

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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date: July 29, 2004

to:

from: Associate Area Counsel
(Large & Mid-Size Business)

subject: TAXPAYER I.R.C. § 1031 EXCHANGE

This memorandum responds to your written request for advice dated Date 1¹, regarding the applicability of § 1031 of the Internal Revenue Code to an exchange of property.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND

Taxpayer=
X=
Y=
TSub=
Date 1=
Date 2=
Date 3=
Date 4=
County 1=
County 2=
City 1=
City 2=

¹ The original request was supplemented with documents that Taxpayer provided to the examination team through the Information Document Request process.

State 1=
 State 2=
 Amount 1=
 Amount 2=
 Amount 3=
 Amount 4=
 Amount 5=
 Amount 6=
 Amount 7=
 Amount 8=
 Amount 9=
 Amount 10=
 Amount 11=
 Amount 12=
 Amount 13=
 Amount 14=

ISSUES

Is the pipeline that is part of a crude oil gathering system of like-kind, within the meaning of § 1031(a), to property for which it was exchanged?

CONCLUSIONS

If the pipeline is personal property for state law purposes, then such pipeline is, under § 1.1031(a)-2(b) of the Income Tax Regulations, of like-kind to other property in the same General Asset Class (as defined in § 1.1031(a)-2(b)(2)) or Product Class (as defined in § 1.1031(a)-2(b)(3)).

FACTS

Taxpayer² is a U.S. corporation engaged in oil and gas exploration and production. TSub, a subsidiary of Taxpayer, is engaged in transporting crude oil, refined petroleum products, liquefied petroleum gases, natural gas liquids, and chemical feedstock through pipelines. TSub is a member of Taxpayer's consolidated group. Taxpayer filed a consolidated Federal income tax return for the taxable year ending Date 3, the year at issue.

On Date 4, TSub and an unrelated third-party entered into an asset exchange agreement (Agreement). Pursuant to the terms of the Agreement, TSub exchanged a crude oil gathering system located in County 1, State 1 for a smaller crude oil gathering system located in County 2, State 1, plus Amount 1. All of the properties transferred and received were held for use in TSub's trade or business or were held for investment.

² On Date 2, a reorganization (a tax-free reorganization within the meaning of I.R.C. § 368) was effected between X and Y. After the reorganization, X existed as a first-tier subsidiary of Y. This same structure exists today, except Y has changed its name to Taxpayer.

The assets exchanged did not include property described in § 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, choses in action, interest in partnership, certificates of trust or beneficial interest, other securities, or evidences of indebtedness or interest.) The cash received by TSub was deposited with a qualified intermediary (as defined in § 1.1031(k)-(1)(g)(4)) and was ultimately used to purchase two service stations located in City 1 and City 2, State 2. All of the time limits set forth in the § 1031 regulations were met with respect to the identification and purchase of the replacement property (i.e. service stations).

On its Federal income tax return for the taxable year ending Date 3, Taxpayer reported a gain of Amount 2 on the exchange. Taxpayer attached Form 8824, Like-Kind Exchanges, to its Federal income tax return for the tax year ending Date 3. Even though Line 15 of the Form 8824 indicates a multi-asset exchange, Taxpayer treated the exchange as a single-asset exchange in its calculations in the Attachment to Form 8824, which was the basis of Taxpayer's reported gain.³ For purposes of the calculation, Taxpayer characterized all the assets as tangible. The personal properties exchanged and received were not further classified in accordance with General Asset Classes or SIC codes as prescribed by the § 1031 regulations. Exam proposes to treat the exchange as a multi-asset exchange.

Exam requests advice regarding the proper classification of the pipelines used exclusively in the crude oil gathering system for purposes of determining the correct gain (if any) to be recognized as the result of this transaction. The County 1 pipeline is comprised of approximately Amount 8 of Amount 9, Amount 10, Amount 11, and Amount 12 pipeline that is buried below plow depth. The County 2 pipeline is comprised of approximately Amount 13 of Amount 14 pipeline that is buried below plow depth. TSub and the unrelated third-party do not own the land across which the pipelines cross, but enjoy numerous agreements with landowners that permit TSub and the unrelated third-party limited access to and use of their land. The examination team proposes to classify the pipelines as personal property in accordance with State 1 law.

LAW AND ANALYSIS

Section 1031(a) 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 (not including stocks, bonds, notes, choses of action, certificates of trust or beneficial interest and certain other types of property not here pertinent) if such property is exchanged solely for property of like kind which is to be held for productive use in a trade or business or for investment.

³ Form 8824 Attachment. Taxpayer calculated gain as follows:

	FMV Received Amount 3	FMV Transferred Amount 4	Surplus Amount 5	Tax Basis Amount 6	Realized Gain Amount 7	Recognized Gain Amount 2
Tangibles						

Section 1.1031(a)-1(b) defines the words “like kind” as having reference to the nature or character of the property and not to its grade or quality. Further, the regulations provide that one kind or class of property may not, under the nonrecognition provisions of § 1031(a), be exchanged for property of a different kind or class. Thus, 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.

In determining the proper classification of property as real or personal for purposes of § 1031 and the like-kind exchange rules, it is well settled that state law must be considered. For example, in Rev. Rul. 55-749, 1955-2 C.B. 295, the Service held that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a non-taxable exchange of like-kind property under § 1031(a).

Similarly, in Oregon Lumber v. Commissioner, 20 T.C. 192 (1953), a taxpayer exchanged a fee simple interest in real property for a limited right to cut and remove standing timber. The court found that the cutting rights were personal property under Oregon law and held that “[a]n exchange of realty for personalty is not an exchange of property for property of like kind.” 20 T.C. at 196. See also Morgan v. Commissioner, 309 U.S. 78, 82 (1940), providing that “[i]n the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayers had in the property or income sought to be reached by the statute.”

Once it is determined that property is personal property, the rules in § 1.1031(a)-2 must be used to determine if the “like-kind” requirements of § 1031 have been satisfied. Under § 1.1031(a)-2(b)(1), if depreciable tangible personal property is exchanged for other property, the properties are of like-kind within the meaning of § 1031 if they are either of a like kind or a like class. For this purpose, depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class. A single property may not be classified within more than one General Asset Class or within more than one Product Class. In addition, property classified within any General Asset Class may not be classified within a Product Class. A property’s class is determined as of the date of the exchange.

Section 1.1031(a)-2(b)(2) sets forth the rules relating to General Asset Classes. The rules relating to whether exchanged properties are within the same Product Class are in § 1.1031(a)-2(b)(3).

Thus, in the present case, the examination team correctly looked to State 1 law in determining the proper classification of the County 1 and County 2 pipelines as either real or personal for purposes of § 1031. If it is determined that the pipelines are personal property under State 1 law, then such property is of like-kind to other property that is considered of like kind or like class. For this purpose, properties in the same General Asset Class or Product Class are considered of like class.

If you have any questions regarding this memorandum, please contact Attorney,

Carol E. Schultze
Associate Area Counsel
(Large & Mid-Size Business)