

[43] Treas. Reg. § 1.1031(a)-3(a)(5)(i).

[44] Treas. Reg. § 1.1031(a)-3(a)(6).

[45] Treas. Reg. § 1.1031(a)-3(a)(7).

[46] Notably, the "incidental property" concern is a problem that pre-dates enactment of the TCJA, *e.g.*, such as a transfer of relinquished property consisting solely of real property and the acquisition of replacement property consisting of some real and some personal property. Although commentators asked the IRS to extend application of the incidental property rule retroactively for these situations, the IRS declined to do so in the Final Regulations arguing that prior to enactment of the TCJA, personal property generally was eligible for a Section 1031 exchange. However, this rationale does not solve the issue under prior law where the relinquished property was comprised solely of real property.

[47] Where the personal property associated with replacement real property does not exceed 15% of the total value of the combined real and personal property, no separate identification of the personal property is necessary. Treas. Reg. § 1.1031(k)-1(c)(5).

[48] Treas. Reg. § 1.1031(k)-1(g)(7)(iii).

[49] Treas. Reg. § 1.1031(k)-1(g)(8)(vi).

[50] Notice 2014-21; Rev. Rul. 2019-24.

[51] Rev. Rul. 2019-24.

1.1031(a)-3(a)(2)(C) lists the following factors:

1. the manner in which the distinct asset is affixed to real property,
2. whether the distinct asset is designed to be removed or to remain in place,
3. the damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed,
4. any circumstances that suggest the expected period of affixation is not indefinite, and
5. the time and expense required to move the distinct asset.

While at present we do not know whether all factors must be present or, if not, what weighting they are to receive, the test is essentially a surrogate for the common-law definition of a "fixture." It has the salutary effect in Example 3 of the Final Regulations of making a large indoor sculpture placed in the atrium of a building a real property asset[17] and it appears that the classification would apply even if the sculpture was not situated inside a building, since the five-factor test does not make this a requirement.[18]

Besides land and inherently permanent structures, the Final Regulations establish a third category of property that can be viewed as real property but must be analyzed separately: Structural components of an inherently permanent structure.[19] It appears that this category flows directly from the current practice of identifying separate components of a building in a cost segregation study. In defining structural components, the Final Regulations focus on whether an item is "a constituent part of and integrated into an inherently permanent structure."[20] A laundry list of examples is provided[21] that includes most items typically identified as separate assets in a cost segregation study,[22] as well as a four-part test applicable where an alleged structural component is not listed. This four-part test provides that the following factors are relevant:

1. the manner, time, and expense of installing and removing the component,
2. whether the component is designed to be moved,
3. the damage that removal of the component would cause to the item itself or to the inherently permanent structure to which it is affixed, and
4. whether the component is installed during construction of the inherently permanent structure.

Final Regulations Abandon the Machinery Exclusion

The most controversial aspect of the Proposed Regulations was their exclusion as real property for Section 1031 purposes of assets classified as machinery and building systems that serve machinery, even where such assets were clearly real property under state law and would have qualified as such for Section 1031 purposes under prior law. This approach received almost universal rejection from commenters and was, on review, determined by Treasury and IRS to be inappropriate.

The IRS' change of position is illustrated by changes in classification of assets described in several of the Examples. Example 5 of the Proposed Regulations characterized a 12-ton machine installed during a building's construction and designed to remain in place indefinitely as personal property because it produced products to be sold and used away from the building where it was located.[23] Similarly, a backup generator installed at the same time that served both the machine and the building was real property, but where the generator served only the machine, it was personal property.[24] These Examples are revised in the Final Regulations to make clear that the real property classification applies to both the 12-ton machine and its back-up generator, irrespective of function.[25]

A steam turbine installed during construction of the building and designed to remain in place indefinitely that produces electricity for sale to customers by an electric utility (the subject of the controversial CCA) exhibits the same change in classification from the Proposed Regulations (not like kind to real property) to Final Regulations (now classified as real property).[26]

But not everything associated with buildings or building-like assets is real property. In two examples, the Final Regulations disclaim real property classification for improvements that are essentially removable and portable. Example 4 deals with modular prefabricated bus shelters that are not permanently affixed to land and will not take significant time or expense to move,[27] and Example 6 deals with raised flooring for a machine that, again, is designed to be installed and removed easily and with little expense.[28] In these cases, state-law fixture treatment would probably not apply and the Regulations' application of the five-factor test rejects real property classification. However, neither of these examples resuscitates the "function" test abandoned by the Final Regulations.

Distinct Assets

Another construct included in the Regulations is the notion that "a distinct asset is analyzed separately from any other assets to which the asset relates to determine whether the asset is real property, whether as land, an inherently permanent structure or a structural component of an inherently permanent structure."[29] Buildings and OIPSs each *per se* are distinct assets. Structural components that are separately listed in Treas. Reg. § 1.1031(a)-3(a)(2)(iii)(B) are distinct assets. For other non-listed assets, the determination of whether a particular separately identifiable item of property is a distinct asset is based on the following four-factor test:

1. whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset,
2. whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset,
3. whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part, and
4. whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.[30]

Conceptually, it is difficult to predict when an integrated facility or interconnected group of assets should be analyzed as a single distinct asset or as a group of individual distinct assets. In light of the change to a "State Law Plus" definition of real property, it remains to

be seen how often these tests will matter. Notably, the Final Regulations also clarify that distinct asset rules apply only for purposes of classifying assets as real property for purposes of Section 1031 and are irrelevant to the 3-property identification rule.

Products of or from Land

Consistent with prior law, unsevered natural products of land, such as growing crops, plants, and timber, are expressly characterized as real property under the Final Regulations. Once severed, extracted, or removed from the land, however, natural products cease to be real property.[31]

Options to Acquire Real Property

The Final Regulations follow the Proposed Regulations in directly addressing a topic that has been somewhat controversial over the years and may continue to give rise to dispute: treatment of various "less than fee" interests that relate to real property. This topic is now addressed in Treas. Reg. § 1.1031(a)-3(a)(5), which includes the following list of intangible assets that are real property for purposes of Section 1031: "a leasehold, an option to acquire real property, an easement, stock in a cooperative housing corporation, shares in a mutual ditch, reservoir or irrigation company[32] … and land development rights." Notably, these interests are considered real property regardless of their duration, but duration is still relevant in determining whether two assets are like kind.

Of great interest to taxpayers is the specific inclusion of "options" to acquire real property, which by their nature do not involve present possessory interests (unless coupled with a lease or license), as real property for Section 1031 purposes.[33] Although an option to acquire real property now is listed as real property in the Final Regulations, the question remains as to whether an option also is like kind to a fee interest in real property (or to other categories of real property as described in the Final Regulations). Generally, as real property interests, the analysis turns on whether the two assets under comparison possess the same "nature or character" (as opposed to differences of only "grade or quality").[34]

According to the Ninth Circuit in *Starker*, the exchange of a contractual right to receive like-kind property would not be treated any differently than ownership rights themselves for Section 1031 exchange purposes.[35] In *Starker*, the taxpayer exchanged a fee interest in timberland for an executory real property contract to purchase a commercial parcel that the grantor had obtained from a third party and then reassigned to the taxpayer. The real property contract was executory because, under the contract's terms, legal title would not pass to the buyer until the original seller's life interest expired; however, the buyer was entitled to immediate possession of the property, subject to certain restrictions (e.g., the buyer could not remove improvements and had to maintain the property in good repair). In addition, if any contract condition was not met, the seller could elect to void the contract. At the time of the trial, legal title to such property still had not passed by deed to the taxpayer.

Despite these contingencies, the Ninth Circuit held that the rights the taxpayer received under the contract to buy real property were the equivalent to a fee interest (or at least the rights of a long-term lessee with an equitable fee subject to conditions precedent) for Section 1031 purposes. Thus, the Ninth Circuit concluded that because "title to real property, like a contractual right to purchase real property, is nothing more than a bundle of potential causes of action. . . , [and the] bundle of rights associated with ownership is obviously not excluded from section 1031; a contractual right to assume the rights of ownership should not . . . be treated as any different than the ownership rights themselves." *Starker* supports the notion that an option or contractual right to purchase real property possesses the same "nature or character" as fee ownership of real property and, thus, such assets may be of like kind.

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[52] Rev. Rul. 82-166.

[53] Rev. Rul. 79-143.

[54] The ruling does not specify whether the Ranch Owners own the Land as tenants in common under State A law, but presumably this is the case. If this is correct, then the ruling is unclear as to how this co-ownership of the Land relates to the earlier factual recitation that each of the "Ranch Owners owns its respective property in fee simple."

[55] 1955-2 C.B. 295.

[56] 228 F. Supp. 2d 1080 (D. Az. 2002).

[57] 1968-2 C.B. 338.

[58] 132 T.C. 105.

[59] 124 T.C. 45.

[60] *See* Section 1245(a)(3)(A) (personal property) and (D) (single purpose agricultural or horticultural structure).

[61] Notably, the decision does not specify whether Andrew Gerhardt was a "related person" (within the meaning of Section 1031(f)) to Jack and Shelley Gerhardt.

[62] Treas. Reg. § 1.1031(a)-3(a)(7).

[63] *See* Treas. Reg. § 1.1245-4(d)(4) Treas. Reg. § 1.1245-4(d)(5) (*Example*).

[64] *See* Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2009," 110 JTAX 27 (January 2009) and Lipton and Gruen, "The 'State of the Art' in Like-Kind Exchanges, 2012," 116 JTAX 246 (May 2012). *See also* Lipton, Grilli, and Pollack, "The 'State of the Art' in Like-Kind Exchanges, 2015," 124 JTAX 5 (January 2016) and Lipton, Gruen, Grilli, and Pollack, "The 'State of the Art' in Like-Kind Exchanges, 2019," 130 JTAX 7 (Feb. 2019), for various state law updates to the drop and swap and swap and drop saga.

[65] *Comm'r v. Court Holding Co.*, 324 U.S. 331 (1945).

[66] *Chase v. Comm'r*, 92 T.C. 874 (1989).

[67] 2004-33 IRB 191.

[68] Treas. Reg. § 301.7701-4(c).

[69] *See* Matejcak and Cullen, "The ABCs of DSTs Revisited—Rev. Rul. 2004-86 at Ten Years", Vol. 42, No. 3 Real Estate Tax'n, 100 (Second Quarter, 2015); Cullen, "The ABCs of DSTs: Using Fixed Investment Trusts in Section 1031 Real Estate Transactions", 34 Real Estate Tax'n 21 (Fourth Quarter, 2006).

[70] Matejcak, Lipton, Steinhause and Cullen, "The Do's and Don'ts of DSTs (Part I)", Journal of Passthrough Entities, Jan.-Feb. 2018, pg. 9 ("Do's and Don'ts of DSTs (Part I)").

[71] Rev. Rul. 2004-86 prohibits the power to (i) dispose of the DST's property and acquire new property; (ii) renegotiate the lease; (iii) enter into new leases (except in the case of a tenant bankruptcy or insolvency); (iv) renegotiate or refinance the debt used to purchase the DST's property (except in the case of a tenant bankruptcy or insolvency); (v) receive additional capital contributions from investors, (vi) invest cash (rents) received to profit from market fluctuations; or (vii) make more than minor, non-structural, modifications to the property (unless otherwise required by law). This list is not the actual famous list of seven deadly sins. The scriptures do not appear to compile seven sins into one list – we understand (but have not confirmed) the actual "seven deadly sins" were enumerated, and declared deadly, by Pope Gregory I.

[72] *See* Do's and Don'ts of DSTs (Part I).

[73] Rev. Rul. 2004-86; Treas. Reg. § 301.7701-4(c) ("An 'investment' trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. *See Commissioner v. North American Bond Trust*, 122 F. 2d 545 (2d Cir. 1941), *cert. denied,* 314 U.S. 701 (1942).").

[74] Rev. Rul. 2004-86.

In Field Service Advice 1995-12,[36] the IRS reached a similar conclusion in considering whether an exchange of land for an option to acquire land constituted a valid Section 1031 exchange. The IRS acknowledged the potential for a valid 1031 exchange, stating:

> Your doubt as to the applicability of section 1031 apparently centers upon whether exchanging land for an option to acquire land constitutes a like kind exchange. We do not view that as the disqualifying aspect for the reasons stated below.... Here, the petitioner's money is arguably "still tied up in real property of the same class or character as they owned before the exchange," just as the court said of the taxpayers in *Koch*. . . . Consequently, we do not recommend a challenge to the transaction here on the basis that the land repurchase option was not of like kind to the land transferred.[37]

The FSA makes a logical argument, namely, that where an option to acquire real property has appreciated in value, the owner of such option is essentially invested in real property, and so if the option holder exchanges the option for other real property, the holder remains invested in real property. Furthermore, the IRS, like the Ninth Circuit in *Starker*, appears to acknowledge that the option and fee interest could possess the same nature or character and be of like kind.[38] However, an FSA is not binding on the IRS or courts and cannot be cited as legal authority.

The Final Regulations do not answer the question of whether an option (or contractual rights) to acquire real estate will be like kind only to another option or option-equivalent or to all other real property interests. Will the term of an option be equated to the term of a lease for purposes of this test—creating a more than 30-year and less than 30-year distinction, as with leases? If no durational test applies, the ability to exchange "in the money" options (or other "in the money" contractual rights, such as real estate contracts or oil & gas farmout agreements, for example) for other real estate could be of great benefit to taxpayers. If the like-kind test requires that options or other interests have equivalent terms, *i.e.*, an option with a 5-year term is like-kind only to an option or lease with a 5-year term, then this clarification may be of limited practical importance.

Licenses, Permits and Similar Rights

The Final Regulations also now clarify that an intangible that derives its value from a real property interest and is inseparable from that interest is real property for Section 1031 exchange purposes.[39] This includes licenses, permits, or similar rights "in the nature of a leasehold or easement" but not licenses or permits to engage in a business on real property if they contribute to production of income other than as consideration for use and occupancy of the real estate.[40] The Final Regulations include examples illustrating these differences. In Example 11, a "special use permit" from the government allowing the placement of a cell tower on government land was in the nature of a leasehold and therefore an interest in real property, while in Example 12 a state-issued license to operate a casino in a building was not a right for the use, enjoyment or occupation of the building, and therefore was not real property.

The rules relating to permits, licenses, and land development rights seem reasonable and should generally be easy to apply. A permit to use public land for placement of a cell tower is like a lease, even if state law provides that such permits are not leases but merely grant use rights that are terminable by the government if needed for "a higher public use."[41] But, under the Final Regulations, a license to operate a casino in a specific building that cannot be transferred to another building is not real property.[42] Assuming the license is transferable to a buyer of the building, it presumably has significant value, likely exceeding its adjusted cost basis. In the past, where the building was sold with the license, gain associated with the license could have been deferred if the seller acquired another licensed casino building. Post-TCJA, there will be no ability to defer gain on value allocated to the casino license on a sale—encouraging sellers to artificially depress the value of the license rights through favorable purchase price allocations. Of course, this may be countered by saying that buyers will still want to assign value to such licenses in order to amortize their costs under Section 197 over 15 years rather than be subject to 39-year cost recovery under Section 168.

Exclusions Under Prior Law

The Final Regulations clarify that the repeal by the TCJA of former Sections 1031(a)(2)(B) through (F), which contained a list of property excluded from Section 1031 treatment (such as stocks, bonds, notes, securities, partnership interests, certificates of trust, and choses in action), did not make any of these categories eligible for Section 1031 after the TCJA, even if such assets could be viewed as real property under state law. The Final Regulations contain an express exclusion for each of the former categories in the definition of potentially qualifying intangible assets "regardless of the classification of such property under State or local law."[43] This puts to bed the assertion made by some in light of the TCJA's repeal of former Section 1031(a)(2)(D) that real estate partnership interests held in tenant-in-common form might again qualify for Section 1031. Moreover, the Final Regulations make clear that real property interests in the form of publicly traded securities also have not been explicitly validated in the wake of the TCJA.

No Inference Provision

Of great relief to the cost segregation industry and others, the Final Regulations (like the Proposed Regulations) limit application of the real property classification rules to the characterization of property only for Section 1031 purposes, and affirm that a classification under those rules has no application under other provisions of the Code, including accelerated depreciation under Section 168, recapture under Sections 1245 and 1250, REIT qualification under Section 856, or FIRPTA withholding under Section 897.[44] While a cost segregation study of relinquished or replacement property will have no effect on qualification of such property under Section 1031, the

Final Regulations remind us that the recapture consequences of an exchange out of or into real property that has been the subject of a cost segregation study should not be ignored.[45]

Incidental Property Clarification

The Final Regulations preserve the aspect of the Proposed Regulations that addressed and gained some notoriety when the restriction of Section 1031 to real property went into effect in 2018. Under Treas. Reg. § 1.1031(k)-1(g)(6)(i), a qualified intermediary may not use exchange funds to purchase non-qualified property during the exchange period without jeopardizing the taxpayer's entire Section 1031 exchange (*i.e.*, a "(g)(6)" violation). With limited exceptions, exchange funds generally may only be used to purchase like-kind property. Following the enactment of the TCJA, practitioners recognized that exchange proceeds generated by a sale of real property could no longer be used to purchase replacement property that included some personal property, such as a hotel acquired along with its furniture and service equipment. If this were to occur, the consequence would be a "(g)(6)" violation which could invalidate the qualified intermediary safe harbor and, thus, risk the taxpayer being in constructive receipt of the entire exchange funds balance, which would negate the entire Section 1031 exchange.[46]

The "incidental property" rule included in the Proposed Regulations and Final Regulations addresses this concern in a favorable way by following the same 15% test applicable to replacement property identification in a deferred exchange.[47] That rule will now also apply to use of relinquished property proceeds to buy replacement property consisting of both real and personal property. This is accomplished by adding an incidental personal property exception to those items for which funds held by a qualified intermediary may be applied. This consists of personal property "incidental to" real property that does not exceed 15% of the aggregate value of the replacement real property and that typically is transferred along with the real property in "standard commercial transactions."[48] Unfortunately, the Final Regulations do not define the meaning of a "standard commercial transaction."

Notably, the incidental property rule is not a safe harbor and therefore acquisition of personal property exceeding the 15% limitation arguably risks vitiating the qualified intermediary safe harbor and the entire Section 1031 exchange. Also, the incidental property rule does not address the acquisition of other types of incidental property, such as non-like kind intangibles or non-like kind real property. Well advised taxpayers therefore should plan to purchase excess personal property, or other non-like kind categories of property, using non-Section 1031 exchange funds in order to avoid a potential (g)(6) violation that could jeopardize the entire Section 1031 exchange.

Despite some mistaken commentary that followed issuance of the Proposed Regulations, and the request of some commenters to make it so, the IRS clearly explains in its introduction to the Final Regulations that the incidental property rule does nothing to eliminate boot treatment for receipt of any personal property in a Section 1031 exchange, regardless of how "incidental." Thus, although a taxpayer may be permitted to use up to 15% of the taxpayer's exchange funds to purchase personal property without losing the benefit of the qualified intermediary safe harbor, the receipt of this personal property nevertheless would constitute taxable boot in the exchange. An example illustrates both the continued boot treatment of the personal property receipt and the constructive receipt safe harbor: where relinquished property worth $1,100,000 having basis of $400,000 is transferred (resulting in $700,000 realized gain) and replacement real property worth $1,000,000 (an office building) plus $100,000 in associated personal property (office furniture) is identified and acquired, the taxpayer recognizes $100,000 of boot gain due to the non-like kind office furniture, but, under the incidental property ex-

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75 *See* Do's and Don'ts of DSTs (Part I).

76 Section 857(b)(6)(C)(ii).

77 *Id.*

78 *See supra*, note 71.

79 *See* Do's and Don'ts of DSTs (Part I).

80 *See supra*, note 69.

81 *See* Do's and Don'ts of DSTs (Part I).

82 *See* Rev. Proc. 2002-28, 2001-1 C.B. 1156.

83 Case law provides that certain factors are indicative that a purported lease may in fact be a partnership for federal income tax purposes. *See Haley v. Comm'r*, 203 F.2d 815 (5th Cir. 1953), *rev'g and rem'g* 16 T.C. 1509 (1951) (citing *Culbertson* and stating that a transaction will be treated as a partnership rather than a lease "if the agreements and the conduct of the parties . . . plainly show the existence of such [a partnership] relationship, and the intent to enter into it"); *Bussing v. Comm'r*, 88 T.C. 449 ("A partnership for federal income tax purposes is formed when the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and/or losses of the venture"). *See also Luna v. Comm'r*, 42 T.C. 1067 (1964) (outlining factors that will aid in the determination of whether a partnership exists for federal tax purposes: "[T]he following factors, none of which are conclusive, bear on this issue: The agreement of the parties and their conduct in executing its terms; the contributions if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the employee of the other; whether business was conducted in the joint name of the parties; whether the parties filed Federal partnership returns or otherwise represented that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.").

84 Transactions structured as leases may be recharacterized for federal income tax purposes to reflect their economic substance. *See, e.g., Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1976), *rev'g* 536 F.2d 746 (8th Cir. 1976); *Rice's Toyota World*, 752 F.2d 89 (4th Cir. 1985); *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939); *Emershaw v. Comm'r*, T.C. Memo 1990-246.

85 Absent sufficient economic substance, the master lease could be recharacterized as an agency relationship between the master lease and the DST resulting in the actions of the master tenant being attributed to the DST in violation of the requirements of the Ruling.

86 Most practitioners apply the policy set forth in Treas. Reg. § 1.856-4(b)(3) relating to REITs to DSTs for this purpose.

87 It is unclear, in our view, if a master tenant might be allowed under the Ruling to make otherwise non-compliant modifications to the property in the limited case where the useful life of such modifications is fully consumed by the master tenant during the term of the lease and no benefit reverts to the DST landlord thereafter.

88 Matejcak, Lipton, Steinhause and Cullen, "The Do's and Don'ts of DSTs (Part II)", Journal of Passthrough Entities, May-June 2018, pg. 3 ("Do's and Don'ts of DSTs (Part II)").

89 *See* Do's and Don'ts of DSTs (Part II) for a detailed list of finance term guidelines essential to properly structuring a Ruling-compliant DST financing.

ception, is not deemed to be in constructive receipt of the entire $1,100,000 placed with the qualified intermediary. Therefore, the Section 1031 exchange is valid and the taxpayer defers $600,000 of the realized gain.[49]

Correcting a 38-Year-Old Mistake

When Treas. Reg. § 1.1031(k)-1 was promulgated in 1992, it contained a clear numerical error that annoyed careful readers for the ensuing 38 years. Examples 3 and 4 in Treas. Reg. § 1.1031(k)-1(d)(2) both use a property value of $250,000 for land which consists of two components—a barn and underlying land and additional land—but state that the barn is worth $187,500 and the adjacent land is worth $87,500, totaling more than the stated composite value. This error was finally corrected to reduce the $87,500 figure to the correct $62,500. A long time coming, but at least no longer a conundrum.

Conclusion

The Final Regulations are a good example of the importance of the notice and comment process at work. There were a number of flaws in the Proposed Regulations, and the Treasury and IRS addressed the most important ones through revisions suggested by the commenters. As finalized, Treas. Reg. § 1.1031(a)-3 provides appropriate and useful guidance to taxpayers on the question of what constitutes "real property" under Section 1031, is consistent with the Congressional mandate on post-TCJA Section 1031, and will serve both tax administrators and the public well.

Other "Like-Kind" Cases and Rulings

CCA 202124008 (June 18, 2021)

In CCA 202124008, the IRS analyzed whether, prior to January 1, 2018 (the effective date of the TCJA rule limiting Section 1031 to only real property), exchanges of Bitcoin for Ether, Bitcoin for Litecoin, or Ether for Litecoin qualified under Section 1031. The IRS concluded that none of the contemplated exchanges qualified as a Section 1031 exchange because the subject assets were not "like kind" under Section 1031.

The ruling begins with a background discussion of Bitcoin, Ether and Litecoin. Per the IRS, virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value other than a representation of the U.S. dollar or a foreign currency.[50] Virtual currency that has an equivalent value in real currency, or acts as a substitute for real currency, such as Bitcoin, is referred to as "convertible" virtual currency and is considered property for federal income tax purposes. Accordingly, general tax principles applicable to property transactions apply to transactions involving convertible virtual currency.

Bitcoin, Ether, and Litecoin are all forms of cryptocurrency, a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain.[51] Distributed ledger technology uses independent digital systems to record, share, and synchronize transactions, the details of which are recorded in multiple places at the same time with no central data store or administration functionality. Cryptocurrencies may be used as a method of payment; however, many taxpayers transact in cryptocurrency for investment or other purposes. Major cryptocurrencies like Bitcoin and Ether typically may be traded for any other cryptocurrency and vice versa. However, some cryptocurrencies on a cryptocurrency exchange can be traded for only a limited number of other cryptocurrencies and cannot be traded for fiat currency at all.

Thus, the key issue at hand was whether the cryptocurrencies at issue were of "like kind." Drawing analogies to rulings holding that gold bullion and silver bullion were *not* of like kind,[52] and that numismatic-type gold coins were *not* of like kind to bullion-type gold coins,[53] the IRS ruled that Bitcoin, Ether and Litecoin are not of like kind because they each possess a different "nature or character" to each other. According to the IRS, in 2016 and 2017, Bitcoin, and to a lesser extent Ether, held a special position within the cryptocurrency market because the vast majority of cryptocurrency-to-fiat trading pairs offered by cryptocurrency exchanges had either Bitcoin or Ether as part of the pair. In other words, an individual seeking to invest in a cryptocurrency other than Bitcoin or Ether, such as Litecoin, would generally need to acquire either Bitcoin or Ether first. Similarly, an individual seeking to liquidate his or her holdings in a cryptocurrency other than Bitcoin or Ether, such as Litecoin, generally would need to first exchange those holdings for Bitcoin or Ether. In contrast, Litecoin's trading pair availability at the time was substantially more limited. Thus, Bitcoin and Ether played a fundamentally different role from other cryptocurrencies within the broader cryptocurrency market during 2016 and 2017. Unlike other cryptocurrencies, Bitcoin and Ether acted as an on and off-ramp for investments and transactions in other cryptocurrencies. Because of this difference, Bitcoin and Ether each differed in both nature and character from Litecoin, and so were not of like kind with Litecoin.

In addition, while Bitcoin and Ether shared similar qualities and uses, the IRS found that they too were fundamentally different from each other because of the difference in overall design, intended use, and actual use. The Bitcoin network was designed to act as a payment network for which Bitcoin acts as the unit of payment. The Ethereum blockchain, on the other hand, was intended to act as a payment network and as a platform for operating smart contracts and other applications, with Ether working as the "fuel" for these features. Thus, although Ether and Bitcoin may both be used to make payments, Ether's additional functionality differentiated Ether from Bitcoin in both nature and character, and, thus, they also were not of like kind.

Gluck v. Commissioner, 129 AFTR 2d 2022-1103 (2nd Cir. March 17, 2022)

In *Gluck*, the taxpayers sold a condominium and then attempted to complete a Section 1031 exchange by purchasing an interest in a rental apartment building in New York. However, the record clearly

established that rather than purchasing an interest in the real estate, the taxpayers instead purchased a 50% interest in a partnership that owned the real estate. The partnership's tax returns reported the transaction in this manner (i.e., with the partnership owning the real estate, the taxpayers purchasing a 50% interest in the partnership, and the partnership thereafter providing a Schedule K-1 to the taxpayers). The IRS determined that the purported Section 1031 exchange failed, because partnership interests were specifically excluded under Section 1031(a)(2)(D), and assessed additional tax liability of more than $1.5 million. The taxpayers appealed to the Tax Court, which dismissed the petition on procedural grounds that, because the taxpayers had failed to file a Notice of Inconsistent Treatment (Form 8082), the Tax Court lacked jurisdiction over the redetermination claim. The Second Circuit upheld the Tax Court determination dismissing the taxpayers' petition.

PLR 202309007 (March 3, 2023)

This PLR involved an exchange of water rights for a fee interest in other real property. In Year 1, "Founder" began "Ranch" and was the original licensee of a "License" for the diversion and use of water issued by "State A," having a priority date of "Date A." Taxpayer and certain other "Ranch Owners" were the successors in interest to Founder and now owned the land comprising the former Ranch, with each party owning "its respective property in fee simple" (and not, apparently, as tenants in common). Ranch was a diversified farming and cattle operation producing crops adjacent to additional rangeland, and the Ranch Owners (including Taxpayer) did not carry on a joint business activity, had never filed partnership tax returns with respect to their ownership of their respective properties, and engaged in their own separate business activities.

The Ranch Owners (including Taxpayer) also were successors in interest to Founder's rights under the License. Pursuant to the License, the Ranch Owners owned the right to divert "y cubic feet per second (about z gallons per minute)" (the "Diversion Rate") of water from "River" during a specified annual "Diversion Season." The ruling states that if diversions were made at the maximum allowed rate for 24 hours a day for the Diversion Season, "the maximum allowed annual diversion amount would be A acre-feet." The ruling refers to the Ranch Owners' rights to use these waters as the "Water Rights."

The lands where the diverted water was put to beneficial use for irrigation purposes totalled "B acres" of the Ranch (such portion, the "Land"), and each of the "Ranch Owners owned a specified percentage of the Land."[54] Although the Ranch Owners each owned different percentages of the Land, each had full access to and the right to divert water under the License. The Ranch Owners agreed that if all or a portion of the Water Rights were sold, the proceeds would be allocated in accordance with their relative percentage interests in the Land.

Taxpayer intended to sell a portion of Taxpayer's Water Rights to a third party "Buyer" in exchange for a cash purchase price, which Taxpayer intended to use to acquire replacement real property through a Section 1031 exchange. In the sale, Taxpayer agreed to permanently sell a portion of the License to Buyer, with Taxpayer retaining the balance of its share of the Water Rights not sold. Pursuant to State A law, the License then would be bifurcated into two separate licenses – one vested in Taxpayer and one vested in the Buyer. Taxpayer requested a ruling that the Water Rights were real property for Section 1031 exchange purposes.

In its analysis, the IRS discussed Revenue Ruling 55-749,[55] which ruled that perpetual water rights that were considered real property under applicable state law were of like kind to a fee interest in land. The ruling states that since the water rights granted were "in perpetuity" and not merely rights "to a specific total amount of water or to a specific amount of water for a limited period," they were of like kind to the fee interest in land. The IRS then discussed *Wiechens v. United States*[56], which held that certain water rights (that were real property under state law) that were limited in duration

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[90] *See* Rev. Proc. 2001-28, 2001-1 C.B. 1156, Section 4.05 ("No member of the Lessee Group may lend to the lessor any of the funds necessary to acquire the property, or guarantee any indebtedness created in connection with the acquisition of the property by the lessor. A guarantee by any member of the Lessee Group of the lessee's obligation to pay rent, properly maintain the property, or pay insurance premiums or other similar conventional obligations of a net lease does not constitute a guarantee of the indebtedness of the lessor.")

[91] One must consider the proper interpretation of the term "Lessee Group" in Rev. Proc. 2001-28 ("That is, after the property is first placed in service or use by the lessee, the lessor must not be entitled to a return of any portion of the Minimum Investment through any arrangement, directly or indirectly, with the lessee, a shareholder of the lessee, or any party related to the lessee (within the meaning of section 318 of the Internal Revenue Code)").

[92] There are a number of judicially created doctrines that may conceivably apply to the DST's contractual arrangements, including the economic substance and business purpose, sham transaction, substance-over-form, and step transaction doctrines.

[93] REITs are subject to a tax equal to 100% of the net income derived from certain prohibited transactions. *See* Section 857(b)(6)(A). For this purpose, a prohibited transaction is the sale of property that is held by the REIT for sale in the ordinary course of a trade or business other than foreclosure property. *See* Section 857(b)(6)(B). In light of the draconian impact of this tax, REIT asset managers seeking to utilize DST structures do so via a Taxable REIT Subsidiary ("TRS") directly owned by the REIT's operating partnership. *See* Section 856(l).

[94] The use of UPREIT roll-up features in connection with Section 1031 real estate structures (TICs and DSTs) is a common technique used frequently over the past decade by several REIT asset managers. *See* Lipton, Donovan and Kassab, "Defense of TICs and DSTs", Reprinted from the Proceedings of the USC Gould School of Law's Fifty-Ninth Institutes on Federal Taxation—Major Tax Planning for 2007, Mathew Bender (Rel. 59-8/2007, Pub. 750).

[95] Section 721. *See also* Section 752 providing that an increase in a partner's share of partnership liabilities is treated as a contribution of money by such partner to the partnership and that a decrease in a partner's share of a partnership's liabilities is treated as a distribution to that partner. To the extent the net effect results in a deemed distribution in excess of such partner's outside basis, taxable gain will be recognized. To prevent this undesirable result, some taxpayers enter into vertical slice guarantee agreements to provide sufficient outside basis to prevent a taxable recognition event. *See* Cullen and Gong, "UPREITs: Vertical Slice Guaranty Agreements", J. of Passthrough Entities, Sept.-Oct. 2017, pg. 41; *see also* Lipton, "The Sky is not Falling, Vertical Slice Guarantees are an Acceptable Alternative to Bottom Dollar Guarantees for most UPREIT Transactions," J. of Tax'n (May, 2017).

[96] *See* Rev. Proc. 2002-22, Section 6.10.

[97] *See L. W. Hardy Co. Inc. v. Comm'r*, T.C. Memo 1987-63; *Transamerica Corp. v. U.S.*, 15 Cl. Ct. 420 (1988), *aff'd* 902 F.2d 1540 (Fed. Cir. 1990); *Cooper v. Comm'r*, 88 T.C. 84 (1987); *Belz Inv. Co. v. Comm'r*, 72 T.C. 1209 (1979), *aff'd* 661 F.2d 76

to 50 years, limited in quantity to a specific percentage of the overall supply of agricultural water, and limited in priority to be secondary to municipal, industrial and Indian uses, were not of like kind to a fee interest in farmland. The District Court held the because the taxpayer's water rights were narrowly restricted in priority, quantity, and duration, they did not have the same "nature and character" as a fee interest and the properties were not of like kind.

Ultimately, the IRS concluded that the Water Rights at issue in PLR 202309007 were "real property," as that term is used in Section 1031, because the Water Rights were classified as real property under State A law, the Water Rights granted the Ranch Owners rights to a set volume of water during the annual Diversion Season, the Water Rights were not limited to a maximum total amount of water, and the Water Rights were of a perpetual duration. In addition, the IRS also ruled that the Water Rights were of like kind to a fee interest in real property under Revenue Ruling 55-749.

This ruling is very favorable in the sense that it confirms that *perpetual* water rights are considered real property and of like kind to a fee interest for Section 1031 exchange purposes. The ruling is somewhat inconsistent, however, in the sense that it states that the Water Rights at issue were allowed a "maximum allowed annual diversion amount" of water, but later concludes that the "Water Rights are not limited to a maximum total amount of water." Thus, it appears that the fact that the Water Rights were considered real property under applicable state law, and were of a perpetual duration, primarily influenced the outcome.

PLR 202335002
(September 1, 2023)

Taxpayer owned Property 1 (held for productive use in a trade or business or for investment) through a disregarded entity subsidiary, and intended to dispose of Property 1 through a Section 1031 exchange. Taxpayer also owned Property 2 through a separate disregarded entity, which Taxpayer intended to develop into an office building to be held for rental income. As part of the Section 1031 exchange for Property 1, Taxpayer intended to acquire certain "transferable development rights" ("TDRs") to be applied to enhance the development of Property 2. The TDRs originated from a Memorandum of Understanding between City B and District that accommodated the District's acquisition of certain property in City B to be developed into a public park, and allowed the District to fund such acquisition in part through the sale of the TDRs. The TDRs would be sold to third party purchasers, who then would seek approval from City B to apply such TDRs to designated sites to allow for development of additional floor area than would otherwise be permitted under normal zoning. Once purchased, the TDRs would become permanent in the hands of the acquirer once a Certificate of Transfer of Development Rights was recorded.

Taxpayer previously received approval from City B to apply the TDRs in question to the development of the Property 2 office building in order to increase the floor area for development. The Property 2 project, once constructed, would be held for rental income by Taxpayer. Taxpayer represented that the TDRs were considered an interest in real property under State Z law.

The IRS noted that the TDRs were real property under applicable State Z law, that land development rights generally are real property for purposes of Section 1031 under Treas. Reg. § 1.1031(a)-3(a)(5)(i), and that the TDRs were permanent rights once recorded. As such, the IRS ruled that the TDRs, as real property to be held to enhance the development of Property 2, were of like kind to Property 1. The IRS reached this conclusion despite the fact that the TDRs were to be used to develop a property already owned by the Taxpayer (Property 2). Relying on Revenue Ruling 68-394,[57] which allowed a taxpayer to replace condemned land under Section 1033 through the acquisition of an unrelated lessee's position in a ground lease with 45 years remaining to run on land already owned by the taxpayer, the IRS concluded that this fact was irrelevant.

Related Party Exchanges

***Malulani Group, Ltd & Subsidiary v. Commissioner*, 123 AFTR 2d 2019-2109 (9th Cir. June 12, 2019)**

The taxpayer in *Malulani* was a Hawaii-based corporation in the business of leasing commercial real estate. The taxpayer disposed of relinquished property located in Maryland, deposited the net exchange proceeds with a qualified intermediary, and subsequently used those funds to acquire replacement property located in Hawaii that was owned by a wholly-owned subsidiary of the taxpayer (i.e., a related party). The Tax Court denied the Section 1031 exchange on the grounds that the transaction violated the related party rules of Section 1031(f)(4), and the 9th Circuit affirmed.

The transaction at issue was similar to those involved in two prior cases in which the Tax Court considered whether a deferred exchange between related persons violated section 1031(f)(4): *Ocmulgee Fields, Inc. v. Commissioner*,[58] and *Teruya Bros., Ltd. & Subs. v. Commissioner*.[59] In both cases, the taxpayers received replacement property from related parties in deferred exchanges involving qualified intermediaries. The Tax Court held in both cases that the substance of the transactions dictated that investment in the relinquished property had been cashed out, contrary to the purpose of Section 1031(f).

The Tax Court in *Malulani* found that the transaction in this case was no different than *Ocmulgee* and *Teruya Bros*. Thus, in effect, the taxpayer cashed out the investment in the Maryland property with the related party retaining the cash proceeds. The Tax Court rejected two taxpayer arguments as to why its exchange should qualify for the "non-tax-avoidance" exception in Section 1031(f)(2)(C). First, the Tax Court deemed the taxpayer's bona fide, but failed, effort to purchase replacement property from an unrelated party as irrelevant for Section 1031(f)(2)(C) purposes. Second, the Tax Court found the taxpayer's argument that the related party had a relatively low tax basis in the Hawaii property also not relevant for Section 1031(f)(2)(C) purposes. Although Congress enacted Section 1031(f) to limit

the exchange of high basis property with low basis property in order to reduce recognition of gain upon subsequent sale, the Tax Court denied the taxpayer's argument in part because the related party seller had net operating losses in excess of its recognized gain.

In a brief opinion, the 9th Circuit affirmed the Tax Court, reasoning as follows:

> Rather than engaging in the intricate like kind exchanges that achieved favorable tax consequences for Malulani and [its subsidiary,] Malulani could have simply consummated the sales itself. Had it done so, Malulani would have had to recognize a $1,888,040 gain. Because the aggregate tax liability arising out of the exchange was significantly less than the hypothetical tax liability that would have arisen from a direct sale between the related parties, the like kind exchange serviced tax-avoidance purposes. Therefore, Malulani was not entitled to nonrecognition of gain under § 1031.

In sum, *Teruya Bros.*, *Ocmulgee* and now *Malulani* continue to stand for the proposition that the IRS will scrutinize 1031 exchanges involving related parties, and transactions are at high risk where a taxpayer sells relinquished property and acquires replacement property from a related party in a taxable transaction.

Section 1245 Recapture

Gladys L. Gerhardt, et al, v. Commissioner, 160 T.C. 9 (April 20, 2023)

In *Gerhardt*, Jack and Shelley Gerhardt owned the "Armstrong Site" located in Armstrong, Iowa, consisting of raw land, hog buildings and equipment, and valued at $300,000 and having an adjusted basis of approximately $15,000. When taxpayers previously purchased this property, they allocated 98.4% of the purchase price to the buildings and equipment (all of which were Section 1245 property),[60] and only 1.6% of the purchase price to the land. In 2017, taxpayers relinquished the Armstrong Site, plus $90,000 of cash, to Andrew Gerhardt[61] in exchange for the "Cape Coral" property, valued at $390,000. The decision does not describe the Cape Coral property and whether it consisted of any Section 1245 property. Taxpayers treated this transaction in full as a Section 1031 exchange. On audit, the revenue agent determined that the entire $285,000 gain realized from the disposition of the Armstrong Site should be recognized and recaptured as ordinary income under Section 1245. Taxpayers, however, argued that Section 1031 trumped Section 1245, and therefore the gain from the disposition of the Armstrong Site was deferred.

The Tax Court began its analysis with a review of the interplay between Sections 1031 and 1245. Generally, Section 1245(b)(4) provides that if property that is Section 1245 property is relinquished as part of a Section 1031 exchange, then the amount of gain to be recaptured under Section 1245(a)(1) "shall not exceed the sum of (A) the amount of gain recognized on such disposition (determined without regard to this section), plus (B) the fair market value of property acquired which is not section 1245 property and which is not taken into account under subparagraph (A)." In plain English, this provisions means that if a taxpayer relinquishes Section 1245 property containing recapture potential, the taxpayer must recognize this recapture to the extent of (A) taxable boot received in the exchange plus (B) the fair market value of like kind property received in such exchange that is not Section 1245 property. Ultimately, the Tax Court held that because the taxpayers presented no evidence as to the relative fair market value allocations among the land (non-Section 1245 property) and hog buildings and equipment (Section 1245 property), then the revenue agent's allocation of 100% of the consideration to Section 1245 property was valid, and therefore the entire gain was recaptured as ordinary income under Section 1245(a)(1).

Gerhardt should serve as a warning to be mindful of purchase price allocation provisions in purchase and sale agreements, especially when exchanging property that is subject to Section 1245 recapture, such as property that has been depreciated under a cost segregation study. As noted above, the Final Regulations state:

> No inference is intended with respect to the classification or characterization of property for other purposes of the Code, such as depreciation and sections 1245 and 1250. For example, a structure or a portion of a structure may be section 1245 property for depreciation purposes and for determining gain under section 1245, notwithstanding that the structure or the portion of the structure is real property under this section. Also, a taxpayer transferring relinquished property that is section 1245 property in a section 1031 exchange is subject to the gain recognition rules under section 1245 and the regulations under section 1245, notwithstanding that the relinquished property or replacement property is real property under this section. In addition, the taxpayer must follow the rules of section 1245 and the regulations under section 1245, and section 1250 and the regulations under section 1250, based on the determination of the relinquished property and replacement property being, in whole or in part, section 1245 property or section 1250 property under those Code sections and not under this section.[62]

Thus, the regulations are clear that property may be both Section 1245 property (for depreciation and recapture purposes) and also real property (for Section 1031 exchange purposes). If Section 1245 property (such as structural components of a building that have been classified as personal property

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(6th Cir. 1981), *acq*. 1980-2 C.B. 1; *Northwest Acceptance Corp. v. Comm'r*, 58 T.C. 836 (1972), *aff'd* 500 F.2d 1222 (9th Cir. 1974); *Lockhart Leasing Co. v. Comm'r*, 54 T.C. 301 (1970), *aff'd* 446 F.2d 269 (10th Cir. 1971); *see also* Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1984 (1984) ("Where [a] purchase option was more than nominal but relatively small in comparison with fair market value, the lessor was viewed as having transferred full ownership because of the likelihood that the lessee would exercise the option.").

98 *See supra*, "Exchanges Involving Partnerships".

99 Staff of the Joint Committee on Taxation, General Explanation of Legislative Enacted in the 108th Congress (JCS-5-05), page 421.

100 For a more detailed discussion of Section 470 and Section 1031, *see* Cullen and Donovan, "The Impact of Tax-Exempt Leases on RESOS", Vol. 33, No. 1 Real Estate Tax'n, 32 (Fourth Quarter, 2005).

in a cost segregation study), that is also real property for Section 1031 purposes, is disposed of in a Section 1031 exchange, the Section 1245 recapture regime will trump the Section 1031 deferral regime.

In these situations, taxpayers and their advisors have two primary methods to minimize the amount of Section 1245 recapture in the exchange. First, if the relinquished property consists of Section 1245 property but the replacement property has zero or minimal Section 1245 property, then the taxpayer should negotiate a purchase price allocation with the buyer of the relinquished property that minimizes the allocation of consideration to the Section 1245 property components, and maximizes the allocation to the balance of the non-Section 1245 property (i.e., land, buildings, and inherently permanent structures). Alternatively, if both the relinquished property and replacement property consist of some Section 1245 property, the taxpayer should instead seek purchase price allocations on both sides of the transaction to reach equivalent fair market value allocations to the Section 1245 properties. In this circumstance, the Treasury Regulations provide a favorable ordering rule that first allocates the value of the replacement Section 1245 property received against the value of the relinquished Section 1245 property disposed of, which serves to minimize the overall amount of recapture in the exchange.[63] In *Gerhardt,* the record indicates that the taxpayers failed to attempt either approach, and so the entire gain was determined to be ordinary income under Section 1245(a)(1).

Exchanges Involving Partnerships

The rules applicable to exchanges involving partnerships were extensively discussed in State of the Art in Like Kind Exchanges, 2009 ("SOTA 2009"), and in State of the Art in Like Kind Exchanges, 2012 ("SOTA 2012").[64] Among those rules were a frequently encountered pair of questions relating to partnerships and Section 1031 transactions, whether a taxpayer can exchange property received in a distribution from a partnership (a "drop and swap"), and whether a taxpayer who receives replacement property in an exchange can immediately transfer the property to a partnership (a "swap and drop"). Both transactions have been targeted by both the IRS and state tax authorities. The main challenges raised with respect to both transactions are (1) whether the taxpayer seeking to accomplish the exchange meets the "held for" test under the language of Section 1031(a)(1), which requires that both relinquished property and replacement property be held for productive use in a trade or business or for investment in a trade or business, and (2) whether the transaction is susceptible to challenge under the *Court Holding* doctrine,[65] wherein the IRS may potentially recast the transaction as a disposition by one taxpayer and a replacement by a different taxpayer, which would result in a failed exchange. In addition, even if properly structured on paper, the taxpayer must actually carry out the steps as planned, or else the transaction may fail on substance-over-form grounds.[66]

Over the years, taxpayers and their advisors have developed varying strategies to avoid these potential challenges, including (1) special allocations of gain to cash-out partners, (2) use of installment notes (either from the actual purchaser of the relinquished property or from the qualified intermediary facilitating the transaction) delivered to the seller of the relinquished property after closing, (3) distributions of tenancy-in-common interests from partnerships to the partners prior to the sale or exchange of such interests by such persons (i.e., a classic drop and swap), (4) use of "tracking" allocations within the partnership to own replacement properties earmarked for certain partners, (5) partnership division transactions, and (6) more recently, synthetic drop and swaps undertaken by converting the partnership into a Delaware Statutory Trust ("DST") (or a series LLC) under state law. For an in depth discussion of the IRS positions, cases and rulings, and legal strategies applicable in the context of drop and swaps and swap and drops, we refer you to SOTA 2009 and SOTA 2012 and their progeny.

DSTs: Investment Trusts Structured as Replacement Property

Nearly two decades ago the IRS issued Rev. Rul. 2004-86[67] (the "Ruling") addressing whether a DST will be treated as a disregarded trust or a business entity for federal income tax purposes. The Ruling held that if a trust is properly structured as a fixed investment trust,[68] and satisfies the requirements of a grantor trust under Section 671, interests in such trust will be treated as direct interests in the underlying real property owned by the trust (as opposed to beneficial interests in the trust itself) for purposes of applying the like-kind exchange rules under Section 1031.[69] By treating interests in a DST as direct interests in real property, the Ruling allows taxpayers disposing of real estate in an otherwise-qualifying like-kind exchange to acquire DST interests as qualifying replacement property, and vice versa. In contrast, if the trust is treated as a business entity and not a fixed investment trust, the trust interests will be treated as interests in a partnership and, therefore, will not constitute qualifying replacement property. With this latter treatment resulting in catastrophic failure for an intended like-kind exchange, it is crucial that a DST be properly structured and executed within not only the framework of the Ruling but also the relevant case law and judicially created doctrines.[70] In the nearly twenty years since the issuance of the Ruling, DSTs have become the preferred structure for syndicated tax-deferred exchanges of undivided fractional interests in real property. Over this time, several key DST tax structuring approaches have emerged to address asset class specific property management needs in the context of the Ruling's stringent requirements. The following discussion provides an overview of these DST structuring issues.

Limitation of Powers

A threshold structuring requirement for ensuring a Ruling-compliant DST is the limitation of the powers of the trust, trustees (and their designees, such as a trust manager) and beneficial owners (investors) under the DST's governing trust agreement. In the Ruling, the trust agreement specifically forbade the DST from undertaking seven categories of prohibited actions. One of your co-authors was the first to call these restrictions "the seven deadly sins," and the name stuck.[71] Importantly, the DST described in the Ruling actually lacked the power under its operative agreements to undertake such actions—it was not simply a matter of the DST avoiding such activities. To ensure a DST does not unintentionally create a business entity (e.g., through an agency relationship, deemed partnership or otherwise), the DST's trust agreement should affirmatively limit the power and authority of the relevant parties and expressly prohibit the various parties from taking actions in violation of the guidance in the Ruling.[72] The mere existence of the prohibited powers (even without the actual exercise of such power) is sufficient to frustrate the desired DST classification as an investment trust for federal income tax purposes.

Varying the DST's Investment and Property Modifications

Correctly limiting the power to vary the DST's investment stands as the cornerstone of properly classifying a DST as a fixed investment trust for federal income tax purposes.[73] A power to vary the DST's investment exists where there is a power under the trust agreement that enables a trust to take advantage of fluctuations in the market to improve the investment of the beneficial owners. A well-drafted trust agreement will expressly limit this power. This legal construct is further developed within the Ruling where it provides that a DST cannot "…make more than minor non-structural modifications to [the DST's property] not required by law…."[74] This "modifications" limitation has created undue consternation for many asset managers (and tax counsel) due to the lack of clear guidance as to what type of modifications will or will not violate the rule.[75] In practice, many practitioners interpret this rule by analogy, looking to the REIT "prohibited transaction" rules and applying a 30% of value test in determining what constitutes "minor."[76] Moreover, the majority view is that common repairs, replacements and maintenance are distinguishable from prohibited "modifications" contemplated in the Ruling.[77] Careful review and discussion of desired property management plans is a critical step in evaluating and structuring a Ruling-compliant DST transaction.

Master Lease Arrangements

The management activities of a DST (undertaken by its Trust Manager) should not exceed the prohibitions set forth in the Ruling and the case law underlying the investment trust regulations.[78] Although the operation of a rental property is a trade or business, a DST should not be involved in active management of the property beyond the level of activity customary for rental property.[79] As stated above, properly limiting the powers of the various DST structural parties is a key element of designing a Ruling-compliant investment trust. DSTs must actually conduct their business in a manner that is consistent with and confined by the investment trust rules (*e.g.*, the seven deadly sins).[80] This includes handling the leasing and operations of the DST's property consistent with the Ruling and any limitations imposed by the trust agreement. The Ruling prohibits, among other actions, the DST's ability to renegotiate leases or enter into new leases (except in the case of a tenant bankruptcy or insolvency). Absent proper structuring, this limitation would prevent a DST's ability to effectively own certain asset classes (particularly the multifamily asset class where dwelling unit-level tenants may be coming and going on a monthly basis). The most common means of addressing this structuring need is to interpose a "master lease" with a master tenant entity owned by the asset manager or REIT operating partnership. Under this approach, the DST and master tenant enter into a master lease that complies with the Ruling and which cannot be modified, while the master tenant entity then serves as landlord to sub-tenants and is free to operate and maintain the property, enter into new leases with new sub-tenants, and take other necessary management actions without causing the DST (as master landlord) to violate the Ruling.[81] Under a master lease structure, the parties must be careful to structure the master lease, asset management agreements and financing documents in a way that creates a "true lease"[82] and not a deemed partnership[83] or deemed financing[84] for federal income tax purposes. It is also critical that the master tenant have economic substance in its own right,[85] which is often accomplished by some combination of participation in gross revenues generated by the DST's property and a capital contribution or demand note providing capital to the master tenant entity. Participation by the master tenant in gross revenues must only be based on "gross rents" and not a net amount in order to avoid potential deemed partnership treatment.[86] It should be noted that the use of a master lease does not necessarily allow the master tenant to take any action the DST cannot take on directly. For example, many practitioners believe a master tenant is also prohibited from making more than "minor, non-structural modifications" to the underlying property.[87] If structured properly, the use of a master tenant structure facilitates a DST's ability to own a broader scope of real estate asset classes (and thereby allowing a broader group of asset managers access to the benefits of using DST transactions to grow assets under management).

DST Financing

As with the leasing and operational considerations discussed above, a Ruling-compliant DST should be locked into the terms of its financing and should close on such financing prior to such time that the DST becomes an investment trust.[88] The Ruling prohibits, among other actions, the DST's ability to renegotiate existing financing or enter into any new financing (except in the case of a tenant bankruptcy or insolvency). DST financings are often

complicated, due to the requirements under the Ruling, and the presence of the master lease in many DST structures. In light of the deemed partnership risks, and necessity that the master lease be viewed as a "true lease" for federal income tax purposes, it becomes critical to structure the financing so that the DST is the only entity that could be viewed as a borrower under the loan and the DST is not deemed to have entered into a loss-sharing arrangement with either the master tenant (if applicable) or the sponsor.[89] In addition, it is important that the lender (to the DST or beneficial owners) is unrelated to the master tenant, otherwise the loan structure may jeopardize the "true lease" status of the DST master lease.[90] In contrast, a lender under common management control, but legally unrelated to the master tenant under the federal income tax attribution rules,[91] should be permissible in a Ruling-compliant DST financing transition, subject in all cases to substantive compliance with various applicable judicial doctrines.[92]

UPREIT Call Options

Currently, several notable REIT asset managers are deploying[93] DST structures to gain access to exchangers with Section 1031 relinquished-property proceeds available to invest into institutionally managed real estate opportunities.[94] In most cases, the property owned by the DST is subject to a fair market value call option held by the REIT's operating partnership. The call option terms currently used are nearly universally based on fair market value at the time of exercise, but vary in terms of consideration paid (usually cash or operating partnership units, often at the REIT's election – but sometimes at the election of the DST beneficial owners). Generally speaking, the exercise of the call option should be tax deferred to the DST beneficial owners.[95] In addition, this call option feature should not create the existence of a "deemed partnership" for federal income tax purposes, which otherwise would compromise an investor's ability to complete a like-kind exchange.[96] Moreover, this call option feature should not jeopardize a DST master lease structure from being properly characterized as a "true-lease" for federal income tax purposes. A number of courts have concluded that a true lease exists even when the lessee has the right to purchase the leased property at a fixed price so long as the purchase price represented an estimate of the fair market value of the leased property as of the option date, or was not nominal in relation to such value.[97] Given the expanded access to indirect equity funding, and related positive impact on assets under management, provided by DST transactions, we anticipate continued growth in the use of DST structures by REIT operating partnerships.

Using DSTs for Partnership Exchanges

As noted above in the discussion concerning Partnership Exchanges, when the partners cannot agree on an exchange and are otherwise considering a "drop and swap" transaction, a new "technique" for a synthetic drop and swap transaction uses DSTs by having the partnership elect under state law to be converted into a DST and then amending and restating the partnership/LLC agreement to make it compliant with the requirements of Revenue Ruling 2004-86. This conversion has the advantage of not requiring any actual transfer of the property, and in some instances the conversion does not require lender or other approvals. This technique works very well when the property is otherwise appropriate for a DST (such as undeveloped land or a triple net leased property), but caution must be exercised if the property is otherwise not suitable for a DST, *e.g.*, a property that is involved in refinancing or needs capital improvements. That said, because no transfer is required, this approach has become quite popular over the last few years, to the point where dropping a tenant-in-common interest to a dissenting partner has become much less frequent.

Notably, because the legal entity owner of the subject property does not change in a synthetic drop and swap using a DST conversion, some practitioners state the view that the DST conversion avoids potential challenge under the *Court Holding* doctrine.[98] Many other advisors, however, view the DST conversion as a constructive liquidation of the prior partnership that owned the property, and thus as a deemed distribution of the property, with full exposure to the same slate of *Court Holding* considerations. Conservative taxpayers and advisors, therefore, should strive to close the DST conversion prior to executing a contract for sale of the underlying relinquished property.

DST Due Diligence Trap - Section 470

Section 470 places a limitation on deductions allocable to property used by tax-exempt entities ("tax-exempt leases") and, more importantly with respect DST transactions, prohibits a taxpayer from using any portion of a property subject to a tax-exempt lease as replacement property in a like-kind exchange transaction under Section 1031. The impact of Section 470 on DST transactions is potentially devastating - if applicable, the underlying tax planning goal is fully unavailable; the real estate becomes ineligible to serve as qualifying replacement property under Section 1031. The legislative history to Section 470 indicates that it is not intended to inhibit legitimate commercial transactions,[99] but it remains a trap for the uninformed. In light of the limitations imposed on like-kind exchanges, a detailed review of all tax-exempt leases has become a critical part of the due diligence process when structuring a DST transaction intended to qualify as like-kind replacement property.[100]

Conclusion

The world of like-kind exchanges continues to evolve. Some of the changes, such as the clarification of the definition of "real property" in the Final Regulations, have been very helpful; the continuing threat to repeal Section 1031 by the Biden Administration has not been helpful. Many of the most significant recent developments involve the usage of DSTs, both as replacement property and to address partnership exchange issues. And the only certainty is that when your co-authors re-visit like-kind exchanges in a few years, there will be new developments for practitioners to consider.