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Memorandum**

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subject: Conflicting State Law Classifications of Exchange Properties in § 1031 Transactions

This memorandum responds to your request for advice dated January 20, 2012.

ISSUE

How do state law characterizations of property as real or personal affect whether the property is of like kind for purposes of § 1031 of the Internal Revenue Code?

CONCLUSIONS

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

FACTS

Case 1: A natural gas pipeline in State A (constructed along a right of way on real property) that is classified as personal property in State A is exchanged for a State B

natural gas pipeline that is constructed along a right of way on real property and that is classified as real property in State B. (The right of ways associated with the exchanged pipelines in State A and State B are also exchanged.)

Case 2: A steam turbine attached as a fixture in a State A land improvement (a building) as a component of a system for the commercial production of electricity that is treated as real property in State A is exchanged for a steam turbine attached as a fixture in a State B land improvement as a component of a system for the commercial production of electricity that is treated as personal property in State B. (The land and buildings associated with the steam turbines in both State A and State B are also exchanged.)

Case 3: A steam turbine that is attached as a fixture in a State A land improvement (a building) as a component of a system for the commercial production of electricity and that is treated as real property in State A is exchanged for raw land in State B. (The land and building associated with the steam turbine were also exchanged as part of the transaction.)

Case 4: A steam turbine that is attached as a fixture in a State A land improvement (a building) as a component of a system for the commercial production of electricity and a State A natural gas pipeline (constructed along a right of way on real property), both treated as real property in State A, are exchanged for a State B natural gas pipeline (constructed along a right of way on real property and that is identical in all material physical respects to the State A natural gas pipeline) that is treated as personal property in State B. (The land, buildings and right of ways associated with the steam turbine and pipelines were also exchanged as part of this transaction.)

APPLICABLE LAW AND ANALYSIS

Section 1031(a) of the Code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1.1031(a)-1(b) of the regulations provides that the words like kind have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under § 1031, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

Section 1.1031(a)-1(c) provides examples of exchanges of property of a "like kind," stating that no gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new

passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

The earliest clear authority for the principle that state law is determinative of the classification of property rights as real or personal is in *Morgan v. Commissioner*, 309 U.S. 424 (1940) *as amended on denial of rehearing*. See also *Aguilino v. United States*, 363 U.S. 509, 513 (1960). In *Morgan*, the Supreme Court specifically acknowledged that state law creates legal interests and rights. *Morgan* at 426.

In addition, a number of cases use state law real property and personal property classifications in determining whether exchanged property is of like kind. For example, in *Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941), the 5th Circuit determined that a mineral right is real property under Louisiana state law and thus of like kind to other real property. Similarly, in *Peabody Natural Resources Co. v. Commissioner*, 126 T.C. 261 (2006), the Tax Court determined that under New Mexico law, coal supply contracts constituted real property interests and were of like kind to the relinquished gold mine. See also *Oregon Lumber Co. v. Commissioner*, 20 T.C. 192 (1953), which held that a taxpayer's transfer of a fee interest in property in exchange for timber cutting rights in property is not an exchange of like kind property because the Tax Court held the timber cutting rights to be personal property. Some may argue that property classified as real property in State A cannot be of like kind to property classified as personal property in State B. We disagree.

Although the above-cited opinions in *Crichton*, *Peabody* and *Oregon Lumber* include discussions of state law characterizations, the courts relied on more than just the state law classifications in their analysis of whether the exchanged properties are of like kind. The court in *Oregon Lumber* stated the following: "It is our conclusion that the right to cut and remove standing timber is so intrinsically different from a fee in land that an exchange of one for the other is not an exchange of property within [the predecessor of § 1031]. The right to cut and remove is transient and depends upon the affirmative action of the holder of that right. The fee is permanent and depends only on the original grant." 20 T.C. at 197-98. Thus, the Court considered not just state law classifications, but also whether the properties were substantially similar or substantially different. Similarly, the Tax Court in *Peabody*, citing to § 1.1031(a)-1(b), stated that in making a like-kind determination, "consideration should be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from the grade and quality." 126 T.C. at 273. Moreover, the Supreme Court in *Morgan*, *supra*, noted the importance of federal law by stating that "federal revenue acts designate what interests or rights, so created, shall be taxed. . ." and ". . . federal law must prevail no matter what name is given the interest or right by state law." *Id.* at 426.

Other cases also demonstrate that the § 1031 like-kind determination is a question of federal law rather than state law. For example, *Fleming v. Commissioner*, 24 T.C. 818, 823-24 (1955), *revd*, 241 F.2d 78 (5th Cir. 1957), *revd sub nom. Commissioner v. P.G. Lake, Inc.*, held that carved-out oil payments, although characterized as real property under state law, are not of like kind to a fee interest in real property. In *Clemente Inc. v. Commissioner*, T.C. Memo. 1985-367, an eight acre parcel of land was held not of like kind to gravel extraction rights on other property. See *also* Rev. Rul. 68-331, 1961-1 C.B. 352 (interest in producing mineral lease is of like kind to improved ranch; and Rev. Rul. 55-749, 1955-2 C.B. 295 (perpetual water rights are of like kind to land).

Sections 48, 263A, and 1245 of the Internal Revenue Code and the regulations thereunder are informative as to whether property is real or personal for federal income tax purposes. For example, § 1.263A-8(c)(1) of the regulations provides, in part, that real property includes land, unsevered natural products of land, buildings, and inherently permanent structures. Section 1.263A-8(c)(3) describes “inherently permanent structures” as including “property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as swimming pools, roads, bridges, tunnels . . . telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment. . . .” Section 1.263A-8(c)(4)(i) generally provides that machinery that is not a structural component of an inherently permanent structure is not real property while machinery that is a structural component to a building or inherently permanent structure is real property.

Section 1.48-1(c) of the regulations provides in part, that for purposes of § 1.48-1, the term “tangible personal property” means any tangible property except land and improvements, including structural components of such buildings or structures. It further provides that “production machinery, printing presses, transportation and office equipment. . . contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38.” Also, “a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered as tangible personal property.”

Finally, § 1245(a)(3) provides that “§ 1245 property” is any property which is or has been subject to depreciation under § 167 and which is either personal property or other tangible property used as an integral part of certain activities, including manufacturing, production or extraction, electrical energy, gas, water, or sewage disposal service.

Relying solely on state property classifications can lead to absurd results and would make federal tax law dependent on state laws and state policies. For example, a conclusion that the exchange of identical pipelines (as in Case 1) is not an exchange of like-kind property merely because of a conflict in the classification of property between the states where the pipelines happen to be located would be difficult to justify. Factors and considerations used by states to classify property as real or personal, such as

revenue considerations or other state law policies, are generally irrelevant to the federal tax law question of what is of like kind. Further, some states classify property as real for some purposes and personal for others. If state laws were determinative, this would raise the question of to which purpose federal tax law should look.

Accordingly, state law property classifications are not determinative of whether property is of like kind. Rather, the Service should consider all facts and circumstances, including state law and federal tax law classifications as appropriate.

In Case 1, whether the natural gas pipelines are deemed to be realty or personalty for state or federal tax law purposes does not override the basic nature and character of the property involved. The natural gas pipelines are of the same nature and character and are of like kind for purposes of § 1031. In addition, the natural gas pipelines should be treated as real property because they are inherently permanent structures that are affixed to real property that will ordinarily remain for an indefinite period of time, and they are transferred as part of the land to which they are affixed. Thus, the pipelines are of the same nature and character as land and improvements or other real property. Therefore, in applying § 1.1031(j)-1, relating to exchanges of multiple properties, the natural gas pipelines in this case should be treated as real property and included in the real property exchange group.

In Case 2, the steam turbines in both State A and State B are of the same nature and character and, therefore, of like kind. The steam turbines, as machinery used in the commercial production of electricity, and not as structural components, are personal property. Therefore, the steam turbines in State A and State B are of like kind, but should not be treated as part of the real property exchange group when applying § 1.1031(j)-1.

In Case 3, a steam turbine in State A is not of the same nature and character as raw land in state B. Therefore, the steam turbine and the raw land exchanged are not of like kind. Also, as in Case 2, the steam turbine should not be treated as real property and should not be treated as part of the real property exchange group when applying § 1.1031(j)-1.

In Case 4, the steam turbine and the natural gas pipeline the taxpayer exchanges are not of like kind. However, the exchanged natural gas pipelines are of like kind. In addition, as in Case 1, the natural gas pipelines should be treated as real property and part of the real property exchange group when applying § 1.1031(j)-1. As in Case 2, steam turbines should be treated as personal property and thus should not be included as part of the real property exchange group.

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