

In order to qualify for tax deferral under Internal Revenue Code Section 1031, both the property sold as relinquished property and the property acquired as replacement property must be like-kind. Section 1.1031(a)-1(b) of the Treasury Regulations clarifies that the term “like-kind” refers to the nature or character of the property interests involved, but not the grade or quality of the specific property. Under this test, the courts have generally concluded that a fee simple interest in real property is like-kind to a wide range of real property interests. Thus, developed land is like-kind to undeveloped land and a fee interest is like-kind to certain mineral interests, water rights, and certain long term leasehold estates. Along those lines, Treasury Regulation §1.1031.(a)-1(c) provides that a tenant’s interest in a leasehold estate with 30 years or more remaining to run, including option extensions, is like-kind to a fee simple interest in real property. Given the specificity of the regulation, most tax advisors believe that a taxpayer attempting to exchange a leasehold interest with less than 30 years remaining at the time of the exchange would not be like-kind to a fee simple interest in other property.

In *VIP Industries Inc. & Subsidiaries v. Commissioner*, T.C. Memo 2013-357, the taxpayer exchanged a leasehold interest with a remaining term of 21 years for fee simple interests in two Oregon replacement properties. There were no option extensions. After citing regulation §1.1031.(a)-1(c) and reviewing precedent cases, the court concluded that leasehold interests with remaining terms similar to the one at issue are not like-kind to fee interests in real property. Precedent cases included *May Department Stores Co. v. Commissioner*, 16 T.C. at 556, (holding that a 20-year leasehold was not like-kind to a fee interest); *Standard Envelope Mfg. Co. v. Commissioner*, 15 T.C. at 48 (holding that leasehold interest with a term of one year and an option to renew for a term of 24 years was not like-kind to a fee interest). Thus, in the *VIP Industries* case, the court found that the taxpayer’s leasehold interest in *VIP Industries* with a term of 21 years and four months remaining is closer in nature to the leasehold interests and not like-kind to a fee interest. As such, the taxpayer was not entitled to deferral of tax under Section 1031.

In light of the *VIP Industries* case, taxpayers who wish to exchange a leasehold interest for a fee interest should only proceed if the leasehold interest has more than 30 years remaining, including options to renew that would extend the leasehold interest over the 30-year threshold.

Compliments of:



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