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February 27, 2003

Mr. Andy Kerr
Director
National Public Lands Grazing Campaign
American Lands Alliance

Re: Proposed Federal Grazing Permit Buyout Program Legislation

Dear Andy:

This letter sets forth our conclusions regarding the United States federal income tax treatment to holders ("Holders") of federal grazing permits ("Permits") who waive their Permits in exchange for cash pursuant to proposed Federal Grazing Permit Buyout legislation (the "Program"). Specifically, you have asked (i) whether such Holders will recognize capital gain or loss, and (ii) whether Permits constitute "property" eligible for non-recognition treatment under Section 1031 of the Internal Revenue Code of 1986, as amended (the "Code").[1]

[1] Unless otherwise noted, all Section references are to the Code.

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I. BACKGROUND

As we understand the facts, the American Lands Alliance's National Public Lands Grazing Campaign is lobbying Congress to enact legislation that would create the Program. If enacted, Holders who voluntarily waive their Permits would be entitled to receive a lump-sum payment determined by reference to a formula based on average grazing use (the "Permit Payment").

The Permits are issued by federal land management agencies under the Taylor Grazing Act of 1934 and allow private individuals, partnerships, and corporations to graze domestic livestock on federal public lands. The Permits are revocable, amendable, non-assignable ten-year licenses to graze public lands and although considered "attached" to the base property once issued, they do not convey any property rights to the holders.[2]

To qualify for a Permit, a Holder must own qualified private "base properties" and be in the business of ranching. Laws prohibit a Holder from detaching the Permits from the base property. Further, if a Holder ceases grazing his allotment, the Permit will be forfeited and the federal land management agency will reclaim and re-assign the Permit.

II. LAW

Section 1001(a) of the Code provides, in part, that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the taxpayer's adjusted tax basis in the property. Section 1001(c) of the Code provides, in part, that, except as otherwise provided in the Code, the entire amount of gain on the sale or exchange of property shall be recognized.

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[2] Although Permits technically expire, the federal law advises agencies to reissue them upon expiration as long as the Holder is in good standing. This practice has created the expectation that Holders will retain their Permits for as long as they desire, and encourages treatment of the Permits as private property. For example, the real estate market recognizes and assesses the "permit value" in the form of higher land prices for properties with attached public grazing lands. This is consistent with the historical treatment of grazing permits by the courts as having an indefinite duration for which no depreciation or amortization is allowed for federal income tax purposes. *See, e.g.*, Shufflebarger v. Commissioner, 24 T.C. 980 (1955).

In general, gain from the sale or exchange of a capital asset held for more than one year is long-term capital gain.[3] Section 1221(a)(1) defines "capital asset" as property held by the taxpayer (whether or not connected with his trade or business), but does not include, among other things, "real property used in his trade or business."[4]

Section 1231(a)(1) of the Code provides, in part, that gains and losses on the sale or exchange of "property used in the trade or business" shall be treated as gains and losses from sales or exchanges of capital assets held for more than one year if the aggregate of such gains exceeds the aggregate of such losses. If the aggregate of such gains does not exceed the aggregate of such losses, such gains and losses shall be treated as ordinary gains and losses.[5] Section 1231(b)(1) defines the phrase "property used in the trade or business," in part, to mean "real property used in the trade or business, held for more than one year," subject to exclusions[6] inapplicable here.

Whether property is "real property" for federal income tax purposes is determined by reference to federal tax laws and not state law, "unless the express statutory language or necessary implication of the section involved so requires."[7] Neither Section 1221 nor Section

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[3] I.R.C. § 1222(3).

[4] I.R.C. § 1221(a)(2).

[5] I.R.C. § 1231(a)(2).

[6] These exclusions include: inventory, property held for sale in the ordinary course of business, copyrights, artistic compositions, letters or memoranda, and U.S. government publications. I.R.C. §§ 1221(1), (3).

[7] Rev. Rul. 68-226, 1968-1 C.B. 362 (interest in producing oil and gas lease is an interest in real property for purposes of Sections 1221 and 1231 of the Code) (citing Burnet v. Harmel, 287 U.S. 103 (1932); Morgan v. Commissioner, 309 U.S. 78 (1940)); *but cf.* Tech. Adv. Mem. 83-27-003 (Mar. 17, 1983) (New Mexico grazing rights lease does not qualify as real property for purposes of Section 1031 of the Code; "[f]or federal income tax purposes, state law controls in determining the nature of the legal interest which a taxpayer has in its property." (citing Aquilino v. United States, 363 U.S. 509 (1960); Morgan, *supra*)). It is difficult to reconcile the Internal Revenue Service's position regarding the rules of statutory construction in this Technical Advice Memorandum with its position in Rev. Rul. 68-226. Indeed, in Rev. Rul. 68-331, 1968-1 C.B. 352, the Internal Revenue Service held that an exchange of an interest in a producing oil lease for a fee interest in an improved ranch was like kind under Section 1031, relying on Rev. Rul. 68-226. Upon closer inspection, Morgan and the other Supreme Court

1231 specifically defines the term "real property." However, for purposes of Section 1221 and 1231, the term "real property" has been held to include a variety of intangible property rights "with respect to land," including a leasehold interest in oil and gas in place,[8] easements,[9] water rights,[10] development rights in agricultural land created by local ordinance,[11] and peanut marketing quotas issued under federal law.[12] In at least one other context, the Internal

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cases cited in these rulings stand for the proposition that while state law creates legal interests and rights, the federal tax laws generally govern the characterization and tax treatment of the rights created. Therefore, federal tax law should control the characterization of the Permits, particularly in this instance, where the rights are creatures of federal law. In any event, a Technical Advice Memorandum represents the litigating position of the Internal Revenue Service and is not entitled to any judicial deference or precedential weight. *See*, *e.g.*, I.R.C. § 6110(k)(3); Textron, Inc. v. Commissioner, 115 T.C. 104, 112 n.12 (2000).

[8] Rev. Rul. 68-226; Rev. Rul. 73-428, 1973-2 C.B. 303.

[9] Rev. Rul. 59-121, 1959-1 C.B. 212, *clarified by* Rev. Rul. 68-291, 1968-1 C.B. 351.

[10] Rev. Rul. 73-341, 1973-2 C.B. 306.

[11] Rev. Rul. 77-414, 1077-2 C.B. 299.

[12] Notice 2002-67, 2002-42 I.R.B. 715. The Internal Revenue Service concluded that a peanut quota is considered "an interest in land." The Farm Security and Rural Investment Act of 2002 eliminated peanut marketing quotas, but also provided compensation to peanut farmers for the lost quotas.

While the Internal Revenue Service did not explicitly conclude that the peanut marketing quota was real property, it did so implicitly by concluding that "the basis of a peanut quota is not subject to adjustment through amortization, depletion, or depreciation" (*i.e.*, peanut quotas are not property of a character which is subject to the allowance for depreciation provided in Section 167). *See* note 1, *supra*. Because, with respect to property used in a taxpayer's trade or business, Section 1221(2) excludes only ***real*** property and ***depreciable*** property, that provision creates a presumption that ***non-depreciable*** personal property used in a trade or business, other than certain kinds of property not relevant here, qualifies as a Section 1221 capital asset. Accordingly, in holding that a peanut quota used by a taxpayer in his trade or business would be treated as a Section 1231 asset, the Internal Revenue Service implicitly concluded that a peanut quota constitutes an interest in real property for purposes of Section 1221 and 1231.

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Revenue Service has concluded that grazing permits and similar rights constitute an "interest in land."[13]

For purposes of Sections 1222 and 1231, neither "sale" nor "exchange" is defined in the Code. Accordingly, courts give the terms their ordinary meanings. A sale is a transfer of property for money or the promise to pay money, while an exchange is a transfer of property for other property.[14]

However, it is well established under federal income tax common law that the extinguishment, cancellation or termination of contractual or similar rights generally does not constitute a "sale or exchange,"[15] unless a statutory exception applies.[16] One such exception is Section 1241, which provides that amounts received by a lessee for cancellation of a lease are considered to be "in exchange for" such lease. The ordinary and common meaning of the term "lease" includes a "[c]onveyance of *an interest in real . . . property for specified period . . .*"[17] Another exception is Section 1234A, which provides that any gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.[18]

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[13] Section 197 of the Code allows an amortization deduction with respect to any so-called "amortizable Section 197 intangible." Section 197(e)(2) excludes from the definition of amortizable Section 197 intangible "any interest in land." Treasury Regulations Section 1.197-2(c) provides that an "interest in land" includes "a fee interest, life estate, remainder, easement, mineral right, timber right, ***grazing right***, riparian right, air right, zoning variance, and any other similar right, such as a ***farm allotment***, ***quota for farm commodities***, or ***crop acreage base***." (Emphasis added).

[14] *See* Iowa v. McFarland, 110 U.S. 471 (1884); Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941).

[15] *See* Fairbanks v. United States, 306 U.S. 436 (1939); Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962); Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962); Cotlow v. Commissioner, 228 F.2d 186 (2d Cir. 1955).

[16] *See, e.g.,* I.R.C. § 1271.

[17] Black's Dictionary 800 (5th ed. 1979) (emphasis added).

[18] I.R.C. § 1234A(1). The "extinguishment" doctrine has been the subject of controversy in the courts and has been criticized as a "formalistic distinction" that ignores economic reality. *See* Ferrer, 304

Section 1031(a) provides that no gain or loss shall be recognized if property held for productive use in a trade or business or for investment (excluding stock in trade or other property held primarily for sale) is exchanged solely for property of a "like kind" to be held for productive use in a trade or business or for investment. As used in Section 1031(a), the words "like kind" refer to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different class. The fact that real estate is improved or unimproved is not material, for that relates only to the grade or quality of the property, not to its kind or class.[19] Therefore, real property may be exchanged for other real property without regard to their similarity or attributes, but may not be exchanged for personal property.[20]

However, not every exchange of real property interests satisfies the like kind requirement under Section 1031.[21] Examples of exchanges that were held not to be like kind include: carved out royalty payments, although characterized as real property, exchanged for a fee interest in real estate;[22] an 8-acre parcel of land exchanged for limited gravel extraction rights in another parcel of land;[23] water rights limited in quantity, priority and duration exchanged for an interest in farm land;[24] and a short-term leasehold in real property exchanged

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F.2d at 131 (surrender of play rights to author in exchange for leading role in film production constituted sale or exchange). The enactment of Section 1234A was motivated in part by these criticisms. *See* S. Rep. No. 33, 105th Cong., 1st Sess. 132, 124-35 (1997). However, the courts have upheld the continuing validity of the "extinguishment" doctrine where the contract rights at issue cease to exist both in substance and in form. *See, e.g.*, Wolff v. Commissioner, 148 F.3d 186 (2d Cir. 1998); Nahey v. Commissioner, 111 T.C. 256 (1998). Nevertheless, where the cancellation merely causes the property rights to revert to the owner of the larger "estate," Ferrer and its progeny continue to be cited in support of "sale or exchange" treatment. *Id.*

[19] Treas. Reg. § 1.1031(a)-1(b).

[20] *See* Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941); Rev. Rul. 68-331.

[21] *See* Wiechens v. United States., 228 F. Supp. 2d 1080 (D. Ariz. 2002); Smalley v. Commissioner, 116 T.C. 450 (2001); Koch v. Commissioner, 71 T.C. 54 (1978).

[22] Fleming v. Commissioner, 24 T.C. 818 (1955), *rev'd* 241 F.2d 78 (5th Cir. 1957), *rev'd sub nom.* Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958).

[23] Clemente, Inc. v. Commissioner, 50 T.C.M. (CCH) 497 (1985).

[24] Wiechens, 228 F. Supp. 2d 1080.

for a fee interest.[25] On the other hand, an overriding royalty interest in minerals exchanged for a fee interest in land has been held to be like kind.[26] Similarly, the Internal Revenue Service has held that an exchange of perpetual water rights for a fee simple interest in land constitutes a like kind exchange within the meaning of Section 1031.[27] The principal distinction between these situations is the duration of the interests involved.

III. CONCLUSION

Based on the foregoing, while the matter is not free from doubt, we believe that a Holder who voluntarily waives his Permit in exchange for cash pursuant to the Program will be treated as recognizing gain or loss from the sale or exchange of the Permit. Such gain or loss will equal the difference between the amount of the Permit Payment received and the Holder's tax basis in the Permit surrendered.

Whether the gain or loss will be capital gain or loss depends on how the Holder made use of the Permit. If the Holder held the Permit for investment purposes or for the production of income (unrelated to a trade or business), any gain or loss should be capital gain or loss, and will be long-term capital gain or loss if the Permit had been held for more than one year.[28]

If the Holder used the Permit in the trade or business of ranching, and held the Permit for more than one year on the date of waiver, then the transaction should be governed by Section 1231 of the Code.[29] In that event, if the Holder had no other Section 1231

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[25] Capri, Inc. v. Commissioner, 65 T.C. 162 (1975); May Dept. Stores Co. v. Commissioner, 16 T.C. 547 (1951); Standard Envelope Manufacturing Co. v. Commissioner, 15 T.C. 41 (1950).

[26] Crichton, 122 F.2d 181; Rev. Rul. 68-331.

[27] Rev. Rul. 55-749, 1955-2 C.B. 295.

[28] In this situation, the Permit should be treated as a capital asset under Section 1221. Any gain or loss should be treated as from the "sale or exchange" of the Permit by reason of Section 1234A or the substance over form rationale in Ferrer. However, given the use requirements imposed by the government on Holders, this situation is unlikely to occur.

[29] Under these circumstances, the Permits should be treated as real property used in the trade or business within the meaning of Section 1231(b)(1). The surrender of a Permit in exchange for the Permit Payment should be treated as a "sale or exchange" of the Permit governed by Section 1231 of

transactions for the year, then any gain should be treated as long-term capital gain, whereas any loss should be treated as ordinary loss. If the Permit has not been held by the Holder for more than one year on the date of the waiver, then any gain or loss would be ordinary gain or loss.

Finally, we believe the Permits should be treated as an interest in real property eligible for non-recognition treatment under Section 1031 of the Code, assuming the proceeds are reinvested in property that is like-kind to be held for productive use in a trade or business or for investment in accordance with applicable Treasury Regulations promulgated under Section 1031 dealing with deferred exchanges (the "Deferred Exchange Regulations").[30] The determination of whether real property identified by the Holder as replacement property will be considered like-kind will depend on the surrounding facts and circumstances.

While the issue is not free from doubt, based on the indefinite duration of the Permits, we believe that the reinvestment of the Permit Payment in a fee interest in real property to be held for productive use in a trade or business or for investment in accordance with the Deferred Exchange Regulations generally should qualify for non-recognition treatment under Section 1031. However, no assurance can be given that the Internal Revenue Service will not successfully assert a contrary position.

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the Code by reason of one or more of the rationale underlying Notice 2002-67, the Fifth Circuit Court of Appeals' substance over form rationale in Ferrer or Section 1241 of the Code.

[30] Treas. Reg. § 1.1031(k)-1. In order to qualify as a deferred exchange under Section 1031, the Deferred Exchange Regulations generally require, *inter alia*, that the taxpayer not actually or constructively receive money, such as the Payments, in the exchange. Rather, any such money generally must be held in a "qualified escrow account" or by a "qualified intermediary," as such terms are defined in the Deferred Exchange Regulations. Accordingly, any Holder intending to qualify the receipt of a Permit Payment under Section 1031 generally must obtain the cooperation of the applicable federal land management agency in structuring the receipt of the Permit Payment.

This letter generally is intended solely for your use and is not to be quoted in whole or in part or otherwise referred to in any documents or delivered to any other person or entity without our prior written consent. We understand that you intend to provide copies of this letter to certain conservationists, Holders and decision-makers for the purpose of educating them regarding the treatment of the Program under federal tax laws. We consent to the use of this letter consistent with such intent.

Sincerely yours,

Leigh-Ann S.K. Higashi

cc: Carl T. Crow

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